

## *The Rum Diary* Addendum: The IRS Initiates Large-Scale Audit Campaign of Puerto Rico Act 22 Grantees

By Mark Leeds and Juan Lopez Valek<sup>1</sup>

We have long been great admirers of the writings of Hunter Thompson, an author who shared our affinity for all things *Boricua*, that is, the lifestyle that reflects the warmth and grace of Puerto Rico. As we have described in detail, the virtues of Puerto Rico extend beyond white sandy beaches and tropical breezes to one of the most advantageous tax regimes for US individuals that aspiring entrepreneurs could hope to find.<sup>2</sup> Thompson's *The Rum Diary* tells a tangled love story involving jealousy, treachery and violent alcoholic lust among Americans who staff a local Puerto Rico newspaper. In other words, it's the story of what can go wrong when a bucolic Caribbean island is overrun by Americans.

Well, Americans who have decamped the States for Puerto Rico should brace themselves for a storm with more power than Hunter himself could have imagined. The US Internal Revenue Service (the "IRS") has just added US individuals who are claiming the advantages of Puerto Rico Act 22 to its Large Business and International Compliance Campaign.<sup>3</sup>

### I. Congressional Interest in Puerto Rico Act 22 Beneficiaries

In December 2019, the Consolidated Appropriations Act (the "CAA"), HR 1158 (2019), was passed by Congress and signed into law. The House Report accompanying the CAA, House Rep. No. 116-122, directed the IRS "to submit a report that provides the number of individuals and businesses that have relocated from each state and the District of Columbia to Puerto Rico since 2012 and have been granted tax exemptions under Puerto Rico Acts 20 and 22" (the "IRS Report"). Congress also directed the IRS to provide specific policy solutions to minimize revenue losses from tax avoidance and evasion. The impetus for the request for the IRS Report arose from a letter to the then-Treasury secretary from four congresspersons<sup>4</sup> who expressed concerns about the generosity of the US federal income tax benefits offered by Sections 933 and 937 of the US Internal Revenue Code of 1986, as amended (the "Code"), to US individuals who became bona fide residents of Puerto Rico.<sup>5</sup> Specifically, the congresspersons were concerned that Puerto Rico's Acts 20 and 22, when combined with US tax incentives for Puerto Rico-source income, enabled wealthy individuals and businesses to avoid both US and Puerto Rico taxes.

### II. The IRS Report

Many individuals and businesses that have moved to Puerto Rico were concerned the IRS Report would present a damning picture of the use of US federal income tax incentives for persons who had migrated their lives and operations to Puerto Rico. The IRS Report, however, provided a balanced picture of the interaction of the US and Puerto Rico tax benefits.<sup>6</sup> Specifically, the IRS Report found:

In certain situations, the operation of Puerto Rico law (in particular Act 22) in conjunction with the [Code] § 933 exclusion may have the result that Puerto Rico-source income, such as interest, dividends and capital gains, could be wholly or partially exempt from both U.S. and Puerto Rico income tax. Such a result is not inconsistent with Congress's long-standing recognition of Puerto Rico's autonomy in matters of internal governance, including territorial tax law and policy.

The IRS Report ends with a commitment by the IRS to expand information sharing with Hacienda (the Puerto Rico revenue service) to ensure that all new applicants for Puerto Rico Act 22 benefits are identified to the IRS. In short, the IRS Report did not presage any significant challenges to enforcement of the existing tax rules.

