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Article

Boricua at Heart: Guidance on Establishing a Closer Connection to Puerto Rico

By Mark Leeds[1]

Many United States individuals have fallen victim to the tropical allure of Puerto Rico. And as savvy taxpayers know, the allure has as much to do with the interaction of favorable Puerto Rico and United States tax rules as it does with warm ocean breezes and beautiful beaches. Specifically, if a US individual qualifies as a *bona fide* resident of Puerto Rico, Puerto Rico-source income earned by such individual can be exempt from both Puerto Rico tax and United States federal income tax. This favorable combination has persuaded many US individuals to consider relocating to the colonial beauty of old San Juan.

In general, a United States individual must satisfy three tests in a taxable year in order to be treated as a *bona fide* resident of Puerto Rico: (i) the presence test, (ii) the tax home test and (iii) the closer connection test.[2] On August 22, 2017, the United States Tax Court released its memorandum opinion in *Acone v. Commissioner*.[3] The *Acone* case addressed whether an airline pilot had a "closer connection" to South Korea than the United States for purposes of the earned income exclusion of Section 911 of the Internal Revenue Code of 1986, as amended (the "Code"). The closer connection test of Code § 911 operates in much the same manner as the closer connection test for *bona fide* residents of Puerto Rico. Accordingly, this new decision provides guidance on how the closer connection test applicable to *bona fide* residents of Puerto Rico will be interpreted by the courts and the Internal Revenue Service (the "IRS").

A Brief Overview of the Taxation of *Bona Fide* Residents of Puerto Rico

Since its passage in January 2012, Puerto Rico Act No. 22 of 2012 ("Act No. 22") has provided numerous incentives to encourage individuals to relocate to Puerto Rico. The law provides the following benefits to new Puerto Rico *bona fide* residents on qualified investments (more on who qualifies as a new *bona fide* resident below): (i) 100-percent tax exemption from Puerto Rico income taxes on all dividends; (ii) 100-percent tax exemption from Puerto Rico income taxes on all interest; and (iii) 100-percent tax exemption from Puerto Rico income taxes on all long-term capital gains accrued after the individual becomes a *bona fide* resident of Puerto Rico.

The Puerto Rico Act 22 rules are complemented by a set of United States federal income tax rules that exempt Puerto Rico-source income earned by an "individual who is a *bona fide* resident" of Puerto Rico from US federal income tax.[4] Thus, there are two levels of inquiries for US individuals who relocate to Puerto Rico. First, is the individual a *bona fide* resident of Puerto Rico? If so, what items of income can be treated as Puerto Rico-source income and thereby be

excluded from US gross income? This article only considers issues related to the first inquiry.

An individual is considered to be a *bona fide* resident of Puerto Rico if three tests are met. The individual must be present for at least 183 days during the taxable year in Puerto Rico or satisfy one of the other four presence tests (the "presence test").[5] Second, the individual must not have a tax home outside of Puerto Rico during the taxable year.[6] Third, the individual must not have a "closer connection" to the United States or a foreign country than to Puerto Rico during the taxable year.[7] Special rules are provided for the year of the move from the United States to Puerto Rico and *vice versa*.

The Closer Connection Test

The closer connection test is a facts and circumstance test. In many ways, the absence of bright lines can make it difficult to be sure that an individual will be considered to satisfy this test in a given year. Broadly, an individual is considered to have a closer connection to Puerto Rico than the United States if he or she maintains more significant contacts with Puerto Rico than the United States.[8] Nine non-exclusive factors are listed as relevant to the determination as to whether an individual maintains a closer connection to Puerto Rico than elsewhere:[9]

1. The location of the individual's permanent home (determined in the same manner as under the presence test[10]);
2. The location of the individual's family;
3. The location of personal belongings, such as automobiles, furniture, clothing and jewelry owned by the individual and his or her family;[11]
4. The location of social, political, cultural or religious organizations with which the individual has a current relationship;
5. The location where the individual conducts his or her routine personal banking activities;
6. The location where the individual conducts business activities (other than those that constitute the individual's tax home);
7. The location of the jurisdiction in which the individual holds a driver's license;
8. The location of the jurisdiction in which the individual votes; and
9. The country of residence designated by the individual on forms and documents.

