Your Final Year in Puerto Rico

Puerto Rico's Act 60 program has seen more than five thousand U.S. taxpayers move to the island since the program's inception in 2012 to take advantage of the once-in-a-lifetime tax benefits offered by Puerto Rico. Eventually, many of these taxpayers will return and transition back to life on the mainland.

When an individual decides to leave Puerto Rico, many questions arise. Is the individual a bona fide resident of Puerto Rico at all during the year of the leave? Can any income earned in the year of the leave be excluded from U.S. taxable income?

This article discusses a number of these questions.

Background

Betty is a U.S. citizen who has been a bona fide resident of Puerto Rico since 2019. Betty changed her residence to Puerto Rico in May 2019. In 2023, she decided to move to New York. On August 1, 2023, she moved from Puerto Rico to New York.

Betty was present in Puerto Rico every day from January 1, 2023 to August 1, 2023. Her principal place of business remained in Puerto Rico and she had a closer connection to Puerto Rico until August 1, 2023.

Home: In 2020, Betty purchased a home in Puerto Rico for $2 million. Prior to her move to New York, Betty sold her home for $7 million and recognized a gain of $5 million.

US Stocks: Also in 2020, Betty purchased U.S. publicly traded stocks (the "US Stocks") for $1 million. Prior to her move to New York, Betty sold the US Stocks for $5 million and recognized a gain of $4 million. The gain on the US Stocks was not attributable to a U.S. office or other fixed place of business.

PR Corp: Betty owned 100% of PRCo, a Puerto Rican limited liability company that was classified as a corporation for U.S. tax purposes. The company was granted an Act 60 export services decree in 2020. Betty was the sole member and employee of the company. PRCo operated solely in

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Puerto Rico and met the 80% and 50% tests in Treas. Reg. §1.937-2(g)(1)(ii).[1] In January of 2023, PRCo paid a dividend to Betty of $3 million.

Betty's tax basis in the shares of PRCo was $100,000. On July 1, 2023, PRCo liquidated, distributing cash of $2,100,000 to Betty. As a result of the liquidation, Betty recognized a gain of $2 million.

Compensation: In 2023, Betty earned a salary from PRCo of $200,000 for services performed in Puerto Rico, and she was paid all of this salary prior to August 1, 2023.

ISSUES

1. Should Betty be a bona fide resident of Puerto Rico for any part of 2023?
2. Should Betty be able to exclude the $5 million gain on her Puerto Rican home from her U.S. taxable income?
3. If Betty had sold the home and recognized the $5 million gain on September 1, 2023 (after she moved to New York), would Betty have been able to exclude the $5 million gain from her U.S. taxable income?
4. Should Betty be able to exclude the $4 million gain on the US Stocks from her U.S. taxable income?
5. If Betty had sold the US Stocks and recognized the $4 million gain on September 1, 2023 (after she moved to New York), would Betty have been able to exclude the $4 million gain from her U.S. taxable income?
6. Should Betty be able to exclude the PRCo $3 million dividend from her U.S. taxable income?
7. Should Betty be able to exclude the $2 million gain on the PRCo liquidation from her U.S. taxable income?
8. If Betty had liquidated PRCo and recognized the $2 million gain on September 1, 2023 (after she moved to New York), would Betty have been able to exclude the $2 million gain from her U.S. taxable income?
9. Should Betty be able to exclude the $200,000 salary from her U.S. taxable income?

[1] All section references are to the Internal Revenue Code of 1986, as amended (the "Code") and the regulations promulgated thereunder.

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10. If (i) PRCo was not liquidated until after September 1, 2023, (ii) Betty received a portion of her salary on September 1, 2023, and (iii) that salary was attributable to her services performed in Puerto Rico prior to August 1, 2023, would Betty have been able to exclude the portion of her salary received on September 1, 2023 from her U.S. taxable income?
11. Is Betty required to file Form 8898 for 2023?
12. If, in 2019, Betty excluded Puerto Rican-source income from her U.S. taxable income, does her 2023 move to New York jeopardize the 2019 exclusion?

