

Form 5471 Filing Requirements for Residents of Puerto Rico

Background

This memorandum discusses the Form 5471 filing requirements for a bona fide resident of Puerto Rico (the “BFR of PR”) with respect to a Puerto Rican corporation (“PRCo”).¹

It should be noted that the vast majority of Puerto Rico companies are established as LLCs.² A Puerto Rico LLC that has not elected to be treated as a flow-through entity for U.S. purposes is treated as a corporation for U.S. purposes. See Treas. Reg. §301.7701-3(b)(2)(i)(B).³

The BFR of PR was a bona fide resident of Puerto Rico for the entire year. The BFR of PR owns 100% of PRCo.

PRCo earns solely US-source income. However, PRCo is not engaged in a trade or business in the US. Further, PRCo is not engaged in a trade or business in Puerto Rico.

There are five categories of filers for purposes of Form 5471.

Category 1 Filer

Category 1 applies to Code §965 specified foreign corporations. If PRCo is a Code §965 specified foreign corporation, then Category 1 would apply.

Category 5 Filer (the BFR of PR should not be treated as a US person for this category)

Category 5 filer applies to US shareholders of CFCs. If the BFR of PR is not a “US shareholder” of PRCo or if PRCo is not a CFC, then the BFR of PR should not be a Category 5 filer with respect to PRCo.

¹ Form 5471 is used by certain U.S. persons who are officers, directors, or shareholder in certain foreign corporations. The form and schedules are used to satisfy the reporting requirements of Code § 6038 and § 6046, and the related regulations.

² 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.

³ All section references are to the Internal Revenue Code of 1986, as amended (the “Code”) and the regulations promulgated thereunder.

In order to be a US shareholder with respect to a Puerto Rican corporation, an individual must be considered a US person as defined in Code §957(c)(1) and Treas. Reg. §1.957-3(b). An individual is not considered a US person with respect to a foreign corporation created in Puerto Rico if the individual is a bona fide resident of Puerto Rico during the entire taxable year and a dividend received by the individual from the Puerto Rican corporation during the year would, for purposes of Code §933(1), be treated as income derived from sources within Puerto Rico. For this purpose, the special rules of Treas. Reg. §1.937-2(g)(1) **do not** apply. Treas. Reg. §1.957-3(b).

Thus, for this purpose, the “normal” dividend sourcing rules under Code §861(a)(2)(B) apply. Under Code §861(a)(2)(B), all of a dividend from PRCo to the BFR of PR should be treated as income derived from sources within Puerto Rico unless 25% or more of PRCo’s gross income from all sources for the prior 3-year period (or for such part of such period as the corporation has been in existence) was effectively connected with the conduct of a trade or business within the US (“ECI”).

1. Because PRCo is not engaged in a trade or business in the US, none of PRCo’s gross income should be ECI.
2. Because none of PRCo’s gross income should be ECI, all of a dividend from PRCo to the BFR of PR should be treated as Puerto Rican source income under Code §861(a)(2)(B).
3. Because all of a dividend from PRCo to the BFR of PR should be treated as Puerto Rican source income under Code §861(a)(2)(B) and because the BFR of PR was a bona fide resident of Puerto Rico for the entire year, the BFR of PR should not be considered a US person as defined in Code §957(c)(1) and Treas. Reg. §1.957-3(b).
4. Because the BFR of PR should not be considered a US person, he should not be treated as a US shareholder of PRCo. Code §951(b).
5. Because the BFR of PR should not be treated as a US shareholder of PRCo, PRCo should not be a CFC. Code §957(a).
6. Because the BFR of PR should not be treated as a US shareholder of PRCo and because PRCo should not be a CFC, the BFR of PR should not be a Category 5 filer with respect to PRCo.

Category 2, 3, and 4 Filers (US Person Definition for These Categories)

As described above, the special rules of Treas. Reg. §1.937-2(g)(1) do not apply for purposes of determining whether the BFR of PR is treated as a US person for Category 5 filer purposes. However, the regulations define US person differently for purposes of Category 2, 3, and 4 filers. Page | 2

The definition of US person for purposes of Category 2 and 3 filers is found in Treas. Reg. §1.6046-1(f)(3)(ii)(A), and the definition of US person for purposes of Category 4 filers is found in Treas. Reg. §1.6038-2(d)(2)(i). Both of these regulations provide that, for an individual who is a bona fide resident of Puerto Rico, the term US person has the meaning assigned to it by Treas. Reg. §1.957-3(b) except that the rules of Treas. Reg. §1.937-2(g)(1) **do** apply.

Thus, the BFR of PR will be treated as a US person for Category 2, 3, and 4 purposes if a dividend from PRCo to the BFR of PR would not, for purposes of Code §933(1), be treated as income derived from sources within Puerto Rico.

PRCo Does Not Meet the 100% Puerto Rican Sourcing Rule (PRCo Fails the 80/50 Tests)

Under Treas. Reg. §1.937-2(g)(1)(ii), the entire amount of a dividend is considered Puerto Rican source if: (A) 80% or more of the gross income of the corporation over a 3-year testing period is from sources within Puerto Rico or was effectively connected with the conduct of a trade or business in Puerto Rico, and (B) 50% or more of the gross income of the corporation for the testing period was derived from the active conduct of a trade or business within Puerto Rico. Because PRCo is not engaged in the active conduct of a trade or business within Puerto Rico, this rule will not apply to PRCo.

The Proportionate Dividend Sourcing Rule Applies to PRCo

Under Treas. Reg. §1.937-2(g)(1)(i), only the “possessions source ratio” of dividends paid by PRCo will be treated as income from sources within Puerto Rico. The possessions source ratio is a fraction, the numerator of which is the gross income of the Puerto Rican corporation from sources within Puerto Rico for the 3-year testing period and the denominator of which is the total gross income of the corporation for the 3-year testing period. Treas. Reg. §1.937-2(g)(1)(i)(A).

Under Treas. Reg. §1.937-2(g)(1)(i)(A), if PRCo only earns US-source income (or even partly earns US-source income) all or a portion of the dividend would not be Puerto Rican-source income.

The BFR of PR is Treated as a US Person For Category 2, 3, & 4 Purposes

Because all or a portion of dividends paid by PRCo to the BFR of PR would not be Puerto Rican-source income, the BFR of PR should be treated as a US person for Category 2, 3, and 4 purposes. This means that the normal requirements to file for these categories should apply to the BFR of PR. For example, the BFR of PR is required to annually file Form 5471 as a Category 4 filer, and the BFR of PR is required to file as a Category 2 and 3 filer in a year in which he or she acquires a 10% or greater interest in PRCo.

The regulations underlying these rules were promulgated in Treasury Decision 9391. The preamble to this Treasury Decision provides in part:

The Treasury Department and the IRS believe that the information required under sections 6038 and 6046 is necessary for purposes of determining whether [bona fide residents of Puerto Rico] have a Federal income tax liability. Thus, the final regulations continue to apply the 80/50 conditions of Sec. 1.937-2(g)(1) when defining United States person for purposes of the information reporting requirements under sections 6038 and 6046.

The language quoted above from the preamble is consistent with the interpretation that the normal Category 2, 3, and 4 filer rules apply to US citizens owning Puerto Rican corporations that do not have active trades or businesses in Puerto Rico (i.e., corporations that do not meet the 80/50 tests).

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.

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