### III. Allegations of Abuse, Greed and Lust (Well, Abuse and Greed, Anyway)

In October 2020, the Justice Department announced that a prominent certified public accountant ("CPA") had been indicted by a grand jury for wire fraud in connection with an alleged scheme to defraud the IRS "via the provisions of Act 20."<sup>7</sup> The Justice Department accused the CPA of having formed a Puerto Rico company for an undercover IRS agent posing as a wealthy taxpayer from Arizona. The following year, the CPA is alleged to have "caused to be prepared and filed" with Puerto Rico's Office of Industrial Development a fraudulent tax exemption application and fraudulently obtained Act 20 tax exemption status for the company. The Justice Department further alleged that the CPA decided that the company would fraudulently report \$500,000 in business earned income in Puerto Rico and filed a Puerto Rico corporate tax return for [the] company with the Puerto Rico Department of Treasury. The indictment was widely covered in the tax press.<sup>8</sup>

The coverage of the CPA indictment brought to light a number of civil litigation cases that highlighted other potential instances of aggressive Puerto Rico tax planning. In the context of a case involving an alleged theft of trade secrets, one of the parties asserted that a company was inappropriately passporting its Puerto Rico presence and local tax exemption to mainland businesses. The buzz around this and other cases elicited some damning comments regarding the US tax benefits offered to bona fide residents of Puerto Rico from unnamed congressional staffers.<sup>9</sup> Initial talk about potential changes to the existing statutory scheme began to circulate.

### IV. The IRS Announces That It Will Take Action

On January 31, 2017, the IRS Large Business and International (LB&I) division announced the identification and selection of its initial audit "campaigns." The launch of campaigns was the culmination of an extensive effort to redefine IRS compliance work and build a supportive infrastructure. The campaign program allows LB&I to address significant compliance and resource challenges. Campaign development coordinates strategic IRS planning and deployment of resources, training and tools, metrics and feedback. The IRS has been adding campaigns to the list since such time.

On January 29, 2021, the IRS added "Puerto Rico Act 22, Individual Investors Act," to its audit campaign. The audit campaign has three areas of focus:

1. The campaign will seek to identify individuals who have Act 22 decrees but do not satisfy the requirements of Code § 937 in order to exclude income or be treated as bona fide residents of Puerto Rico.

2. The campaign will also seek to determine if individuals claiming the benefits of Code § 933 and meeting the requirements of Code § 937 are inappropriately claiming non-Puerto Rico-source income as Puerto Rico-source income in order to avoid US tax.
3. The campaign will address non-compliance through examinations, outreach and soft letters.

At the current time, there is no word if an amnesty program will be offered to individuals and businesses that desire to change their reporting of tax benefits stemming from the interaction of US and Puerto Rico tax benefits. Presumably, the IRS will consider such a program once it determines the magnitude of noncompliance issues.

## V. Takeaways from These Developments

The risk of audits for individuals and businesses that claim advantage of Code § 933 for Puerto Rico-source income and avoid US-source tax on Puerto Rico-source business income respectively, appears to be growing in a significant way. The authors of the 2019 letter to Treasury are Democratic congresspeople and may have an influence on how the US tax benefits apply on a go-forward basis now that the White House and Congress are Democratically controlled. US individuals living, and US-owned businesses operating, in Puerto Rico now should undertake a check-up of their compliance responsibilities and operations to ensure that they do not end up on the wrong side of an IRS compliance audit.

---

*For more information about the topics raised in this Legal Update, please contact either of the following lawyers.*

**AUTHORS:**

**Mark H. Leeds**

Partner

[mleeds@mayerbrown.com](mailto:mleeds@mayerbrown.com)

+1 212 506 2499

**Juan F. Lopez Valek**

Associate

[jlopezvalek@mayerbrown.com](mailto:jlopezvalek@mayerbrown.com)