SUMMARY CONCLUSIONS

1. Yes. Betty should be a bona fide resident of Puerto Rico up until August 1, 2023 when she moved her tax home to New York.
2. Yes. Betty should be able to exclude the $5 million gain on her Puerto Rican home from her U.S. taxable income.
3. Probably. If Betty had sold the home and recognized the $5 million gain on September 1, 2023, Betty likely would have been able to exclude the $5 million gain from her U.S. taxable income. The gain would be Puerto Rican-source income, and the gain likely would be attributable to Betty's period of residence in Puerto Rico.
4. Yes. Betty should be able to exclude the $4 million gain on the US Stocks from her U.S. taxable income.
5. No. If Betty had sold the US Stocks and recognized the $4 million gain on September 1, 2023, the gain would not have been Puerto Rican-source income. Therefore, she would not have been able to exclude the $4 million gain from her U.S. taxable income.
6. Yes. Betty should be able to exclude the PRCo $3 million dividend from her U.S. taxable income.
7. Yes. Betty should be able to exclude the $2 million gain on the PRCo liquidation from her U.S. taxable income.
8. No. If Betty had liquidated PRCo and recognized the $2 million gain on September 1, 2023, she would not have been able to exclude the $2 million gain from her U.S. taxable income.
9. Yes. Betty should be able to exclude the $200,000 salary from her U.S. taxable income.
10. Yes. If (i) PRCo was not liquidated until after September 1, 2023, (ii) Betty received a portion of her salary on September 1, 2023, and (iii) that salary was attributable to her

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services performed in Puerto Rico prior to August 1, 2023, Betty would have been able to exclude the portion of her salary received on September 1, 2023 from her U.S. taxable income.

11. Yes. Betty is required to file Form 8898 for 2023.
12. No. If, in 2019, Betty excluded Puerto Rican-source income from her U.S. taxable income, her 2023 move to New York does not jeopardize the 2019 exclusion.

ANALYSIS

Part Year Bona Fide Resident

An individual must meet the "tax home" requirement to be a bona fide resident of Puerto Rico.[2] In general, to meet the tax home test the individual must "not have a tax home outside [Puerto Rico] during **any part** of the taxable year."[3] (Emphasis added) However, a special rule applies to "an individual who * * * ceases to be a bona fide resident of [Puerto Rico] during a taxable year."[4]

Treas. Reg. §1.937-2(f)(2)(ii) provides in part:

> Year of move from Puerto Rico. Notwithstanding an individual's failure to satisfy the presence, tax home, or closer connection test * * * for the taxable year, the individual is a bona fide resident of Puerto Rico for that part of the taxable year described in paragraph (f)(2)(ii)(E) of this section if the individual—
>
> (A) Is a citizen of the United States;
>
> (B) Is a bona fide resident of Puerto Rico for a period of at least 2 taxable years immediately preceding the taxable year;
>
> (C) Ceases to be a bona fide resident of Puerto Rico during the taxable year;
>
> (D) Ceases to have a tax home in Puerto Rico during the taxable year; and

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2 Treas. Reg. §1.937-1(d).

3 Treas. Reg. §1.937-1(d)(1).

4 Treas. Reg. §1.937-1(d)(2).

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> (E) Has a closer connection to Puerto Rico than to the United States or a foreign country throughout the part of the taxable year preceding the date on which the individual ceases to have a tax home in Puerto Rico.[5]

With respect to Betty:

A. She is a U.S. citizen,
B. She was a bona fide resident of Puerto Rico for at least the two taxable years immediately preceding 2023,
C. She ceased to be a bona fide resident of Puerto Rico in 2023,
D. She ceased to have a tax home in Puerto Rico in 2023, and
E. She had a closer connection to Puerto Rico in 2023 before ceasing to have a tax home in Puerto Rico.

Consequently, Betty should be a bona fide resident of Puerto Rico up until August 1, 2023, when she moved her tax home to New York.

