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Knight Watch

Recent Developments Regarding the IRS and Puerto Rican Residency

By Christopher S. Rizek, James Dawson, Andrea Darling de Cortés, Chad M. Vanderhoef, Leif Anderson, and Joshua D. Odintz

A taxpayer filed a petition with the U.S. Tax Court on April 27, 2026, after the Internal Revenue Service (IRS) issued a Notice of Deficiency determining that he was not a *bona fide* Puerto Rican resident in 2021 under Code Sec. 937. The case, *Gary V. Karakashian, Petitioner*, offers a glimpse into some of the legal theories that the IRS may pursue in future Puerto Rican residency cases.

Separately, Senate Committee on Finance Ranking Member Ron Wyden (D-OR) recently opened an investigation regarding tax opinions issued to taxpayers regarding Puerto Rico residency and called on the IRS Chief Tax Compliance Officer to respond to questions on the issue.

This Knight Watch column summarizes some of the issues presented in this U.S. Tax Court case as well as recent congressional developments.

Gary V. Karakashian, Petitioner, v. Commissioner

Tax Court Petition

According to the U.S. Tax Court petition, the taxpayer is a medical doctor who operated dermatology facilities in New Jersey and owned a Puerto Rican limited liability company (LLC) that provided related physician, management, and administrative services. The taxpayer also provided telehealth services to patients from Puerto Rico. The taxpayer claims that he has been a Puerto Rican resident since 2018 and that he was physically present in Puerto Rico for 209 days in 2021. Yet according to the petition, the IRS determined that he did not satisfy the relevant tests, including physical presence, to be treated as a *bona fide* Puerto Rican resident in 2021 under Code Sec. 937, resulting in increases to his U.S. taxable income.

In addition to his medical practice, the taxpayer formed several Puerto Rican entities, including an insurance company and another LLC. Because the IRS concluded that the taxpayer was not a *bona fide* Puerto Rican resident in 2021, it proposed treating him as a U.S. shareholder of three controlled foreign



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corporations (CFC), including the Puerto Rican LLC that provided services in connection with the dermatology facilities in New Jersey. As a result, the IRS asserted that he had Subpart F and global intangible low-taxed income (GILTI) inclusions under Code Secs. 951 and 951A attributable to these entities for 2021.¹

The Notice of Deficiency, which prompted the U.S. Tax Court case, also proposes substantial penalties against the taxpayer for civil fraud under Code Sec. 6663. If the IRS cannot demonstrate civil fraud, then the Notice of Deficiency proposes alternative accuracy-related penalties.

Key Legal Issues

The issues presented in this U.S. Tax Court case warrant close attention as the IRS begins targeting taxpayers who have claimed Puerto Rican residency to take advantage of favorable tax laws under Puerto Rico's Act 60. Many of the critical issues are discussed below.

Issue 1: Bona Fide Residency in Puerto Rico Under Code Sec. 937(a)

The central focus of the U.S. Tax Court case is whether the taxpayer was a *bona fide* resident of Puerto Rico within the meaning of Code Sec. 937(a) in 2021. This issue involves a three-part analysis, which was explored in a Holland & Knight alert:

- **Determining the Taxpayer's Physical Presence in Puerto Rico.** The IRS determined that the taxpayer was not physically present in Puerto Rico for at least 183 days during 2021 and did not satisfy the alternative tests in Reg. §1.937-1(c). In the petition, however, the taxpayer alleges that he was present in Puerto Rico for 209 days in 2021, including days counted through physical presence and qualifying medical treatment.
- **Determining the Taxpayer's Tax Home.** The IRS determined that the taxpayer had a tax home outside of Puerto Rico, specifically New Jersey or Florida, and did not meet the exceptions in Reg. §1.937-1(d). The taxpayer asserts his principal place of business was in Puerto Rico during 2021.
- **Determining Whether the Taxpayer Has a Closer Connection to the United States.** The IRS determined that the taxpayer had a closer connection to New Jersey and/or Florida than to Puerto Rico and did not meet the exceptions in Reg. §1.937-1(f). The taxpayer asserts he had minimal personal connections in the U.S.

The resolution of this threshold issue affects nearly every other adjustment that the IRS proposed in the Notice of

Deficiency, so establishing *bona fide* Puerto Rican residency is essential to this case.

Issue 2: Exclusion of Income Under Code Sec. 933

Based on its residency determination, the IRS concluded that the taxpayer is not entitled to exclude from gross income under Code Sec. 933 any items of income for the taxable year 2021, regardless of source.

