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Corporate Inversions – Is Your Puerto Rico Act 60 Company Still Subject to U.S. Tax?

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As the combined federal, state and local tax rates for high-income earners in many parts of the country exceed 40% (and approach or exceed 50% in states like California, New Jersey and New York), many U.S. taxpayers are looking for a less onerous tax environment in which to conduct business operations. Puerto Rico offers an attractive alternative with entity-level tax rates as low as 4%, and corresponding distributions taxed at 0% for eligible companies. This favorable tax treatment is available by obtaining a tax grant from Puerto Rico under Act 60-2019 and qualifying as an Act 60 company.[1] Sadly, in a rush to relocate to Puerto Rico to take advantage of these incredible tax incentives, many taxpayers are overlooking various provisions of the Internal Revenue Code designed to impose punitive taxes against U.S. companies that leave the U.S. taxing jurisdiction and relocate offshore.

Of particular importance is a serious provision buried inside the Internal Revenue Code - Section 7874[2], otherwise known as the Corporate Inversion Statute. This statute acts to penalize an Act 60 company, that is the product of a "corporate inversion", by imposing full U.S. corporate tax rates on its Puerto Rico earnings. In addition, the distributions that their Puerto Rico owners have been receiving at a 0% tax rate in Puerto Rico also remain fully subject to U.S. tax. Unfortunately, the Corporate Inversion Statute is often overlooked by tax and business advisors, resulting in disastrous tax consequences.

This article will use a fictional case study to explain and address the issue of corporate inversions for Act 60 companies.

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[1] Act 60–2019, known as the Puerto Rico Incentives Code, was signed into law on July 1, 2019, with an effective date of January 1, 2020 ("Act 60"). Act 60, among other things, consolidated various tax decrees, including Act 20, the Promotion of Export Services Act, and Act 22, the Act to Promote the Relocation of Individual Investors to Puerto Rico.

[2] All section references are to the Internal Revenue Code of 1986 as amended (the "Code") and the regulations promulgated thereunder.

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Case Study

John Johnson ("John") is a U.S. citizen who lives in New York. John is a consultant who provides consulting services through his wholly owned S corporation, Johnson NY Consulting, Inc. ("Johnson NY"). John does not own any other companies.

Johnson NY has annual revenue of $5.3 million from several clients located in New York. The S corporation has miscellaneous expenses of $300,000 and it pays John a salary of $200,000. John's taxable income is $5.0 million, which is comprised of his salary of $200,000 and S corporation pass-thru income of $4.8 million.

John is frustrated with the high federal, state, and city income taxes he pays. He has heard about the potential for significant tax savings if he moves his business to Puerto Rico and opens an Act 60 company.

After speaking with some tax advisors, John decides to move to Puerto Rico and become a bona fide resident of Puerto Rico. He sets up a new Puerto Rican company, Johnson PR Consulting, Inc. ("Johnson PR").[3] Johnson PR qualifies for the reduced Puerto Rican tax rate (the income is taxed in Puerto Rico at a 4% tax rate).

John closes his old New York corporation because he no longer needs it. Now his Puerto Rican corporation performs services for the same New York clients. The services are all performed in Puerto Rico.

The Anti-Inversion Problem

The advisors that moved John into this new structure failed to inform him of the substantial risk that Johnson PR will be taxed as a U.S. C corporation under the "anti-inversion" rules of Code §7874. If Johnson PR is taxed as a U.S. C corporation, then all of the income earned by Johnson PR will be subject to U.S. federal corporate income tax (21%) and dividends paid by Johnson PR will be taxed to John at federal rates up to 23.8%.

For example, if Johnson PR were to be audited by the IRS four years after starting up, the U.S. corporate income tax could be $4,032,000[4] and the U.S. individual income tax could be as much as $3,609,984.[5] The IRS may assert various penalties, such as failure to file, failure to pay tax, etc. which would be 25% or more of the tax due, or an additional $1,910,496.[6] Not including

3 A Puerto Rico LLC is classified as a corporation for U.S. tax purposes by default. Treas. Reg. §301.7701-3(b)(2).

4 Annual pre-tax profit, times 21%, times 4 years ($4,800,000 x 21% x 4).

5 Assuming all profits distributed to John, annual after-tax profit, times 23.8%, times 4 years ([$4,800,000 – 1,008,000] x 23.8% x 4).

