



## **IMPACT OF NEW PUERTO RICO INTERNAL REVENUE CODE ON CORPORATIONS, PARTNERSHIPS AND LIMITED LIABILITY COMPANIES**

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**T**he Internal Revenue Code for a New Puerto Rico (the “New Code”) makes significant modifications to the Puerto Rico income tax treatment of corporations, limited liability companies and partnerships, effective for taxable years commencing after December 31, 2010. Pass-through treatment of partnerships and limited liability companies (“LLCs”), reduction in the corporate income tax rates and a new alternative minimum tax feature are among the most significant amendments. In this newsletter we will summarize the salient modifications.

### **CORPORATIONS**

A. Income Tax Rates. For taxable years commencing after December 31, 2010 and prior to January 1, 2014, the maximum income tax liability of Puerto Rico corporations and foreign corporations engaged in trade or business in Puerto Rico is reduced to (i) 20% for corporations with net taxable income of up to \$750,000; (ii) 25% for corporations with net taxable income of up to \$2,500,000; and (iii) 30% for corporations with net taxable income in excess of \$2,500,000. For subsequent taxable years the maximum corporate income tax rate is further reduced to 25%, if certain government expense control and economic growth tests are met.

As a result of these rate reductions, for taxable years commencing prior to January 1, 2014 the combined Puerto Rico income tax liability of corporations and their shareholders (i.e., corporate tax plus dividend tax or branch profits tax, as applicable) is generally reduced to a minimum of 28% on net taxable income of up to \$750,000 (20% on net taxable income plus 10% dividend or branch profits tax on remaining 80%) and a maximum of approximately 37% on net taxable income in excess of \$2,500,000 (approximately 30% on net taxable income plus 10% dividend or branch profits tax on remaining 70%). If the government expense control and economic growth tests are met, for taxable years commencing after December 31, 2013 the maximum combined rate will be further reduced to approximately 32.5% (approximately 25% on net taxable income plus 10% dividend or branch profits tax on remaining 75%).

The foregoing combined rates represent a significant reduction from the maximum combined income tax rate of 46.955% (39% maximum corporate income tax rate plus 5% surtax on net taxable income, plus 10% dividend or branch profits tax on remaining 60.05%) that was applicable under the Puerto Rico Internal Revenue Code of 1994, as amended (the “1994 Code”). For corporations that do not repatriate their earnings, and reinvest them to grow their Puerto Rico business, the reduction of the maximum income tax rate from 39% to a minimum of 20% and a maximum of approximately 30% also constitutes a significant reduction of the income tax burden.

To fend off the possibility of reducing the corporate income tax rate by conducting an integrated business through various corporate entities, the corporate income tax rate applicable to each of the members of certain controlled groups of corporations and certain affiliated corporations is determined based on the aggregate net taxable income of such members and affiliates, instead of on the net taxable income of each member or affiliate.

B. New Alternative Minimum Tax Feature. The corporate alternative minimum tax is reduced from 22% to 20%. However, under the New Code the alternative minimum tax is the higher of (i) the 20% alternative minimum tax or (ii) 1% of the value of certain purchases of personal property from related parties. For this purpose, the term personal property includes inventory and any tangible personal property purchased from a related party to be used in the corporation’s trade or business, and excludes (i) raw materials and intermediate products to be used by the purchaser in manufacturing operations conducted in Puerto Rico and (ii) distilled spirits and alcoholic beverages subject to the tax imposed upon such products by subtitle E of the New Code.

The specter of the 1% alternative minimum tax coupled with the income tax deficiencies that arise from the reallocation of income by the Puerto Rico Treasury, should dissuade nonresident affiliated sellers from charging a sales price to their Puerto Rico affiliates in excess of market value to reduce the Puerto Rico income tax liability of the Puerto Rico affiliate.

C. Corporations of Individuals and Special Partnership Elections. Under the 1994 Code, the combined corporate rate of 46.955% (45.10% prior to the 5% surtax) and the maximum individual income tax rate of 33% (34.65% with the 5% surtax) led qualifying corporations owned by individuals to structure their Puerto Rico operations as pass-through corporations of individuals (“CIs”). By doing this, the Puerto Rico income tax cost of such operations was reduced from a maximum of 46.955% to a maximum of 34.65%. Certain limited type of operations could also use pass-through special partnerships (“SPs”) to achieve such objective, without the limitations imposed by the 1994 Code (and retained by the New Code) on the number and type of shareholders of CIs. In the case of SPs owned by foreign corporations not engaged in trade or business in Puerto Rico, the income tax savings were even higher because the rate was reduced to 29%.

Under the New Code the maximum individual income tax rate (at least 33%, or 30% for taxable years commencing after December 31, 2015, if the government expense control and economic growth tests are met) may be higher than the combined corporate rate. Consequently, CIs and SPs must determine whether it is advantageous to continue conducting their operations in such fashion. By the same token, business operations that did not qualify for CI or SP treatment and could not enjoy pass-through treatment under the 1994 Code must determine whether they may reduce their income tax burden by operating as a LLC or partnership, which enjoy pass-through treatment under the New Code.

D. Management Services. Under the 1994 Code, the payment of arm's length fees to nonresidents affiliates for management services rendered in the United States resulted in reducing the income subject to the combined rate of 45.10% or 46.955%, as applicable, and subjecting the fee income of the affiliate to the lower 35% federal income tax rate. Because of the New Code's reduction in the combined corporate income tax rate, the payment of such fees will not necessarily result in income tax savings. For example, in cases in which the combined Puerto Rico income tax rate is 28% or approximately 32.5% and the fees are paid for services rendered in the United States, the payment of the fees generally result in income otherwise subject to the Puerto Rico combined tax of 28% or approximately 32.5%, being subject to the higher 35% federal income tax rate.

