

Special Instructions For Bona Fide Residents Of Puerto Rico Who Must File A U.S. Individual Income Tax Return (Form 1040 or 1040A)

If you are a bona fide resident of Puerto Rico who will file a U.S. Federal Income Tax Return, Form 1040, and claim an exclusion for income earned in Puerto Rico, you will have to make certain adjustments on your return. These special instructions explain the adjustments, and how to make them on your return.

Caution: The rules for determining if an individual qualifies as a bona fide resident of Puerto Rico and other U.S. possessions for U.S. income tax purposes were changed by the American Jobs Creation Act of 2004. For additional information, see Publication 570, Tax Guide for Individuals with Income from U.S. Possessions, and IRS Form 8898, Statement for Individuals who Begin or End Bona Fide Residency in a U.S. Possession.

Who Must File

In general, section 933 of the U.S. Internal Revenue Code requires that U.S. citizens who are bona fide residents of Puerto Rico during the entire taxable year, but who receive income from sources outside Puerto Rico and/or receive income as a civilian or military employee of the U.S. Government in Puerto Rico, must file a U.S. Federal income tax return. The income you receive from Puerto Rican sources is not subject to U.S. income tax. Because some of the income is exempt (under Code section 933) a part of the itemized deductions or a part of the standard deduction amount on your U.S. return must be allocated to that exempt income. This computation must be made before you can determine if you must file a U.S. tax return, because the minimum income level at which you must file a return is based, in part, on the standard deduction for your particular filing status. Use the following worksheet to determine if you have to file a U.S. income tax return:

Who Must File Worksheet for Bona Fide Residents of P.R. with exempt income (under Section 933)

1. Enter STANDARD DEDUCTION

If your filing status is _____

Single	under 65 enter \$5,000	_____
	65 or older enter \$6,250	_____
Married filing jointly	both under 65 enter \$10,000	_____
	one 65 or older enter \$11,000	_____
	both 65 or older enter \$12,000	_____
Head of household	under 65 enter \$7,300	_____
	65 or older enter \$8,550	_____
Qualifying widow(er) with dependent child	under 65 enter \$10,000	_____
	65 or older enter \$11,000	_____

CAUTION: If someone can claim you as a dependent, enter amount from the Standard Deduction Worksheet for Dependents in the instructions for Form 1040 or Form 1040A, as applicable.

2. Allowable portion of STANDARD DEDUCTION

- a. Gross income subject to U.S. tax (include taxable social security benefits)..... _____
- b. Total gross income from all sources (including exempt P.R. Income)..... _____
- c. Divide line 2a by line 2b
- d. Multiply STANDARD DEDUCTION (line 1) by line 2c

3. Enter:

married filing jointly \$6,400

if someone can claim you as a dependent enter "0"

all others enter \$3,200

4. Add lines 2d and 3

You must file a return if your gross income subject to U.S. tax (line 2a) is equal to or more than line 4. If you are married filing a separate return, you must file a return if your gross income subject to U.S. tax is equal to or more than \$3,200.



Department of the Treasury
Internal Revenue Service

www.irs.gov

Source Of Income

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

Example Of Source Of Income Rules

Item of Income	Factor Determining Source
Salaries and other compensation	Where the service is performed
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 stock or other nondepreciable personal property	Residence of the seller.

Caution: The American Jobs Creation Act of 2004 added section 937(b) to the U.S. Internal Revenue Code. Code section 937(b) clarifies and provides source rules for U.S. possessions, including Puerto Rico. The new temporary and proposed regulations §1.937-2T add further detail and some special sourcing rules specific to the U.S. possessions. Generally, the regulations provide that the rules for determining whether income is from sources within U.S., which are summarized in the table above, apply for purposes of determining whether income is from sources within U.S. possessions. However, there are several important exceptions, including:

