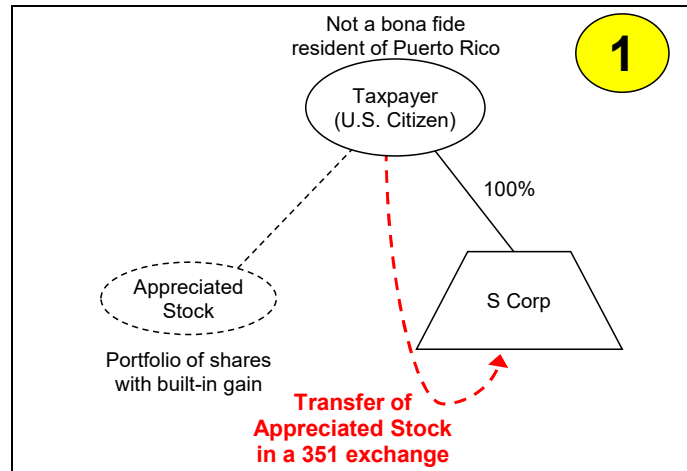


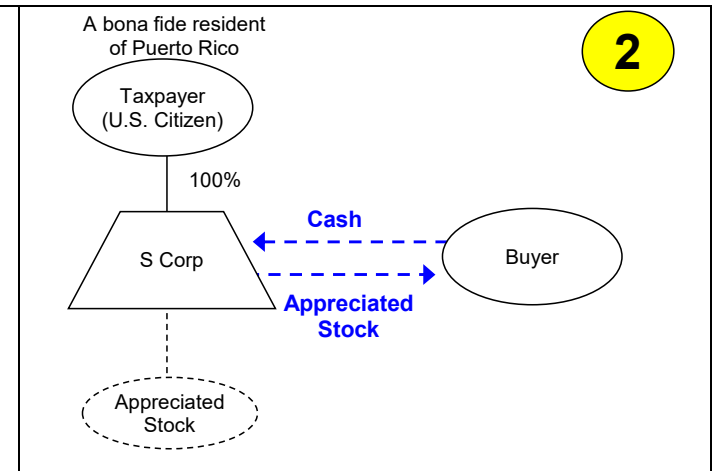
S Corp Sells Appreciated Stock Two Years After Shareholder Moves to Puerto Rico

A citizen of the U.S. (“Taxpayer”) owns a portfolio of shares with built-in gain (“Appreciated Stock”). Taxpayer also owns all the shares of stock of an S corporation. Taxpayer transfers the Appreciated Stock to the S corporation in a section 351 exchange. 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. Taxpayer continues to be a U.S. citizen. Two years after moving to Puerto Rico, the S corporation sells the Appreciated Stock for a gain.

351 Exchange Before Shareholder Moves to Puerto Rico



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The Memo concludes that if no election is made under Reg. 1.937-1(f)(1)(vi), the entire gain is U.S.-source income. I agree that the gain is U.S. source income for purposes of section 933, but I disagree that the gain is U.S. source income for purposes of section 904. The Appreciated Stock is non-inventory personal property. Non-inventory personal property is generally sourced to the residence of the seller under section 865(a). The seller was the S corporation. The S corporation is a U.S. resident. Therefore, the general rule is that the gain would be U.S.-source income.

However, section 1373(a) provides that, for purposes of sections 901-908, 951-965, and 999, an S corporation is treated as a partnership. In order to compute the foreign tax credit limitation in section 904, the amount and source of the income must be determined. Just as the code sections to determine the amount of taxable income are not referenced in section 1373(a), the code sections to determine the source of the income are also not referenced in section 1373(a). If the S corporation were treated as a partnership for purposes of section 865 (a sourcing rule), then section 865(i)(5) would require the gain on the sale of non-inventory personal property to be sourced at the partner/shareholder level.

I believe that for purposes of the foreign tax credit limitation in section 904, the gain should be sourced at the partner/shareholder level. However, for purposes of excluding income under section 933 (a section not referenced in section 1373(a)), the gain should be sourced at the S corporation level. The gain could not be excluded from gross income under section 933 because it would be U.S.-source income.

If, instead of a section 351 exchange into a corporation, the Appreciated Stock was transferred to a partnership in a section 721 contribution, Taxpayer’s distributive share of the partnership gain from the sale of the Appreciated Stock would not be Puerto Rican-source income. See Reg. 1.937-2(f)(1)(v).