

## **Interest Expense Allocation For Bona Fide Residents of Puerto Rico**

### Taxable Income – Gross Income Less Expenses

U.S. income tax is generally imposed on taxable income.<sup>1</sup> Taxable income is defined as gross income minus certain deductions.<sup>2</sup>

For example, business income of an individual starts with gross income.<sup>3</sup> The gross income can then be reduced by certain trade or business expenses,<sup>4</sup> interest expense,<sup>5</sup> losses,<sup>6</sup> bad debt expense,<sup>7</sup> depreciation,<sup>8</sup> etc.<sup>9</sup>

### Exempt/Excluded Income & Related Expenses

At times, U.S. tax law allows certain gross income to be excluded from taxable income.<sup>10</sup> Bona fide residents of Puerto Rico can exclude gross income derived from sources within Puerto Rico.<sup>11</sup>

When gross income is excluded from taxable income, a fundamental principle of U.S. tax law is that expenses related to that excluded income cannot be claimed as deductions.<sup>12</sup> Code §265(a)

---

<sup>1</sup> Code §§1 and 11. All section references are to the Internal Revenue Code of 1986, as amended (the “Code”) and the regulations promulgated thereunder.

<sup>2</sup> Code §63(a).

<sup>3</sup> Code §61

<sup>4</sup> Code §162.

<sup>5</sup> Code §163.

<sup>6</sup> Code §165.

<sup>7</sup> Code §166.

<sup>8</sup> Code §167.

<sup>9</sup> Internal Revenue Code, Chapter 1, Subchapter B, Part VI.

<sup>10</sup> Code §103 (interest income on state and local bonds) and Code §911 (foreign earned income for certain individuals working outside the U.S.).

<sup>11</sup> Code §933.

<sup>12</sup> It’s “basically tax 101” said U.S. Treasury Secretary Steven Mnuchin in 2020. <https://www.foxbusiness.com/personal-finance/mnuchin-irs-coronavirus-ppp-loan-tax-> Page | 1

provides that no deduction is allowed for expenses allocable to income that is exempt from the income taxes. Code §911(d)(6) provides that no deduction is allowed to the extent the deduction is properly allocable to amounts excluded from gross income under Code §911(a).

Similarly, Code §933(1) provides that a bona fide resident of Puerto Rico is not allowed deductions allocable to amounts excluded from gross income under Code §933.

### Allocation of Expenses

Only deductions “allocable to” amounts excluded from taxable income must be disallowed. Thus, when a taxpayer has some excluded income and some taxable income, it is necessary to perform an allocation of expenses between excluded income and taxable income.

The regulations under Code §861 provide extensive rules for allocating expenses between U.S. source income and foreign source income.<sup>13</sup> The Treasury Department has adopted these Code §861 expense allocation rules for multiple purposes, including for purposes of the exclusion of income under Code §933.<sup>14</sup>

Thus, bona fide residents of Puerto Rico who have both excluded income and taxable income must allocate expenses between those two categories of income.

### Interest Expense Allocations Generally

The interest expense allocation rules are primarily based on the concept that money is fungible and that interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid.<sup>15</sup> Following this fungibility concept, the regulations provide that interest expense is considered related to all income producing activities and assets of the taxpayer.<sup>16</sup>

---

break-denial, visited on January 11, 2023. Secretary Mnuchin was referring to IRS Notice 2020-32, which was later legislatively overturned.

<sup>13</sup> See Treas. Reg. §1.861-8, *et. seq.*

<sup>14</sup> Treas. Reg. §1.861-8(f)(1)(vi)(F). This regulation provides that Code §933 is an “operative section”.

<sup>15</sup> Temp. Treas. Reg. §1.861-9T(a).

