Back to Basics- An Overview of Sourcing Rules for Bona Fide Residents of Puerto Rico

An individual who is a bona fide resident of Puerto Rico can generally exclude from US income his or her "income derived from sources within Puerto Rico."[1] Because Puerto Rican-sourced income is the only income that can be excluded, it is important to understand what income **is** and what income **is not** Puerto Rican-sourced.

Category-by-category rules determine the source of income.[2] Some of the more common categories include:

- Interest,
- Dividends,
- Compensation for personal services,
- Rentals and royalties,
- Income from the sale or exchange of real property, and
- Income from the sale or exchange of personal property.[3]

Interest Income

Interest income is generally derived from Puerto Rican sources if it is paid by a resident of Puerto Rico or by a Puerto Rican corporation.[4] If a bona fide resident of Puerto Rico receives interest income from a U.S. corporation or a U.S. resident, the income will be considered U.S.-sourced income, and that income cannot be excluded from U.S. taxable income.

[1] Code §933(1) and Treas. Reg. §1.933-1(a)(1). All section references are to the Internal Revenue Code of 1986, as amended (the "Code") and the regulations promulgated thereunder.

[2] Code §§861, 862, and 863 provide rules for determining whether a particular class of income is US or foreign source. Code §§861(a)(1) through (a)(9) provide rules as to when specific classes of income are sourced within the US. Code §862(a) is a parallel section providing when those same classes of income are sourced without the US. Code §863 grants the Secretary authority to promulgate regulations allocating income not specified within Code §§861(a) and 862(a) to sources within and without the US.

[3] *See generally* Code §§861(a), 862(a), and 865.

[4] Code §861(a)(1) and Treas. Reg. §1.937-2(b).

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Dividend Income

Dividend income is generally derived from Puerto Rican sources if it is paid by a Puerto Rican corporation.[5] If a bona fide resident of Puerto Rico receives dividend income from a U.S. corporation, the income will be considered U.S.-sourced income, and that income cannot be excluded from U.S. taxable income.

Compensation For Personal Services

Compensation for personal services is generally sourced to the place of performance of the service.[6] Thus, compensation for personal services performed in Puerto Rico is generally treated as Puerto Rican-sourced income. Compensation for services performed both within and outside Puerto Rico is allocated between Puerto Rican and non-Puerto Rican-sources.[7]

Thus, if services are performed both within Puerto Rico and outside Puerto Rico, only a portion of the income can be excluded from U.S. taxable income.

(Note: Working in the U.S. on behalf of a Puerto Rican company can result in some very nasty U.S. tax consequences for the Puerto Rican company. Refer to the following article for an in-depth discussion of this issue https://tomduffycpa.com/articles/.)

Rental & Royalty Income

Rental and royalty income is generally sourced by reference to the location, or place of use, of the property.[8] Rental and royalty income from property located or used in Puerto Rico is Puerto Rican-source income, but rental income from property located or used outside of Puerto Rico is not Puerto Rican-source income. If a bona fide resident of Puerto Rico receives rents or royalties from property used outside of Puerto Rico, the income will not be considered Puerto Rican-sourced income, and that income cannot be excluded from U.S. taxable income.

[5] Code §861(a)(2) and Treas. Reg. §1.937-2(b).

[6] Code §861(a)(3) and Treas. Reg. §1.937-2(b).

[7] Treas. Reg. §§1.861-4(b) and 1.937-2(b).

[8] Code §861(a)(4) and Treas. Reg. §1.937-2(b).

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Sale or Exchange of Real Property

Income derived from the sale of Puerto Rican real estate is Puerto Rican-sourced income.[9] In contrast, income derived from the sale of real estate outside of Puerto Rico is not Puerto Rican-source income.

If a bona fide resident of Puerto Rico sells Puerto Rican real estate, gain on the real estate can be excluded from U.S. taxable income. In contrast, if a bona fide resident of Puerto Rico sells real estate outside of Puerto Rico, gain on the real estate cannot be excluded from U.S. taxable income.

Sale or Exchange of Personal Property – Inventory

Different sourcing rules apply to income from sales of personal property treated as inventory and personal property that is not treated as inventory. Inventory is generally property held for sale to customers in the ordinary course of a trade or business.[10]

Income from the sale of inventory that was manufactured by the taxpayer in Puerto Rico is generally Puerto Rican-sourced income.[11] Income from the sale of inventory that was manufactured by the taxpayer outside of Puerto Rico is not Puerto Rican-sourced income.[12]

Income from the sale of inventory that was purchased by the taxpayer (i.e., inventory that was not manufactured by the taxpayer) is generally Puerto Rican-sourced income if title to the property transfers in Puerto Rico.[13] On the other hand, income from the sale of inventory that was purchased by the taxpayer is generally not Puerto Rican-source income if title to the property transfers outside of Puerto Rico.

