ALVARADO
TAX & BUSINESS ADVISORS
Taxand

The Tax Advisor

Special Bulletin on Latest Tax News
February, 2015

House Bill 2329: Pass-thru Entities

By César De Jesús-Umpierre

Entities that are subject to income tax at their owners level, better known as "pass-thru entities", were first introduced into the Puerto Rico tax system in 1985 with the adoption of the Special Partnership ("SP"). Later, in 1994, a similar tax vehicle was introduced with the Corporation of Individuals ("COI"). However, SP and COI had some limitations as to the sourcing of the qualifying income and the type of qualifying income, as well as the type and amount of shareholders in the case of COI, which restricted the type of entities that could elect this pass-thru treatment.

Until the enactment of the Puerto Rico Internal Revenue Code of 2011 (the "2011 Code"), partnerships were taxed as regular corporations. However, the 2011 Code included new rules for partnerships to be taxed as pass-thru entities and also provided for limited liability companies to elect to be treated as pass-thru entities. The rules included in the 2011 Code with regards to partnership taxation were mostly copied from the United States Internal Revenue Code, as amended, and did not place any restrictions like those established to SP and COI.

Continues on Page 2

Alvarado Tax & Business Advisors LLC is a Limited Liability Corporation organized under the laws of Puerto Rico and is engaged in providing tax and business advisory services. We are a multidisciplinary tax and business advisory professional service firm, unencumbered by the constrains of association with an auditing firm, and the regulatory and disclosure rules of the Security and Exchange Commission.

Backed up by years of unmatched hands-on experience in public accounting, government and corporate tax, our team of tax consultants has redefined the market by providing professional tax and business advisory services through our "top-heavy" structure, designed specifically to provide high level tax consulting to our clients on a more personalized basis.

For information visit us at: **www.alvatax.com** or contact one of our Tax Professionals for an appointment:

Ph. (787) 999-4400
E. taxadvisors@alvatax.com

Alvarado Tax & Business Advisors is part of Taxand, the World's largest independent tax consulting organization.

Taxand

House Bill 2329…
Continued from Page 1

So today there are three types of pass-thru entities in the 2011 Code: SP, COI and partnerships, each with its own set of rules.

House Bill 2329 ("HB 2329" or the "2015 Code")

In order to provide uniformity to pass-thru entities, HB 2329 proposes to consolidate, for tax purposes, the treatment of all existing pass-thru entities under a new type of entity to be called "Pass-Thru Entities".

The following entities will be treated as Pass-Thru Entities pursuant to the 2015 Code:

- existing partnerships, SP and COI with a valid election. These entities will be automatically converted to Pass-Thru Entities (statutory conversion);
- any limited liability company or corporation that elects to be treated as a Pass-Thru Entity pursuant to the 2015 Code;
- any partnership (except for existing partnerships at the time of adoption of the 2011 Code that elected to be treated as corporations);
- any foreign limited liability company that elected to be treated as a partnership or as a "disregarded entity" in its country of organization.

The following entities can't be treated as Pass-Thru Entities:

- insurance companies;
- registered investment companies
- employee-owned special corporations;
- not-for-profit organizations;
- corporations whose stock are publicly traded in the stock exchange.

Under the proposed 2015 Code, the income tax rules for these Pass-Thru Entities are basically the ones applicable to the SP under the 2011 Code, but with some minor changes. One difference that exists in the 2011 Code between the rules applicable to SP and COI versus partnerships is that, for SP and COI, a nonresident partner is considered as not engaged in a trade or business within Puerto Rico and is taxed on its distributable share of income through income tax withholdings. In contrast, a nonresident partner of a partnership is considered to be engaged in a trade or business within Puerto Rico with regards to its distributable share of income, and may be required to file a Puerto Rico income tax return.

Under the proposed 2015 Code, a nonresident partner of a Pass-Thru Entity will be considered as engaged in a trade or business within Puerto Rico with respect to its share of distributable income from the Pass-Thru Entity. However, it provides a grandfather rule for nonresident partners of an existing SP and COI at the time of the statutory conversion, in which case the nonresident partners will still be considered as not engaged in a trade or business within Puerto Rico under the 2015 Code.

Statutory Conversion of an Existing SP and COI

As previously mentioned, upon the enactment of the 2015 Code, the existing SP and COI will be statutorily converted to Pass-Thru Entities and no gain or loss will be recognized at the entity level or partner level from this conversion. The tax basis of the partners on the "new" Pass-Thru Entities will be the tax basis they had on the SP and the COI at the close of the taxable year beginning before January 1st 2015. The tax basis at the time of the statutory conversion will be determined using the applicable rules and regulations under the 2011 Code.

Conversion of Corporate taxpayers to Pass-Thru Entities

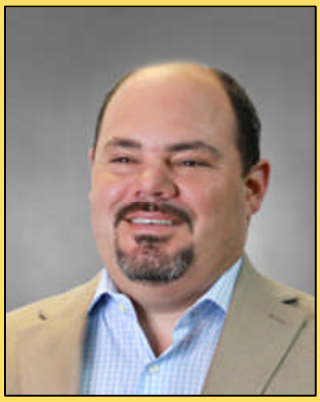
Taxpayers taxed as corporations under the 2011 Code, including limited liability companies, can elect to be treated for income tax purposes as Pass-Thru Entities under the 2015 Code. However, there may be a cost associated with this conversion, which will depend on when the conversion occurs.