+1 212 506 2471

---

## Endnotes

- <sup>1</sup> Mark Leeds ([mleeds@mayerbrown.com](mailto:mleeds@mayerbrown.com); (212) 506-2499) and Juan Lopez Valek ([jlopezvalek@mayerbrown.com](mailto:jlopezvalek@mayerbrown.com)) are tax lawyers with the New York office of Mayer Brown. Mark and Juan regularly work with US companies and individuals who relocate to Puerto Rico.
- <sup>2</sup> For our articles of the federal income tax benefits for US persons relocating to Puerto Rico, please see <https://www.mayerbrown.com/en/perspectives-events/publications/2017/09/boricua-at-heart-guidance-on-establishing-a-closer> and <https://www.mayerbrown.com/en/perspectives-events/publications/2013/04/everyone-there-will-have-moved-here-bran-overview>
- <sup>3</sup> See Internal Revenue Service, Large Business and International Active Campaigns (Jan. 29, 2021).
- <sup>4</sup> The letter was signed by José E. Serrano, Nydia M. Velázquez, Raúl M. Grijalva and Alexandria Ocasio-Cortez.
- <sup>5</sup> See [https://s3.amazonaws.com/pdfs.taxnotes.com/2019/2019-48150\\_TNTIRSDocs\\_Puerto-Rico---Letter-to-Mnuchin.pdf](https://s3.amazonaws.com/pdfs.taxnotes.com/2019/2019-48150_TNTIRSDocs_Puerto-Rico---Letter-to-Mnuchin.pdf)
- <sup>6</sup> See IRS, *Report to Congress Pursuant to Pub. L. 116-93 Regarding Interaction of Certain Puerto Rico and U.S. Tax Laws* (Nov. 2020) (Tax Notes 2020-43051).
- <sup>7</sup> Department of Justice, United States Attorney's Office District of Puerto Rico, *Puerto Rico CPA Indicted and Arrested On Wire Fraud Charges In Relation To Act 20 And Act 22 Scheme* (Oct. 21, 2020).
- <sup>8</sup> See Hoke, *IRS Report on Puerto Rican Tax Shelters May Not Tell Full Story* (Tax Notes Nov. 3, 2020); Doc. No. 2020-42853.
- <sup>9</sup> *Id.*

---

Mayer Brown is a distinctively global law firm, uniquely positioned to advise the world's leading companies and financial institutions on their most complex deals and disputes. With extensive reach across four continents, we are the only integrated law firm in the world with approximately 200 lawyers in each of the world's three largest financial centers—New York, London and Hong Kong—the backbone of the global economy. We have deep experience in high-stakes litigation and complex transactions across industry sectors, including our signature strength, the global financial services industry. Our diverse teams of lawyers are recognized by our clients as strategic partners with deep commercial instincts and a commitment to creatively anticipating their needs and delivering excellence in everything we do. Our “one-firm” culture—seamless and integrated across all practices and regions—ensures that our clients receive the best of our knowledge and experience.

Please visit [mayerbrown.com](http://mayerbrown.com) for comprehensive contact information for all Mayer Brown offices.

Any tax advice expressed above by Mayer Brown LLP was not intended or written to be used, and cannot be used, by any taxpayer to avoid U.S. federal tax penalties. If such advice was written or used to support the promotion or marketing of the matter addressed above, then each offeree should seek advice from an independent tax advisor.

This Mayer Brown publication provides information and comments on legal issues and developments of interest to our clients and friends. The foregoing is not a comprehensive treatment of the subject matter covered and is not intended to provide legal advice. Readers should seek legal advice before taking any action with respect to the matters discussed herein.

Mayer Brown is a global services provider comprising associated legal practices that are separate entities, including Mayer Brown LLP (Illinois, USA), Mayer Brown International LLP (England), Mayer Brown (a Hong Kong partnership) and Tauil & Chequer Advogados (a Brazilian law partnership) (collectively the “Mayer Brown Practices”) and non-legal service providers, which provide consultancy services (the “Mayer Brown Consultancies”). The Mayer Brown Practices and Mayer Brown Consultancies are established in various jurisdictions and may be a legal person or a partnership. Details of the individual Mayer Brown Practices and Mayer Brown Consultancies can be found in the Legal Notices section of our website.

“Mayer Brown” and the Mayer Brown logo are the trademarks of Mayer Brown.

© 2021 Mayer Brown. All rights reserved.