Pre-Move Transfer Of Property To A Partnership

Facts

Amy is a U.S. citizen who lives in the United States. Amy owns shares of marketable stock (the "SHARES") that have appreciated in value. The SHARES have a value of $22,000,000, and Amy's basis in the SHARES is $2,000,000. If Amy were to sell the shares, she would recognize a gain of $20,000,000.

Amy would like to sell the SHARES, but she doesn't want to pay U.S. tax on the gain. Amy recently came across the Puerto Rico Act 60 program which allows qualifying individuals to apply for a tax decree that provides for a 0% tax rate on Puerto Rico source capital gains, dividends and interest income.

Amy is considering moving to Puerto Rico and becoming a bona fide resident of Puerto Rico. Amy understands that certain Puerto Rican source income can be excluded from U.S. taxable income. However, she also understands that if she sells the SHARES soon after she becomes a bona fide resident of Puerto Rico, most or all of the gain will not be considered Puerto Rican source income, and therefore cannot be excluded from her U.S. taxable income.

Amy has heard that gains on sales by partnerships flow through to their partners and are sourced at the partner level. Prior to her move the Puerto Rico, Amy wants to create a new partnership (the "PARTNERSHIP") between her and her wholly owned corporation. She will contribute the SHARES into the PARTNERSHIP for a 99% interest in the PARTNERSHIP. Amy will then become a bona fide resident of Puerto Rico.

In her second year after becoming a bona fide resident of Puerto Rico, Amy will cause the PARTNERSHIP to sell the SHARES. The gain recognized by the PARTNERSHIP on the sale of the SHARES will flow through to Amy and be taxed to her. However, she is hopeful that that gain will be sourced to Puerto Rico, and that the gain can be entirely excluded from her U.S. taxable income.

Can Amy Exclude the Gain?

No. Amy cannot exclude any of the gain.

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Gains on sales of personal property recognized by partnerships are generally sourced at the partner level. Code §865(i)(5). Gains from sales of personal property are generally sourced on the basis of the residence of the seller. Code §865(a). Amy will be a resident of Puerto Rico. So why can't Amy claim that the gain on the sale of the SHARES by the PARTNERSHIP are Puerto Rican-source income?

Special Anti-Abuse Sourcing Rules

Special rules apply to gains from dispositions of certain investment property (for example, stocks, bonds, debt instruments, diamonds, gold, cryptocurrencies, etc.) owned prior to becoming a bona fide resident of Puerto Rico. Treas. Reg. §1.937-2(f)(1). Under these special rules, gains from dispositions of the property within 10 years after becoming a bona fide resident of Puerto Rico generally are treated as non-Puerto Rican-source income. *Id.*

Treas. Reg. §1.937-2(f)(1)(i) provides in part:

> Except to the extent an election is made under paragraph (f)(1)(vi) of this section, income from sources within the relevant possession will not include gains from the disposition of property described in paragraph (f)(1)(ii) of this section by an individual described in paragraph (f)(1)(iii) of this section. * * *

The election under (f)(1)(vi) allows for a portion of the gain to be Puerto Rican-source income. Amy wants to argue that the full amount of the gain is Puerto Rican-source income. Consequently, Amy will not be making an election under (f)(1)(vi).

Are the SHARES Property Described In (f)(1)(ii)?

Yes, the SHARES are property described in (f)(1)(ii). Treas. Reg. §1.937-2(f)(1)(ii) provides:

> Property is described in this paragraph (f)(1)(ii) when the following conditions are satisfied -
>
> > (A) The property is of a kind described in section 731(c)(3)(C)(i) or 954(c)(1)(B); and
> >
> > (B) The property was owned by the individual before such individual became a bona fide resident of the relevant possession.

Shares of stock of a corporation are property described in Code §954(c)(1)(B) ("property * * * which gives rise to [dividend] income * * *."). Thus, the SHARES are property of a kind described

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in Code §954(c)(1)(B). In addition, **the SHARES were owned by Amy before she became a bona fide resident of Puerto Rico**. Consequently, the SHARES are property described in (f)(1)(ii).

Will Amy Be An Individual Described In (f)(1)(iii)?

Yes, Amy will be an individual described in (f)(1)(iii). Treas. Reg. §1.937-2(f)(1)(iii) provides:

> An individual is described in this paragraph (f)(1)(iii) when the following conditions are satisfied -
>
> > (A) For the taxable year for which the source of the gain must be determined, the individual is a bona fide resident of the relevant possession; and
> >
> > (B) For any of the 10 years preceding such year, the individual was a citizen or resident of the United States (other than a bona fide resident of the relevant possession).

In her second year after becoming a bona fide resident of Puerto Rico, Amy will cause the PARTNERSHIP to sell the SHARES. During this year, Amy will be a bona fide resident of Puerto Rico. In addition, for 8 of the 10 years preceding this year, Amy will have been a citizen or resident of the United States (other than a bona fide resident of Puerto Rico). Consequently, in the year that the SHARES are sold, Amy will be an individual described in (f)(1)(iii).

Conclusion

Amy is determining the source of the gain on the disposition of the SHARES. It was the partnership that sold the SHARES. However, under the partnership sourcing rules, the gain on the sale of the SHARES is determined at Amy's level, and not at the PARTNERSHIP level. Amy used to own the SHARES. Therefore, the SHARES are property described in (f)(1)(ii). Amy will be an individual described in (f)(1)(iii). Consequently, the gain from the disposition of the SHARES will not be Puerto Rican-source income and cannot be excluded from Amy's U.S. taxable income.

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