

Sourcing Capital Losses Generated by a Resident of Puerto Rico

Facts

Individual A is a US citizen who is a bona fide resident of Puerto Rico with a tax home in Puerto Rico. Under Act 60 (formerly Act 22)¹, capital gains recognized by Individual A are excluded from Puerto Rican taxable income.

Individual A purchases shares of stock after becoming a bona fide resident of Puerto Rico. Individual A sells the shares of stock at a loss (the “Stock Loss”) while he is a bona fide resident of Puerto Rico.

Issue

Should the Stock Loss be allocated against Puerto Rican-source income or non-Puerto Rican-source income?

Gains as Foreign-Source Income – 10% Foreign Tax Rule

Pursuant to Code §865(a)², the source of income from the sale of personal property, such as shares of stock, is determined by the seller’s residence at the time of sale. Code §865(g)(2), however, provides that gains on the sale of personal property by a US citizen or resident alien who, at the time of sale, is a resident of a foreign country are still considered US-source income, unless the person must pay a foreign income tax on the gain of at least 10%.

¹ Act 60–2019, known as the Puerto Rico Incentives Code, was signed into law on July 1, 2019, with an effective date of January 1, 2020 (“Act 60”). Act 60, among other things, consolidated various tax decrees, including Act 20, the Promotion of Export Services Act, and Act 22, the Act to Promote the Relocation of Individual Investors to Puerto Rico.

² All section references are to the Internal Revenue Code of 1986, as amended (the “Code”) and the regulations promulgated thereunder.

Symmetrical Rule for Losses

When Congress enacted Code §865, it directed the Treasury Department to issue regulations governing the source of losses from the sale of personal property; see Code §865(j)(1). In its explanation of the 1986 TRA, the Joint Committee on Taxation noted that:

[Congress] anticipated that regulations will provide that losses from sales of personal property generally will be allocated consistently with the source of income that gains would generate but that variations of this principle may be necessary.³

Losses are not gross income. Therefore, losses are not sourced under the normal income sourcing rules. Instead, losses are allocated against gross income.⁴

Treas. Reg. §1.865-2(a)(1) provides the general rule that losses on stock are allocated against the type of gross income with respect to which gain from a sale of such stock would give rise in the hands of the seller. Treas. Reg. §1.865-2(a)(3)(i) provides rules for US citizens and resident aliens with a foreign tax home, and provides in part:

[I]n the case of loss with respect to stock that is recognized by a United States citizen or resident alien that has a tax home * * * in a foreign country, the loss shall be allocated to reduce foreign source income if a gain on the sale of the stock would have been taxable by a foreign country and the highest marginal rate of tax imposed on such gains in the foreign country is at least 10 percent.

Obviously, losses are not subject to tax. The 10% tax rate is a reference to what the tax rate would have been if there had been a gain instead of a loss. Thus, the regulation provides a symmetrical rule. Losses from sales of stock are allocated against foreign-source income if the gain on the same asset would have been foreign-source income.

Exception to 10% Foreign Tax Rule for Puerto Rico

For purposes of sourcing gains, Puerto Rico is considered a foreign country. Thus, absent an exception to the 10% foreign tax rule, gains from the sale of personal property by a US citizen

³ Staff of the Jt. Comm. on Taxation, General Explanation of the Tax Reform Act of 1986, at 923 (JCS-10-87) (1987) (1986 Bluebook).

⁴ Treas. Reg. §1.861-8(a)(1).

who is a bona fide resident of Puerto Rico would be Puerto Rican-source income only if the person had to pay a Puerto Rican income tax on the gain of 10% or more.

In Notice 89-40, the IRS announced its decision to waive the 10% foreign tax requirement for sales of personal property by US citizens and resident aliens who are bona fide residents of Puerto Rico. Thus, gains from sales of stock by a US citizen who is a bona fide resident of Puerto Rico are Puerto Rican-source income regardless of the Puerto Rican tax rate on those gains.

Notice 89-40 only discusses the source rules for gains. The notice has no discussion of the allocation of losses.

Questions on Stock Losses Recognized by Individual A

Here, Individual A is a US citizen who has a tax home in Puerto Rico. Individual A has recognized the Stock Loss. Under Treas. Reg. §1.865-2(a)(3)(i), the Stock Loss is allocated against Puerto Rican-source income if two requirements are met:

1. A gain on the sale of the stock would have been taxable in Puerto Rico, and
2. The highest marginal rate of tax imposed on such gains in Puerto Rico is at least 10%.

A gain on the sale of the stock would have been Puerto Rican-source income. A symmetrical rule would provide that the Stock Loss should be allocated against Puerto Rican-source income.

However, a literal reading of the regulation may provide other than a symmetrical rule. Should the regulation be read literally? If the gain is excluded from Puerto Rican taxable income, would the gain have been “taxable in Puerto Rico”? Even if the gain would have been subject to a zero percent tax rate, is that gain “taxable in Puerto Rico”?

Because the 10% foreign tax rule does not apply to gains recognized by bona fide residents of Puerto Rico, should the 10% rule in Treas. Reg. §1.865-2(a)(3)(i) be ignored for bona fide residents of Puerto Rico? In other words, do the regulations imply a symmetrical rule?

Individual A is taxed at a zero rate on capital gains because he qualifies under Puerto Rico’s Act 60. Most bona fide residents of Puerto Rico do not qualify for Act 60. These individuals may be taxed in Puerto Rico on capital gains at a rate of more than 10%. Is the required 10% rate specific to Individual A, or is it the rate that generally applies to bona fide residents of Puerto Rico?

Notice 89-40 was published in 1989. The stock loss regulations were proposed in 1999 and finalized in 2001.⁵ The proposed and final regulations contained a special rule for gains on certain Puerto Rican corporations (not relevant here).⁶ Thus, the drafters of the regulations contemplated special rules that apply to bona fide residents of Puerto Rico. The drafters presumably were aware of the existence of Notice 89-40. Yet, no special loss allocation rule was provided for bona fide residents of Puerto Rico where the Puerto Rican tax rate would be below 10%.

Publication 570

Page 9 of IRS Publication 570 states:

If personal property is sold by a bona fide resident of a relevant territory, the gain (or loss) from the sale is treated as sourced within that territory.

However, “authoritative sources of Federal tax law are in the statutes, regulations, and judicial decisions and not in such informal publications.” *Zimmerman v. Commr.*, 71 T.C. 367 (1978).⁷

Tentative Conclusion

Although not entirely clear, it would seem that a position could be taken that the Stock Loss recognized by Individual A could be allocated against non-Puerto Rican-source income. Possibly even the Stock Loss should be allocated against non-Puerto Rican-source income.

⁵ T.D. 8973.

⁶ Treas. Reg. §1.865-2(a)(3)(ii)

⁷ Similarly, in *Casa De La Jolla Park, Inc. v. Commr.*, 94 T.C. 384 (1990), the Tax Court noted that “the sources of authoritative law in the tax field are the statute and regulations and not government publications.”