Form 926 – One of the Most Important U.S. Tax Forms that Most Act 60 Recipients Fail to File

Question:

If a U.S. citizen forms a Puerto Rican corporation (or a Puerto Rico LLC that is taxed as a corporation for U.S. purposes) and contributes cash to the Puerto Rican corporation, is the U.S. citizen obligated to notify the IRS?

Answer:

Yes. The U.S. citizen is a U.S. person and the Puerto Rican entity is considered a foreign corporation. Consequently, the contribution of the cash to the Puerto Rican corporation must be disclosed on Form 926.

Requirement to File Form 926

Code §6038B(a)[1] provides that each U.S. person who transfers property to a foreign corporation in a Code §351 exchange (among other types of exchanges) must provide the IRS certain information regarding the exchange. The regulations under Code §6038B provide that the information is to be provided on Form 926, *Return by a U.S. Transferor of Property to a Foreign Corporation*, and that the form must be attached to, and filed by the due date (including extensions) of, the transferor's income tax return for the year that includes the transfer.[2]

It is not just cash transfers that must be reported on Form 926. Other types of property transferred by U.S. persons to foreign corporations in Code §351 exchanges must also be reported on Form 926.

In addition, it is not just transfers qualifying under Code §351 that must be reported on Form 926. Transfers qualifying for nonrecognition under Code §§332, 354, 355, 356, and 361 must

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

2 Treas. Reg. §1.6038B-1(b)(1)(i)

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also be reported on Form 926. However, Code §351 exchanges are the most common types of transfers that must be reported on Form 926. So, the focus here is on Code §351 exchanges.

No Exception for Puerto Rican Corporations

Some IRS international information returns have special rules or exceptions for bona fide residents of Puerto Rico. For example, Puerto Rican financial assets are not included in determining the threshold amount for purposes of filing Form 8938.[3] In addition, Form 5471 is not required for certain Puerto Rican corporations with active businesses in Puerto Rico and mostly Puerto Rican-sourced income.[4]

However, neither the statute nor the regulations contain any exceptions to the requirement to file Form 926 for bona fide residents of Puerto Rico. In addition, Puerto Rican corporations are generally treated as foreign corporations. Under Code §7701(a)(4) the term "domestic", when applied to a corporation, means created or organized in the United States or under the law of the United States or of any State. Also, Code §7701(a)(9) defines the term "United States" to include only the States and the District of Columbia. Puerto Rican corporations are generally not considered domestic corporations. Instead, they are considered foreign corporations.

Consequently, the normal filing requirements with respect to Form 926 apply to bona fide residents of Puerto Rico, just as they apply to any other U.S. person transferring property to a foreign corporation.

It is common to set up businesses in Puerto Rico as limited liability companies ("LLCs"). When a U.S. domestic LLC is formed and no entity classification election is made, the LLC defaults to be classified as a pass-through entity (a partnership if the entity has more than one owner and a disregarded entity if there is a single owner).[5] However, when a Puerto Rican LLC is formed and no entity classification election is made, the LLC defaults to be classified as a corporation.[6] A Puerto Rican LLC is an "eligible entity", and an entity classification election can be made to treat the LLC as a partnership or a disregarded entity (depending on the number of its owners). Entity classification elections are made on Form 8832, *Entity Classification Election*. If a Puerto

3 Treas. Reg. §1.6038D-7(c).

4 Treas. Reg. §§1.6038-2(d)(2)(i) and 1.6046-1(f)(3)(ii)(A).

5 Treas. Reg. §301.7701-3(b)(1).

6 Treas. Reg. §301.7701-3(b)(2)(i)(B).

Rican LLC is treated as a pass-through entity for U.S. tax purposes, it must also be treated as a pass-through entity for Puerto Rico tax purposes.[7]

Special Rule for Transfers of Cash

A U.S. person that transfers cash to a foreign corporation in a Code §351 exchange must report the transfer only if: (1) immediately after the transfer such person holds (directly, indirectly, or by attribution) at least 10% of the vote or value of the foreign corporation, or (2) the amount of cash transferred by such person (or any related person) to the foreign corporation during the 12-month period ending on the date of the transfer exceeds $100,000.[8]

Therefore, if (1) only cash is transferred, (2) less than $100,000 is transferred, and (3) the transferor owns less than 10% of the foreign corporation, no Form 926 is required.

