

# Puerto Rico Act 60 Tax Exemptions: IRS Examination and Audit, Key Issues for Individuals and Business Taxpayers

Puerto Rico Act 60, Key Issues for Taxpayers,  
Navigating IRS Examination and Audits, Tax Planning

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**Mr. Leeds focuses his practice on the tax consequences of a variety of cross-border and domestic capital markets products and strategies, including migrating individuals and businesses to Puerto Rico in a manner that ensures compliance with both of the US tax rules for *bona fide* residents of Puerto Rico and the Puerto Rico Act 60 rules. Mark also has experience in responding to Internal Revenue Service examinations of US individuals and businesses who have become *bona fide* residents of Puerto Rico. In addition to cross-border Puerto Rico work, Mark advises on the tax aspects of capital markets, structured finance, derivatives, financial products and insurance transactions and has extensive experience working with both buyers and sellers to develop and structure complex derivatives.**

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# The US & Puerto Rico Statutory Schemes

- **US Tax Code Section 933:**

The following items shall not be included in gross income and shall be exempt from taxation under this subtitle:

- (1) Resident of Puerto Rico for entire taxable year

In the case of an individual who is a bona fide resident of Puerto Rico during the entire taxable year, income derived from sources within Puerto Rico . . .

- (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 . . . attributable to that part of such period of Puerto Rican residence before such date . . .

- **Puerto Rico Act 60 (July 1, 2019)**

Section 2032.02(a)(1): The net income derived from Export of Services or Promoter Services, as provided in subsection (a) of Section 2031.01 of this Code, shall be subject to a flat preferential income tax rate of four percent (4%) in lieu of any other income tax, if any, provided by the Puerto Rico Internal Revenue Code or any other law. . . .

# The US & Puerto Rico Statutory Schemes

- **Note that US benefits are not available to corporations**
- **Benefits are available to owners of closely-held businesses**
- **Structures must satisfy 2 sets of rules:**
  - **Residency of individual**
  - **Generating Puerto Rico-source income**

# Determining When an Individual Is a Bona Fide Resident of Puerto Rico

# *Bona Fide* Residency Tests

**Section 937 of the US Tax Code provides that an individual qualifies as a Bona Fide Resident of Puerto Rico only if the person meets ALL of the following three tests:**

- **Presence Test**
- **Tax Home Test**
- **Closer Connection Test**

# Bona Fide Residency Tests: Presence Test

**Presence Test:** The Presence Test can be met in any of five ways:

- The individual is present in Puerto Rico (“PR”) at least 183 days during the taxable year;
- The individual is present in PR a minimum of 549 days during the 3-year period that includes the current taxable year and the two preceding taxable years, as long as the individual is also present in PR for a minimum of 60 day during each year of the 3-year period;
- The individual’s presence in the United States (“US”) does not exceed of 90 days during the taxable year;
- The individual generates no “earned income” from sources within the US (i.e., compensation for labor or personal services rendered by the individual in the US in excess of \$3,000), and is present in Puerto Rico for more days than in the US;  
or

The individual has “no significant connection” to the US.

# Presence Test: Counting Puerto Rico Days

- Physical presence in Puerto Rico for any length of time during a given day counts as a “day” in PR
- Physical presence in the US for any length of time during a given day counts as a “day” in the US, except that if on the same day the individual is also present in PR, the presence in the US does not count as a day of presence in the US
- Any day that an individual is outside PR to receive or to accompany a parent, spouse or child who is receiving “qualified medical treatment” (in-patient care in a hospital or hospice) will be considered as a “day of presence” in PR
- Any day during a 14-day period within which an individual is outside PR because he/she has left or is unable to return due to a major disaster (i.e. FEMA/Presidential declaration State of Disaster) will be considered as a “day of presence” in PR
- Days spent in transit between two points outside of the US do not count as a day in the US, so long as the presence in the US is less than 24 hours
- Days in the US as a student (as defined in US-IRC §152(f)(2)) do not count as “days of presence” in the US
- Days in the US serving as an elective representative of PR, or as a full time elected or appointed official or employee of the PR Government, do not count as “days of presence” in the US
- Physical presence in PR and in another US possession (i.e., US Virgin Islands) on the same day, count as a “day of presence” in PR if the tax home of the individual is in PR



# Bona Fide Residency Tests: Tax Home Test

**Tax Home Test:** This test is met if the individual does not have a tax home outside Puerto Rico for any part of the taxable year.

