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Two Steps Forward, One Step Back: Puerto Rico's New LLC Law

By: Nikos Buxeda Ferrer, Esq.

In the United States, limited liability companies ("LLCs") have been gaining in popularity over the last several years because they combine some of the most attractive features of partnerships and corporations. Specifically, LLCs provide the organizational flexibility and pass-through income tax treatment of partnerships with the limited liability of corporations.

LLCs organized in the U.S. and foreign countries have been faced with a dilemma when they wanted to begin operations in Puerto Rico, as Puerto Rico law did not recognize the existence of LLCs. While not illegal for a U.S. or foreign LLC to do business here, there was some uncertainty as to whether the Puerto Rico courts would recognize their limited liability. Additionally, since they could not obtain an authorization to do business in Puerto Rico from the Department of State as "foreign corporations", they frequently confronted delays in obtaining licenses and authorizations from governmental agencies. U.S. and foreign LLCs that qualified as "merchants" under the Puerto Rico Mercantile Code were able to avoid some of these delays by registering in the Mercantile Registry.

The Governor of Puerto Rico on September 23, 2004 approved an amendment to Puerto Rico's General Law of Corporations of 1995, which establishes a legal framework for creating LLCs in Puerto Rico and registering U.S. and foreign LLCs in Puerto Rico. The amendment becomes effective 90 days after its approval. The new LLC law is beneficial in that it creates legal certainty with respect to the status of U.S. and foreign LLCs in Puerto Rico. In addition, we will now have the opportunity of organizing LLCs in Puerto Rico with the organizational flexibility and limited liability of their U.S. and foreign counterparts.

However, the Legislature failed to take this opportunity to amend Puerto Rico's Internal Revenue Code so as to provide for pass-through income tax treatment to LLCs. In fact, the LLC law specifically provides that LLCs will be taxed as corporations. While this is consistent with Puerto Rico's general rule that no legal entity has pass-through income tax treatment (other than special partnerships and corporations of individuals – the PR equivalent of Subchapter S corporations), this tax treatment defeats one of the primary reasons for using an LLC in the United States.

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In addition, the new LLC law has certain technical defects. As with Puerto Rico's Corporations Law, it is based on, but not exactly the same as, Delaware's law. Therefore, one has to be careful in assuming that any given provision of Delaware's LLC law will be the same in Puerto Rico's LLC law. In addition, certain sections appear to be mistranslated, or simply incorrect. For example, Article 19.07 states that an LLC may grant loans to any member, or guarantee its obligations, when the board of directors approves such loan or guarantee. However, LLCs don't have boards of directors, they have managers and members. There are also a few references to "shares of the corporation" which are clearly mistakes that will hopefully be remedied through technical amendments.

The LLC law also engages in some wishful thinking. Article 21.01 provides that with the payment of \$500 the Department of State will provide certain services to LLCs (such as obtaining a goodstanding certificate) within 2 hours and that in two years all LLC documents filed with the Department of State will be available free of charge over the internet. Whether the Department of State will be able to comply with these provisions remains to be seen.

Finally, the Legislature has made the somewhat peculiar choice of including the LLC law as an amendment to the Corporations Law, rather than a stand-alone law. This was apparently done in order to cross-reference sections of the Corporations Law. For example, the LLC law states that mergers and dissolutions will be made in accordance with the procedures applicable to corporations. However, the organizing principles behind corporations and LLCs are so different that it seems likely that the application of the corporate provisions to LLCs will prove difficult and fraught with ambiguity.

As with all new legislation, only time will tell how effective the new LLC legislation will be. For the time being, however, it is imperative that all U.S. and foreign LLCs currently doing business in Puerto Rico obtain an authorization to do business in Puerto Rico from the Department of State as soon as the law becomes effective. The filing fee is \$50.00 for a certificate of authorization and \$50.00 for a certificate to designate a resident agent. The law provides all U.S. and foreign LLCs currently doing business in Puerto Rico a grace period of 90 days to obtain a certificate of authorization. After such grace period, such LLCs will be prohibited from doing business in Puerto Rico without such certificate of authorization. U.S. and foreign LLCs which fail to obtain the certificate of authorization will be subject to a penalty of \$200.00 for each year or part of a year that they fail to obtain the certificate of authorization. In addition, although all contracts entered into by a U.S. or foreign LLC will remain valid, such LLCs will be prohibited from suing other parties and will be subject to injunctions prohibiting them from doing business in Puerto Rico. Since the procedure for obtaining an authorization to do business is straightforward and should not present any major problems, all U.S. and foreign LLCs doing business in Puerto Rico are strongly advised to act promptly in order to comply with the law.