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subject: Source of Gain under Section 937 from Certain Dispositions of Stock

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FACTS

A citizen of the United States (“Taxpayer”) owns a portfolio of shares with built-in gain (“Appreciated Stock”). Taxpayer also owns all the shares of stock of a domestic corporation that has made a valid election to be an S corporation under section 1362(a) of the Internal Revenue Code.¹ Taxpayer transfers the Appreciated Stock to the S corporation and receives or is deemed to receive shares of the S corporation in exchange in a transaction described in section 351(a). The S corporation holds no other property, and the Taxpayer is not a dealer in securities. Taxpayer is not a bona fide resident of Puerto Rico during this period.

Thereafter, Taxpayer moves to Puerto Rico and becomes a bona fide resident of Puerto Rico within the meaning of section 937(a). Taxpayer continues to be a U.S. citizen. Two years thereafter,² one of the following occurs:

¹ All section references are to the Internal Revenue Code or the Treasury Regulations issued thereunder.

² As noted below, the conclusions described below would be the same if Taxpayer were a citizen or resident of the United States (and not a bona fide resident of Puerto Rico) for any of the 10 years preceding the year of the sale.

1. Situation 1: Taxpayer sells shares of the S corporation's stock for a gain.
2. Situation 2: The S corporation sells the Appreciated Stock for a gain.

ISSUES

1. In Situation 1, is Taxpayer's gain from the sale of the S corporation shares considered derived from sources within Puerto Rico for purposes of section 933?
2. In Situation 2, is Taxpayer's pro rata share of the S corporation's gain from the sale of the Appreciated Stock considered derived from sources within Puerto Rico for purposes of section 933? Would the conclusion be the same if, instead of an S corporation, a partnership were the transferee and seller of the Appreciated Stock?

CONCLUSION

1. In Situation 1, Taxpayer's gain from the sale of S corporation shares is not considered derived from sources within Puerto Rico, except to the extent: (i) the gain is attributable to Taxpayer's possession holding period, and (ii) Taxpayer properly makes an election under section 1.937-2(f)(1)(vi). The conclusion would be the same if the only difference in facts were that Taxpayer became a bona fide resident of Puerto Rico before the corporation was incorporated and elected to be an S corporation and before Taxpayer transferred the Appreciated Stock to the S corporation.
2. In Situation 2, because an S corporation must be a U.S. resident, none of Taxpayer's pro rata share of the S corporation's gain from the sale of the Appreciated Stock is considered derived from sources within Puerto Rico. If the facts were the same except that a partnership, rather than an S corporation, sells the Appreciated Stock, the conclusion would be identical because the Taxpayer's pro rata share of the partnership's gain from such sale would not be considered derived from sources within Puerto Rico under section 1.937-2(f)(1)(v).

LAW AND ANALYSIS

Under section 61, gross income generally includes all income, from whatever source derived. But under section 933(1), income of a bona fide resident of Puerto Rico (as that term is defined in section 937(a) and the regulations thereunder) that is "derived from sources within Puerto Rico" is generally excluded from gross income and exempt from U.S. income taxation. Thus, determining whether income is derived from sources within Puerto Rico is critical to establishing the U.S. income tax liability of a bona fide resident of Puerto Rico.

A. Applicable Source Rules

Section 937(b)(1) and section 1.937-2(b) of the Income Tax Regulations provide that, subject to specified exceptions, the principles of the sourcing rules in sections 861 through 865 apply to determine whether income is territory-source, making appropriate substitutions where necessary. For example, when applying sections 861 through 865 to determine whether income is territory-source, the words “United States” should be substituted with the name of the relevant territory, and the term “United States resident” should be substituted with “bona fide resident” of the relevant territory.

Section 865(a)(1) provides that income that a “United States resident” derives from selling personal property is generally classified as U.S.-source.³ By extension, income that a “nonresident” derives from selling personal property is generally sourced outside the United States under section 865(a)(2). Section 865(g)(1) provides that for purposes of section 865, an individual is a “United States resident” if the individual (1) is a U.S. citizen or resident alien who does not have a tax home in a foreign country, or (2) is a nonresident alien whose tax home is within the United States.⁴ An individual who is not a United States resident is a nonresident. A domestic corporation is a United States resident under section 865(g)(1).⁵

Accordingly, applying the principles of section 865(a)(1) pursuant to section 937(b)(1) and section 1.937-2(b) provides that gain from the sale of personal property by a bona fide resident of Puerto Rico⁶ generally will generate Puerto Rico-source income. Exceptions to this general rule are provided in section 1.937-2(c) through (i). For example, section 1.937-2(c) provides an exception if direct application (i.e., without the territory-related modifications described above) of the sourcing rules of sections 861 through 865 would characterize the gain as U.S.-source.⁷ Thus, for purposes of section 937, income that a “United States resident” derives from selling personal property is still generally classified as U.S.-source.