<sup>16</sup> *Id.*

### Interest Expense Allocation Rules for Individuals

Individuals generally allocate interest expense based on the type of interest expense incurred.<sup>17</sup> Interest expense of an individual must first be put into the following categories:

1. Trade or business interest
2. Investment interest
3. Passive activity interest
4. Qualified residence and personal interest.<sup>18</sup>

Business interest is allocated using an asset method by reference to the individual's business assets.<sup>19</sup> Investment interest is allocated on the basis of the individual's investment assets.<sup>20</sup> Passive activity interest is allocated on the basis of the individual's passive activity assets.<sup>21</sup> Qualified residence interest is allocated under a gross income method.<sup>22</sup>

### Asset Method & Characterization of Assets

The asset method applies to business, investment, and passive activity interest. In order to perform the necessary computations, the individual must determine the average tax basis of his or her: (i) worldwide business assets, (ii) worldwide investment assets, and (iii) worldwide passive activity assets.<sup>23</sup> The average is computed on the basis of values of assets at the beginning and end of the year.<sup>24</sup>

---

<sup>17</sup> Temp. Treas. Reg. §1.861-9T(d)(1).

<sup>18</sup> *Id.*

<sup>19</sup> Temp. Treas. Reg. §1.861-9T(d)(1)(i).

<sup>20</sup> Temp. Treas. Reg. §1.861-9T(d)(1)(ii).

<sup>21</sup> Temp. Treas. Reg. §1.861-9T(d)(1)(iii).

<sup>22</sup> Temp. Treas. Reg. §1.861-9T(d)(1)(iv).

<sup>23</sup> Temp. Treas. Reg. §1.861-9T(g)(1)(i) and Treas. Reg. §1.861-9(g)(1)(ii).

<sup>24</sup> Treas. Reg. §1.861-9(g)(2)(i)(A).

The assets are characterized according to the type of income that they generate, have generated, or may reasonably be expected to generate.<sup>25</sup>

#### Sub-Characterization of Assets (By Source)

As mentioned above, the Code §861 expense allocation rules are used for multiple different purposes. Here, our focus is on bona fide residents of Puerto Rico. We are trying to determine how much otherwise deductible interest expense should be allocated to income that is excluded under Code §933. To the extent the interest expense is allocated to excluded income, it will be disallowed as a deduction.<sup>26</sup>

After we have determined the average tax basis of the assets in the three categories (business, investment, and passive activity), we must then subdivide those categories by source of income:

1. Assets that generate Puerto Rican-source income, and
2. Assets that generate non-Puerto Rican-source income.<sup>27</sup>

Puerto Rican-source income is referred to in the regulations as the “statutory grouping” of gross income, and non-Puerto Rican-source income is referred to as the “residual grouping” of gross income.<sup>28</sup>

Once we know the assets that generate Puerto Rican-source and non-Puerto Rican-source income for each category, we can perform the interest expense allocation.

#### Example – Business Interest Expense & Business Assets

Fred is a bona fide resident of Puerto Rico. Fred has gross business income of \$1,000 and business interest expense of \$100. The gross business income from Puerto Rican sources is \$500. Thus,

---

<sup>25</sup> Temp. Treas. Reg. §1.861-9T(g)(3).

<sup>26</sup> Code §933(1) provides that a bona fide resident of Puerto Rico “shall not be allowed as a deduction from his gross income any deductions \* \* \* properly allocable to \* \* \* amounts excluded from gross income under this paragraph.”

<sup>27</sup> The assets are characterized according to the source of the income that they generate, have generated, or may reasonably be expected to generate. Temp. Treas. Reg. §1.861-9T(g)(3).

<sup>28</sup> Treas. Reg. §1.861-8(a)(4).

Fred is able to exclude \$500 of the gross business income from his U.S. taxable income. However, the expenses related to this income must be disallowed.

Fred cannot use an income method to allocate the business interest expense. Instead, Fred must use the asset method. The average tax basis of Fred’s business assets is \$10,000. The average tax basis of the business assets that generate Puerto Rican-source income is \$8,000. The remaining \$2,000 of business assets generate non-Puerto Rican-source income.

Here is the formula to allocate the business interest expense to Puerto Rican-source income:

$$\begin{array}{r} \text{Total} \\ \text{business} \\ \text{interest} \\ \text{expense} \end{array} \times \frac{\begin{array}{c} \text{Puerto Rican assets generating} \\ \text{business income} \end{array}}{\begin{array}{c} \text{Worldwide assets generating} \\ \text{business income} \end{array}} = \begin{array}{c} \text{Business interest expense} \\ \text{allocated to Puerto Rico (and} \\ \text{disallowed as a deduction)} \end{array}$$

The portion of the \$100 of business interest expense that is allocated to Puerto Rican-source income is computed as follows:

$$100 \times \frac{8,000}{10,000} = 80$$

Thus, Fred must disallow a deduction for \$80 of the business interest expense. Even though only 50% of Fred’s business gross income could be excluded from U.S. taxable income, he had to disallow 80% of his business interest expense because the tax basis of his Puerto Rican business assets was 80% of the tax basis of his total business assets.