6 Total corporate and individual tax of $7,217,280 (4,032,000 + 3,185,280) times 25%.

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interest, the effective tax rate could be as high as 50%.[7] Obviously, a 50% tax rate is much higher than the promoted rate of 4%.

Normally, the statute of limitations would limit the period that the IRS could go back and assess tax.[8] However, because Johnson PR did not file any U.S. tax returns, the IRS could go back as many years as it wants.[9]

The Anti-Inversion Rules

The anti-inversion rules were enacted to discourage U.S.-based multinationals from "inverting" (i.e., reincorporating the U.S. parent company outside the U.S.). However, these same rules can apply to a single U.S. corporation that reincorporates outside the U.S., even if the corporation is owned by a single individual.

The anti-inversion rules will apply to Johnson PR (and it will be treated as a U.S. corporation) if it is a "surrogate foreign corporation." A foreign corporation[10] is treated as a surrogate foreign corporation if, pursuant to a plan (or a series of related transactions), three conditions are satisfied:

1. The foreign corporation completes the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation,[11]
2. At least 80% of the stock of the foreign corporation is held by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation,[12] and
3. After the acquisition, the expanded affiliated group that includes the foreign corporation does not have substantial business activities in the foreign country in which the foreign corporation is created or organized when compared to the total business activities of the expanded affiliated group.[13]

Liquidation-Reincorporation

John has liquidated his New York corporation and incorporated a Puerto Rican corporation. He operates the same business in the Puerto Rican corporation that used to be operated in the New York corporation. This fact pattern is similar to something known as the "liquidation-

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7 Total tax and penalties $9,552,480 (7,641,984 + 1,910,496) divided by pre-tax income (4,800,000 x 4).

8 Code §6501(a).

9 Code §6501(c)(3).

10 Puerto Rico is treated as a foreign country for most U.S. tax purposes. Code §7701(a)(9) ("The term 'United States' when used in a geographical sense includes only the States and the District of Columbia.").

11 Code §7874(a)(2)(B)(i).

12 Code §§7874(a)(2)(B)(ii) and 7874(b).

13 Code §7874(a)(2)(B)(iii).

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reincorporation" doctrine. As described below, the anti-inversion rules can have certain similarities to the liquidation-reincorporation doctrine. Therefore, a brief review of the doctrine is provided.

In the past (when capital gains tax rates were lower than dividend tax rates), taxpayers would sometimes try to pull accumulated earnings out of their corporation at capital gains rates by liquidating their corporation and distributing the accumulated cash and operating assets to the shareholder(s). However, the taxpayers wanted to continue operating the business so they would recontribute the operating assets to a new corporation. The new corporation would then operate the same business.

The IRS attacked this "liquidation-reincorporation" strategy by arguing that the old corporation never truly liquidated. Instead, the IRS argued that the old corporation reorganized into a new corporation. This meant that the cash retained by the shareholder(s) was taxed at the higher dividend rates and not at the reduced capital gains rates.

The IRS was quite successful in making these arguments.[14] One of the challenges that the IRS needed to overcome was that, to be treated as a reorganization, "substantially all of the assets" of the old corporation needed to be transferred to the new corporation.[15]

Fortunately for the IRS, the courts generally interpreted "substantially all of the assets" to mean operating assets. For example, in *Telephone Answering Service Co., Inc. v. Commr.*[16] the IRS was successful in arguing that a reorganization occurred where a shareholder of an old corporation transferred the old corporation's operating assets (which represented only 15% of the gross value of all the corporation's assets) to a new corporation.[17]

Another challenge for the IRS in making these arguments was that the statute provided there was a reorganization "only if * * * stock * * * of the [new] corporation * * * [was] distributed" by the old corporation.[18]

The courts again supported the IRS by developing what is known as the "meaningless gesture" doctrine. Under the meaningless gesture doctrine, where the shareholders of the old corporation are the same as the shareholders of the new corporation, there is no need to have the shares of the new corporation first issued to the old corporation and then distributed by the old corporation. Since the shareholders of both corporations are the same, it would be a meaningless gesture to

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14 See, e.g., *Smothers v. United States*, 642 F.2d 894 (5th Cir. 1981), *Commr. v. Morgan*, 288 F.2d 676 (3d Cir. 1960), *cert. denied*, 368 U.S. 836 (1961), reh'g denied, 369 U.S. 826 (1962), *James Armour, Inc. v. Commr.*, 43 T.C. 295 (1964), *Grubbs v. Commr.*, 39 T.C. 42 (1962).

