



June 7, 2021

## Income from Sources within Puerto Rico

*Presented by: ACCI Branch 7*



## Front Matter Items

- ❖ [The IRS Mission Statement](#)
- ❖ [14 General Principles of Ethical Conduct for Federal Employees](#)
- ❖ [Your Rights as a Taxpayer](#)



## Course Objectives

- ❖ At the end of this course, you will be able to:
  - Identify general sourcing rules applicable to Puerto Rico residents
  - Identify modifications to sourcing rules applicable to different types of income with respect to Puerto Rico
  - Discuss Puerto Rico specific sourcing rules and exceptions to different sets of facts
  - Calculate income from sources within Puerto Rico and income effectively connected with a Puerto Rico trade or business



## Acronyms

- ❖ BFR – Bona fide resident
- ❖ NRA – Nonresident alien



## General Income Tax Rules Applicable to Bona Fide Residents of Puerto Rico

- ❖ Section 933 – Excludes Puerto Rico source income from U.S. income tax for BFRs of Puerto Rico
- ❖ If all income sourced in Puerto Rico, no U.S. income tax filing requirement
- ❖ If any income sourced outside Puerto Rico -- 50 states, D.C., or foreign country – income must be reported on U.S. income tax return (still exclude Puerto Rico source income)
- ❖ If income subject to income tax with IRS and Hacienda, individual eligible for (no double taxation)



## Puerto Rico Source Rules – General

- ❖ Rules similar to those in §§ 861 through 865 and regulations generally apply in determining whether income is from sources within and without Puerto Rico and whether income is effectively connected with the conduct of a Puerto Rico trade or business.

**Note:** Amounts received for services performed as an employee of the United States or any agency thereof are not excluded

- ❖ Substitution of terms and meaning (where appropriate):
  - “Puerto Rico” for “United States”
  - “Bona fide resident of Puerto Rico” for “United States resident”
  - “Domestic” construed as created or organized in Puerto Rico
  - additional substitutions may be necessary
- ❖ Reference: I.R.C. §§ 933(1) and 937(b)(1); Treas. Reg. §§ 1.937-2(b) and 1.937-3(b)



## Puerto Rico Source Rules – U.S. Source Income Rule

- ❖ U.S. Source Income Rule -- income treated as income from sources within the United States or as effectively connected with the conduct of a U.S. trade or business are not treated as income from sources within Puerto Rico or as effectively connected with the conduct of a Puerto Rico trade or business
  
- ❖ Reference: I.R.C. § 937(b)(2)



## Puerto Rico Source Rules – Conduit Arrangements

- ❖ Conduit Arrangements -- Income will be considered sourced within the United States if, pursuant to a plan or arrangement:
  - The income is received in exchange for consideration provided to another person; and
  - Such person (or another person) provides the same consideration (or consideration of a like kind) to a third person in exchange for one or more payments constituting income from sources within the United States.
  
- ❖ Reference: Treas. Reg. §§ 1.937-2(c)(2), 1.937-3(c)(2)





## Puerto Rico Source Rules – Modifications

- ❖ In no case will a BFR have, as a result of the application of these principles, more income:
  - from sources within Puerto Rico than the amount of income from sources within the United States that a similarly situated U.S. person who is not a BFR would have under §§ 861 through 865; or
  - effectively connected with the conduct of a Puerto Rico trade or business than the amount of U.S. effectively connected income that a similarly situated U.S. person who is not a BFR would have under § 864(c).
  
- ❖ Reference: Treas. Reg. §§ 1.937-2(b), 1.937-3(b)



# Puerto Rico Source Rules – Dividends from Puerto Rico Corporation - General Rule

- ❖ For Puerto Rico shareholders, only the “Puerto Rico source ratio” of a dividend paid or accrued by a Puerto Rico corporation is deemed income from Puerto Rico sources
  - “Puerto Rico shareholder” means an individual who is a Puerto Rico BFR who owns, directly or indirectly, at least 10 percent of the corporation’s total voting stock.
  - “Puerto Rico source ratio” = (gross income from Puerto Rico sources) **divided by** (total gross income for the “testing period”)
  - Testing period is the 3-year period ending with the close of the taxable year of the payment of the dividend (or the period the corporation has been in existence, if shorter)
- ❖ References: Treas. Reg. § 1.937-2(g)(i) & (iii)