- A person's "tax home" is that individual's regular or principal place of business that is claimed by the taxpayer for purposes of determining income tax deductions for traveling expenses while away from home in the pursuit of a trade or business.
- If the individual does not have a regular or principal place of business—because the individual is not engaged in a trade or business or does not conduct it at any principal place—then the tax home is the individual's regular place of abode in a real and substantial sense.

# Bona Fide Residency Tests: Closer Connection Test

**Closer Connection Test:** This test is met if the individual has a closer connection with Puerto Rico than with the United States or a foreign country. It is a facts-and-circumstances test, with the following factors specifically identified (IRS Publication 570):

- The location of the individual's permanent home
- The location of the individual's family
- The location of personal belongings, such as automobiles, furniture, clothing and jewelry owned by the individual and that individual's family
- The location of social, political, cultural or religious organizations with which the individual has a current relationship
- The location where the individual conducts his/her routine personal banking activities
- The location where the individual conducts business activities (other than those relevant to the individual's tax home)
- The location of the jurisdiction in which the individual holds a driver's license
- The location of the jurisdiction in which the individual votes
- The location of charitable organizations to which the individual contributes
- The country of residence designated by the individual on official government forms, documents and tax returns
- The types of official forms and documents the individual files, such as Form W-8BEN or Form W-9

# Internal Revenue Service Residency Audits

# IRS Campaigns: Background

- **Congressional Letter.** In December 2019, certain members of Congress sent a letter to the Treasury secretary expressing concerns about benefits of US tax laws for taxpayers that become residents of Puerto Rico
- **IRS Report.** At the same time, Congress directed the IRS to determine the number of individuals that had relocated to Puerto Rico since 2012 and been granted tax exemptions under Act 22
  - IRS identified 2,331 individuals who had obtained Act 22 benefits from 2012-2019
- **Criminal Indictment.** In October 2020, a CPA with a large accounting firm was indicted on charges related to assisting clients fraudulently obtain benefits associated with Act 22
- **IRS Activity.** In a May 2024 interview with *The New York Times*, then-IRS Commissioner Danny Werfel said the IRS has audited “dozens” of taxpayers and assessed “millions of dollars” related to Puerto Rico tax incentives, with the IRS enforcement campaign in Puerto Rico only in its “early chapters”

# Relevant IRS Audit Campaigns

## **Puerto Rico Act 22, Individual Investors Act**

Practice Area: Withholding, Exchange & International Individual Compliance

Lead Executive: Orrin Byrd, Director, Withholding & International Individual Compliance

Campaign Point of Contact: Ursula Gee, Program Manager, Withholding, Exchange & International Individual Compliance

This campaign addresses taxpayers who have claimed benefits through Puerto Rico Act 22, "Act to Promote the Relocation of Individual Investors to Puerto Rico", without meeting the requirements of IRC Section 937, Residence and Source Rules Involving Possessions. As a result, these individuals may be excluding income subject to US tax on a filed US income tax return or failing to file and report income subject to US tax. This campaign will also address those individuals who have met the requirements of IRC Section 937 but may be erroneously reporting US source income as Puerto Rico source income in order to avoid US taxation. The objective of this campaign is to address noncompliance in this area through a variety of treatment streams including examinations, outreach and soft letters.