In addition, an individual must be considered to possess a closer connection to Puerto Rico than to the United States or a foreign country for the entire taxable year.

A regulatory example illustrates the application of the closer connection test to an investment manager.[12] In the example, a fund manager with two teenage children in high school relocates to Puerto Rico, but his wife and children remain in the United States to enable the children to complete high school there.[13] The manager regularly travels back to the United States to visit his wife and children, conduct business and take vacations. While he rents an apartment in Puerto Rico, he co-owns a home in the United States with his wife where she and their children live. The manager joins the Puerto Rico Chamber of Commerce, but has current social, political, cultural and religious affiliations in the United States, receives personal correspondence in the United States, including brokerage and bank statements. He also has substantial personal effects at the US residence, remains registered to vote in the United States and holds a US driver's license. On these facts, the example concludes that the fund manager has a closer connection to the United States.

The *Acone* Case

In *Acone*, the taxpayer was an airline pilot who worked for Korean Air Lines ("KAL") from late 2006 until the end of 2013, at which point he retired. KAL stationed the pilot in Seoul, South Korea. KAL owned a hotel in Seoul and, when the pilot was in Seoul, he was entitled to, and did, use the hotel without charge. No special room was maintained for the pilot; when he was in Seoul, he checked into the hotel as a complimentary guest. KAL paid South Korean taxes on behalf of the pilot (at a 4-percent rate), but declared him a non-resident of South Korea.

Not surprisingly, during the pilot's seven-year term working at KAL, he developed an ordinary social life in South Korea. He regularly played golf and tennis in Seoul. He regularly dined out with both American expats and Korean pilots. He became a regular customer at a bar called the "Jet-Lagged Lizard" and took Korean language and culture lessons. Although it was not entirely clear from the documentation before the court, it appeared that the pilot qualified as a South Korean resident.

The taxpayer was married before taking the job at KAL to a spouse with whom he resided in New Hampshire. The couple jointly owned a home in New Hampshire throughout his entire time in South Korea. The wife was a New Hampshire schoolteacher and retained this position during the years that the pilot worked at KAL. The couple had adult children, one of whom lived in Korea (but the taxpayer did not visit with this child in South Korea). The pilot spent 80 percent of his days off in the United States. He mowed the lawn at the New Hampshire house when he could. This last fact was recited no less than twice by the court.

The pilot retained his US driver's license and did not apply for a South Korean driver's license. The couple owned two cars, both of which were located in New Hampshire. The pilot was registered to vote in New Hampshire, but not in South Korea. He also retained his church membership in New Hampshire. The pilot spent substantial periods of time in both New Hampshire and South Korea.

The pilot claimed the earned income exclusion provided by Code § 911 for 2011 and 2012, which shielded his earned income from US federal income tax. The earned income exclusion is available only to a "qualified individual." A qualified individual is a person who is a "*bona fide* resident of a foreign country."[14] The court listed eleven factors to be considered in determining whether the pilot had taken up a *bona fide* residence in South Korea:

1. the intention of the taxpayer;
2. the establishment of his home temporarily in the foreign country for an indefinite period;
3. participation in the activities of his chosen community on social and cultural levels, identification with the daily lives of the people and, in general, assimilation into the foreign environment;
4. physical presence in the foreign country consistent with his employment;
5. the nature, extent and reasons for temporary absences from his temporary foreign home;
6. the assumption of economic burdens and payment of taxes to the foreign country;
7. the status of resident contrasted to that of transient or sojourner;
8. the treatment accorded his income tax status by his employer;
9. marital status and residence of his family;
10. nature and duration of his employment; whether his assignment abroad could be promptly accomplished within a definite or specified time; and
11. good faith in making his trip abroad; whether for purpose of tax evasion.[15]

The court separately evaluated each factor. The court stated that while intent is an extremely important factor, there must be objective indication of that intent. In this case, the court found that the taxpayer did not intend "to be anything more than a transient in South Korea," in spite of his oral expression of intent that he was a South Korean resident during the years at issue. The court found that living in various hotel rooms supported the conclusion that the pilot never intended to establish a home in South Korea. On the other hand, the facts that the pilot developed friends in South Korea and attempted to learn the Korean language made the third factor "moderately favorable" to the taxpayer. The court concluded that the taxpayer was in South Korea only when his employment required him to be there. Since the pilot did not use the job as a mechanism to be in South Korea (but was only there as required), the fourth factor weighed against the conclusion that he was a *bona fide* resident of South Korea. In a related vein, the fifth factor weighed against the conclusion that the pilot was a *bona fide* resident because his absences from South Korea were for the purpose of staying with his wife in New Hampshire, that is, his "important personal connections" were not in South Korea.