If Fred has investment interest expense or passive activity interest expense, he would perform similar computations for those categories of interest expense.

#### Partnerships – General Partners & 10% or Greater Limited Partners (Aggregate Rule)

Individuals who are general partners, and individuals who are limited partners owning 10% or more of the partnership, apply an “aggregate rule”.<sup>29</sup> That is, the individuals include their share

---

<sup>29</sup> Temp. Treas. Reg. §1.861-9T(e)(1) and Treas. Reg. §1.861-9(e)(3).

of the partnership's interest expense and their share of the partnership's assets in applying the interest expense allocation rules.<sup>30</sup>

Although the example above did not mention it, Fred was a 20% limited partner in a partnership (USPS). Because he owned more than 10% of USPS, he included his share of USPS's business interest expense and his share of USPS's business assets in performing the interest expense allocations.

Fred's total business interest expense was \$100. This amount included his share of the business interest expense incurred by USPS. The average tax basis of Fred's business assets was \$10,000. This amount included his share of the business assets held by USPS. When USPS provided Fred his Form K-3 at the end of the year, it included all the information Fred needed to perform his interest expense allocations, including what portion of the USPS assets generated U.S.-source income and what portion generated Puerto Rican-source income.

As indicated above, if Fred has investment interest expense or passive activity interest expense, he would perform similar calculations for those categories of interest expense with respect to partnerships he owns.

#### Partnerships – Less Than 10% Limited Partners (Entity Rule & Income Method)

An individual who is a limited partner and owns less than 10% of the partnership applies an "entity rule".<sup>31</sup> In this case, the individual allocates his or her share of the partnership's interest expense based on his or her share of the partnership gross income.<sup>32</sup> Here, interest expense is not allocated using an asset method. Instead, the interest expense is allocated using an income method.

Continuing the example above, let's say that the facts are the same except that Fred also owns a 5% interest in a partnership (USLP) in which he is a limited partner. Fred's share of business interest expense incurred by USLP is \$20. USLP earns only business income. USLP earns \$90 of gross income from U.S.-sources and \$10 of gross income from Puerto Rican-sources.

---

<sup>30</sup> *Id.*

<sup>31</sup> Treas. Reg. §1.861-9(e)(4)(i) and Temp. Treas. Reg. §1.861-9T(e)(4)(ii).

<sup>32</sup> Treas. Reg. §1.861-9(e)(4)(i).

Here is the formula to allocate Fred's portion of the USLP business interest expense to Puerto Rican-source income:

$$\text{Fred's share of USLP's business interest expense} \times \frac{\text{USLP's gross income from Puerto Rican sources}}{\text{USLP's total gross income}} = \text{Fred's share of USLP's business interest expense allocated to Puerto Rico (and disallowed as a deduction)}$$

Using the income method, Fred's interest expense allocation with respect to USLP would be computed as follows:

$$20 \times \frac{10}{100} = 2$$

In this case, Fred will allocate \$2 of his share of USLP's business interest expense to Puerto Rican-source income, and this \$2 of business interest expense will not be deductible. The remaining \$18 of business interest expense that flowed through from USLP will be allowed as a deduction.

#### Asset Method Example Continued

Although Fred's share of the USLP business interest expense was allocated using the income method, he generally allocates business interest expense using the asset method.

When performing the asset method allocation, Fred must consider his ownership in the USLP partnership as an asset. Consistent with the entity rule, Fred does not take into account his share of USLP's gross assets. Instead, Fred takes into account his tax basis in the partnership interest.<sup>33</sup> However, the tax basis must be reduced to the extent that his basis consists of liabilities taken into account under Code §752.<sup>34</sup>

Let's say that Fred's tax basis in the USLP partnership is \$1,100. Fred's basis includes his share of \$500 of USLP liabilities. After reducing the basis in his partnership interest by his share of the

<sup>33</sup> Temp. Treas. Reg. §1.861-9T(e)(4)(ii).

