E–ALERT

March 14, 2011 www.mcvpr.com

TAX ALERT

Choice of Entity Determinations Under the New Internal Revenue Code

On January 31, 2011, a new Internal Revenue Code for Puerto Rico was signed into law to be known as the Internal Revenue Code for a New Puerto Rico ("2011 Code"). With certain exceptions, the 2011 Code is effective as of January 1, 2011 (i.e., for taxable years commenced after December 31, 2010).

The 2011 Code introduces many important changes to the Puerto Rican tax system, presents new planning opportunities for taxpayers and, in some instances, requires immediate attention by entities operating in Puerto Rico. As we note in the following paragraphs, certain transition rules may cause unintended results if not timely managed.

For example, under the Puerto Rico Internal Revenue Code of 1994 ("1994 Code"), major business entity forms (corporations, limited liability companies, partnerships, etc.) were taxed as corporations. Flow-through treatment was only available through elections as either special partnerships or corporations of individuals, each of which had its own limitations as to types of business allowed; such as, number of owners, kinds of ownership interests, etc.

Under the 2011 Code no elections for special partnership status will be permitted for taxable years commencing after December 31, 2010. Furthermore, one of the most sought after benefits of special partnership elections, the netting of individual income (including wages) with losses from existing special partnerships, will no longer be available. Such losses will be available to offset income from other flow through entities.

Instead, the 2011 Code defines partnerships separate from corporations and includes a new chapter for taxation of partnerships and their partners that incorporates rules similar to those found in the US Internal Revenue Code of 1986 ("US Code"). Under the new rules, partnerships are not subject to tax on their income at the partnership level. Partners will be treated as undertaking the business of the partnership and will be subject to tax on partnership profits, whether or not such income is distributed. Although this will be the default treatment under the 2011 Code, partnerships in existence on January 1, 2011 may elect to continue to be treated as corporations for tax purposes.

Limited liability companies ("LLCs") have also received attention in the 2011 Code. These will, by default, continue to be subject to tax as corporations. LLCs may, nonetheless, elect to be treated as partnerships for tax purposes (even if having a single member). If an LLC is treated as a flow through (or disregarded) entity under the law of another jurisdiction, it will also be treated as a partnership for Puerto Rico income tax purposes, unless it holds a grant or concession under the "Puerto Rico Development Economic Incentives Act" or the "Puerto Rico Tourism Development Act" or similar predecessor acts. In that case, the LLC will be ineligible to be taxed as a corporation.

The enactment of these provisions broadens the range of activities and entities eligible for flow through treatment when compared to the 1994 Code and, as stated above, presents new planning opportunities for taxpayers. These changes may, nonetheless, be far from elective for some taxpayers. As transitory rules, existing partnerships and LLCs that had been taxed as corporations and either do not elect to continue such treatment or are ineligible to elect such treatment1**[1]**, will be treated as having liquidated as of their last taxable year under the 1994 Code. Upon such liquidation their assets and liabilities will be considered distributed to their partners or members and immediately thereafter contributed to a new partnership.

From a taxation standpoint the liquidation and contribution will be subject to the provisions applicable to corporations that convert into corporations of individuals (i.e., causing recaptures of items such as LIFO accounting for inventories, flexible and accelerated depreciation, etc.). Further, the entities would be deemed to have distributed accumulated earnings and profits and trigger certain built-in gains. Finally, the partners of the entity will be treated as engaged in the partnership's business in Puerto Rico, thus required to file Puerto Rico income tax returns.

The unexpected results of these transitory provisions can be avoided. As one option, taxpayers may opt-out of the application of the 2011 Code and remain subject to the rules of the 1994 Code. Opting out may be achieved by so electing when filing their income tax return for taxable year 2011. The election however is irrevocable for taxable years 2011, 2012, 2013, 2014 and 2015.

In sum, with new opportunities there may come some new risks. A careful assessment of current business structures and the impact of the 2011 Code must be undertaken in order to avoid unexpected tax consequences.

For further information on this matter, you may contact any of the attorneys listed below, all members of our Tax Practice Group:

Carlos E. Serrano	787-250-5698	ces@mcvpr.com
Juan Luis Alonso	787-250-5655	jla@mcvpr.com
Ariadna Alvarez	787-250-2602	aar@mcvpr.com
Roberto L. Cabañas	787-250-5611	rlc@mcvpr.com
Ruben Muñiz	787-250-2623	rm@mcvpr.com

[1] For example, hybrid entities such as non Puerto Rico partnerships or LLCs treated as either partnerships or as disregarded entities in another jurisdiction.

E–ALERT

The content of this McV Alert has been prepared for information purposes only. It is not intended as, and does not constitute, either legal advice or solicitation of any prospective client. An attorney-client relationship with McConnell Valdés LLC cannot be formed by reading or responding to this McV Alert. Such a relationship may be formed only by express agreement with McConnell Valdes LLC.