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From:

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To:

Cc:

Bcc:

Subject: Application of Treasury Regulation Section 1.937-2(f)(1)(i) to Personal Property Sales by a Partnership

You asked about the applicability of section 1.937-2(f)(1)(i) when a bona fide resident of Puerto Rico has income attributable to gains from the sale of personal property by a partnership. Section 1.937-2(f)(1)(i) can apply to sales by a partnership based on the principles of section 865(i)(5), which determines sourcing at the partner level with respect to income from a partnership's sale of personal property.

Section 937(b) and the associated regulations set forth the rules for determining whether income is from sources within Puerto Rico. As described in section 1.937-2(b), the principles of the sourcing rules in sections 861 through 865 apply to determine whether an item of income is Puerto Rico-source, making appropriate substitutions where necessary. Section 865 contains the rules for sourcing gain from the sale of personal property. Therefore, in general, the principles of section 865 apply (with appropriate substitutions) in determining whether gain from a sale of personal property is Puerto Rico-source.

Section 865(a)(1) states that "Except as otherwise provided in this section, income from the sale of personal property [...] by a United States resident shall be sourced in the United States[.]" Making the appropriate substitutions called for by section 1.937-2(b), this section effectively reads "Except as otherwise provided in this section, income from the sale of personal property [...] by a bona fide resident of Puerto Rico shall be sourced in Puerto Rico." Accordingly, the application of section 865 with these substitutions generally results in income from the sale of personal property by a bona fide resident of Puerto Rico being derived from sources within Puerto Rico.

When the seller is a partnership, section 865(i)(5) provides that "except as provided in regulations, this section shall be applied at the partner level." Thus, for the purpose of sourcing an item of income under section 865 (and by extension, under section 1.937-2 per section 1.937-2(b)), the sale of personal property by a partnership is sourced as if the partner sold the property. Putting these principles together, the general rule of section 1.937-2(b) provides that when a bona fide resident of Puerto Rico is a partner of a partnership and the partnership sells personal property, that partner's distributive share of such gain is sourced to Puerto Rico.

Section 1.937-2(f)(1)(i) modifies the general rule of section 865(a)(1), as incorporated into section 1.937-2 by section 1.937-2(b), by stating that "income from sources within [Puerto Rico] 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." We assume that you

have determined the property sold by the partnership is described in section 1.937-2(f)(1)(ii) and the partner is an individual described in section 1.937-2(f)(1)(iii).

As noted, section 1.937-2(b) generally applies the principles of section 865, including section 865(i)(5), to section 1.937-2. Thus, a partnership sale is treated as a sale by its partners for the purpose of applying section 1.937-2, including section 1.937-2(f)(1)(i). Consequently, section 1.937-2(f)(1)(i) applies to a partnership's sale of property the same as it would apply to a partner's sale of such property.

We do not think there is merit to an interpretation of section 1.937-2(f)(1)(i) that deems the sourcing framework of section 865, including section 865(i)(5), wholly inapplicable. Although section 1.937-2(f)(1)(i) modifies the general sourcing rule of section 865(a), section 1.937-2(f)(2)(ii) reiterates that the principles of section 865 apply, as expressed in section 1.937-2(b) ("In applying the principles of section 865 and the regulations under that section pursuant to paragraph (b) of this section, the rules of section 865(g) will not apply, but the special rule of section 865(h)(2)(B) will apply with respect to gain recognized upon the liquidation of corporations created or organized in the United States"). Moreover, section 1.937-2(f)(2)(ii) states specific provisions of section 865 that are not applicable. Because 1.937-2(f) does not state that section 865(i)(5) is not applicable and that the partnership should be treated as disposing of an asset for sourcing purpose, there is little reason to think that 1.937-2(f)(i) should be interpreted as a regulatory exception for 865(i)(5) purposes. More generally, such an interpretation would be inconsistent with the general policy rationale of section 1.937-2(f)(1), as reflected in relevant legislative history, of preventing U.S. persons from avoiding U.S. income tax on appreciated property by acquiring residency in Puerto Rico prior to its disposition. See H.R. Rep. No. 108-755, at 795 (2004).