<sup>34</sup> *Id.* Normally, a partner's tax basis in a partnership includes the partner's share of the partnership liabilities. See Code §752.

liabilities, the “net” tax basis is \$600 (1,100 – 500).<sup>35</sup> It is this \$600 that Fred treats as an asset in performing the asset method business interest expense allocations.<sup>36</sup>

If we assume that the \$600 was not already included in Fred’s assets described above, then the tax basis in his worldwide business assets would be \$10,600 (10,000 + 600). Fred allocates the \$600 between US-source income and Puerto Rican-source income based on the gross income of USLP.<sup>37</sup> Since USLP earns 90% of its gross income as U.S.-source income and 10% of its gross income as Puerto Rican-source income, only \$60 (10% X 600) will be treated as a Puerto Rican asset.

Again, here is the formula to allocate the business interest expense to Puerto Rican-source income using the asset method:

$$\begin{array}{r} \text{Total} \\ \text{business} \\ \text{interest} \\ \text{expense} \end{array} \times \frac{\begin{array}{c} \text{Puerto Rican assets generating} \\ \text{business income} \end{array}}{\begin{array}{c} \text{Worldwide assets generating} \\ \text{business income} \end{array}} = \begin{array}{c} \text{Business interest expense} \\ \text{allocated to Puerto Rico (and} \\ \text{disallowed as a deduction)} \end{array}$$

With the addition of Fred’s interest in USLP, his asset method interest expense allocation would be computed as follows:

$$100 \times \frac{8,060}{10,600} = 76$$

In this case, Fred must disallow a deduction for \$76 of the business interest expense.

---

<sup>35</sup> If USLP were a corporation and Fred were determining his tax basis in the shares of the corporation, the basis would not consider liabilities. Thus, applying the “entity rule” for a partnership is, in a way, conceptually similar to treating the partnership as a corporation.

<sup>36</sup> If USLP had earned both gross business income and gross investment income, Fred would have had to first allocate the \$600 between business assets and investment assets. Then, only the business portion of the \$600 would be included for the business interest expense allocation. The investment portion would be included for Fred’s investment interest expense allocation. Temp. Treas. Reg. §1.861-9T(e)(4)(ii).

<sup>37</sup> Temp. Treas. Reg. §1.861-9T(e)(4)(ii).

### S Corporations

For certain purposes, an S corporation is treated as a partnership.<sup>38</sup> However, for purposes of Code §933, an S corporation is not considered a partnership.<sup>39</sup> Therefore, a bona fide resident of Puerto Rico would not apply the partnership aggregate rule with respect to an S corporation. Instead, the individual would (1) determine his or her average tax basis in the shares of the S corporation, (2) determine the type of income earned by the S corporation (business, investment, passive activity), and (3) determine the source of income earned by the S corporation. These amounts would then be used in performing the asset method interest expense allocations.

---

### **About Tom Duffy, C.P.A., P.A. & P.C.**

Tom Duffy C.P.A., P.A. & P.C. is a Greater Chicago-based firm that specializes in international taxation with a particular focus on U.S. possessions. In addition, the firm is one of the few CPA firms in the country that specializes in representing residents of Puerto Rico during IRS examinations, specifically those taxpayers granted tax incentives under Puerto Rico's Act 60 (formerly Act 20/22).

Our foreign clients rely on our knowledge and expertise in complying with their U.S. tax obligations. Tom Duffy has over fifteen years of experience in international tax planning and associated U.S. tax return preparation. The firm services clients in the United States, its possessions, and throughout the world. Tom Duffy is a member in good standing with the American Institute of CPAs and the Puerto Rico Society of CPAs. He is licensed to practice in Florida, Illinois, and Puerto Rico.

For more information and tax-related articles on Puerto Rico's Act 60 program, please visit us at [www.tomduffycpa.com](http://www.tomduffycpa.com)

---

<sup>38</sup> Code §1373(a).

<sup>39</sup> Code §933 does not fall within the sections of the Internal Revenue Code specified in Code §1373(a).