## **Financial service entities engaged in a U.S. trade or business campaign**

Practice Area: Cross Border Activities

Lead Executive: Deborah Palacheck, Director, Cross Border Activities

Campaign Point of Contact: Cindy Kim, Program Manager, Cross Border Activities

This campaign addresses whether foreign investors were subject to U.S. tax on effectively connected income from lending transactions engaged in through a U.S. trade or business. In general, foreign investors who only trade stocks and securities for their own account are not engaged in a U.S. trade or business under the safe harbor rule set forth in 26 USC 864(b)(2). The safe harbor rule, however, is not available to dealers in stocks or securities, or to entities engaged in a lending business, or to foreign investors in partnerships engaged in such activities. The treatment stream for this campaign is issue-based examinations.

# IRS Campaigns: Pattern IDR – Residency Questions

10. Copies of the following Puerto Rico tax returns and information return forms filed with the **Departamento de Hacienda de Puerto Rico**:

- A. Complete copies of all individual Puerto Rico income tax returns, including all schedules and attached information returns, filed by you for the year(s) 2016 – 2021.
- B. Complete copies of any Puerto Rico corporation tax returns, including all schedules and attached information returns, for the year(s) 2016 – 2021 for each non-publicly traded corporation of which you owned directly or indirectly any class of stock of the corporation.
- C. Complete copies of any Puerto Rico partnership returns, including all schedules and attached information returns for the years 2016 – 2021 for each partnership, domestic or foreign, of which you owned directly or indirectly a partnership interest in.
- D. Complete copies of any Estate and Trust returns, including all schedules and attached information returns for which were the fiduciary, grantor, creator, director or a beneficiary of the Estate or Trust for the years 2016 – 2021.

11. Copies of any Forms 1099-, and/or the equivalent Form 480 series used in Puerto Rico, received for the years 2016 – 2021 and not previously provided for either U.S. or Puerto Rico tax purposes.

12. All insurance contracts, whether life, medical, automobile, liability, homeowners, etc., in force during the 2016 – 2021 years, which were the owner, the insured or the beneficiary.

13. All closing DOCUMENTS for all real estate purchases and/or sales made by during the years 2016 – 2021.

14. All leases in effect for the years 2016 – 2021, which was the Lessor (or had authority to execute on behalf of the Lessor), or the Lessee (or had authority to execute on behalf of the Lessee).

15. All homestead exemptions filed by or in effect for for the years 2016 – 2021.



# IRS Campaigns: Pattern IDR – Residency Questions

16. Copies of all property tax bills paid by or on behalf of [REDACTED] for the years 2016 – 2021, including records to substantiate the payment method used to pay the property taxes.
17. Voter registration cards in effect for the years 2016 – 2021.
18. Driver's license and the registration cards for all vehicles registered in [REDACTED] name for the years 2016 – 2021.
19. All records substantiating social, political, cultural, or religious organizations in which [REDACTED] was a member during 2016 – 2021.
20. All DOCUMENTS related to [REDACTED] change in residency from the U.S. to Puerto Rico, including, but not limited to, invoices for: airline tickets, fees paid to commercial moving companies for moving of automobiles, furniture, personal belongings, and all other physical assets, travel agency services, berthing of personal yachts and other watercraft, hanger or other storage and maintenance of personal aircraft.
21. Daily business and personal planners, calendars, or any other form or device that documents all days [REDACTED] spent in Puerto Rico or elsewhere and the reason or circumstances for his presence in each location, for the years 2016 – 2018. Provide all DOCUMENTS related to these trips including, but not limited to, invoices for: airline travel, hotel/resort/logging accommodations, travel agency services, automobile rentals, vacation packages, deposits and monthly rental or lease of temporary and/or permanent business locations and business property or equipment.
22. Documents for all commercial flights [REDACTED] was on that took off from or landed in Puerto Rico during 2016 – 2018. These documents include but are not limited to airline tickets, receipts for purchase of any tickets, frequent flyer account records, etc.
23. Documentation for any non-commercial, corporate, or personal flights [REDACTED] was on that took off from or landed in Puerto Rico during 2016 – 2018. These documents

# IRS Campaigns: Pattern IDR – Residency Questions

include but are not limited to airline tickets, receipts for purchase of any tickets, frequent flyer account records, flight logs, etc.