Outbound Transfers by Partnerships

When a partnership transfers property to a foreign corporation in a Code §351 exchange, it is the partners in the partnership who are treated as transferring the property to the foreign corporation.[See Treas. Reg. §§1.6038B-1(b)(1)(i) and 1.367(a)-1T(c)(3).] Consequently, if a partnership with U.S. partners forms a foreign corporation and transfers property to that foreign corporation, it is the U.S. partners in the partnership that are obligated to file Form 926. The partnership itself does not need to file Form 926. Each partner is treated as having transferred a proportionate share of the property. A U.S. person's proportionate share of partnership property is determined under the partnership rules and principles of Code §§701 through 761. [9]

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7 If a Puerto Rico LLC elects to be taxed as a partnership or as a disregarded entity for US purposes, Forms 8865 and 8858, respectively, are required to be filed with the individual's Form 1040 tax return.

8 Treas. Reg. §1.6038B-1(b)(3).

9 See also IRS Advice Memorandum 2008-006.

Outbound Transfers to Foreign Partnerships

Form 926 is not used to report transfers by U.S. persons to foreign partnerships. Instead, Form 8865 is used to report such transfers. [10]

Penalty for Failing to File

If a taxpayer fails to file Form 926 when required to do so, the IRS can impose a penalty equal to 10% of the fair market value of the property at the time of the transfer.[11] The penalty is limited to $100,000 unless the failure to comply was due to intentional disregard. In addition, the period of limitations for assessment of tax (i.e., the IRS initiating an audit and assessing additional tax) is extended to the date that is 3 years after the date on which the information required to be reported is provided.[12] **Basically, this means that if you do not file this form, the IRS can open up your tax return at any time in the future for examination and the assessment of tax, interest and penalties.**

Strict Requirements for Reasonable Cause Relief

It is not uncommon for taxpayers to miss filing Form 926. However, if a taxpayer later realizes that Form 926 should have been filed, it is important for the taxpayer to promptly file an amended tax return with the missed Form 926 included. The prompt filing of the amended tax return is required if the taxpayer wants to claim reasonable cause to avoid penalties.[13]

For example, say a taxpayer fails to timely file Form 926. The taxpayer later learns that the form should have been filed. The taxpayer does not at that time promptly file an amended tax return with a Form 926, but instead waits to see if they are audited by the IRS. Once the IRS audit starts, the taxpayer decides then to file the late Form 926. The regulations would prevent the taxpayer from claiming reasonable cause for the late filing in this case.

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10 See Category 3 filers for Form 8865 and Treas. Reg. §1.6038B-2.

11 Code §6038B(c) and Treas. Reg. §1.6038B-1(f)(1).

12 Code §6501(c)(8) and Treas. Reg. §1.6038B-1(f)(1)(ii).

13 Treas. Reg. §1.6038B-1(f)(3)(ii)(A).

Gain Recognition on Outbound Transfers of Appreciated Property

Generally, gain is recognized when a U.S. person transfers appreciated property to a foreign corporation. [14] However, certain transfers of appreciated stock to a foreign corporation may not require recognition of gain.[15] Under the regulations, a transfer of appreciated stock of a foreign corporation to another foreign corporation in a Code §351 exchange generally requires the transferor to enter into a "gain recognition agreement" in order to avoid immediate gain recognition. [16] In addition, a transfer of appreciated stock of a domestic corporation to a foreign corporation in a Code §351 exchange generally triggers gain unless at least five separate tests are met. [17]

The active conduct of a trade or business exception to recognizing gain on an outbound transfer of property was repealed in 2017 with the enactment of the Tax Jobs and Cuts Act. [18]

Outbound Transfers of Intangible Property

If the property being transferred by the U.S. person to the foreign corporation is certain intangible property, different rules apply. [19] Instead of recognizing immediate gain, the U.S. person is treated as having sold the property to the foreign corporation in exchange for annual deemed royalty payments over the useful life of the property.[20] However, the U.S. transferor can elect to treat the transfer as a sale instead of annually recognizing deemed royalties. [21]

Various Other Rules May Apply

Various other overlapping rules may also apply to a U.S. person's transfer of property to a foreign corporation. Branch loss recapture rules may apply under Code §91; gain may be

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14 Code §367(a)(1).

15 Code §367(a)(2)

16 Treas. Reg. §§1.367(a)-3(b) and 1.367(a)-8.

17 Treas. Reg. §1.367(a)-3(c).

18 See former Code §367(a)(3).

19 Code §367(d).

20 Code §367(d) and Treas. Reg. §1.367(d)-1T.

21 Treas. Reg. §1.367(d)-1T(g)(2).

recognized under the overall foreign loss rules of Code §904(f); gain may be recognized under the dual consolidated loss rules of Code §1503(d); or the anti-inversion rules under Code §7874 may apply to cause the foreign corporation to be treated as a domestic corporation. Therefore, it is important to consider the full range of outbound transfer rules when a U.S. person transfers property to a foreign corporation.

