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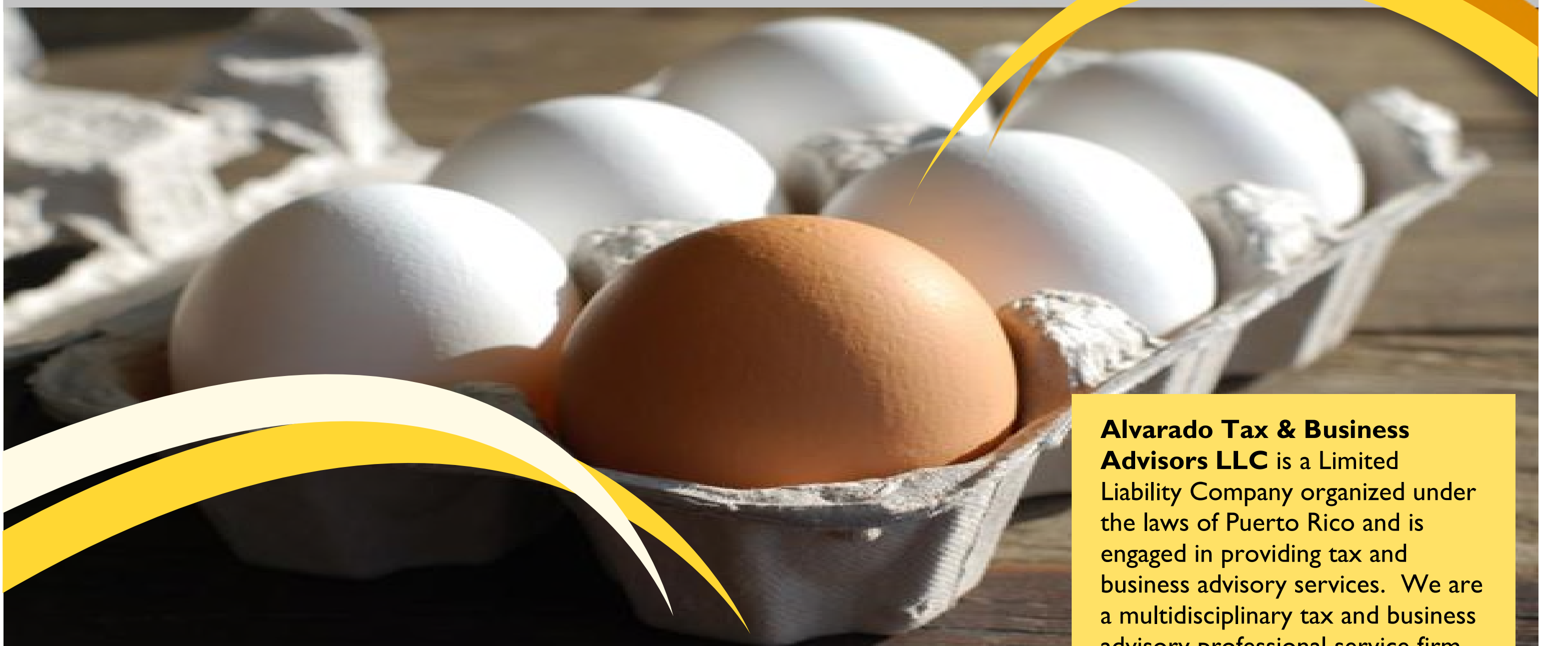

New Disregarded Entities in Puerto Rico

By: Elisa Vélez-Pérez

In 2011 the Government of Puerto Rico adopted, as part of a tax reform, the Puerto Rico Internal Revenue Code of 2011 (the "Code"). This new code introduced to Puerto Rico's tax system the concept of "Partnerships," by mainly adopting in Puerto Rico the Partnership provisions included in the United States' Internal Revenue Code ("USIRC"), with minor exceptions. However, the concept of "disregarded entities" was not, at that time, incorporated into our tax system. Unlike partnerships, under the USIRC disregarded entities are "ignored" for income tax purposes, and it is considered that its sole owner directly performs the business activities of the entity. It is an income tax status reserved only for non-corporate entities that provide limited liability to its sole owner and its goal is to simplify the income tax compliance of the entity.