24. Documents for all commercial watercraft used to enter or leave Puerto Rico during 2016 – 2018. These documents include but are not limited to tickets, receipts for purchase of any tickets, account records, etc.

25. Documentation for any non-commercial, corporate, or personal watercraft used to enter or leave Puerto Rico during 2016 – 2018. These documents include but are not limited to tickets, receipts for purchase of any tickets, account records, captain, or similar, logs, etc.

26. All telephone and cellular phone statements for all phones used by for the years 2016 – 2021. These copies should include all pages included with each billing statement and contain details of calls and text messages made and received by that would include location while utilizing the phone or text message features.

**Please note that additional items may be requested as needed during the examination.**



# Puerto Rico-Source Income

# US Tax Code Source Rules Generally Apply

- **Rules similar to the rules for determining whether income is US-source income or ECI to a USTB apply for purposes of determining whether income is Puerto Rico source income or ECI with a Puerto Rico Trade or Business**
- **However: any income treated as “US-source income” is excluded from Puerto Rico-source income even if it is ECI with a Puerto Rico Trade or Business**
- **Service income is sourced to where the services are performed**
- **Income from intellectual property is sourced to where the IP is used**
- **Capital gains are sourced to the residence of seller unless the office rule applies**

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# Special Rules for Dividends from PR Corporations

- **If shareholder owns 10% or more of the voting stock of PR corporation, then look through PR corporation for source & allocate based on gross income**
- **If creditor owns 10% or more of the voting stock of the PR corporation, then look through PR corporation for source & allocate interest based on gross income**
- **Note that there are indirect ownership rules**

# Business Income – General Rules

- **Service income is considered to be Puerto Rico-source income if the services are performed in Puerto Rico.**
  - Income can be bifurcated if services are performed within and without Puerto Rico. Only PR-source income is excluded from US tax.
- **Income from sale of goods traditionally has been sourced under title passage rule.**
  - 2017 Tax Act relaxes title passage rule, provided that no US office is involved with the sale.
- **Source rules for patents and other IP look to where the IP is used.**
  - Internet services may still look to where servers are located under specific circumstances.

# Transfer Pricing Study Considerations

- **If services are provided to a related entity in the US, the fee must be an arm's length fee that meets the requirement of US IRC Sec. 482**
  - **The IRS has authority under Sec. 6662(e) and (h) to assess transfer-pricing penalties**
- **The taxpayer must prepare a Transfer Pricing study in order to comply with the requirements of US IRC Sections 482 and 6662 enforceable on the US entity**
  - **Penalties will not be imposed if the taxpayer's controlled transactions satisfy the specified method and documentation requirements provided in the regulations**
- **A benchmarking analysis may serve as a preliminary tool to determine the charges among related entities, but not to avoid penalties and sustain challenges from the IRS**

# Capital Gains from Securities Transactions

- **Capital gains from securities sales generally are sourced to the residence of the seller**
  - **If seller is a bona fide resident of PR, then gain from securities sales will be PR-source. Code § 865(a)**
  - **Swap income is also sourced to the residence of the payee. Treas. Reg. § 1.863-7(b)(1)**
- **If the sale is made from an office or other fixed place of business located outside of Puerto Rico, then the source of the sale is that office or fixed place of business**
  - **Notice 89-40: Source rules apply regardless of rate of Puerto Rico tax**

# Capital Gains from Split Holding Period Securities

- **Special rules apply to stock, debt instruments, swaps, currencies, derivatives and options if sold within 10 years of becoming a bona fide resident of Puerto Rico**
  - If property is publicly-traded, only gain in excess of closing price on first day of possessions holding period is Puerto Rico-source income (snap shot approach)
  - If property is not publicly-traded, only fraction that is attributable to holding period within Puerto Rico is PR-source income (day count approach)
- **Possessions holding period begins when taxpayer does not have a tax home outside of Puerto Rico**