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[9] Code §861(a)(5) and Treas. Reg. §1.937-2(b).

[10] Code §1221(a)(1).

[11] Treas. Reg. §§1.863-3(f)(1) and 1.937-2(b).

[12] Id.

[13] Treas. Reg. §§1.861-7(c) and 1.937-2(b).

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Sale or Exchange of Personal Property – Non-Inventory

Subject to significant exceptions, income from the sale of personal property is generally sourced on the basis of the residence of the seller.[14] Under this general rule, income from the sale of personal property by a bona fide resident of Puerto Rico would generally be Puerto Rican-sourced income.

Appreciated/Tainted Property for First 10 Years in Puerto Rico

Special rules apply to gains from dispositions of certain investment property (for example, stocks, bonds, debt instruments, diamonds, gold, cryptocurrencies, etc.) owned prior to becoming a bona fide resident of Puerto Rico ("Tainted Property").[15] Under these special rules, gains from dispositions of Tainted Property within 10 years after becoming a bona fide resident of Puerto Rico generally are treated as not Puerto Rican-sourced income.[16]

For example, say an individual is a U.S. tax resident and owns appreciated shares of stock. If that individual becomes a bona fide resident of Puerto Rico and then sells the appreciated stock within 10 years of moving to Puerto Rico, the special rule provides that the gain generally will not be Puerto Rican-sourced income. In other words, the gain generally cannot be excluded from U.S. taxable income.

Election to Split Source of Tainted Property Gain

A bona fide resident of Puerto Rico may elect to split the source of Tainted Property gain by using a mark-to-market allocation in the case of marketable securities and a time-based allocation in the case of other personal property.[17]

Under this special election, gain is allocated partly to the U.S. holding period and partly to the Puerto Rican holding period. The Puerto Rican holding period is the time the property was owned while the individual was a bona fide resident of Puerto Rico. The U.S. holding period is the time the property was owned prior to becoming a bona fide resident of Puerto Rico.

[14] Code §865(a).

[15] Treas. Reg. §1.937-2(f)(1).

[16] Treas. Reg. §1.937-2(f)(1)(iii)(B).

[17] Treas. Reg. §1.937-2(f)(1)(vi)(A) and (B), respectively.

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The election is made by reporting the gain attributable to the Puerto Rican holding period on the U.S. income tax return for the year of disposition.[18]

Marketable Securities – Mark-to-Market Allocation

Marketable securities are those actively traded on an established financial market, such as stock in a publicly held corporation.[19] The securities must be marketable throughout the individual's entire holding period.[20]

Gain attributable to the Puerto Rican holding period is the difference in the fair market value of the security at the beginning of the Puerto Rican holding period and the fair market value of the security when it is sold.[21] This is the gain that is treated as being from sources within Puerto Rico.

> Example 1: Assume that in 2020 Jane lived in the United States and on January 1, 2020, she paid $1,000,000 to purchase 1,000 shares of stock in a U.S. corporation listed on the New York Stock Exchange. On January 1, 2021, Jane moved to Puerto Rico and became a bona fide resident of Puerto Rico. On January 1, 2021, the closing value of the 1,000 shares of stock was $2,000,000. On January 1, 2022, while still a bona fide resident of Puerto Rico, Jane sold all of the 1,000 shares of stock for $10,000,000.
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> Jane's total gain on the sale would be $9,000,000. Under the mark-to-market allocation rules, Jane would allocate $1,000,000 of the gain to her U.S. holding period ($2,000,000 - $1,000,000) and she would allocate $8,000,000 of the gain to her Puerto Rican holding period ($10,000,000 - $2,000,000).

Gain allocated to US holding period	Gain allocated to PR holding period	Total gain
$1,000,000	$8,000,000	$9,000,000

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[18] Treas. Reg. §1.937-2(f)(1)(vi).

[19] Treas. Reg. §1.937-2(f)(1)(vii)(A).

[20] Id.

[21] Treas. Reg. §1.937-2(f)(1)(vi)(A).

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Thus, in Example 1, Jane would be able to exclude $8,000,000 of the gain from her U.S. taxable income.