# Puerto Rico Source Rules – Dividends from Puerto Rico Corporation - Exception

- ❖ The **entire amount** of a dividend will be treated as income from Puerto Rico sources if:
  - 80 percent or more of the corporation’s gross income for the “testing period” was derived from sources within Puerto Rico or effectively connected with the conduct of a Puerto Rico trade or business; and
  - 50 percent or more of the corporation’s gross income for the testing period was derived from the active conduct of a Puerto Rico trade or business.
  
- ❖ Reference: Treas. Reg. § 1.937-2(g)(ii)



## Puerto Rico Source Rules – Interest from Puerto Rico Corporation - General Rule

- ❖ **General Rule** - For Puerto Rico shareholders, interest paid by a Puerto Rico corporation will be treated as Puerto Rico source income to the extent the interest is allocable to assets that generate, have generated, or could reasonably have been expected to generate income from Puerto Rico sources or income effectively connected with the conduct of a Puerto Rico trade or business
  
- ❖ Reference: Treas. Reg. § 1.937-2(i)(1)(i)



# Puerto Rico Source Rules – Interest from Puerto Rico Corporation - Exception

- ❖ The entire amount of interest paid by a Puerto Rico corporation will be treated as income from Puerto Rico sources if:
  - 80 percent or more of the corporation's gross income for the testing period was derived from Puerto Rico sources or effectively connected with the conduct of a Puerto Rico trade or business; and
  - 50 percent or more of the corporation's gross income for the testing period was derived from the active conduct of a trade or business within Puerto Rico.
  
- ❖ Reference: Treas. Reg. § 1.937-2(i)(1)(ii)



# Puerto Rico Source Rules – Interest from Partnerships

## ❖ Interest from Partnerships

- Interest paid by a partnership will be treated as income from Puerto Rico sources to the extent it is allocable to income effectively connected with the conduct of a Puerto Rico trade or business

## ❖ Reference: Treas. Reg. § 1.937-2(i)(2)



## Puerto Rico Source Rules – Ten-Year Lookback Rule

- ❖ Applies to dispositions of tangible or intangible personal property
- ❖ Under general sourcing rules, source of a gain (or loss) from sale or exchange of such property is determined under § 865 source rules, i.e., sourced at seller's residence if:
  - the property is not part of a U.S. trade or business; and
  - is either personal use property or investment property
- ❖ Thus, under general source rules, if a Puerto Rico BFR receives income from the sale of stock not in a trade or business, the source of that income will be Puerto Rico.
- ❖ Exception – “Ten-year lookback rule”
- ❖ References: Treas. Reg. § 1.937-2(f)(1)(i)-(iii)



## Puerto Rico Source Rules – Ten-Year Lookback Rule (cont'd)

- ❖ “10-year look-back rule”
  - If the rule applies, income generally sourced in Puerto Rico will not include gains from the disposition of certain property
- ❖ Applies to individuals who:
  - are Puerto Rico BFRs for the year in which source of gain must be determined;
  - are U.S. citizens or residents (other than a Puerto Rico BFR) for any of the 10 preceding years; and
  - owned the property before becoming a Puerto Rico BFR
- ❖ References: Treas. Reg. § 1.937-2(f)(1)(i)-(iii)





## Specific Modifications – Ten-Year Lookback Rule

- ❖ Types of property subject to the rule:
  - stock in a corporation;
  - notes, bonds, debentures, or other evidences of indebtedness;
  - interest rate, currency, or equity notional principal contracts;
  - foreign currencies;
  - interests in or derivative financial instruments (including options, forward or futures contracts, short positions, and similar financial instruments);
  - property that gives rise to dividends, interest, royalties, rents, and annuities; and
  - interest in a trust, partnership, or real estate mortgage investment conduit
- ❖ References: Treas. Reg. § 1.937-2(f)(1)(ii); I.R.C. §§ 731(c)(3)(C)(i), 954(c)(1)(B)