## **PARTNERSHIPS**

A. Income Tax Treatment. Under the 1994 Code, partnerships other than special partnerships were subject to Puerto Rico income tax in the same way as corporations. Under the New Code, partnerships are treated as pass-through entities in essentially the same way as partnerships are treated under the United States Internal Revenue Code of 1986, as amended. Thus, their net taxable income is not subject to Puerto Rico income tax at the partnership level, and each partner is subject to Puerto Rico income tax on its share of the partnership's net taxable income.

B. Income Tax Treatment of Partners. Partners of partnerships engaged in trade or business in Puerto Rico are deemed to be engaged in the Puerto Rico trade or business conducted by the partnership. Consequently, nonresident corporate partners are subject to Puerto Rico income tax on their share of the partnership's net taxable income, and upon the repatriation of such income a 10% dividend withholding tax or branch profits tax is also applicable. Thus, in these cases the Puerto Rico income tax liability of the corporate partner is a minimum of 28% and a maximum of approximately 37%, as explained above.

C. Option to be Treated as Corporations. While partnerships existing on the effective date of the New Code may elect to continue to be treated as corporations under the New Code, the availability of such election is uncertain. The uncertainty arises because the New Code also provides that partnerships (without carving out the ones that make the election to be treated as corporations) are deemed to have been liquidated on the last day of their taxable year prior to January 1, 2011 and their partners are deemed to have immediately contributed their assets and liabilities to a new partnership subject to pass-through treatment under the New Code. Thus, although the election should override such deemed liquidation and distribution, it is not clear whether such is the case. If the deemed liquidation and distribution provision were to prevail, or if the partnership does not make the election, the partnership is also deemed to have distributed its accumulated earnings and profits subject to Puerto Rico income tax in two equal annual installments and must pay a 10% Puerto Rico income tax on such deemed distributions. Additionally, in such event the partnership must pay Puerto Rico income tax on its deferred income resulting from certain tax preferences.

#### LIMITED LIABILITY COMPANIES

A. Income Tax Treatment. The New Code allows LLCs organized in Puerto Rico and LLCs organized outside of Puerto Rico engaged in trade or business in Puerto Rico, to elect to be treated as partnerships or corporations. However, LLCs that are treated as pass-through entities or are disregarded under the United States Internal Revenue Code of 1986, as amended, or under the laws of any other jurisdiction, are treated as pass-through partnerships for Puerto Rico income tax purposes. Consequently, such LLCs are not subject to Puerto Rico income tax, and their members are subject to Puerto Rico income tax on their share of the LLC's net taxable income subject to Puerto Rico income tax. Moreover, foreign corporate members of such LLCs are deemed to be engaged in trade or business in Puerto Rico and are subject to (i) the corporate income tax on their share of the LLC's net taxable income and (ii) a 10% tax upon the repatriation of such income .

Surprisingly, LLCs that are treated as pass-through entities, or disregarded for United States or foreign countries income tax purposes, are not afforded the option granted to partnerships to continue to be taxed as corporations. Thus, the deemed liquidation and contribution and the potential tax costs derived therefrom are applicable to these LLCs. Since these LLCs (like partnerships) were treated as corporations under the 1994 Code and (like partnerships) as pass-through entities for United States income tax purposes, the denial of the option to continue to be treated as corporations, constitutes an unwarranted discrimination against these LLCs.

## SPECIAL PARTNERSHIPS

A. Income Tax Treatment. The SP election available under the 1994 Code is not available under the New Code. SPs under the 1994 Code will continue to be subject to the pass-through income tax treatment afforded to them under the 1994 Code, but the deductibility of 50% of their losses by the partners from income derived from any other sources is no longer available. The losses of such SPs are now subject to the following rules:

- (i) an amount equal to the partner's distributable share in the losses of each of its SPs or regular partnerships, up to the partner's adjusted basis in the relevant SP or regular partnership, must be added to determine the partner's deductible losses (the "Losses"); and
- (ii) the Losses must be used in the following order: (A) to offset the partner's aggregate distributable share of the net taxable income of profitable SPs and regular partnerships, if any; and (B) any excess Losses, to offset the partner's aggregate distributable share of the net taxable income of profitable CIs, if any.

## OPTION TO COMPUTE INCOME TAX UNDER 1994 CODE

Corporations, including LLCs, and partnerships in existence on the effective date of the New Code are granted an irrevocable option to compute their income tax liability and file their income tax returns in accordance with the provisions of the 1994 Code. The option is effective for taxable years commencing after December 31, 2010 and prior to January 1, 2012 and the four subsequent taxable years, and must be exercised with the filing of the income tax return for the taxable year commencing after December 31, 2010 and prior to January 1, 2012.

The availability of this option to existing partnerships and LLCs treated as pass-through entities under the New Code is uncertain, because the partnerships and LLCs that make the election are not carved out from the previously discussed liquidation and distribution provision of the New Code.

## TECHNICAL AMENDMENTS

We understand that technical amendments will be made to the New Code in the near future. Hopefully, such amendments will clarify the uncertainty with respect to the existing partnerships' election to continue to be taxed as corporations, and the partnerships and pass-through LLCs' election to be subject to income tax under the 1994 Code, and will grant LLCs the option to continue to be treated as corporations under the New Code.

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Should you have any questions with respect to the above, please contact Fernando Goyco-Covas, Esq. at (787) 281-1802 .

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