On October 7, 2021, the Governor of Puerto Rico signed Executive Order No. 2021-072 to create an advisory group to provide recommendations on how to simplify and improve the tax system in Puerto Rico (the "Advisory Group"). In 2022 the Advisory Group issued a preliminary report which detailed various tax reform initiatives on income taxes, consumption taxes, tax incentives, municipal taxes, and tax evasion policies. One of the income tax initiatives proposed by the public sector was to incorporate into Puerto Rico's tax system the concept of disregarded entities. Under this initiative, as detailed in the Advisory Group's preliminary report, the concept of "disregarded entities" would:

- apply only for the Department of Treasury's purposes and not for Municipality's purposes;
- simplify compliance, as there would be no need for a separate tax return for the entity; and
- allow to use all losses against income from other entities without limitations.

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This initiative proposed by the Advisory Group was enacted under Act 52-2022, known as the "Stabilization of the Public Finances of Puerto Rico Act", signed by the Governor of Puerto Rico on June 30, 2022. Act 52-2022 originated from the House of Representatives Bill No. 1367 ("PC 1367") which provided the blueprint to transition from the excise tax applicable to foreign intercompany purchases to a higher income tax, which is a matter related to tax incentives in Puerto Rico. However, during the legislative process of PC 1367 other amendments to the Code were included and passed under Act 52-2022, including the new disregarded entities concept in Puerto Rico.

The concept of disregarded entities is new in Puerto Rico and will require administrative guidance from the Department of Treasury, which we are anxiously awaiting. We also anticipate that technical amendments to the provisions included under Act 52-2022 may need to be legislated to properly address some issues with the current language, some of which we point out below. Also, since all income taxes are administered by the Department of Treasury through the Unified System of Internal Revenue ("SURI" for its Spanish acronym), SURI programming will also have to be modified to incorporate the disregarded entity concept in Puerto Rico's tax system.

But how will the new disregarded entities work in Puerto Rico? Below we summarize the provisions of Act 52-2022 with regards to the new disregarded entities in Puerto Rico. However, please keep in mind that the summary below refers to the provisions as enacted under Act 52-2022. The conclusions in the summary below may be subject to change depending on future guidance from the Puerto Rico Department of Treasury or due to technical amendments enacted.

1. **Which entities qualify as "disregarded entities"?**

   Only limited liability companies, domestic or foreign, or similar foreign entities, with a single member **that is an individual resident in Puerto Rico** can qualify as "disregarded entities." The requirement that the sole member be an individual resident in Puerto Rico is a limitation not seen under the USIRC. Under the USIRC, the only limitation to qualify as a disregarded entity is that the entity must have a single member, be it individual, resident, non-resident, foreign, domestic, corporation, limited liability company, partnership, or any type of taxpayer. This requirement greatly limits the qualification of the taxpayers as a disregarded entity. Considering that the purpose of this new concept is to simplify compliance, as proposed by the Advisory Group, we understand that this requirement should be modified in a future technical amendment to the Code to only require a single-member structure and allow any type of taxpayer as the single-member. Other provisions in the Code refer to disregarded entities as having a "single owner" not referencing the requirement that it be a resident individual. This is also a fact that makes us wonder if such requirement was a legislative unintended drafting error.

   Spouses married under the community property regime will be considered a single member to determine if the entity qualifies to be taxed as a disregarded entity. This provision is inconsistent with Revenue Procedure 2002-69 issued by the IRS which states that entities owned by spouses in a community property state may elect partnership or disregarded treatment. In any case, it is possible to have partnership treatment for United States income tax purposes and disregarded entity treatment for Puerto Rico income tax purposes without impairing the tax treatment in the other taxing jurisdiction.

2. **Is the tax treatment as a disregarded entity mandatory or is it elected?**

   Generally, limited liability companies, whether single member or not, will, by default, be taxed as a corporation. However, if the entity is owned by a single-member individual resident, the entity **may elect to be treated** as a

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From 2014 to 2016 she worked at the Puerto Rico Department of Treasury, first as advisor to the Secretary and then as the Assistant Secretary for Tax Policy, where she serviced the tax needs of numerous taxpayers, ranging from salaried to high-wealth individuals, from local to multinational entities, and from small to large taxpayers. She was also responsible for the analysis of complex tax issues, drafting and commenting tax bills, requests for exemptions and tax credits, requests for rulings, closing agreements, issuance of tax regulations as well as dealing with tax consultations for the Department and for other agencies of the Commonwealth of Puerto Rico and the Federal Government.