The taxpayer argues that as a *bona fide* resident of Puerto Rico, he properly excluded from his U.S. income compensation that he received from his Puerto Rican LLC for services performed exclusively in Puerto Rico and capital gains.

Issue 3: CFC Status and Subpart F/GILTI Income Inclusions Under Code Secs. 951 and 951A

The IRS determined that because the taxpayer was not a *bona fide* resident of Puerto Rico, he was a U.S. shareholder in three CFCs, resulting in Subpart F and GILTI inclusions under Code Secs. 951 and 951A attributable to these entities for 2021.

Penalties and Additions to Tax

This case also offers insight into the penalties the IRS may assert in Puerto Rican residency cases.

Primary Position: Civil Fraud Penalty (Code Sec. 6663)

The IRS determined a 75-percent civil fraud penalty of nearly \$5 million against the taxpayer. The IRS will have the burden of proving fraud by clear and convincing evidence in the U.S. Tax Court case.

Alternative Penalties

If the IRS cannot demonstrate civil fraud, then the Notice of Deficiency proposes alternative accuracy-related penalties in connection with the adjustments that followed its determination that the taxpayer is not a Puerto Rican resident, including the following:

- **Undisclosed Foreign Financial Asset Understatement.** The IRS asserts a 40-percent penalty on the underpayment attributable to various adjustments because the taxpayer did not report information that the IRS asserts was required under Code Sec. 6038, 6038B, 6038D, 6046A, or 6048.

- **Substantial Understatement.** The IRS asserts a 20-percent penalty for substantial understatement of income tax if the above penalties do not apply.
- **Negligence.** The IRS asserts a 20-percent penalty for negligence or disregard of rules or regulations as a further alternative to its civil fraud argument.

Key Observations

Residency Determination

The *bona fide* residency issue under Code Sec. 937(a) is the critical issue to the IRS' theory of the case. If the taxpayer prevails on his claim of Puerto Rican residency, then many of the tax adjustments and penalties the IRS has proposed will be entirely eliminated, including the Subpart F and GILTI inclusions and the penalty for not disclosing foreign financial assets. Also, the taxpayer would be entitled to exclude income from Puerto Rican sources from his taxable income under Code Sec. 933.

Factual Disputes on Physical Presence

The IRS has determined the taxpayer did not satisfy the 183-day physical presence requirement, while the taxpayer asserts that he accrued 209 days in Puerto Rico when days attributable to physical presence and qualifying medical treatment are included. The dispute over the taxpayer's residency will likely turn on evidence of the taxpayer's daily physical presence, proper characterization of travel days, and whether medical treatment days qualify as days physically present in Puerto Rico.

Similarly Situated Taxpayers

The IRS is asserting the 75-percent civil fraud penalty and, therefore, assumes the burden of proof. The IRS' assertion

of the civil fraud penalty in this case should signal to taxpayers that the agency has a certain level of confidence that it will be able to seek maximum civil penalties against high-net-worth taxpayers who have claimed Puerto Rican residency for its tax advantages. As a reminder, all cases stand on their own merits.

As the IRS intensifies its review of Puerto Rican residency cases, taxpayers with potential vulnerabilities should seek legal guidance promptly to ensure they are well positioned to respond.

Congressional Developments

Ranking Member Wyden initiated an investigation into the practices of certain tax advisors related to their opinions regarding the intersection of the Puerto Rico 60 Act and the Internal Revenue Code. Specifically, Wyden is concerned that taxpayers with significant built-in gain in partnership interests are claiming Puerto Rican residency and are therefore exempt from U.S. tax on the disposition of such interests.

On April 29, 2026, Wyden wrote to Jared Koopman, the IRS Chief Tax Compliance Officer, with a request for answers on several topics, including the accuracy of the tax opinions authored by two attorneys and a review of all tax returns for specified partners of a partnership for tax years 2021–2025.² The names of the taxpayers and the partnership were blacked out.

Wyden's staff frequently conducts tax investigations, which lead to reports and legislative proposals. It is likely Wyden will prepare legislation to address concerns related to the tax opinions, which could include changes to Circular 230 and tax penalties on advisors and taxpayers. The legislation will likely be supported by an interim or final report.

ENDNOTES

¹ According to the petition, various other adjustments were made to the taxpayer's 2021 taxable income, including adjustments related to captive insurance. The primary focus of this column is the adjustments

related to Puerto Rico residency; therefore, the other issues (of which there are several) are not discussed.

² [2026-04-30] Wyden Calls for Full IRS Investigation of Tax Shelter Involving Puerto

Rico Residency, Unveils New Findings in Ongoing Investigation | The United States Senate Committee on Finance.

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