- Section 937(b)(2) (the US income rule) and the regulations provide that an item of income shall not be considered to be derived from sources within a possession (or effectively connected income (EIC) of a trade or business within a possession) if such item of income constitutes income from sources within the U.S. or as EIC of a U.S. trade or business under the general rules of IRC sections 861 through 865.
- The regulations provide that a gain from a disposition of certain property by a U.S. citizen or resident who becomes a bona fide resident of a possession and owned the property on the date they became a bona fide resident may NOT be treated as from sources within a possession. This special gain rule (SGR) applies to disposition of certain personal property like stocks, bonds, debt instruments, and other investment property like diamonds or gold, which is held for investment, and that is sold within 10 years of the date that the individual became a bona fide resident of the possession. Because these gains are treated for U.S. income tax purposes as from sources not within Puerto Rico, this income may not be excluded under IRC §933. However, individuals generally may claim a foreign tax credit for income tax paid to Puerto Rico on such gain.
- The regulations provide an exception to the U.S. income rule that preserves the existing treatment of income from the sale of goods manufactured in a possession and allocates income from such sales between U.S. and possessions sources under regulations §1.863-3(f).
- The regulations also provide special rules relating to the use of conduit arrangements and for dividends and interest from corporations created or organized in a possession that is paid to shareholders that own, directly or indirectly, 10 percent or more of the possessions corporation.

The U. S. income rule is effective for income earned after December 31, 2004. The SGR applies to sales of appreciated property after April 11, 2005. And, the other exceptions generally apply to income earned, or amounts paid or accrued, after April 11, 2005.

Deductions

It is important to remember that deductions which apply to your exempt Puerto Rican income are not deductible on your Federal income tax return. For example, if you incurred employee business expenses of \$1,250 on wages of \$18,500 that are exempt from tax on your Federal return, the employee business expenses are not deductible on the Federal return.

Deductions for personal exemptions are allowed in full and need not be allocated.

Deductions that do not specifically apply to a particular income item must be allocated between your gross income subject to U.S. tax and your total gross income from all other sources. Examples of deductions that do not definitely apply to a particular type of income are alimony payments and certain itemized deductions (such as medical expenses, charitable contributions, and real estate taxes and mortgage interest on your personal residence). To find the part of the deduction that is allowable, you must apportion those items that do not apply to any specific type of income based on the ratio that your gross income subject to Federal tax bears to gross income from all sources.

EXAMPLE: You and your spouse, both under 65, are U.S. citizens and bona fide residents of Puerto Rico for the entire year. You file a joint return. During 2005 you earned \$15,000 from Puerto Rican sources and your spouse earned \$25,000 from the U.S. Government. You have \$16,000 of itemized deductions that do not apply to any specific type of income. These are medical expenses (doctor's fees) \$4,000, real estate taxes \$5,000, home mortgage interest from a financial institution of \$6,000, and charitable deductions of \$1,000 (cash contributions).

You apportion deductions for your Federal tax return as follows: multiply the deduction to be allocated by a fraction. The numerator of the fraction is your gross income subject to Federal tax and the denominator is your total gross income from all sources (including exempt Puerto Rican income).

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

SCHEDULE A—Itemized Deductions should be modified as shown in the sample below:

- Medical Expenses** (doctor’s fees)
 $\frac{\$25,000}{\$40,000} \times \$4,000 = \$2,500$ (Enter on line 1 of Schedule A.)
- Real Estate Taxes**
 $\frac{\$25,000}{\$40,000} \times \$5,000 = \$3,125$ (Enter on line 6 of Schedule A.)
- Home Mortgage Interest Paid to Financial Institutions**
 $\frac{\$25,000}{\$40,000} \times \$6,000 = \$3,750$ (Enter on line 10 of Schedule A.)
- Charitable deduction** (cash contributions)
 $\frac{\$25,000}{\$40,000} \times \$1,000 = \625 (Enter on line 15 of Schedule A.)

NOTE: Enter on Schedule A only the allowable portion of each deduction. Deductions directly allocable to the income subject to Federal tax (such as employee business expenses and other miscellaneous deductions) need not be allocated.

Taxpayers Who Do Not Itemize Deductions

Standard Deduction

The standard deduction and the additional standard deduction for taxpayers who are blind or age 65 or over are deductions that do not apply to any particular type of income. If you do not itemize, they must be apportioned by the ratio that gross income subject to Federal tax bears to gross income from all sources. This adjustment must be made before you enter your standard deduction on line 40 of Form 1040 or line 24 of Form 1040A.

Use the following worksheet to apportion the standard deduction.

Worksheet For Puerto Rico Filers With Exempt Income Under Section 933 Who Do Not Itemize Deductions

1. Enter STANDARD DEDUCTION: If you checked Form 1040, Filing Status box

1, enter \$5,000	}	
2 or 5, enter \$10,000		
3, enter \$5,000		
4, enter \$7,300		

CAUTION: If you are 65 or over and/or blind, enter amount from chart in the instructions for Form 1040 or Form 1040A, as applicable;
or
 If someone can claim you as a dependent, enter amount from the Standard Deduction Worksheet for Dependents in the instructions for Form 1040 or Form 1040A, as applicable.

