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Tax Update

Flow-Through Entities under the Proposed Puerto Rico Internal Revenue Code of 2015

Adding to our Tax Updates on House Bill No. 2329 (“HB 2329”), which is expected to drive the efforts for the Puerto Rico 2015 Tax Reform, we now focus on a new entity classification that the proposed Puerto Rico Internal Revenue Code of 2015 (“2015 Code”) would introduce, known as the conduit entity.

We will first provide a recap of the existing flow-through regime under the Puerto Rico Internal Revenue Code of 2011, as amended (“2011 Code”), then provide some highlights on the new conduit entity and its owners under the proposed 2015 Code, and lastly, we will highlight the transition rules applicable to current partnerships, special partnerships and corporations of individuals converting to conduit entities.

Background

Under the 2011 Code, businesses generally have the following choices to achieve flow-through tax treatment:

1. Special partnerships
2. Corporations of individuals
3. Partnerships

Each of the above types of taxpayers are subject to different rules regarding eligibility, the determination of the distributable share of income, gain, losses, deductions and credits to owners, the determination of their internal and external tax bases, and the use of losses. For purposes of simplification the 2015 Code proposes to consolidate these three types of taxpayers into a new conduit entity. This would constitute a new flow-through regime under which partnerships, corporations and limited liability companies (“LLCs”) would either be forced to operate or make an affirmative election to be so treated.

Recap of Current Regime

Special Partnerships

Rules relating to special partnerships were made applicable to qualifying local law partnerships, LLCs, and corporations for taxable years beginning after December 31, 1984. Such entities have to make an election to be treated as a special partnership and have to derive at least 70% of their gross income from sources within Puerto Rico and from certain defined activities (such as construction, land development, substantial rehabilitation of buildings, sale or lease of buildings, manufacturing generating substantial employment, tourism, agriculture, exports, films, infrastructure, and green energy).



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Corporation of Individuals

A corporation of individuals is a corporation or a partnership that elects to be treated as a corporation of individuals and that meets certain eligibility requirements. The eligibility requirements are similar to the eligibility requirements for “S corporations” under U.S. Internal Revenue Code of 1986, as amended (“U.S. Code”). Among other things, a corporation of individuals must: (1) be organized under the laws of Puerto Rico, a U.S. state, or the District of Columbia; (2) be engaged in the active conduct of a trade or business solely in Puerto Rico; (3) have no more than 75 shareholders; (4) have only shareholders that are individuals, estates, and certain kinds of trusts; and (5) have only one class of stock. In addition, only 10% of the gross receipts of a corporation of individuals can be derived from passive activities or from sources outside of Puerto Rico.

Partnership

Partnership taxation, similar to that available under Subchapter K of the U.S. Code, was introduced with the enactment of the 2011 Code. Partnerships are not subject to Puerto Rico income tax at the partnership level, but their partners are subject to income tax on their distributable share of income, gain, losses, deductions and credits.

Special Situations with LLCs

As in the 2011 Code, under the proposed 2015 Code an LLC is generally taxable as a corporation, unless the LLC makes an affirmative election to be treated as a partnership. However, LLCs that are treated as partnerships or disregarded entities for U.S. federal (and other jurisdictions) income tax purposes, are automatically treated as partnerships for Puerto Rico income tax purposes without the option of electing to be treated as corporations for such purposes. If an LLC elects partnership status at a time after its formation, the transition from corporation to partnership status for tax purposes gives rise to a deemed liquidation of the corporation; this liquidation can be taxable for current conversions.

New Conduit Entity Regime

The new conduit entity regime shares similarities with the current special partnership regime and also adopts some provisions from corporations of individuals and partnerships. Conduit entities will not be subject to Puerto Rico income taxes, but their owners will be subject to income tax on their distributable share of income, gain, losses, deductions and credits.

The conduit entity provisions will apply to the following entities:

1. Entities, including corporations and LLCs that are otherwise taxable as corporations, which make an irrevocable election to be treated as a conduit entity.

The election must be made within the first 90 days of the taxable year in which the election shall apply. Such 90 days may be extended, at the discretion of the Secretary of the Treasury, until the due date for filing the entity’s income tax return, without taking into account any extensions of time to file.