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Elisa has a Bachelor's degree and a Master's degree both in Business Administration, and a Juris Doctor from the University of Puerto Rico. She has been admitted to practice law in Puerto Rico and the United States District Court for Puerto Rico.

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disregarded entity. An **exception to this rule** is in the case of foreign entities (including entities organized in the United States) that are already treated as partnerships, disregarded entities, or pass-through entities in the foreign country. In such case, the entity is required to be treated as a disregarded entity when the entity has **only one owner** and will not be eligible to be taxed as a corporation, except if the entity has a tax exemption decree, in which case, it may elect corporation tax treatment. Note that the Code changes the term in this case to "owner" instead of individual resident. The use of the term "owner" in this provision suggests that an entity with a single-member other than an individual resident in Puerto Rico is required to be taxed as a disregarded entity if in a foreign country (such as the United States) is treated as a disregarded entity. But why does this distinction between the entities allowed to make an election versus the entities required to be taxed as a disregarded entity? We, again, must conclude that the requirement that the single member be an individual resident in Puerto Rico is, at best, a legislative error that must be addressed by a technical amendment to the Code or, at least, administratively by the Department of Treasury.

3. **In the case of the entities that can make the election, when is the election due and how is it done?**

   The election to be taxed as a disregarded entity is due with the income tax return of the first effective year of the tax treatment. For example, if the entity wants the election to be effective for the year 2023, then the election must be filed with the income tax return for the year 2023, on or before the due date of the income tax return for such year, including extensions (October 15, 2024, for a calendar year-based taxpayer). We must wait for the Department of Treasury to establish the process of filing the election, but, considering the process already in place for the partnership election, must likely the Department will require an additional schedule to be included with the return to make the election.

4. **Which is the first year that the entity can elect to be taxed as a disregarded entity?**

   We also find inconsistencies in the Code to determine the effective date of the disregarded entity provisions. According to the text of Act 52-2022, the election to be taxed as a disregarded entity is available for years commencing after December 31, 2021. Therefore, it seems that the election to be taxed as a disregarded entity will be available for the calendar years 2022 and thereafter. However, when referring to the single-member entities that cannot elect to be taxed as a corporation (question 2 above), the Code states that such provision will be effective for taxable years commencing after December 31, 2022, making the mandatory disregarded entity tax treatment effective for the calendar year 2023 and thereafter. Furthermore, when referring conversions to limited liability companies, the Code provides that the entity may elect disregarded entity treatment for taxable years commencing after December 31, 2022, making the election in this case effective for the calendar year 2023 and thereafter.

   Based on these provisions, we can reconcile the effective dates stating that the general election will be effective for 2022, foreign pass-through single-member entities must be considered disregarded entities for 2023 and thereafter, and entities converted to limited liability companies can elect disregarded entity treatment for 2023 and thereafter (although we understand that the converted entity can still elect disregarded entity treatment for 2022 if it desires so under Section 1010.01(a)(3) of the Code). We will have to await Treasury's advice or technical amendments to confirm the effective dates under each item.

5. **What are the consequences of an entity being treated as a disregarded entity?**

   If an entity is treated as a disregarded entity:

   - the activity of the entity must be recognized in the income tax return of the owner as if the entity did not exist, considering the owner's tax year and accounting method;
   - the entity must comply with the requirements to withhold income taxes (from salaries, professional services, etc.), and to prepare informative returns (Forms 480), as well as with any other provision related to the computation of the income tax return of the economic activity of the entity;
   - the entity must also still comply with the provisions related to municipal volume of business tax and personal property taxes; and
   - the entity will not be required to separately prepare audited financial statements, but its volume of business will be attributed to its owner to determine its own requirement.