<u>Special Exclusion Rules for Year of Change of Residence from Puerto Rico</u>

Code §933 provides in part:

> The following items shall not be included in gross income and shall be exempt from taxation under this subtitle:
>
> > * * *
> >
> > (2) Taxable year of change of residence from Puerto Rico
> >
> > In the case of an individual citizen of the United States who has been a bona fide resident of Puerto Rico for a period of at least 2 years before the date on which he changes his residence from Puerto Rico, income derived from sources therein * * * which is attributable to that part of such period of Puerto Rican residence before such date * * *.[6]

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5 See also Example 10 of Treas. Reg. §1.937-1(g).

6 See also Treas. Reg. §1.933-1(b).

Under this rule, to be excludable the income must be Puerto Rican-source income and the income must be attributable to the period of Puerto Rican residence.

Betty is a U.S. citizen who has been a bona fide resident of Puerto Rico for at least 2 years. Betty changed her residence from Puerto Rico to New York on August 1, 2023. Thus, Betty can exclude Puerto Rican-source income from her U.S. taxable income if the Puerto Rican-source income is attributable to the period before August 1, 2023.

Sale of Puerto Rican Home

As described above, Betty purchased a home in Puerto Rico for $2 million in 2020. She sold that home for $7 million prior to August 1, 2023.

Gains on sales of real estate are sourced to the location of the real estate.[7] The home was located in Puerto Rico. Thus, the gain of $5 million should be Puerto Rican-source income. The gain was attributable to the time that Betty was a bona fide resident of Puerto Rico.[8] Consequently, Betty should be able to exclude the $5 million gain from her U.S. taxable income.

If Betty had sold the home and recognized the $5 million gain on September 1, 2023, the gain would still be Puerto Rican-source income.[9] Unless something very unusual occurred between August 1, 2023 and September 1, 2023, all or nearly all of the gain should be attributable to the time that Betty was a bona fide resident of Puerto Rico. Thus, Betty would be able to exclude all or nearly all of the $5 million from her U.S. taxable income.

Sale of US Stocks

As described above, Betty purchased the US Stocks in 2020 for $1 million. Prior to her move to New York, Betty sold the US Stocks for $5 million and recognized a gain of $4 million. The gain on the US Stocks was not attributable to a U.S. office or other fixed place of business.

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7 Code §§861(a)(5) and 862(a)(5).

8 Code §933(2) and Treas. Reg. §1.933-1(b).

9 Code §§861(a)(5) and 862(a)(5).

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Gains on sales of personal property, such as shares of stock, are generally sourced based on the residence of the seller.[10] Special residency rules apply for this purpose.[11] When Betty sold the US Stocks, she had a tax home in Puerto Rico.[12] Consequently, when Betty sold the US Stocks, she was considered a nonresident for purposes of sourcing gains on sales of personal property.[13]

Gains on sales of personal property by nonresidents that are attributable to a U.S. office or other fixed place of business are U.S.-source income.[14] Here, the gain on the US Stocks was not attributable to a U.S. office or other fixed place of business. Consequently, the general rule of Code §865(a) will apply, and Betty should be able to exclude the $4 million gain on the US Stocks from her U.S. taxable income.

The result would not be the same if Betty sold the US Stocks on September 1, 2023. As of September 1, 2023, Betty's tax home was in New York. Because her tax home was in New York, she would not be considered a nonresident at this time.[15] Instead, she would have been a U.S. resident.[16] As a U.S. resident, her gain recognized would be US-source income.[17] Because the gain would not have been Puerto Rican-source income, if Betty had sold the US Stocks on September 1, 2023, she would not have been able to exclude the $4 million gain from her U.S. taxable income.[18]

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10 Code §865(a).

11 Code §865(g).

12 Code §865(g)(1)(A).

13 Code §865(g)(1)(B). Typically, a U.S. citizen individual will not be considered a nonresident for purposes of Code §865(g) unless a foreign income tax of at least 10% is actually paid on the gain. Code §865(g)(2). However, this 10% foreign income tax requirement is not required for bona fide residents of Puerto Rico. See Notice 89-40.

