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Tax Procedures / BFR and Non-BFR

Presented by: Withholding, Exchange, and International Individual Compliance (WEIIC)



Front Matter Items

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



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Course Objectives

- ❖ At the end of this course, you will be able to:
 - Describe filing requirements based on residency status
 - Identify adjustments based on residency determination
 - Define general rules for sourcing of income
 - Calculate the allowable portion of itemized and standard deductions



Acronyms

- ❖ BFR – Bona Fide Resident
- ❖ IDR – Information Document Request
- ❖ PR – Puerto Rico
- ❖ US – United States
- ❖ IRC – Internal Revenue Code
- ❖ WW – Worldwide
- ❖ SFR – Substitute For Return
- ❖ NR – Non-Resident
- ❖ TP – Taxpayer



❖ Examination Process

- Pre-Contact Analysis, TP/POA contact
- IDR's and summons issued, documents secured and analyzed, interviews conducted
- Issue Resolution
 - Residency Determination
 - Income Sourcing
- Report Writing
 - TP is a BFR of Puerto Rico
 - TP is not a BFR of Puerto Rico
 - Allowable Portion of Itemized Deductions



Determination, BFR of PR- Filing Requirement

- ❖ Bona fide residents of Puerto Rico generally will pay tax to Puerto Rico on their worldwide income

- ❖ US Citizen or Resident Alien:
 - PR tax return reporting income from worldwide sources
 - US tax return reporting income from worldwide sources (including US source) but excluding PR source income per IRC Section 933

- ❖ Nonresident Alien:
 - PR tax return reporting income from worldwide sources
 - US tax return (Form 1040NR) reporting income from worldwide sources but excluding PR source income



Determination, Not a BFR of PR-Filing Requirement

- ❖ An individual who is not a bona fide resident of Puerto Rico for the tax year would generally file tax returns with both Puerto Rico and the United States

- ❖ US Citizen or Resident Alien:
 - PR tax return reporting only TP's income from PR sources
 - US tax return reporting income from worldwide sources

- ❖ Nonresident Alien:
 - PR tax return reporting only income from PR sources
 - US tax return (Form 1040NR) reporting income from US sources
 - Income Effectively Connected (ECI); Fixed, Determinable, Annual and Periodic (FDAP)



Source of Income

❖ The source of income is important in determining if the income may be excluded under section 933. The table below describes the general rules for determining the source income:

Example Of Source Of Income Rules

Item of Income	Factor Determining Source
Salaries and other compensation	Where the service is performed
Social Security Benefits	*U.S. Source income by definition (IRC Sec. 861)
Pensions:	
Contributions	Where services were performed that earned the pension
Investment earnings	Where pension trust is located
Interest	Residence of the payer
Dividends	Location of payer
Rents	Location of property
Royalties:	
Natural resources	Location of property
Patents, copyrights, etc.	Where the property is used
Sale of real property	Location of property
Sale of personal property	**Seller's tax home (<i>but see Special Rules for Gains From Dispositions of Certain Property for exceptions</i>)



❖ US Citizen or Resident Alien:

- US tax return reporting income from worldwide sources but excluding PR source income per IRC Section 933
 - Adjustment to F1040 or prepare SFR:
 - Omitted income from worldwide sources
 - US source income reported as PR source income

❖ Nonresident Alien:

- US tax return (Form 1040NR) reporting income from worldwide sources but excluding PR source income
 - Adjustment to F1040NR or prepare SFR:
 - Omitted income from worldwide sources (excluding PR source)
 - US source income reported as PR source income



Not a BFR of Puerto Rico- Report Writing

❖ US Citizen or Resident Alien:

- US tax return reporting income from worldwide sources
 - Adjustments to F1040 or prepare SFR:
 - Omitted income from worldwide sources
 - US source income reported as PR source income

❖ Nonresident Alien:

- US tax return (Form 1040NR) according to the rules for a nonresident alien.
 - Adjustment to F1040NR or prepare SFR:
 - US source income reported as PR source income



Report Writing- Itemized and Standard Deductions

- ❖ In general, IRC section 933 allows bona fide residents of PR during entire tax year to exclude PR source income from US tax

- ❖ Deductions or credits cannot be taken on US income tax return on Puerto Rican source income that was excluded
 - Deductions that specifically apply to excluded PR source income are not allowed on the US return

 - Deductions that do not specifically apply to any particular type of income must be allocated between excluded PR source income and income from all other sources to determine deductible amount.