## Specific Modifications – Ten-Year Lookback Rule – Taxpayer Election

- ❖ Gain on property derived after becoming Puerto Rico BFR: Individuals may elect to treat as gain from sources within Puerto Rico the portion of gain attributable to individual's Puerto Rico holding period
- ❖ Election will be considered made if the individual's income tax return for year of disposition of property reports the portion of gain attributable to the taxpayer's Puerto Rico holding period as determined in accordance with the regulation.
- ❖ Taxpayer's Puerto Rico holding period begins when the individual moves to Puerto Rico and becomes a BFR
- ❖ References: Treas. Reg. § 1.937-2(f)(1)(vi)



## Specific Modifications – Ten-Year Lookback Rule – Taxpayer Election (cont'd)

### ❖ Election (cont'd)

- For marketable securities, the portion of gain attributable to the Puerto Rico holding period will be determined by reference to the fair market value at the close of the market on the first day of the individual's Puerto Rico holding period
- For property other than marketable securities, the portion of gain attributable to the Puerto Rico holding period will be determined as follows:

Total gain x (Puerto Rico holding period/total holding period)

### ❖ References: Treas. Reg. § 1.937-2(f)(1)(vi)



# Specific Modifications – Ten-Year Lookback Rule – Example (Without Taxpayer Election)

## ❖ Example

- Tom, a U.S. citizen, resides in Florida and acquires stock of Corporation C, a U.S. corporation, in 2015 for \$100x. Tom moves to Puerto Rico on March 1, 2016. Assume Tom is a Puerto Rico BFR for 2016 through 2019. On March 1, 2016, the closing value of Tom's stock in Corporation C, a marketable security, is \$200x. On January 3, 2019, Tom sells all his Corporation C stock for \$700x.
- All of Tom's gain (\$600x) will be treated as income from sources within the United States and not as income from sources in Puerto Rico.

## ❖ References: Treas. Reg. § 1.937-2(k) ex. 1



## Specific Modifications – Ten-Year Lookback Rule (with Taxpayer Election)

### ❖ Example (with election)

- Tom's Puerto Rico holding period begins on March 1, 2016, the date his tax home changes to Puerto Rico. The portion of Tom's gain attributable to the Puerto Rico holding period is \$500x, the excess of the sale price of the stock (\$700x) over its closing value (\$200x) on the first day of the Puerto Rico holding period.
- By reporting \$500x of gain on his 2019 Puerto Rico return, Tom has elected to treat that amount as Puerto Rico source income.

### ❖ References: Treas. Reg. § 1.937-2(k) ex. 1



# Specific Modifications – Sale of Personal Property – Nonresident Alien

- ❖ Recall: U.S. General Source Rule
  - Income from the sale of personal property:
    - by a U.S. resident is sourced in the United States
    - by a nonresident alien (“NRA”) shall be sourced outside the United States
  - Special meaning of resident:
    - U.S. citizen or a resident alien who does not have a “tax home” in a foreign country
    - NRA who has a tax home in the United States
    - any corporation, trust, or estate that is a U.S. person (as defined in section 7701(a)(30))
    - Result: Sale by Puerto Rico BFR with no tax home in the United States will have Puerto Rico-source income
- ❖ References: I.R.C. §§ 865(a) & (g)(1), 7701(a)(30)



# Specific Modifications – Sale of Personal Property -- Nonresident Alien

## ❖ Exception

- U.S. citizens and residents will not be treated as an NRA with respect to the sale of personal property unless an income tax equal to at least 10 percent of the gain is actually paid to a foreign country.
- Result: if not satisfied, U.S.-source income

## ❖ Exception to the exception

- Sales by Puerto Rico BFRs: the corporation is engaged in the active conduct of a trade or business in Puerto Rico, and more than 50 percent of its gross income for the preceding 3-year period was derived from the active conduct of a Puerto Rico trade or business.
- Result: if satisfied, Puerto Rico-source income

