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## TAX ALERT

### ***The Act to Transform the Tax System of the Commonwealth of Puerto Rico: Conduit Entities***

This is the second of a series of Tax Alerts on the recently unveiled House Bill 2329, known as “The Act to Transform the Tax System of the Commonwealth of Puerto Rico,” which will introduce a new tax code to be known as the Puerto Rico Internal Revenue Code of 2015 (the “Code”).

Below is a summary of the most significant provisions of the Code dealing with “conduit entities.”

#### CONDUIT ENTITIES

##### A. Introduction

A new entity classification is created for income tax purposes, the conduit entity. It will replace existing “pass-through” vehicles, such as, corporations of individuals, partnerships and special partnerships, as the vehicle to avoid double taxation under the proposed Code.

##### B. Eligible Entities

The following entities are subject to the conduit entity provisions:

- (i) Eligible corporations and limited liability companies otherwise taxable as corporations that make an election.
- (ii) Partnerships and certain limited liability companies (i.e., those that, as a result of an election or other statutory or regulatory provision pursuant to the U.S. Internal Revenue Code of 1986, as amended, or analogous foreign country provision, are subject to tax as a partnership, or that its income or expenses are attributed to its members, for federal or foreign country tax purposes) that commence operations after December 31, 2014.
- (iii) Partnerships and limited liability companies subject to taxation as partnerships during the last taxable year commencing before January 1, 2015.
- (iv) Entities with special partnership elections or corporation of individual elections during the last taxable year commencing before January 1, 2015.

In general, corporations, limited liability entities and partnerships will be considered eligible, except for certain insurance companies, investment companies, employee-owned special corporations, tax exempt/non-profits, corporations whose shares are traded in a recognized stock market and corporations organized outside Puerto Rico that are subject to taxation as corporations as a result of an election or other statutory or regulatory provision pursuant to the U.S. Internal Revenue Code of 1986, as amended, or analogous foreign country provision.

C. Election

An election must be made within the first 90 days of the taxable year for which the election is to be effective.

D. Conduit Entity and Owner Taxation

The new conduit entity will not be subject to income taxation and instead its owners will be subject to tax on their distributable share of income, gain, losses, deductions and credits. Generally, the conduit entity provisions are similar to the existing partnership provisions under the Puerto Rico Internal Revenue Code of 2011, as amended (the "2011 Code"). Nonetheless, certain existing partnership provisions relating to, among others, electing optional adjustment to basis of partnership property have not been included in the proposed new conduit entity provisions.

1. Non-Puerto Rico owners

Not clear whether owners of a conduit entity that is engaged in a trade or business in Puerto Rico will be considered engaged in a trade or business in Puerto Rico with respect to their participation in a conduit entity. However, the proposed provisions do indicate that certain non-Puerto Rico owners in conduit entities that as of December 31, 2014, had in effect a special partnership or a corporation of individual election and that are not otherwise engaged in a trade or business in Puerto Rico will not be considered engaged in a trade or business in Puerto Rico with respect to their participation in the income, gain, losses, deductions or credits of the conduit entity by reason of this provision.

E. Transition Rules

1. Statutory Conversion: Partnerships and limited liability companies subject to tax as partnerships under the 2011 Code during the last taxable year commencing before January 1, 2015 will be subject to the conduit entity provisions for taxable years commencing after December 31, 2014

These entities will be considered to have undergone a change in identity to a conduit entity, as of the last day of the last taxable year commencing before January 1, 2015.

No gain or loss on these transfers will be subject to tax and the basis of the assets in the partnership or limited liability company, their holding periods and other tax attributes will carry over to the new conduit entity. A partner or member basis in the partnership or limited liability company will carry over to the new conduit entity.

These entities will continue to have the same taxable year until there is a change in the partners or members, at which time the entity will be subject to the conduit provisions applicable to a change in taxable year.

2. Statutory Conversion: Entities subject to taxation as special partnerships or corporations of individuals under the 2011 Code for the last taxable year commencing before January 1, 2015 will be subject to the conduit entity provisions for taxable years commencing after December 31, 2014

These entities will be considered to have undergone a change in identity to a conduit entity, as of the last day of the last taxable year commencing before January 1, 2015.

No gain or loss on these transfers will be subject to tax and the basis of the assets in the special partnership, their holding periods and other tax attributes will carry over to the new conduit entity. A partner, member or shareholder basis in the special partnership or corporation of individuals, as applicable, will carry over to the new conduit entity. These entities will continue to have the same taxable year until there is a change in the partners, members or shareholders, at which time the entity will be subject to the conduit provisions applicable to a change in taxable year.

The statutory conversion for tax purposes will not have the effect of deeming a partner, member or shareholder that, otherwise is not engaged in a trade or business in Puerto Rico, as engaged in a trade or business in Puerto Rico, so long as there is no change in partner.

3. Entities subject to taxation as corporations for the last taxable year commencing before January 1, 2015 subject to the conduit entity provisions for taxable years commencing after December 31, 2014

These entities will be considered to have transferred all assets and liabilities to its shareholders in complete liquidation of the corporation and immediately thereafter contributed its assets and liabilities to the new conduit entity. No gain or loss on these transfers will be subject to tax. Nonetheless, the corporation will be subject to recapture of LIFO benefits, recognition of deferred income under long-term contracts, recognition of deferred income from installment sales and certain built-in gains.

Accumulated earnings and profits as of the last day of the last taxable year subject to taxation as a corporation will be deemed distributed during the first two years as a conduit entity subject to a 10% tax rate. No less than 50% of such accumulated earnings and profits shall be deemed distributed during the first year as a conduit entity.

4. Entities subject to taxation as corporations pursuant to the provisions of the Code or the 2011 Code for the taxable year prior to the first taxable year subject to tax pursuant to the conduit entity provisions, other than entities referred to in 3. above.

These entities will be considered to have transferred all assets and liabilities to its shareholders in complete liquidation of the corporation and immediately thereafter contributed its assets and liabilities to the new conduit entity. These transfers are not per se tax exempt. Furthermore, the corporation will be subject to recapture of LIFO benefits, recognition of deferred income under long-term contracts, recognition of deferred income from installment sales and certain built-in gains.

Accumulated earnings and profits as of the last day of the last taxable year subject to taxation as a corporation will be deemed distributed during the first two years as a conduit entity subject to a 20% tax rate. No less than 50% of such accumulated earnings and profits shall be deemed distributed during the first year as a conduit entity.

F. Special rule for Puerto Rico resident partners in partnerships and members of limited liability companies not engaged in a trade or business in Puerto Rico.

In the case of partnerships and limited liability companies subject to partnership taxation under the U.S. Internal Revenue Code of 1986, as amended, or under analogous provisions of the tax laws of a foreign country, or that its income and expenses are attributed to its partners or members, the partner or member that is a resident of Puerto Rico must report the income in accordance with the amount reported by such partnership or limited liability company for federal or foreign country tax purposes, as applicable. Such entities will be considered conduit entities.

If you have any questions, you may contact any of the attorneys of our Tax Practice Group listed below:

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