Section 1.937-2(f)(1)(i) (the “ten-year lookback rule”) provides that gain from the sale of certain property by an individual who is a bona fide resident of a territory for the year for which the gain must be determined is nevertheless not territory-source if the individual owned the property before becoming a bona fide resident and the individual was a citizen or resident of the United States (but not a bona fide resident of the relevant

³ Exceptions exist for certain sales of inventory property, but they are not applicable here. See sections 861(a)(6) and 865(b).

⁴ Puerto Rico is considered a foreign country for purposes of section 865. See section 865(i)(3).

⁵ Under section 865(g)(1), a corporation that is a United States person under section 7701(a)(30) is a United States resident. Under section 7701(a)(30), a United States person includes a domestic corporation.

⁶ By definition, a bona fide resident of Puerto Rico must have a tax home in Puerto Rico for the relevant taxable year. See section 937(a)(2).

⁷ See section 937(b)(2) and section 1.937-2(c); another exception exists for certain sales of inventory property, but it is not applicable here. Section 1.937-2(d).

territory) for any of the ten years preceding the year of the sale in question.⁸ The ten-year lookback rule applies to the sale by such an individual of property described in section 731(c)(3)(C)(i) or section 954(c)(1)(B).⁹ Stock in a corporation is a form of property subject to the ten-year lookback rule.¹⁰ If the ten-year lookback rule applies, all gain from the sale of the property will be sourced outside of the relevant territory, unless the individual elects under section 1.937-2(f)(1)(vi) to treat some of the gain from the sale as territory-source as described below.

Section 1.937-2(f)(1)(iv) specifies that if property covered by the ten-year lookback rule is exchanged by an individual subject to the ten-year lookback rule for other property in a transaction in which gain or loss is not required to be recognized (in whole or part), that other property will be treated as property covered by the ten-year lookback rule.

Section 1.937-2(f)(1)(v) provides that if (1) an individual subject to the ten-year lookback rule owns, directly or indirectly, at least 10% (by value) of an entity, (2) property covered by the ten-year lookback rule was transferred to the entity in a transaction in which gain or loss was not required to be recognized (in whole or part), and (3) any gain from the sale of the individual's interest in the entity would not be considered territory-source under section 1.937-2(f)(1)(iv), then any gain from the sale of that property by that entity will not be considered territory-source. For purposes of determining ownership of the entity, section 1.937-2(j) provides that the rules of section 318(a)(2) apply (substituting 5 percent for 50 percent in section 318(a)(2)(C)).

Section 1.937-2(f)(1)(vi) provides that, notwithstanding the general rule of section 1.937-2(f)(1)(i), an individual subject to the ten-year lookback rule may elect to allocate a portion of gain subject to the ten-year lookback rule to the relevant territory. For marketable securities, the allocation of gain to the territory pursuant to such election is based on the fair market value and the property's appreciation in value after the individual becomes a bona fide resident of the territory.¹¹ A "marketable security" is one that is actively traded throughout the holding period of the security's owner.¹² A security is actively traded if there is an established financial market for the security.¹³

For property other than marketable securities, the allocation of the gain to the territory pursuant to the election is based on the amount of gain multiplied by a fraction—the number of days that the individual held the property as a bona fide resident of the territory divided by the individual's overall holding period.¹⁴ An individual's overall holding period includes any days required to be included under section 735(b), section 1223, and any other applicable holding period rule.

⁸ See section 1.937-2(f)(1)(iii).

⁹ See section 1.937-2(f)(1)(ii).

¹⁰ Section 731(c)(3)(C)(i)(II).

¹¹ Section 1.937-2(f)(1)(vi)(A).

¹² Section 1.937-2(f)(1)(vii)(A).

¹³ Section 1.1092(d)-1(a).

¹⁴ Section 1.937-2(f)(1)(vi)(B).