15 Code §354(b)(1)(A).

16 63 T.C. 423, 433 (1974), aff'd, 547 F.2d 423 (4th Cir. 1976), cert. denied, 431 U.S. 914 (1977).

17 See also, *Smothers v. United States*, 642 F.2d 894 (5th Cir. 1981) (15% of assets were substantially all where they constituted all operating assets).

18 Code §368(a)(1)(D). In "asset" reorganizations, the old corporation exchanges its assets for stock in the new corporation, and then the old corporation liquidates, distributing the stock in the new corporation to the shareholders.

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have the shares first issued to the old corporation and then distributed to the shareholders of the old corporation.[19]

Having provided a brief summary of the liquidation-reincorporation doctrine, we will now turn to the application of the anti-inversion rules to John and his two companies.

Acquisition of Substantially All of the Properties

As described above, the first requirement is that the foreign corporation must complete the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation. There is currently no guidance on the meaning of "substantially all" for purposes of Code §7874. The legislative history indicates that Congress "expect[s] that the [IRS] will issue regulations applying the term 'substantially all' in this context and will not be bound in this regard by interpretations of the term in other contexts under the Code."[20]

Even though the IRS has not yet published any guidance in this area, the phrase "substantially all of the properties" in the anti-inversion statute is quite similar to the phrase "substantially all of the assets" in the reorganization statute. As described above, in the reorganization context the courts have treated the operating assets of the old corporation as being substantially all of the assets of the old corporation. It therefore seems likely that the IRS would view the operating assets of a corporation as being substantially all of the properties of a corporation in the anti-inversion context. This would also be consistent with the policy underlying the anti-inversion statute, which is to prevent U.S. corporations from reincorporating as foreign corporations.

In the facts described above, Johnson NY is in the business of consulting. Consulting companies often have very little tangible property. Instead, they may have intangible assets, such as goodwill, customer lists, processes, or knowhow.[21] It would seem likely that Johnson PR uses the same operating assets that were previously used by Johnson NY. Therefore, it seems likely that the first requirement of the anti-inversion rules would be met.[22]

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19 See, e.g., *Commr. v. Morgan*, 288 F.2d 676 (3d Cir. 1960), *cert. denied*, 368 U.S. 836 (1961), reh'g denied, 369 U.S. 826 (1962) (an exchange of stock of the new corporation for stock of the old corporation was not required where the exchange was meaningless because the same shareholders owned all of the old and new corporation's stock).

20 H.R. REP. NO. 108- 755, at 570 n.429 (2004) (Conf. Rep.), reprinted in 2004 U.S.C.C.A.N. 1341, 1638.

21 Some of these intangible assets may be held by the shareholder, rather than by the corporation. However, arguing that the corporation holds few intangible assets may make it all that much easier for the IRS to successfully argue that a transfer of a small amount of assets from the old corporation to the new corporation was substantially all of the properties of the old corporation.

22 Code §367(d) regarding the outbound transfer of intangible assets could also be used as another avenue of attack by the IRS.

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80% of Stock of Foreign Corp Held by Reason of Holding Stock in Domestic Corporation

As described above, the second requirement is that at least 80% of the stock of the foreign corporation must be held by the former shareholders of the domestic corporation by reason of holding stock in the domestic corporation.

In an asset reorganization, the old corporation exchanges its assets for stock in the new corporation, and then the old corporation liquidates, distributing the stock in the new corporation to the shareholders. Under these circumstances, the shareholders own their stock in the new corporation by reason of holding their stock in the old corporation. However, as described above, where the shareholders of the old corporation, such as Johnson NY, are the same as the shareholders of the new corporation, such as Johnson PR, the courts have held that it would be a meaningless gesture to actually issue the shares. As long as John is the sole shareholder of both corporations and the operating assets of Johnson NY are transferred to Johnson PR, it seems likely that John would be treated as having received his shares in Johnson PR by reason of his holding of shares in Johnson NY. Therefore, it seems likely that the second requirement of the anti-inversion rules would be met.