The Department of Treasury will require in the owner's income tax return a detail of the volume of business of the disregarded entity. We can expect that the Department of Treasury will provide the instructions on how to properly reflect on the owner's income tax return the activity of the disregarded entity. In the meantime, we suggest that the owners of the disregarded entity keep all records separate to prepare a year-end balance sheet and income statement.

6. **Are there any conversion costs to the entity or its owner when electing or converting to a disregarded entity?**

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The costs associated with the conversion to a disregarded entity depends on the type of entity from which it converts from.

If the entity is already treated as a pass-through entity, be it a partnership, corporation of individuals or a special partnership, the conversion is treated as a distribution in total liquidation of the entity as if it were a partnership, under the provisions of Section 1073.01. In general, capital gain or loss will be recognized in the transaction if the cash, unrealized credits, or inventory of the entity exceeds the tax basis of the owner in the entity. The entity is not required to recognize any gain on the transaction. The tax basis of the assets in the hands of the new disregarded entity will be the same as the tax basis in the hands of the previous disregarded entity.

If the entity is originally treated as a corporation, then the transaction will be treated as a distribution in total liquidation of the entity, under the provisions of Section 1034.04(q) of the Code. In general, the entity, prior to its conversion to a disregarded entity, is required to recognize gain for any appreciation of its property (including unrecognized intangibles). The owner is also required to recognize a capital gain or loss for the value of the assets received in liquidation of the corporation. In this case, the tax basis of the assets will be stepped-up considering the market value of the assets at the time of the conversion. However, if it is finally determined that an owner of a disregarded entity can be a corporation, then in such case where there is a single corporate owner there would be no conversion cost when converting the entity from a corporation to a disregarded entity since the transaction would qualify as a parent-subsidiary liquidation exempt from taxation under Section 1034.04 (b)(6) of the Code.

The employer's identification number of the new disregarded entity will be the same as for the original entity since this election only affects income taxes in Puerto Rico.

7. **If the entity converts to a disregarded entity, what would be the cost to revoke the election?**

If the disregarded entity later wants to revoke such election, then it shall be considered that the owner contributed the assets and liabilities to the new pass-through entity or corporation, whichever applies, which will generally be a transaction exempt from income taxes, subject to the provisions of Sections 1072.01 and 1034.04(b)(5), respectively, of the Code. Further guidance from the Department of Treasury will be required when additional members are added to an entity that was previously taxed as a disregarded entity, and no longer qualifies as such.

The following table summarizes the conversion effects described in No. 6 and 7 above.

Original Entity	New Entity Type	Effect
Conduit Entity	Corporation	Capital Contribution
Conduit Entity	Disregarded Entity	Total Distribution
Corporation	Conduit Entity	Total Distribution and Capital Distribution
Corporation	Disregarded Entity	Taxable Liquidation
Disregarded Entity	Conduit Entity	Capital Contribution
Disregarded Entity	Corporation	Capital Contribution

8. **Do existing single-member entities organized in Puerto Rico have to change their current tax election?**

It appears that current single-member entities can be taxed as a corporation, disregarded entities or conduit entities. Conduit entities are taxed as "partnerships". So, it might not be necessary to change current elections of single-member entities unless elected, provided further guidance by the Department of Treasury. Stay tuned to our upcoming newsletter on the "New" Conduit Entities.

ATBA Comments:

There are various inconsistencies in Act52-2022 with regards to the Effective Dates and other technical matters applicable to disregarded entities. Such inconsistencies must be resolved either by technical amendments to the Code or by administrative interpretation from the Puerto Rico Department of Treasury. It is important to determine the conversion costs when electing disregarded treatment as the transaction will not always result in a tax-free conversion. Furthermore, single-owned entities currently in existence must analyze if the new disregarded entity or conduit entity provisions in Puerto Rico, result in additional tax costs, especially if mandatory conversion apply. Unlike when the partnership provisions were incorporated in the Code back in 2011, there is no transition-year exemptions or grandfather clauses applicable to entities that may be affected by any provision that might make mandatory an automatic conversion to a disregarded entity, which may create additional tax costs when applying such provisions. We at ATBA can assist in determining how the entity can benefit or may be impacted by the new disregarded entity provisions in Puerto Rico.

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