Under section 1223(1), a person's holding period for property received in an exchange includes the period during which such person held the previously exchanged property if (1) the person has the same basis in the received property as he/she had in the exchanged property and (2) the exchanged property was a capital asset (as defined in section 1221) or is property described in section 1231. Section 1221 defines a capital asset as all property other than that which is specifically excluded by section 1221. Stock in a corporation is not described in any exclusion relevant to the Situations described herein¹⁵ and is therefore a capital asset. Under section 358(a), a person who contributes property to a corporation in a section 351 exchange will receive stock with a basis equal to that of the contributed property. Thus, if an individual contributes stock to a corporation in exchange for shares of stock in that corporation in a section 351 transaction, the individual's holding period for the shares received in the transaction will include the period that the individual held the contributed stock for purposes of the ten-year lookback rule.

Under section 1366(a)(1), a shareholder of an S corporation takes into account the shareholder's pro rata share of the corporation's items of income in determining the shareholder's tax liability. Under section 1366(b), the corporation's items of income will generally retain their character in the hands of the shareholder. Thus, the source of an S corporation's items of income in the hands of the shareholder will generally be treated as if such items were "realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation."¹⁶

Section 1373(a) provides that for the purposes of subpart A of part III (i.e., sections 901–908), subpart F of part III (i.e., sections 951–965), and part V (i.e., section 999) of subchapter N, an S corporation will be treated as a partnership and its shareholders will be treated as partners of such partnership.

B. Situation 1: Taxpayer Sells Shares of the S Corporation

As stated above, gain from the sale of personal property by a bona fide resident of a territory is generally sourced to the territory of residence. Although Taxpayer is a U.S. citizen, as a bona fide resident of Puerto Rico, Taxpayer has a tax home outside the United States and therefore is a nonresident for section 865 purposes. Thus, the gain from Taxpayer's sale of the S corporation's stock is not U.S.-source based on direct application of the sourcing rules of sections 861 through 865, and the exception under section 1.937-2(c) does not apply.

In this case, however, the ten-year lookback rule affects the source of Taxpayer's gain. Taxpayer was a U.S. citizen or resident, and not a bona fide resident of Puerto Rico, for one or more of the ten years before the year in which Taxpayer sold the shares of the S

¹⁵ The 1221(a)(1) exclusion is not applicable to the Taxpayer, who is not a dealer in securities.

¹⁶ See section 1366(b).

corporation stock. Therefore, subject to the election under section 1.937-2(f)(1)(vi), none of the gain from such sale is considered Puerto Rico-source under section 1.937-2(f)(1)(i), and Taxpayer may not exclude the amount of such gain from his/her gross income for U.S. income tax purposes under section 933.

Taxpayer may elect under section 1.937-2(f)(1)(vi) to treat a portion of the gain as Puerto Rico-source. The shares of stock in the S corporation here are not a “marketable security” under section 1.937-2(f)(1)(vii)(A) because an S corporation is a privately held corporation and therefore an established financial market for the security does not exist. Therefore, if Taxpayer makes an election under section 1.937-2(f)(1)(vi), the Puerto Rico-source portion of the gain will be calculated based on the number of days the Taxpayer held the S corporation stock issued or deemed issued in exchange for the Appreciated Stock as a bona fide resident of Puerto Rico in comparison to the total number of days the Taxpayer held such S corporation stock and (before the transfer to the S corporation) the Appreciated Stock. Taxpayer’s holding period includes the days Taxpayer held the Appreciated Stock because section 1.937-2(f)(1)(vi)(B) provides that Taxpayer’s holding period includes days required to be included under section 1223. As described above, in the case of shares received in a section 351 exchange, section 1223(1) requires a taxpayer to include the days that the taxpayer held the property transferred to a corporation in the taxpayer’s holding period for the shares received in exchange.