It is also important to note that "deemed" transfers to a foreign corporation can occur. For example, if (1) a foreign entity is owned by a U.S. person, (2) the foreign entity is classified as a disregarded entity, and (3) an election is made to change the classification of the foreign entity to be a corporation, then the U.S. person is deemed to have contributed all of the assets and liabilities of the entity to a foreign corporation in exchange for stock of the foreign corporation.[22]

Example – Forming a Puerto Rican LLC (Year 1)

Joe is a bona fide resident of Puerto Rico for all of Year 1. Joe had been operating as a sole proprietorship. During Year 1, Joe forms a Puerto Rican LLC ("PRCo"). He does not make an entity classification election for PRCo, and PRCo defaults to be classified as a corporation.

During Year 1, Joe contributes into PRCo cash of $10,000 and a customer list that he had been using in his sole proprietorship.

Both the cash and the customer list must be disclosed on Form 926. Because the customer list is intangible property, as defined in Code §367(d)(4), Joe is treated as having sold the customer list to PRCo in exchange for annual deemed royalty payments over the useful life of the customer list.

If we assume that the customer list has a value of $200,000 and that the appropriate arm's length royalty for use of the customer list is 10%, then Joe would need to include $20,000 (10% of $200,000) in his U.S. income as a deemed royalty. The deemed royalties would continue each year for the useful life of the customer list.

[22] Treas. Reg. §§1.367(a)-1T(c)(6) and 301.7701-3(g)(1)(iv).

Example Continued– Contributing Cash to the Puerto Rican LLC in Year 2

If in Year 2, Joe contributes additional cash of $5,000 into PRCo, he would need to file another Form 926 for Year 2 to disclose the cash contribution.

As described above, one of the types of transfers required to be included on Form 926 is when a U.S. person transfers property to a foreign corporation in a Code §351 exchange. To qualify as a Code §351 exchange, there generally must be a transfer of property to a corporation in exchange for stock in the corporation, and the transferor or transferors must control (80%) of the corporation. See Code §351(a).

A transaction where a shareholder contributes property to a corporation, but the corporation does not issue any shares in exchange for the property, is referred to as a "contribution to capital." It is arguable that a contribution to the capital of a corporation is not a Code §351 exchange. [23] However, the Tax Court and the Second Circuit have both held that the exchange requirements of Code §351 are met "where a sole stockholder transfers property to a wholly-owned corporation even though no stock or securities are issued therefor. Issuance of new stock in this situation would be a meaningless gesture."[24] Furthermore, in response to the *Abegg* decision, Congress enacted Code §367(c)(2), which provides:

> For purposes of this chapter, any transfer of property to a foreign corporation as a contribution to the capital of such corporation by one or more persons who, immediately after the transfer, own (within the meaning of section 318) stock possessing at least 80 percent of the total combined voting power of all classes of stock of such corporation entitled to vote shall be treated as an exchange of such property for stock of the foreign corporation equal in value to the fair market value of the property transferred.

In Joe's situation, he owns 100% of PRCo. Therefore, Joe owns "stock possessing at least 80 percent" of PRCo, and he is treated as having received stock in PRCo in exchange for the cash contribution. Since Joe is deemed to have received stock in PRCo in exchange for the cash, the transaction is treated as a Code §351 exchange, and Joe is required to file Form 926 in Year 2.

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23 *Abegg v. Commr.*, 50 T.C. 145 (1968), *aff'd* on appeal on other grounds, *Abegg v. Commr.*, 429 F.2d 1209 (2d Cir. 1970).

24 *Lessinger v. Commr.*, 85 T.C. 824 (1985) and *Lessinger v. Commr.*, 872 F.2d 519 (2d Cir. 1989).

Conclusion

As the IRS Campaign kicks off, taxpayers should note the Campaign is being coordinated by the Large Business and International Tax Division (LB&I) of the IRS. It is our experience that the LB&I division is staffed with seasoned and sophisticated revenue agents that will be very familiar with the importance of Form 926, as well as other U.S. filing issues that Act 60 companies and residents should be complying with. Those taxpayers unfortunate enough to be selected for an IRS audit will likely be asked to provide a copy of this form to the IRS at the very early stages of the IRS examination. If you have failed to file this form, the IRS will have an unlimited amount of time to spend on auditing your individual tax return (as the statute of limitations never started due to the failure to file this form). In addition, given the nature of the Campaign, we believe penalties will likely be assessed against those taxpayers who failed to file the form.

Although we cannot predict whether the failure to file Form 926 will result in any referrals by IRS civil agents to the IRS criminal division, we certainly would not place it outside the realm of possibility for the most egregious cases.

Taxpayers should review past filings to determine if appropriate forms were filed. In the event of noncompliance, they should consult their tax advisors to discuss potential next steps. Once an audit begins, it is normally too late to file corrective returns to avoid civil and/or criminal penalties.