

## The Closer Connection Rules – Tax Planning for In-Bound Taxpayers, Income Earned Abroad and Bona Fide Residents of Puerto Rico

Understanding When and Why the Closer Connection Test Matters

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- Anthony Diosdi, Managing Shareholder, **Diosdi & Liu, LLP**, San Francisco
- Mark H. Leeds, Partner, **Pillsbury Winthrop Shaw Pittman**, New York

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July 8, 2025

**Mark Leeds**

Partner

[mark.leeds@pillsburylaw.com](mailto:mark.leeds@pillsburylaw.com)

212.858.1080

**Anthony Diosdi**

Managing Shareholder

[adiosdi@sftaxcounsel.com](mailto:adiosdi@sftaxcounsel.com)

415.318.3990



# Speakers



**Mark Leeds, Partner - 212.858.1080 – [mark.leeds@pillsburylaw.com](mailto:mark.leeds@pillsburylaw.com)**

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.



**Bio to come.**

# **Rules for the US Taxation of Foreign Individuals**

# U.S. taxation of foreign nationals

- **Nonresident aliens (NRA)**
  - Only subject to tax on income from sources within the United States (“U.S.-source” income)
    - U.S.-source income taxed under two different regimes:
      - U.S.-source income not connected with a U.S. business taxed at flat 30% rate (unless reduced rate in Code or a treaty)
      - U.S.-source income connected with a U.S. business taxed a normal graduated rates
  - Generally allowed fewer deductions
  - Generally cannot file as “married filing jointly” (MFJ) (absent making an election under section 6013(g) or (h))
- **Resident aliens**
  - Subject to tax in the same manner as a U.S. citizen
    - Taxed on all income from all sources
    - Eligible for more deductions/credits than NRA
    - May file as married filing jointly

# Part-Year Residents

- In year of transition (arrival/departure) from United States, foreign national may be a resident alien for part of the year and NRA for part of the year
- Taxed as an NRA for the part of the year the individual is an NRA
- Taxed as a resident alien for the part of the year the individual is a resident alien



# Determining residency

- Foreign national is considered NRA *unless* individual meets any of the following residency tests:
  - 1.Substantial presence test (SPT);
  - 2.Lawful permanent resident test (“the green card test”)
  - 3.First-year residency election under section 7701(b)(4)
- A married foreign national may be able to elect to be treated as a full-year U.S. resident under section 6013(g) or (h) if specified requirements are satisfied.

# Substantial presence test (SPT)

- A foreign national is a U.S. resident under SPT in a calendar year if 2 requirements are met in that year:
  - 1) Present in the United States on at least 31 days during the current year (CY); *and*
  - 2) The sum of:
    - All days of U.S. presence during CY; *plus*
    - 1/3 of the days of U.S. presence during the first preceding year; *plus*
    - 1/6 of the days of U.S. presence during the second preceding yearequals or exceeds 183

## Example:

Ben, a U.K. national, regularly travels to the United States for work. Present in the U.S. for 130 days in 2025 (CY) and was present in the U.S. for 120 days in both 2024 and 2023.

Ben is present for at least 31 days in 2025.

Applying the SPT formula to Ben's presence results in 190 SPT days:

Year	Actual Days	Ratio	SPT Days
2025	130	1	130
2024	120	1/3	40
2023	120	1/6	20
Total			190

- Ben is a resident (unless Closer Connection Exception applies)

# Defining U.S. Presence

- “[A]n individual shall be treated as present in the United States on any day that he or she is physically present in the United States at any time during the day.”
- Not counted for SPT, any day an individual is:
- present as an exempt individual:
  - Student - Status can be extended beyond 5<sup>th</sup> year if substantial compliance with visa, no intent to reside in U.S. permanently
  - Professional athlete
    - Temporarily present in the U.S. to compete in charitable sports event
    - Exemption only applies to days competing in charitable sports event
  - present as an exempt individual:
    - Foreign government-related individual
      - full-time employee of an international organization; or
      - has diplomatic status
    - Teacher or trainee
      - J or Q visa holder in “substantial compliance” with visa
      - Not treated as exempt individual in CY if exempt teacher, trainee or student for any part of 2 of the last 6 calendar years
        - Period may be extended to four out of last six if compensation paid by foreign employer

# Exceptions to Physical Presence Test Day Count

- Not counted for SPT, any day an individual is:
  - prevented from leaving the U.S. because of a medical condition that arose while the individual was present in the U.S.;
  - A day is not excluded if:
    - subsequently able to leave the U.S. and then remains beyond a reasonable period for making arrangements to leave, or
    - Medical condition arose during a prior stay in the U.S. and the individual returns to the U.S. for medical treatment
  - Pre-existing medical condition not covered by exception
- in transit between two points outside the United States;
  - Physically present in the U.S. for fewer than 24 hours
  - Pursue activities substantially related to completing travel to foreign destination
    - No business meetings in the airport! Business calls?