The court did not view the filing of South Korean tax returns and the payment of the 4-percent tax as indicative of having assumed the economic burden and taxes of a South Korean resident because the tax was a minimal burden and the taxpayer's other expenses—lodging, meals, etc.—were paid for by KAL. The fact that the documentation submitted by the pilot did not conclusively establish that he was a resident of South Korea led the court to conclude that he was a transient and not a resident. Similarly, the fact that KAL treated the pilot as a non-resident of South Korea weighed in favor of not treating him as a *bona fide* resident of South Korea. Although the taxpayer did have a child residing in South Korea, the fact that they did not meet in that country, coupled with the fact that his other family resided in the United States, led the court to conclude that marriage and family weighed in favor of not treating him as a *bona fide* resident of South Korea. On a positive note, the nature and duration of the pilot's employment in South Korea weighed in favor of treating him as a *bona fide* resident of South Korea because it was open-ended, full-time and lasted for years. The court found that the pilot had no tax evasion motive in relocating to South Korea, so this factor also weighed in favor of treating him as a *bona fide* resident of South Korea.

The court then weighed the three factors which supported the conclusion that the taxpayer was a *bona fide* resident of South Korea against the five which, in its view, supported the opposite conclusion. The court found that, on balance, the strength of the factors that weighed against treating the pilot as a *bona fide* resident of South Korea were insufficient to overcome the strong proof standard needed to rebut the IRS's conclusion that the taxpayer could not claim the benefits of Code § 911.

Prior Decisions on the Earned Income Exclusion

It is worth considering the contrasts between the facts and result in *Acone*, *supra*, with the contrary conclusion reached by the Tax Court in *Cobb v. Commissioner*,[16] which also involved an airline pilot. Some of the facts are remarkably similar. Specifically, this pilot was employed by Japan Air Lines ("JAL") and was stationed in Tokyo, Japan. He lived in a JAL-owned hotel when in Tokyo and was assigned a different room for each night of his stay (he paid a discounted rate for the room). He did not become integrated into Japanese society, but played golf and tennis in Japan and frequently dined out with friends. His wife and family resided in the United States during the time the taxpayer worked in Japan. He owned a home in California, to which his bank statements and other account statements were mailed. He filed

both US and Japanese tax returns. He held a US driver's license and his doctors were located in the United States.

Certain facts were more favorable to a finding that the taxpayer was a *bona fide* resident of Japan during the years at issue. First, the terms of his transfer stated that it was for an indefinite period. Second, he only made limited visits to his family and only when he was flying through California. Third, he held a 48-month visa. The terms of his transfer made clear that commuting was not permitted by JAL.

The court began by setting forth the *Sochurek* factors discussed above. The court acknowledged the factors weighing in favor of not treating the taxpayer as a *bona fide* resident of Japan. It believed, however, that these negative factors were outweighed by the contemporaneous documentation that the transfer was permanent. The court found that the documentation was evidence of the pilot's intent to move his permanent residence to Japan. In addition, since the pilot's visits with his family were infrequent, the court held that the family's home in California did not constitute a permanent place of abode for the taxpayer during the years at issue.[17]

Lessons for Individuals Seeking to Become *Bona Fide* Residents of Puerto Rico

While the test for *bona fide* non-US residence under the earned income exclusion and the rules for *bona fide* residents of Puerto Rico are not identical, valuable lessons can be gleaned from the decisions involving Code § 911 in interpreting the US rules applicable to Puerto Rico residents. First, it is imperative that the taxpayer provide objective evidence of his intent to move his life to Puerto Rico. Actions supporting this intent would include changing churches, mailing address for financial statements, obtaining a Puerto Rico driver's license and listing US residences for sale. While the taxpayers in *Acone* and *Cobb*, *supra*, kept their US homes, as these taxpayers were seconded to a non-US address, they would be able to return to the United States without jeopardizing their ability to claim the earned income credit. In contrast, taxpayers seeking to establish that they are *bona fide* residents of Puerto Rico should show an intent to make a permanent move. This would include moving family members to Puerto Rico.

