VALDES, GARCIA, MARIN & MARTINEZ, LLP
San Juan, Puerto Rico
(www.vgmmcpa.com)

Tax Topics – Limited Liability Companies

As we discussed in our Tax Alert from March 2011, the new Puerto Rico Internal Revenue Code of 2011 (the "2011 Code") significantly changed the way Limited Liability Companies ("LLC's") are taxed in Puerto Rico. Prior to January 1, 2011, LLC's were taxed as regular corporations, unless they had elected to be treated as flow through entities under the various provisions of the tax code (i.e.: Corporation of Individuals or Special Partnership).

Effective January 1, 2011, LLC's will continue to be subject to tax as corporations. However, LLC's may elect to be treated as partnerships for tax purposes (even if having a single member). Furthermore, if an LLC is treated as a flow through or disregarded entity under the laws of any foreign jurisdiction, it will also be treated as a partnership for Puerto Rico tax purposes. This exception will not be applicable in the event the LLC holds a tax exemption grant issued under any of the Puerto Rico Development Economic Incentives Acts, the "Puerto Rico Tourism Development Act" or similar predecessor acts. In this case, the LLC's tax treatment will remain unchanged.

The 2011 Code provides certain transitory rules in the event an LLC previously treated as a corporation is subject to the new tax treatment explained above. In such cases, the LLC's will be treated as having liquidated as of their last taxable year before the application of the 2011 Code. Upon such reorganization their assets and liabilities will be considered distributed to their partners or members and immediately thereafter contributed to a new partnership.

This liquidation/contribution transaction will not be subject to tax. However, the transaction will be treated as if the LLC converted into a corporation of individuals (flow through entity). That is, its current and accumulated earnings and profits will be deemed distributed (and subject to a 10% tax). Furthermore, the LLC would be subject to recaptures of items such as LIFO accounting for inventories, flexible and accelerated depreciation, etc. It may also be subject to tax on certain built-in gains. Finally, all members of the LLC will be treated as being engaged in a trade or business in PR and, therefore, required to file Puerto Rico Income Tax Returns.

Although these transition rules can certainly be economically costly, the 2011 Code have options to temporarily avoid these reorganization steps. The 2011 Code offers LLC's the option to remain under their current tax status by electing to be subject to taxation under the 2011 Code's predecessor, the 1994 Code. This 5-year election is irrevocable. After this period, the taxpayer will be taxed under the 2011 Code and subject to the reorganization procedure explained above.

These new rules are complex and careful planning is paramount to avoid unexpected tax consequences. We can definitely assist you in determining which path to follow. Feel free to contact us should you have any questions or if you wish to discuss your current business structure and the impact these new rules may have on your operations.

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Please contact Rafael A. Arce, JD, CPA, MST, Tax Senior Manager at 787-725-1600 or at rarce@vgmmcpa.com or your service partner should you have any questions or comments or if you need additional information regarding this matter.