14 Code §865(e)(2).

15 Code §865(g)(1)(A).

16 *Id.*

17 Code §865(a).

18 Code §933(2) and Treas. Reg. §1.933-1(b).

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PRCo Dividends

As described above, Betty owned 100% of PRCo. PRCo operated solely in Puerto Rico and met the 80% and 50% tests in Treas. Reg. §1.937-2(g)(1)(ii). In January of 2023, PRCo paid a dividend to Betty of $3 million.

Because PRCo met the 80% and 50% tests in Treas. Reg. §1.937-2(g)(1)(ii), the entire amount of the dividend paid by PRCo should be Puerto Rican-source income.[19]

Because the dividend was Puerto Rican-source income and Betty was a bona fide resident of Puerto Rico at the time she received the dividend, she should be able to exclude the PRCo $3 million dividend from her U.S. taxable income.

PRCo Gain on Liquidation

As described above, Betty's tax basis in the shares of PRCo was $100,000. On July 1, 2023, PRCo liquidated, distributing cash of $2,100,000 to Betty. As a result of the liquidation, Betty recognized a gain of $2 million.

The gain is treated as if Betty sold her shares of PRCo stock.[20] Gains on sales of personal property, such as shares of stock, are generally sourced based on the residence of the seller.[21] When Betty disposed of the PRCo stock, she had a tax home in Puerto Rico.[22] Consequently, when Betty disposed of the PRCo stock, she was considered a nonresident for purposes of sourcing gains on sales of personal property.[23]

The gain on the PRCo stock was not attributable to a U.S. office or other fixed place of business. Consequently, the general rule of Code §865(a) will apply, and Betty should be able to exclude the $2 million gain on the PRCo stock from her U.S. taxable income.

19 Treas. Reg. §1.937-2(g)(1)(ii).

20 Code §331.

21 Code §865(a).

22 Code §865(g)(1)(A).

23 Code §865(g)(1)(B).

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The result would not be the same if Betty recognized the gain on the liquidation on September 1, 2023. As of September 1, 2023, Betty's tax home was in New York. Because her tax home was in New York, she would not be considered a nonresident at this time.[24] Instead, she would have been a U.S. resident.[25] As a U.S. resident, her gain recognized would be U.S.-source income.[26] Because the gain would not have been Puerto Rican-source income, if Betty had liquidated PRCo on September 1, 2023, she would not have been able to exclude the $2 million gain from her U.S. taxable income.

<u>Puerto Rican Salary</u>

As described above, in 2023 Betty earned a salary of $200,000 for services performed in Puerto Rico, and she was paid all of this salary prior to August 1, 2023.

Compensation for services performed in Puerto Rico is Puerto Rican-source income.[27] Because the salary was Puerto Rican-source income and Betty was a bona fide resident of Puerto Rico at the time she received the salary, she should be able to exclude the $200,000 salary from her U.S. taxable income.[28]

If Betty had received a portion of her salary on September 1, 2023 and that salary was attributable to her services performed in Puerto Rico prior to August 1, 2023, the salary would have been Puerto Rican-source income.[29] In addition, because the salary was attributable to the time that Betty was a bona fide resident of Puerto Rico, she would have been able to exclude the salary received on September 1, 2023 from her U.S. taxable income.[30]

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24 Code §865(g)(1)(A).

25 *Id.*

26 Code §865(a).

27 Code §861(a)(3) and Treas. Reg. §1.861-4.

28 Code §933(2) and Treas. Reg. §1.933-1(b).

29 Code §861(a)(3) and Treas. Reg. §1.861-4.

30 Code §933(2) and Treas. Reg. §1.933-1(b). If Betty were to receive a portion of her salary in the year following the year of her change of residence, Rev. Rul. 68-7 would suggest that she would be unable to exclude the salary from her U.S. taxable income, even if the salary was attributable to the time that Betty was a bona fide resident of Puerto Rico. The conclusion in Rev. Rul. 68-7 may not be correct.

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Form 8898

If an individual takes the position that he or she ceases to be a bona fide resident of Puerto Rico for a taxable year, the individual is required to file Form 8898.[31] A penalty of $1,000 is imposed for failing to file Form 8898 when required to do so.[32]

Form 8898 is not attached to Form 1040. Instead, Form 8898 is filed separately, by mailing it to the address shown in the instructions to the form.