Property Other Than Marketable Securities – Time-Based Allocation

In the case of property other than marketable securities, the portion of gain attributable to the Puerto Rican holding period is determined by multiplying the total gain by a fraction, the numerator of which is the number of days in the Puerto Rican holding period and the denominator of which is the total number of days in the entire holding period for the property.[22]

Example 2: Assume the same facts as in Example 1, except that the property was not a marketable security. Thus, in 2020 Jane lived in the United States and on January 1, 2020, she paid $1,000,000 to purchase 1,000 shares of stock in a privately held corporation. On January 1, 2021, she moved to Puerto Rico and became a bona fide resident of Puerto Rico. On January 1, 2022, while still a bona fide resident of Puerto Rico, Jane sold all of the 1,000 shares of stock for $10,000,000.

Jane owned the shares for a total of two years. She owned the shares for one year prior to becoming a bona fide resident of Puerto Rico, and she owned the shares for an additional year after becoming a bona fide resident of Puerto Rico.

Jane's total gain on the sale would be $9,000,000. Under the time-based allocation rule, she would allocate $4,500,000 of the gain to her U.S. holding period ($9,000,000 x 365 / 730) and she would allocate $4,500,000 of the gain to her Puerto Rican holding period ($9,000,000 x 365 / 730).

Gain allocated to US holding period	Gain allocated to PR holding period	Total gain
$4,500,000	$4,500,000	$9,000,000

Thus, in Example 2, Jane would only be able to exclude $4,500,000 of the gain from her U.S. taxable income.

[22] Treas. Reg. §1.937-2(f)(1)(vi)(B).

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Income Earned Through Partnerships & S Corporations

Partnerships and S corporations are generally not subject to income tax.[23] Instead, the income of partnerships and S corporations generally flows through to, and is taxed to, the partners/shareholders.[24]

Subject to certain exceptions, the character of income that flows through to the partner or S corporation shareholder is determined as if the income were realized directly from the source for which realized by the partnership or S corporation.[25]

Where it is necessary to determine the amount or character of gross income of a partner, the partner is allocated his or her share of the gross income of the partnership.[26] For example, a partner may be required to include his distributive share of partnership gross income in computing the amount of gross income received from sources within Puerto Rico.[27] Similar rules apply to shareholders of S corporations.[28]

It is important to note, especially for bona fide residents of Puerto Rico, that certain sales of partnership personal property are sourced to the residence of the partner.[29]

> Example 3: On January 1, 2021, Jane moved to Puerto Rico and became a bona fide resident of Puerto Rico. Jane is a partner in a U.S. partnership ("USP") that is a trader but not a dealer in securities. On February 15, 2021, USP purchases 1,000,000 shares of stock in a U.S. company that is traded on the New York Stock Exchange. On November 1, 2022, USP sells the 1,000,000 shares of stock at a gain of $100,000,000. Jane's partnership distributive share of the gain is $5,000,000.

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23 Code §§701 and 1363(a).

24 Code §§702(a) and 1366(a).

25 Code §702(b) and Treas. Reg. §1.702-1(b), and Code §1366(b) and Treas. Reg. §1.1366-1(b).

26 Treas. Reg. §1.701(c)(1).

27 Treas. Reg. §1.701(c)(1)(iii).

28 Treas. Reg. §1.1366-1(c)(1).

29 Code §865(a) and (i)(5).

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> The $5,000,000 gain allocated to Jane is sourced based on where she is resident. Because Jane is a bona fide resident of Puerto Rico, the gain is likely Puerto Rican-sourced income and can likely be excluded from Jane's U.S. income.

An S corporation is treated as a partnership, and the shareholders of the S corporation are treated as partners, for certain foreign-sourced income purposes.[30] Specifically, an S corporation is treated as a partnership for purposes of subparts A and F of part III, and part V, of subchapter N of Chapter 1 of the Internal Revenue Code.[31] Importantly, the sourcing rules for bona fide residents of Puerto Rico are included in Code §937, which is in subpart D of part III of subchapter N – and notably <u>not</u> in subparts A or F as described above. Therefore, an S corporation is <u>not</u> treated as a partnership for purposes of sourcing entity-level gains on sales of personal property when sourcing income under Code §937. In other words, the special rule that sources partnership personal property gains based on the residence of the partner does <u>not</u> apply to gains recognized on personal property by S corporations for purposes of Code §937.