## ❖ Reference: I.R.C. § 865(g)(2) & (g)(3)



## Specific Modifications – Sale of Personal Property -- NRAs

- ❖ Exception to the exception to the exception
  - 10-year look-back rule
  - Result: if applicable, all (without election) or part (with election) of gain is U.S.-source income
  
- ❖ Reference: Treas. Reg. § 1.937-2(f)(1)





## Specific Modifications – Puerto Rico Production Sales

### ❖ Puerto Rico Production Sales

- Income derived from the purchase of personal property within Puerto Rico and its sale within the United States
- Gross income is allocated in its entirety to the taxpayer's business activity and then apportioned between United States and Puerto Rico
- Gross income from the taxpayer's business activity is sourced in Puerto Rico in the same proportion that the amount of the taxpayer's business activity for the taxable year within Puerto Rico bears to the amount of the taxpayer's business activity for the taxable year both within Puerto Rico and outside Puerto Rico, with respect to Puerto Rico Purchase Sales. The remaining income is sourced in the United States

❖ Reference: I.R.C. § 863(b)(3); Treas. Reg. § 1.863-3(e)(3)



## Specific Modifications – Puerto Rico Production Sales (cont'd)

### ❖ Puerto Rico Production Sales

- Income derived from the sale of inventory produced (in whole or in part) by a taxpayer within the United States and sold within Puerto Rico, or produced (in whole or in part) by a taxpayer in Puerto Rico and sold within the United States
- Tax years beginning after December 31, 2017 - allocated and apportioned solely on basis of the production activities with respect to the property.
- The source of gross income is determined under Treas. Reg. § 1.863-3(c), except that the term Puerto Rico is substituted for foreign country wherever it appears

❖ Reference: I.R.C. §§ 937(b), 863(b); Treas. Reg. §§ 1.937-2(d), 1.863-3(e)(2)



## Specific Modifications – Puerto Rico Production Sales (cont'd-2)

### ❖ Puerto Rico Production Sales

- When production assets are located only within the United States only within Puerto Rico, income is sourced where the taxpayer's production assets are located
- When production assets are located both within the United States and Puerto Rico, income from sources within Puerto Rico will be determined by:

**multiplying** (gross income) **by** (average adjusted basis of production assets located in Puerto Rico) **divided** by (average adjusted basis of all production assets in the United States and Puerto Rico).

### ❖ Reference: Treas. Reg. § 1.863-3(c) & (e)(2)



## Specific Modifications – Inventory Sales

- ❖ Business activity is equal to the sum of:
  - The amounts for the taxable period paid for wages, salaries, and other compensation of employees, and other expenses attributable to Puerto Rico purchase sales (other than amounts that are nondeductible under section 263A, interest, and research and development);
  - Cost of goods sold attributable to Puerto Rico purchase sales during the taxable period; and
  - Puerto Rico purchase sales for the taxable period
  
- ❖ Reference: Treas. Reg. § 1.863-3(e)(3)(ii)(B)



## Specific Modifications – Inventory Puerto Rico Purchase Sales (cont'd)

### ❖ Location of business activity

- For purposes of determining the location of the taxpayer's business activity, the following rules apply:
  - Sales activity. Receipts from gross sales will be attributed to Puerto Rico in accordance with § 1.861–7(c)
  - Cost of goods sold. Payments for cost of goods sold will be properly attributable to gross receipts from sources within Puerto Rico only to the extent that the property purchased was manufactured, produced, grown, or extracted in Puerto Rico
  - Expenses. Expenses will be attributed to Puerto Rico under the rules of §§ 1.861–8 through 1.861–14T.

### ❖ Reference: Treas. Reg. § 1.863-3(e)(3)(ii)(C)



## Course Summary

### ❖ You are now able to:

- Identify the general sourcing rules applicable to Puerto Rico taxpayers
- Identify modifications to sourcing rules applicable to different types of income with respect to Puerto Rico
- Discuss Puerto Rico specific sourcing rules and exceptions to different sets of facts
- Calculate income from sources within Puerto Rico and income effectively connected with a Puerto Rico trade or business



# Questions?





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