A corporate taxpayer that elects to be treated as a Pass-Thru Entity for the first taxable year that commences after December 31, 2014 will be considered as if, on the last day of its taxable year before the election, it transferred all of its assets and liabilities to its shareholders, and

Continues on Page 3

ABOUT THE AUTHOR

César De Jesús-Umpierre



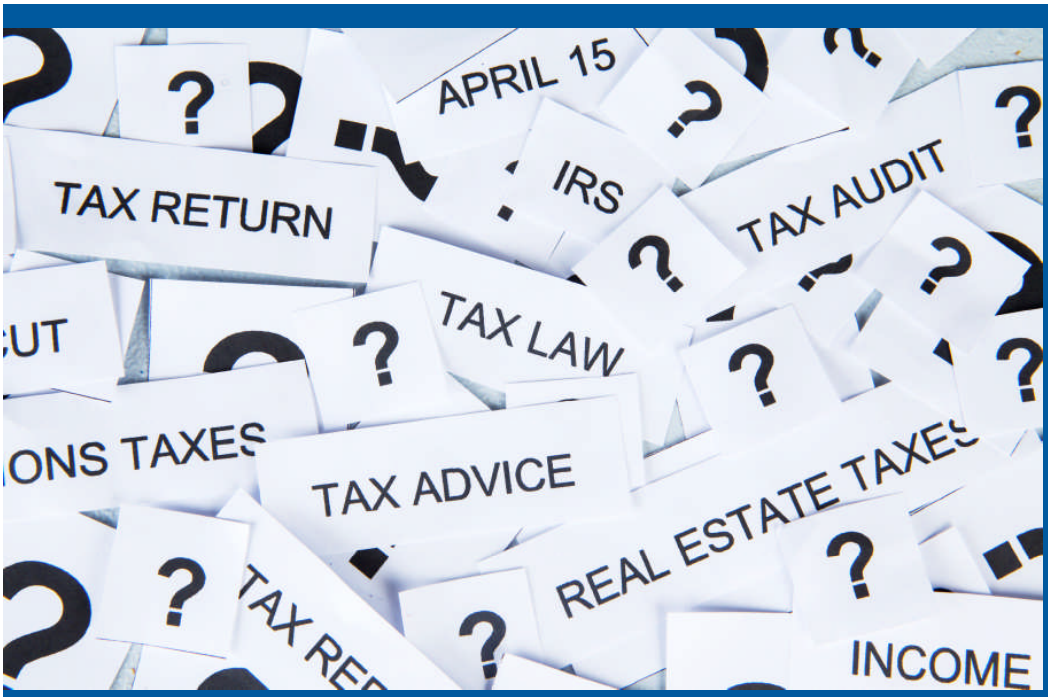
Tax Is Our Business®

César is a Member at Alvarado Tax & Business Advisors. Prior to that, he was Partner at Zaragoza & Alvarado LLP. His Curriculum Vitae also includes previous experience in the corporate and individual tax advisory area working as Tax Manager for Wal-Mart Puerto Rico, Inc., and Assistant Vice-President responsible for all business tax consulting and tax compliance work for over 30 entities in Puerto Rico and US at Interstate General Properties L.P., S.E., a member of American Community Properties Trust (a publicly traded partnership) with real estate operations in Puerto Rico and Maryland.

César provides corporate tax services for clients in the manufacturing, advertising, retail, insurance and banking industries. He is frequently invited as speaker at many tax seminars sponsored by the Puerto Rico Society of Certified Public Accountants.

César is a member of the Puerto Rico Certified Public Accountants Society and the American Institute of Certified Public Accountants.

He has a Bachelor degree in Business Administration, major in Accounting from the University of Puerto Rico.



House Bill 2329… Continued from Page 2

immediately thereafter, the shareholders contributed such assets and liabilities to the "new" Pass-Thru Entity. Generally the tax cost associated with this election will be a 10% tax on accumulated earnings and profits (adjusted for LIFO method of inventory, long term contracts and installment sales) payable in two installments, and a 30% built-in gain tax on property held at the time of conversion that have appreciated in value, if the property is disposed within a period of 10 years after the election.

On the other hand, an entity that is subject to corporate income tax under the 2015 Code and subsequently elects to be treated as a Pass-Thru Entity will be subject to a 20% tax on its accumulated earnings and profits, a built-in gain tax and, may also be subject to additional income taxes triggered by the conversion.

ATBA Comments

Under HB 2329, for the first time, certain corporations are presented with the opportunity to convert to pass-thru entities. A corporation interested in switching its tax status to a Pass-Thru Entity, should consider the potential approval of House Bill 2316, which provides windows with reduced tax rates of 5% or 8% applicable to dividends and deemed dividend distributions, for periods up to June 30, 2015. It is also important to evaluate the conversion on the first year of the 2015 Code since the cost associated with a conversion after the first year may be substantially higher. We may help you in analyzing the potential benefits of making such election.

Key Contacts at Alvarado Tax & Business Advisors LLC

Juan Alvarado-Zayas, Esq., CPA
Managing Member
787-620-7730
jalvarado@alvatax.com

Felipe Mariani-Franco, CPA
Member
787-620-7736
fmariani@alvatax.com

Sandra Marie Torres-Martínez, CPA
Member
787-620-7728
storres@alvatax.com

Edgardo Sanabria-Valentín, CPA
Member
787-999-3015
esanabria@alvatax.com

Carlos R. González-Martínez, CPA
Member
787-620-7739
cgonzalez@alvatax.com

César De Jesús-Umpierre, CPA
Member
787-620-7734
cdejesus@alvatax.com

Alvarado Tax & Business Advisors LLC

104 Acuarela Marginal Street
Martinez Nadal Expressway
Guaynabo PR 00969

PO Box 195598
San Juan PR 00919-5598

T. 787.999.4400
F. 787.999.4646
E. taxadvisors@alvatax.com
www.alvatax.com
www.taxand.com

We are Green. Are You?

Please consider the environment before printing this publication.

Tax Is Our Business®