> Example 4: On January 1, 2021, Jane moved to Puerto Rico and became a bona fide resident of Puerto Rico. Jane is a 5% shareholder in a U.S. S corporation ("S Corp") that is a trader but not a dealer in securities. On February 15, 2021, S Corp purchases 1,000,000 shares of stock in a U.S. company that is traded on the New York Stock Exchange. On November 1, 2022, S Corp sells the 1,000,000 shares of stock at a gain of $100,000,000. Jane's pro rata share of the gain is $5,000,000.
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> For purposes of computing the foreign tax credit limitation under Code §904, the gain allocated to Jane is sourced based on where she is resident. However, for purposes of excluding income under Code §§933 and 937, the gain allocated to Jane is sourced to the residence of the seller. In this case, the seller is a U.S. S corporation. Because the S corporation is a U.S. resident, the gain is US-sourced income, Code §865(a), and <u>cannot</u> be excluded from Jane's U.S. income.

As noted above, special rules apply to gains from dispositions of certain investment property (for example, stocks, bonds, debt instruments, diamonds, gold, cryptocurrencies, etc.) owned

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[30] Code §1373(a).

[31] *Id.*

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prior to becoming a bona fide resident of Puerto Rico.[32] If such investment property is owned by a partnership prior to one or more of the partners becoming bona fide residents of Puerto Rico, it is not clear whether the investment property held by the partnership should be subject to the 10-year Tainted Property rules discussed above.

Sourcing By Analogy

It is well settled that Code §§861 through 863 and their predecessors were not intended to be all inclusive.[33] When an item of income is not classified within the confines of the statutory scheme nor by regulation, courts have sourced the item by comparison and analogy with classes of income specified with the statutes. (See *Howkins v. Commr*., 49 T.C. 689 (1968), *Bank of America v. U.S.*, 230 Cl. Ct. 679 (1982).)

Allocation of Expenses to Puerto Rico Sourced Income

Where an amount is excluded from gross income under Code §933, deductions or losses properly allocable to the excluded gross income cannot be deducted.[34] The allocation and apportionment rules under Treas. Reg. §1.861-8 apply for purposes of determining what portion of the expenses should be allocated and apportioned against the excluded income.[35]

Temp. Treas. Reg. §1.861-8T(c)(1) provides in part:

> A deduction is apportioned by attributing the deduction to gross income * * * which is [Puerto Rican source income] and to gross income * * * which is [non-Puerto Rican source income]. Such attribution must be accomplished in a manner which reflects to a reasonably close extent the factual relationship between the deduction and the grouping of gross income.

That regulation provides that a taxpayer may apportion the deduction using various bases and factors, such as the following, provided the basis or factor chosen by the taxpayer reasonably reflects the factual relationship between the deduction and the grouping of gross income: 1) comparison of units sold; 2) comparison of the amount of gross sales or receipts; 3) comparison

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[32] Treas. Reg. §1.937-2(f)(1).

[33] Helvering v. Suffolk Co., 104 F.2d 505 (4th Cir. 1939); Welsh Trust v. Commr., 16 T.C. 1398 (1951); De Stuers v. Commr., 26 B.T.A. 201 (1932).

[34] Code §933(1) and Treas. Reg. §1.933-1(c)

[35] Treas. Reg. §1.933-1(c).

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of the cost of goods sold; 4) comparison of profit contribution; 5) comparison of expenses incurred, assets used, salaries paid, space utilized, and time spent related to the activities or properties giving rise to the class of gross income; and 6) comparison of the amount of gross income.

A taxpayer must furnish, if requested, information supporting the factual relationship for purposes of the apportionment of the deduction between the two groups of gross income.[36]

If a taxpayer incurs a business expense that is related to both Puerto Rican sourced income and US-sourced income, the taxpayer may choose to allocate the expense among the two groups of income based on the source of the gross income generated by the entire business. For example, if the business generates 80% of its gross income from Puerto Rican sources, then 80% of the expense would be allocable to the Puerto Rican sourced income. In this example, the 80% portion of the expense allocable against the Puerto Rican sourced income could not be deducted for US tax purposes.

However, in all cases, whatever method is chosen, the method must reflect “to a reasonably close extent the factual relationship between the deduction and the grouping of gross income.”[37]

About Tom Duffy, C.P.A., P.C.

Tom Duffy C.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. He is licensed to practice in Florida, Illinois, and Puerto Rico and services clients in the United States, its possessions, and throughout the world.

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[36] Treas. Reg. §1.861-8(f)(5).

[37] Treas. Reg. §1.861-8T.