# Passing Through Exceptions

- **Not counted for SPT, any day an individual is:**
  - **a regular commuter residing in Canada or Mexico commuting to and from employment/self-employment in the United States**
    - **Considered to commute regularly if commute to a place of employment in the U.S. from residence in Canada or Mexico on more than 75% of workdays during the working period.**
    - **Commute:**
      - **Travel to place of employment (or self-employment) and to return to a place of residence within 24-hr period**
        - **Exception only applies to daily commuters**
  - **Certain crew members of foreign vessels**
    - **Temporarily present in the U.S. as a regular member of the crew of a foreign vessel engaged in transportation between the U.S. and a foreign country or U.S. possession**
      - **Does not apply if individual engages in any U.S. trade or business on the day**

# What Constitutes the “United States” for SPT

- For SPT purposes, United States includes:
  - The 50 states and the District of Columbia
  - Territorial waters of the United States
  - The seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the United States and over which the United States has exclusive rights with respect to exploration and exploitation of natural resources.
- It does NOT include:
  - Possessions and territories of the United States:
    - Territories:
      - American Samoa, Guam, The Commonwealth of Puerto Rico, The Commonwealth of the Northern Mariana Islands and the U.S. Virgin Islands
    - Possessions:
      - Baker Island, Howland Island, Jarvis Island, Johnston Island, Kingman Reef, Midway Islands, Palmyra Atoll, Wake Island, and other U.S. islands, cays, and reefs that are not part of any of the fifty states
  - Air space over the United States

• Treas. Reg. § 301.7701(b)-1(c)(2)(ii)

# **Rules for Income Earned Abroad by US Persons**

# Qualified Residents

- A US person who earns income abroad may exclude up to \$130,000 (2025 limit) of that income from US tax if (s)he is a qualified resident.
- A qualified resident must have a tax home in a foreign country.
- Presence test – one of two tests must be met:
  - Must be a bona fide resident of the foreign country or
  - During 12 consecutive months, must spend at least 330 days in such country
- While the US person need not establish that (s)he has a closer connection to the foreign country than the US, courts have employed similar tests. See Morgan, TC Mem. 2022-20.



# Tax Home Alone Insufficient for Exclusion

- Even if a US person has a tax home in a foreign country, the earned income exclusion is unavailable if the individual has an “abode” within the US.
- Abode is looser than closer connection because an abode can be the primary residence of the earner without causing a loss of the exclusion.
- Courts compare familial, economic & personal ties to the US to those ties abroad in determining if an individual has an abode in the US. This is similar to the closer connection test.

# **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.

# **The Tax Home & Closer Connection Exception for Foreign Persons**

# Closer connection exception (CCE) for Foreign Persons

- **An individual is not treated as meeting SPT with respect to any current year if 3 requirements are met:**
  - **The individual is present in the United States on fewer than 183 days during the current year, and**
  - **It is established that for the current year such individual:**
    - **has a tax home in a foreign country, and**
    - **has a closer connection to such foreign country than to the United States**



# Tax “Home” Is a Misnomer

- “The term “tax home” means, with respect to any individual, such individual's home for purposes of section 162(a)(2) (relating to traveling expenses while away from home).”
- “[A]n individual's tax home is considered to be located at the individual's regular or principal (if more than one regular) place of business.”
- Generally, the city/metropolitan area of an individual’s regular work or post of duty
  - Not necessarily the location of one’s personal principal residence
  - Facts and circumstances analysis:
    - Total time spent at each location
    - Level of business activity at each location with consideration for:
      - Financial return, and
      - Performance of administrative and managerial tasks
    - Whether the location is temporary or permanent
      - Reasonably expected to be for one year or less, and lasts for one year or less
- “If the individual has no regular or principal place of business because of the nature of the business, or because the individual is not engaged in carrying on any trade or business within the meaning of section 162(a), then the individual's tax home is the individual's regular place of abode in a real and substantial sense”

# Tax Home Factors

- Regular place of abode in a real and substantial sense
  - Facts and circumstances determination, IRS considers 3 objective factors:
    - 1) Whether the taxpayer performs a portion of his business in the vicinity of his claimed abode and uses such abode (for purposes of his lodging) while performing such business there;
    - 2) Whether the taxpayers living expenses incurred at his claimed abode are duplicated because his business requires him to be away therefrom; and
    - 3) Whether the taxpayer:
      - a) has not abandoned the vicinity in which his historical place of lodging and his claimed abode are both located,
      - b) has a member or members of his family (marital or lineal only) currently residing at his claimed abode, or
      - c) uses his claimed abode frequently for purposes of his lodging.