If, alternatively, the facts were the same except that Taxpayer transferred the Appreciated Stock to the S corporation after becoming a bona fide resident of Puerto Rico within the meaning of section 937(a), the result would be identical. Under section 1.937-2(f)(1)(iv), because Taxpayer obtained the S Corporation shares in a nonrecognition transaction, in exchange for property that is covered by the lookback rule (the Appreciated Stock), the S Corporation shares would also be covered by the ten-year lookback rule, and the gain from the sale of such shares would not be treated as Puerto Rico-source and so would not be excludable from Taxpayer’s gross income for U.S. income tax purposes under section 933. Taxpayer may elect under section 1.937-2(f)(1)(vi) to treat a portion of the gain as Puerto Rico-source.¹⁷

C. Situation 2: The S Corporation Sells the Appreciated Portfolio Shares

¹⁷ The Puerto Rico-source portion of Taxpayer’s gain in this alternative fact pattern would not differ from that in the original fact pattern, despite Taxpayer holding the S corporation stock issued or deemed issued in exchange for the Appreciated Stock as a bona fide resident of Puerto Rico for fewer days. Under section 1.937-2(f)(1)(vii)(B), an individual’s “possession holding period” is “the part of the individual’s holding period for the property during which the individual is a bona fide resident of the relevant possession” and under section 1.937-2(f)(1)(vi)(B), Taxpayer’s holding period for the S corporation stock includes the days Taxpayer held the Appreciated Stock. Thus, for purposes of calculating the Puerto Rico-source portion of Taxpayer’s gain under section 1.937-2(f)(1)(vi)(B), Taxpayer’s possession holding period will also include the days that Taxpayer held the Appreciated Stock as a bona fide resident of Puerto Rico.

As noted above, under section 1366(a)(1), the income tax liability of a shareholder of an S corporation takes into account the shareholder's pro rata share of the S corporation's income. Under section 1366(b), the character, and therefore the source, of any gain in the hands of the shareholder is generally the same as it would be if the S corporation realized such gain directly. While section 1373(a) provides that, for purposes of applying certain sections of the Code, an S corporation will be treated as a partnership and its shareholders will be treated as partners, section 1373(a) does not apply for purposes of applying section 865. Therefore, the source of gain from a sale of personal property by an S corporation is evaluated at the entity level.¹⁸ Accordingly, under the general rule of section 865(a), the source of Taxpayer's pro rata share of the S corporation's gain in Situation 2 is dependent on the residence of the S corporation.

A corporation is a United States resident if it is a United States person under section 7701(a)(30).¹⁹ A United States person includes a domestic corporation.²⁰ Under section 1361(a), an "S corporation" means a small business corporation for which an election under section 1362(a) is in effect. Section 1361(b) defines, in part, a "small business corporation" as a domestic corporation. Thus, in Situation 2, Taxpayer's pro rata share of the S corporation's gain under section 1366(a)(1) is not Puerto Rico-source and is therefore not excludable from Taxpayer's gross income for U.S. tax purposes under section 933.

If, alternatively, the facts are the same except that (1) Taxpayer instead transfers the Appreciated Stock to an entity classified as a partnership for federal tax purposes in an exchange pursuant to section 721 and (2) Taxpayer owns (taking into account the attribution rules of section 318(a)(2), as modified by section 1.937-2(j)) a 10% or greater interest (by value) in that partnership when the partnership sells the Appreciated Stock, the ultimate result would be identical. Under section 1.937-2(f)(1)(v), each partner's distributive share of the gain from the partnership's sale of the Appreciated Stock would be treated as gain from sources outside of Puerto Rico for U.S. income tax purposes, because Taxpayer contributed the Appreciated Stock to the partnership, Taxpayer owns a 10% or greater interest (by value) in the partnership, and section 1.937-2(f)(1)(iv) would apply to Taxpayer's sale of his/her interest in the partnership.²¹ Thus, Taxpayer's (and any other partner's) distributive share of the partnership's gain from the sale of the Appreciated Stock would not be Puerto Rico-source, and Taxpayer could not exclude his/her distributive share of such gain from gross income for U.S. income tax purposes under section 933.²²

¹⁸ This interpretation is not in conflict with the language of Shareholder's Instructions for Schedule K-3 (Form 1120-S). The statements found in that IRS publication specifically concern sourcing for purposes of calculating the foreign tax credit limitation under section 904. Section 904, unlike section 865, is referenced in section 1373(a).

¹⁹ Section 865(g)(1)(A)(ii).

²⁰ Section 7701(a)(30).

²¹ Note that this more specific rule applies in lieu of the general rule that gain from a partnership's sale of property is sourced at the partner level. See section 865(i)(5) ("except as provided in regulations").

²² The question of whether or how the section 1.937-2(f)(1)(vi) election applies in this situation is not addressed herein.

In appropriate cases, the gain in Situation 2 may be considered instead as derived directly by Taxpayer under, for example, section 482 or the step transaction doctrine.

Please call Joseph Walsh at (202) 317-5439 if you have any questions.