Not Having Substantial Business Activities in Puerto Rico

As described above, the third requirement is that after the acquisition the expanded affiliated group[23] that includes the foreign corporation does not have substantial business activities in the foreign country in which the foreign corporation is created or organized when compared to the total business activities of the expanded affiliated group. Since John does not own any other companies, the expanded affiliated group would be comprised of only Johnson PR.

Pursuant to Treas. Reg. §1.7874-3(b), the expanded affiliated group is considered to have substantial business activities in the relevant foreign country only if each of four requirements is met. One of those requirements is that "[t]he group income derived in the relevant foreign country is at least 25 percent of the total group income * * *",[24] and "[g]roup income is considered derived in the relevant foreign country only if it is derived from a transaction with a customer located in such country."[25]

As described in the facts above, Johnson PR performs services solely for New York clients. Since none of Johnson PR's clients are in Puerto Rico, Johnson PR will not meet the 25% threshold, and it will not be treated as having substantial business activities in Puerto Rico. Therefore, the third and final anti-inversion requirement of the anti-inversion rules would be met.

23 Code §7874(c)(1).

24 Treas. Reg. §1.7874-3(b)(3).

25 Treas. Reg. §1.7874-3(c)(5).

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Summary

Johnson PR has indirectly acquired substantially all of the properties of Johnson NY. John received all of his Johnson PR stock by reason of holding Johnson NY stock. Johnson PR does not have substantial business activities in Puerto Rico. Consequently, all three of the anti-inversion requirements would be met, and Johnson PR would be taxed as a U.S. corporation for U.S. tax purposes.

As now being statutorily deemed a U.S. corporation, Johnson PR would be taxed in the U.S. on its worldwide income, and it would need to annually file a U.S. tax return and pay U.S. tax. If John knew that Johnson PR should be taxed as a U.S. corporation and John willfully failed to file U.S. tax returns and pay U.S. tax for Johnson PR, then John potentially could be subject to criminal penalties and prosecution.[26]

It should be noted that on December 19, 2019, certain members of Congress sent a letter[27] to the Secretary of Treasury expressing their concern and demanding action as to Puerto Rico becoming a tax haven for wealthy Americans. In fact, it was specifically stated in the letter that these members of Congress are requesting:

> *…that the Department of Treasury conduct greater oversight over a variety of tax breaks provided to wealthy individuals and business in Puerto Rico….Acts 20 and 22 of Puerto Rico have led to significant tax avoidance by wealthy individuals residing in the island…..**We understand that the IRS is aware of cases**……in Puerto Rico…..*

Although it is unknown how the Secretary of Treasury responded, or may respond, it was clear from the letter that the IRS has agents on the ground in Puerto Rico who are actively working Act 60 (formerly Act 20 and 22) cases.

Corporate inversions have been perceived by some taxpayers to only apply to the large multinational companies. However, there is absolutely nothing in the statute or the regulations to limit the applicability of the law to certain taxpayers. Therefore, corporate inversion statutes become an arrow in the government's quiver to obtain tax compliance.

With proper tax planning the disastrous tax consequences in the above case study could have been avoided.[28] It is imperative to seek out a competent and experienced U.S. tax advisor when attempting to shift business operations from the U.S. to Puerto Rico. The corporate inversion

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26 See Code §7201, *et. seq*.

27 Puerto Rico-Letter to Mnuchin on Acts 20 and 22, December 19, 2019. https://serrano.house.gov/media-center/press-releases/serrano-vel-zquez-grijalva-ocasio-cortez-call-greater-transparency-and

27 We should note that many of these U.S. taxpayers that moved to Puerto Rico without proper tax planning may also be liable for U.S. taxes under other provisions of the Internal Revenue Code, including I.R.C. § 367(d) and I.R.C. § 882(a), to name a few.

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statutes are just some of many landmines that one will need to navigate when relocating to Puerto Rico.

About Tom Duffy C.P.A., P.C.

Tom Duffy C.P.A., P.C. is a Greater Chicago-based firm that specializes in international taxation with a particular focus on U.S. possessions. In addition, the firm is one of the few CPA firms in the country that specializes in representing residents of Puerto Rico during IRS examinations, specifically those taxpayers granted tax incentives under Puerto Rico's Act 60 (formerly Act 20/22).

Our foreign clients rely on our knowledge and expertise in complying with their U.S. tax obligations. Tom Duffy has over fifteen years of experience in international tax planning and associated U.S. tax return preparation. The firm services clients in the United States, its possessions, and throughout the world.

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