For 2023, Betty ceased to be a resident of Puerto Rico. Consequently, Betty will be required to file Form 8898 for 2023.

2019 Three Year Rule Does Not Apply to Betty

Betty moved to Puerto Rico in May of 2019. Even though Betty lived in Puerto Rico for only a portion of 2019, she was generally able to exclude Puerto Rican-source income she earned in 2019 from her U.S. taxable income.[33] This "year of move" to Puerto Rico exception, however, applies only if Betty remains a bona fide resident of Puerto Rico for each of the 3 taxable years immediately following 2019.[34]

If Betty excluded Puerto Rican-source income from her U.S. taxable income in 2019, moving back to the U.S. too early would jeopardize her 2019 exclusion. Here, however, Betty remained a bona fide resident of Puerto Rico for each of the 3 taxable years immediately following 2019. Consequently, moving back to the U.S. in 2023 should not jeopardize Betty's 2019 exclusion.

What If Betty's Home Were Sold In 2024?

A potential issue arises if Betty had sold her Puerto Rican home in 2024, the year after she moved from Puerto Rico.

31 Code §937(c).

32 Code §6688.

33 Treas. Reg. §1.937-1(f)(1).

34 Treas. Reg. §1.937-1(f)(1)(iii).

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As described above, Code §933(2) and Treas. Reg. §1.933-1(b) provide a special rule for taxpayers moving out of Puerto Rico. Under this special rule, a taxpayer is able to exclude from their U.S. taxable income Puerto Rican-source income that is attributable to the period of Puerto Rican residence.

In Rev. Rul. 68-7, the IRS held that income received in a year after the year of the move could not be excluded from U.S. taxable income, even though the income was derived from sources in Puerto Rico and was attributable to the period of Puerto Rican residence.

Neither the statute nor the regulations limit the special rule to the year of the move. And it does not make sense to limit this rule to the year of the move. If an individual moves from Puerto Rico in December and receives Puerto Rican-source income in January, Rev. Rul. 68-7 would suggest that the income received just after moving out of Puerto Rico could not be excluded from U.S. taxable income.

Presumably, the IRS based its conclusion in Rev. Rul. 68-7 on the heading of Code §933(2). Code §933(2) and Treas. Reg. §1.933-1(b) both contain a heading of "Taxable year of change of residence from Puerto Rico". This heading may suggest that the special rule only applies for the taxable year of the move. However, even though headings can a useful aid in resolving a statutory text's ambiguity,[35] they do no more than indicate the provisions in "a most general manner". The Supreme Court has stated:

> Headings and titles are not meant to take the place of the detailed provisions of the text. Nor are they necessarily designed to be a reference guide or a synopsis. Where the text is complicated and prolific, headings and titles can do no more than indicate the provisions in a most general manner; to attempt to refer to each specific provision would often be ungainly as well as useless. As a result, matters in the text which deviate from those falling within the general pattern are frequently unreflected in the headings and titles. Factors of this type have led to the wise rule that the title of a statute and the heading of a section cannot limit the plain meaning of the text. * * * For interpretative purposes, they are of use only when they shed light on some ambiguous word or phrase. They are but tools

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35 *FTC v. Mandel Brothers, Inc.*, 359 U. S. 385 (1959); *U.S. v. Quality Stores, Inc.*, 572 U.S. 141 (2014).

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> available for the resolution of a doubt. But they cannot undo or limit that which the text makes plain.[36]

Because neither the statute nor the regulations limit the special rule in Code §933(2) to only the taxable year of the move and because the special rule is quite narrow (the excludable income is limited to Puerto Rican source income and only if that Puerto Rican-source income is attributable to the period of Puerto Rican residence), it is far from clear that income received in the year after the move cannot be excluded from income.

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

36 *Bhd. of R.R. Trainmen v. Balt. & Ohio R.R.*, 331 U.S. 519, 528-529 (1947).

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