Tax Procedures / Report Writing- Itemized Deductions

- ❖ Deductions that do not specifically apply to a particular income item must be allocated between gross income subject to U.S. tax and total gross income from all other sources.
 - Examples: medical expenses, charitable contributions, real estate taxes and mortgage interest on personal residence

Formula:
$$\frac{\text{gross income subject to Federal tax}}{\text{gross income from all sources}} \times \text{deduction} = \text{allowable portion of deduction}$$

- ❖ Refer to worksheet in Publication 1321



Example- Allocation of Itemized Deductions

- ❖ TPH and TPW are BFR's of Puerto Rico.
- ❖ \$24,000 Puerto Rico source income
- ❖ \$96,000 income from US Government
- ❖ \$42,250 Itemized Deductions
 - \$11,000 Medical Expenses
 - \$10,000 Real Estate Taxes
 - \$16,250 Home Mortgage Interest
 - \$5,000 Charitable Contributions



Example- Allocation of Itemized Deductions (cont'd)

- ❖ Itemized Deductions would be modified as shown below:

Medical Expenses |

$$\frac{\$96,000}{\$120,000} \times \$11,000 = \$8,800$$

Real Estate Taxes

$$\frac{\$96,000}{\$120,000} \times \$10,000 = \$8,000$$

Home Mortgage Interest

$$\frac{\$96,000}{\$120,000} \times \$16,250 = \$13,000$$

Charitable deduction

$$\frac{\$96,000}{\$120,000} \times \$5,000 = \$4,000$$



Pop Quiz -

Allocation of Itemized Deductions

- ❖ TP filed a US income tax return and incorrectly sourced US income as PR source income. Examination adjustment was made to resource this income to the US. Referring to this formula that calculates the allowable portion of each itemized deduction, what other steps should you take?

$$\text{Formula: } \frac{N}{D} \times \text{Deduction} = \text{allowable portion of deduction}$$

- A. Adjust the numerator “N” per exam adjustment.
- B. Adjust the denominator “D” per exam adjustment.
- C. Recall something about itemized deductions being mentioned during C685 training, and then phone a friend who also attended



Answer -

Allocation of Itemized Deductions

❖ TP filed a US income tax return and incorrectly sourced US income as PR source income. Examination adjustment was made to resource this income to the US. Referring to this formula that calculates the allowable portion of each itemized deduction, what other steps should you take?

A. Adjust the numerator “N”, increasing gross income subject to Federal tax

$$\text{Formula: } \frac{\text{gross income subject to Federal tax}}{\text{gross income from all sources}} \times \text{deduction} = \text{allowable portion of deduction}$$



- ❖ If TP did not itemize, the standard deduction must be allocated by the ratio that gross income subject to Federal tax bears to gross income from all sources
- ❖ The standard deduction must be allocated by the ratio that gross income subject to US tax bears to gross income from all sources
- ❖ Refer to worksheet in Publication 1321



Tax Procedures / Report Writing- Allocation of Standard Deduction

- ❖ If TP did not itemize, or a SFR is being prepared, the standard deduction must be allocated by the ratio that gross income subject to US tax bears to gross income from all sources

Formula:
$$\frac{\text{Gross income subject to US tax}}{\text{Total gross income from all sources}} \times \text{Standard Deduction} = \text{allowable portion of deduction}$$

(including exempt PR income)

- ❖ Refer to worksheet in Publication 1321



Pop Quiz - Allocation of Standard Deduction

- ❖ TP is single and did not file a US Income Tax return. You determined that TP was not a BFR of PR, had US source income, a US filing requirement and are preparing an SFR. Standard deduction is \$12,200. Gross income subject to US tax totaled \$200,000 and total gross income from all sources is \$400,000.

How much is the allowable portion of standard deduction?

- A. \$12,200
- B. \$6,100
- C. \$24,400



Answer- Allocation of Standard Deduction

- ❖ TP is single and did not file a US Income Tax return. You determined that TP was not a BFR of PR, had US source income, a US filing requirement and are preparing an SFR. Standard deduction is \$12,200. Gross income subject to US tax totaled \$200,000 and total gross income from all sources is \$400,000.

How much is the allowable portion of standard deduction?

B. \$6,100



Course Summary

- ❖ You are now able to:
 - Describe TP filing requirements based on residency status
 - Identify exam adjustments based on residency determination per exam
 - Define general rules for sourcing of income
 - Calculate the allowable portion of itemized and standard deductions



Questions?