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# More on Split Holding Period Property

## Exceptions to exemption of capital gains from US taxation:

- **10-Year Lookback Rule:** “[I]ncome from sources within [Puerto Rico] will not include gains from the disposition of property described in paragraph (f)(1)(ii) of this section by an individual described in paragraph (f)(1)(iii) of this section.” **Treas. Reg. §1.937-2(f)(1)(i).**
  - What kind of “property”? “Property . . . of a kind described in section 731(c)(3)(C)(i) or 954(c)(1)(B) . . . [if the] property was owned by the individual before such individual became a bona fide resident of Puerto Rico].”
  - Which “individuals”? The 10-year rule applies to a bona fide resident of Puerto Rico is “[f]or any of the 10 years preceding [the taxable] year, the individual was a citizen or resident of the United States (other than a bona fide resident of [Puerto Rico]).”
  - Election to split-source gains: Marketable securities vs. other property. **Treas. Reg. §1.937-2(f)(1)(vi).**
- **Treatment of losses:** Generally follows sourcing of gains. **Treas. Reg. §1.865-2(a)(1).**
- **US and Foreign Office Rules:** US and foreign sourcing of gains “attributable” to US and foreign offices, respectively. **IRC §§865(e)(1)(A) and 865(e)(2)(A).**
- **FIRPTA:** Gains on US real property interests are US source. **IRC §861(a)(5).**



# US Taxation of Puerto Rico Corporations

- **Rules for determining whether income is US-source income or ECI to a US trade or business apply for purposes of determining whether income is Puerto Rico source income or ECI with a Puerto Rico trade or business**
- **Income treated as “US-source income” is excluded from Puerto Rico-source income even if it is earned in connection with a Puerto Rico Trade or Business**
- **Interest and dividend income is sourced to the residence of the payer of such income**
- **Income from sale of goods traditionally has been sourced under title passage rule.**
  - **2017 Tax Act relaxes title passage rule, provided that no US office is involved with the sale.**
- **Source rules for patents and other IP look to where the IP is used.**
- **Internet services may still look to where servers are located under specific circumstances.**

# US Taxation of Puerto Rico Corporations

**Sourcing services income to Puerto Rico and benefiting from Act 60 can require more than creating a Puerto Rico entity:**

- **Entity classification**
- **Time basis apportionment**
- **US trade or business**
- **Effectively connected income**
- **Export services and services incidental thereto**
- **Obligation to report Puerto Rico-source income on a US tax return**

# The IRS Responds to Aggressive Tax Planning to Avoid 10-Year Rule

# Advice Memorandum 2024-005 (December 2024)

- **Taxpayer held appreciated split-holding period securities**
- **Taxpayer makes a tax-free contribution of split-holding period securities to an S corporation**
- **After contribution, the taxpayer became a *bona fide* resident of Puerto Rico**
- **Taxpayer holds S corporation stock, and S corporation holds securities, for 2 years**

# Advice Memorandum 2024-005 Sale of S corp stock

- **Taxpayer sells S corporation stock & determines Puerto Rico holding period with reference to the holding period of the S corporation stock, not the split holding period securities**
- **IRS holds that the US-source portion of the gain is determined with reference to the holding period of the split holding period securities transferred to the S corporation**
- **IRS refuses to allow the use of the mark-to-market method of determining the Puerto Rico portion of the gain**

# Advice Memorandum 2024-005 - S corp sells securities

- **Taxpayers apparently have claimed that S corporation determines its Puerto Rico holding period based on the shareholder's holding period of the S corporation stock**
- **IRS narrowly interprets Code § 1366(b) and holds that since an S corporation is a US person (statutorily required) that none of the gain from the disposition of the securities can be Puerto Rico-source income.**
- **IRS concludes that Code § 1373(a) (allowing the determination of foreign tax credits at the shareholder level) does not apply to determine the source of the gain.**