2. Allowable portion of STANDARD DEDUCTION:

- a. Gross income subject to U.S. tax
- b. Total gross income from all sources (including exempt P.R. income)
- c. Divide line 2a by line 2b
- d. Multiply Standard Deduction (line 1) by line 2c and enter this amount on Form 1040, line 40 or Form 1040A, line 24 (allowable portion of STANDARD DEDUCTION)

Write the following above line 40, Form 1040 or line 24 of Form 1040A: “Standard Deduction modified due to exempt income under section 933.”

Example: John and Mary are U.S. citizens, under 65, and bona fide residents of Puerto Rico for all of 2005. They file a joint income tax return. During 2005 they received \$15,000 of income from Puerto Rican sources and \$6,000 interest income from a bank account in the U.S. They do not itemize deductions. Line 37 of their Federal tax return, Form 1040, shows \$6,000. They will apportion their standard deduction as follows:

Worksheet For Puerto Rico Filers With Exempt Income Under Section 933 Who Do Not Itemize Deductions	
1. Enter STANDARD DEDUCTION: If you checked Form 1040, Filing Status box	
1, enter \$5,000	} <u>10,000</u>
2 or 5, enter \$10,000	
3, enter \$5,000	
4, enter \$7,300	
<p>CAUTION: If you are 65 or over and/or blind, enter amount from chart in the instructions for Form 1040 or Form 1040A, as applicable;</p> <p>or</p> <p>If someone can claim you as a dependent, enter amount from the Standard Deduction Worksheet for Dependents in the instructions for Form 1040 or Form 1040A, as applicable.</p>	
2. Allowable portion of STANDARD DEDUCTION:	
a. Gross income subject to U.S. tax	<u>6,000</u>
b. Total gross income from all sources (including exempt P.R. income)	<u>21,000</u>
c. Divide line 2a by line 2b	<u>.2857</u>
d. Multiply Standard Deduction (line 1) by line 2c and enter this amount on Form 1040, line 40 or Form 1040A, line 24 (allowable portion of STANDARD DEDUCTION)	<u>2,857</u>
Write the following above line 40, Form 1040 or line 24 of Form 1040A: "Standard Deduction modified due to exempt income under section 933."	

Credits

If you have income from P.R. sources not taxable on the Federal tax return, you must reduce your foreign taxes paid or accrued by the taxes allocable to exempt income. To find the amount allocable to the exempt income, multiply the taxes paid or accrued to Puerto Rico by a fraction. The numerator of the fraction is the exempt income (under IRC 933) from P.R. sources less deductible expenses allocable to that income. The denominator is the total amount of income subject to P.R. tax less deductible expenses allocable to that income.

<p>Formula:</p> $\frac{\text{Income from P.R. sources not subject to Federal tax less deductible expenses allocable to that income}}{\text{Total income subject to Puerto Rico tax less deductible expenses allocable to that income}} \times \text{Tax paid or accrued to Puerto Rico} = \text{Reduction in Foreign taxes}$

Example: John and Mary are bona fide residents of Puerto Rico filing jointly. John works for the Federal Government and received salary of \$25,000 during 2005 and had employee business expenses allocable to that income of \$500. Mary works for private industry and received salary of \$15,000 and had employee business expenses of \$300 allocable to that income. Total taxes paid to Puerto Rico: \$5,000.

$\$14,700 \times \$5,000 = \$1,875 = \text{taxes allocable to excluded income. (Enter on Form 1116, Part III, line 12 "Reduction in Foreign taxes".)}$
 $\$39,200$

For additional information, see Publication 570, Tax Guide for Individuals with Income from U.S. Possessions, and IRS Form 8898, Statement for Individuals Who Begin or End Bona Fide Residency in a U.S. Possession. Taxpayers from Puerto Rico who are liable for filing Form 1040, U.S. Individual Income Tax Return, should call 1-800-829-1040 or write to Internal Revenue Service, San Patricio Office Center, #7 Tabonuco Street, Guaynabo, PR 00966.

To call Taxpayer Service from Puerto Rico, dial 1-800-829-1040.
 For automated refund information, dial 1-800-829-4477.
 For recorded tax information, dial 1-800-829-4477.
 To request forms and publications, dial 1-800-829-3676.