# Other Tax Home Requirements

- Tax home maintained by individual must be in existence for entire current year
  - CCE not available in year tax home shifts to United States
    - Example: Individual comes to U.S. to begin a work assignment expected to exceed 12-months, tax home shifts to U.S. in arrival year, so CCE not available
- Must be located in the same country for which the individual is claiming to have the closer connection

# When Is There a Closer Connection?

- **Must establish that the individual has maintained more significant contacts with a foreign country than with the United States**
  - **Facts and circumstances determination, regulations provide a non-exhaustive list of considerations:**
- **The location of:**
  - **the individual's permanent home;**
    - **house, an apartment, or a furnished room**
    - **owned or rented by the alien individual**
    - **dwelling must be available at all times, continuously, and not solely for stays of short duration**
  - **the individual's family;**
    - **regulations do not define whether “family” is limited to immediate family, but more weight likely granted to location of immediate versus extended**

# More Closer Connection Factors

- The location of:
  - personal belongings
    - automobiles, furniture, clothing and jewelry owned by the individual and his or her family
      - Presumably, location of taxpayer's personal belongings granted more weight than family members' belongings
    - Not limited to the above – art, photo albums, sentimental keepsakes
  - social, political, cultural or religious organizations with which the individual has a current relationship;
    - Registered parishioner? Gym membership? Belong to a country club? Member of a social club?
  - where the individual conducts his or her routine personal banking activities;
  - where the individual conducts business activities (other than those that constitute the individual's tax home);
  - the jurisdiction in which the individual holds a driver's license;
  - the jurisdiction in which the individual votes;
    - Generally, a foreign national will not be able to vote in a U.S. election (although may be able to vote in certain state or local elections)

# More Closer Connection Factors

- **Must establish that the individual has maintained more significant contacts with a foreign country than with the United States**
  - **Contacts not listed in the regulations, but potentially relevant:**
    - **Location of real property owned by the individual?**
    - **Location of family pet?**
    - **Location of friend group?**
    - **Location of personal, financial, and legal documents?**
    - **Derive most income?**
    - **Location of doctors, financial advisors, business advisors, legal counsel?**
    - **Qualify for any foreign country's national health plan?**
  - **The country of residence designated by the individual on forms and documents;**
    - **Bad facts: if the individual files forms to be treated a nonresident in the foreign country, or deregisters from the social security system**
  - **The types of official forms and documents filed by the individual.**
    - **Form W-8 (Certificate of Foreign Status) or Form W-9 (Payer's Request for Taxpayer Identification Number).**
    - **Consider any foreign country equivalents**

# Morgan Facts (Earned Income Exclusion)

- Taxpayer spent most of his time in Saudi Arabia
- Free time was spent as president of a Saudi social club organizing local charitable events for local charities
- Frequented Saudi grocery stores and restaurants
- Vacationed with other US persons in Saudi Arabia to surrounding countries
- Obtained an Iqama (Saudi resident alien card)
- Saudi medical insurance and drivers license
- Did not seek work outside of Saudi Arabia

# Adapting New York Case Law on Snowbirds

- **Does the individual maintain significant ties to the US after the move?**
- **Has the home in the US been sold or rented or listed for sale in a manner that it is reasonable to expect that it will be sold?**
- **If business is continued in the US, does the individual attempt to manage the business from Puerto Rico?**
- **Where is correspondence sent?**
- **Safe deposit boxes location?**
- **Boat & airplane registration location?**



# Closer Connection Filing Requirements

- **Must file a fully completed Form 8840, *Closer Connection Exception Statement for Aliens* (or successor form) with the IRS to be eligible to claim CCE**
  - **Attach to Form 1040-NR, *U.S. Nonresident Alien Income Tax Return* and file by due date (including extensions) of tax return to address shown in tax return instructions**
  - **If not tax return required, Form 8840 mailed to IRS by due date for filing Form 1040NR:**
    - **Department of the Treasury, Internal Revenue Service Center, Austin, TX 73301-0215**
- **Penalty for not filing**
- **If Form 8840 is not timely filed, not eligible to claim CCE**
  - **Required to include all days of presence in the United States**
- **Exceptions:**
  - **Not penalized if individual can show by “clear and convincing evidence” that individual “took reasonable actions to become aware of the filing requirements and significant affirmative steps to comply with those requirements”**
  - **Secretary has discretion to disregard failure to file timely when in best interest of government**

# **Internal Revenue Service Puerto Rico 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.**