The decisions also point to the importance of putting down ties, such as learning Spanish, joining Puerto Rico social institutions and becoming a member of local society. In short, individuals seeking to become *bona fide* residents of Puerto Rico should assimilate into Puerto Rican culture. The court in *Acone*, *supra*, also focused on the number of visits made to the United States after the move to South Korea was established. Taxpayers seeking to become *bona fide* residents of Puerto Rico should limit their trips back to the United States so as not to create an impression that the move to Puerto Rico was made predominantly to obtain tax benefits or that they are transients. Of course, an individual seeking to become a *bona fide* resident of Puerto Rico must do much more than satisfy the closer connection test in order to make the move work taxwise. But as the *Acone* decision makes clear, if the closer connection test is not met, the move will not accomplish important tax objectives.

For more information about this topic, please contact any of the following lawyers.

Mark H. Leeds
+1 212 506 2499
mleeds@mayerbrown.com

Endnotes

1 Mark Leeds is a tax partner in the New York office of Mayer Brown. Mark regularly works on the United States tax issues faced by businesses and individuals relocating to Puerto Rico

from the United States. Mark will be speaking on issues affecting US persons relocating to Puerto Rico at the 2017 Puerto Rico Investment Summit in San Juan on October 9-10, 2017.

2 For a fulsome discussion of all three tests and the other rules affecting bona fide residents of Puerto Rico, please see our prior Legal Update available at https://www.mayerbrown.com/files/Publication/6fb13bce-6b5f-4553-b715-622fe9aa5905/Presentation/PublicationAttachment/49782a2d-5953-480f-9225-fe4590279af9/Update_US-PR%20Tax_Incentives.pdf

3 T.C. Mem. 2017-162.

4 See Code § 933(1) (rules for individuals who are bona fide residents of Puerto Rico for an entire taxable year).

5 Code § 937(a)(1).

6 Code § 937(a)(2).

7 *Id.*

8 *See* Treas. Reg. § 1.937-1(e)(1), incorporating the rules contained in Treas. Reg. § 301.7701(b)-2(d).

9 Treas. Reg. § 301.7701(b)-2(d)(1). This list contains 10 factors, but the tenth factor is not relevant vis-à-vis the relationship between the United States and Puerto Rico.

10 Treas. Reg. § 301.7701(b)-2(d)(2). It is worth noting that occasional use of United States business facilities should not cause an individual to have a closer connection to the United States. See NYS Audit Guidelines, p. 36.

11 Special attention should be paid to specific items of value, such as jewelry, a rare book, art or an antique collection. NYS Audit Guidelines, p. 29. In addition, insurance policies should be amended to state that these items have been moved to Puerto Rico. See Matter of James & Helen Dittrich, DTA No. 811479.

12 Treas. Reg. § 1.937-1(g)(Ex.7).

13 The fact that the children remain in the United States in boarding school should not be indicative of a closer connection to the United States. NYS Audit Guidelines, p. 32.

14 Code § 911(d)(1)(A).

15 These factors are sometimes referred to as the Sochurek factors after the decision in Sochurek v. Comm'r, 300 F.2d 34 (7th Cir. 1962), *rev'g and remanding* 36 T.C. 131 (1961).

16 T.C. Mem. 1991-376.

17 We note that on similar facts, but in the absence of documentation stating that the transfer was permanent, the Tax Court had held that another JAL pilot was not a bona fide resident of Japan. The US Court of Appeals for the Fifth Circuit, however, held that the taxpayer was entitled to the earned income exclusion. *Jones v. Comm'r*, T.C. Mem. 1989-616, *rev'd and remanded* 927 F.2d 84 (5th Cir. 1991).