2. Partnerships, including LLCs that are treated as partnerships, which commence operations after December 31, 2014.

3. Entities subject to a statutory conversion into a conduit entity, including entities that for taxable years beginning on or before December 31, 2014, were treated as partnerships (including applicable LLCs), special partnerships or corporations of individuals.

The following entities are not eligible for the conduit entity regime: (1) foreign corporations that are taxable as corporations under the U.S. Code or an analogous foreign country provision; (2) insurance companies; (3) investment companies; (4) employee owned special corporations; (5) not-for-profit entities; and (6) publicly traded corporations.

Treatment of Owners under the New Conduit Entity Regime

Under the 2011 Code, partners are deemed to be engaged in trade or business in Puerto Rico but only with respect to their distributable share in the partnership's income, gain, losses, deductions and credits. It was reportedly Treasury's intent that partners should be deemed engaged in a Puerto Rico trade or business for all purposes under the 2011 Code, not only with respect to their distributable share of partnership items.

In the case of conduit entities under the proposed 2015 Code, language has been modified so that owners shall be deemed to be engaged in trade or business in Puerto Rico, presumably for all tax purposes, as no reference is made to the owner's distributable share as the source of being engaged in trade or business.

In the case of foreign partnerships engaged in trade or business in Puerto Rico, partners shall be deemed to be engaged in trade or business in Puerto Rico to the extent of their distributable share of the partnership's income, gain, losses, deductions and credits.

Further, in the case of special partnerships or corporations of individuals existing as of December 31, 2014, and that are subject to a statutory conversion, owners that are not otherwise engaged in trade or business in Puerto Rico, shall not be considered to be engaged in trade or business in Puerto Rico with respect to their distributable share of the conduit entity's income, gain, losses, deductions and credits.

Transition Rules

1. Statutory conversion of entities that were treated as partnerships (including applicable LLCs), special partnerships or corporations of individuals for taxable years beginning on or before December 31, 2014

These entities shall be considered to merely have had a change in identity and converted into a conduit entity on the last day of the last taxable year beginning on or before December 31, 2014.

No loss or gain shall be recognized in the statutory conversion and the entity shall maintain the same taxable year until there is a change in the owners. In addition, the basis, holding periods and tax attributes of the entity's assets will carry over to the conduit entity. A partner's or member's basis in the prior entity will also carry over as the owner's initial basis in the conduit entity.

2. Corporations and LLCs that are taxable as corporations for the last taxable year beginning on or before December 31, 2014, which make the election to be treated as conduit entities for the first taxable year beginning after December 31, 2014

It shall be considered that, on the last day of the last taxable year subject to taxation as corporations, these entities transferred all assets and liabilities to its shareholders in complete liquidation of the entity, and that such shareholders immediately contributed such assets and liabilities into a new conduit entity.

No gain or loss shall be subject to income tax as a result of the above transfers.

The accumulated earnings and profits as of the last day of the last taxable year in which the entities were subject to taxation as corporations, shall be deemed distributed during the first 2 years of the conduit entity and shall be subject to a 10% income tax rate.

In determining the accumulated earnings and profits, the entity shall be subject to the following adjustments: (1) recapture of LIFO benefits; (2) recognition of deferred income under long-term contracts; (3) recognition of deferred income from installment sales.

For purposes of determining income tax, the entity shall not be subject to the abovementioned adjustments on its last taxable year as a corporation.

The conduit entity will be subject to the built-in gains tax.

3. Corporations and LLCs that are taxable as corporations under the 2011 Code or the 2015 Code, which make the election to be treated as conduit entities for taxable years other than the first taxable beginning after December 31, 2014

It shall be considered that, on the last day of the last taxable year subject to taxation as corporations, these entities transferred all assets and liabilities to its shareholders in complete liquidation of the entity, and that such shareholders immediately contributed such assets and liabilities into a new conduit entity.

No gain or loss shall be subject to income tax as a result of the above transfers.

The conduit entity shall be subject to the following adjustments: (1) recapture of LIFO benefits; (2) recognition of deferred income under long-term contracts; (3) recognition of deferred income from installment sales. The conduit entity shall also be subject to the built-in gains tax.

The accumulated earnings and profits as of the last day of the last taxable year in which the entities were subject to taxation as corporations, shall be deemed distributed during the first 2 years of the conduit entity and shall be subject to a 20% income tax rate.

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