

## Act 52: Amendments to the Puerto Rico Internal Revenue Code

### ATTORNEYS

- Isis Carballo-Irigoyen
- Yamary I. González-Berríos
- Rubén Muñiz-Bonilla
- Lillian Toro-Mojica
- Xenia Vélez
- Carlos J. Villafañe-Real
- Mariana M. Contreras-Gómez
- Leyla González-Ibarría
- Rafael Fernández-Suárez

### PRACTICE AREAS

- Tax

### An McV Tax Alert

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On June 30, 2022, Governor Pedro Pierluisi signed into law House Bill no. 1367. In addition to providing transition rules for the Act 154-2010 (“Act 154”) excise tax, the new Act 52-2022 (“Act 52”) incorporates amendments to the Puerto Rico Internal Revenue Code of 2011, as amended (“PR Code”).

This Tax Alert is the first of two alerts that will summarize some of the most relevant provisions amending the PR Code in areas such as (i) Entity Classification, (ii) Tax Credits, (iii) Miscellaneous Income Tax Provisions, (iv) Remote Work, (v) Sales and Use Taxes, and (vi) Administrative Matters.

### **Disregarded Entities and Conduit Entities**

Act 52 introduced two new entity classifications for income tax purposes: disregarded entities (“Disregarded Entities”) and conduit entities (“Conduit Entities”).

#### Definitions

Disregarded Entity is defined as an entity that is ignored as separate from its owner only for income tax computation purposes under the PR Code.

A limited liability company (“LLC”) with a single member who is a resident of Puerto Rico may elect to be treated as a “Disregarded Entity.” The community of property (“sociedad de gananciales”) constituted by a married couple is regarded as a single owner for these purposes.

- The owner of a Disregarded Entity will recognize the activity of the entity on the owner’s income tax return as if the entity does not exist. Accordingly, the Disregarded Entity will not be required to file income tax returns and its income and expenses will be reported by its owner using the owner’s same taxable year and accounting method.
- The election to be treated as a Disregarded Entity must be made on or before the income tax return filing due date, including extensions.

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- The Disregarded Entity must comply with the withholding and reporting tax responsibilities imposed by the PR Code to any other entity, as well as with any other provisions under the PR Code not related to the computation of the income tax.

Act 52 also introduced the Conduit Entity. Such term is defined as an entity organized under the General Corporation Law of Puerto Rico, or any other analogous state or foreign law, whose income is attributable to its owners, members, or partners for income tax purposes.

- Any corporation, partnership or LLC may elect to be treated as a Conduit Entity even if it has only one member.
- The Conduit Entity will be subject to all the partnership provisions under the PR Code.
- The term “partnership” was amended to include Conduit Entities.

### Effective Dates

For taxable years starting after December 31, 2021, LLCs can elect to be treated as Conduit Entities or as Disregarded Entities. As previously mentioned, in the case of Disregarded Entities, the election can be made when the LLC has one member who is a Puerto Rico resident individual.

Effective for taxable years beginning after December 31, 2022, a foreign (non-PR) LLC that is treated as a partnership, a disregarded entity, or whose income is attributable to its members under the provisions of the U.S. Internal Revenue Code or of any analogous foreign law, will be treated as a Conduit Entity, or as Disregarded Entity in the case of sole member LLCs (it is not clear whether the sole member must be an individual).

Also effective for taxable years beginning after December 31, 2022, when a corporation converts into an LLC, the election to be taxed as a partnership, as a Conduit Entity, or as a Disregarded Entity can be made, at the election of the entity, retroactively effective to the prior taxable year if at the time of the conversion the income tax return filing due date, including extensions, has not expired.

In connection with the expiration of the entity classification rules currently in place, there appears to be a mistake in the act since those rules will also apply for taxable years beginning after December 31, 2022. This may have to be clarified through a technical amendment to Act 52.

### Changes in Entity Classification

Act 52 also clarifies the tax treatment of certain changes in the classification of an entity. Specifically, special rules will apply when there is a change (i) from a Conduit Entity to a corporation or Disregarded Entity, (ii) from a corporation to a Conduit Entity or Disregarded Entity, and (iii) from an LLC treated as a Disregarded Entity to a Conduit Entity or corporation. Any change in entity classification whose effective date is not the last day of the taxpayer's taxable year, will be subject to the rules related to short-year tax returns.

### Sale of Partnership Interest

For sales of partnership interests after December 31, 2018, but before July 1st, 2022, any gain, benefit, or income derived from the sale of partnership interests in a partnership generating income from Puerto Rico sources will be considered Puerto Rico source income to the extent the partnership would have generated Puerto Rico source income if the partnership had sold its assets at its fair market value. This rule applies during the above period regardless of the residency of the seller.

For sales after June 30, 2022, the gain that will be subject to Puerto Rico income tax withholding in the case of a nonresident alien individual or foreign corporation will be in an amount equal to their distributable share in the gain which would have been income effectively connected with the conduct of a Puerto Rico trade or business if the partnership had sold all its assets at their fair market value as of the date of the **direct or indirect** sale of the interest in the partnership.

### **New Tax Credits Manager**

Act 52 enacted new PR Code Section 1051.16 which grants authority to the Secretary of the Treasury ("Secretary") to create the "Tax Credits Manager" ("MCC," for its Spanish acronym) as part of the electronic system of the Puerto Rico Treasury Department ("Treasury").

The purpose of the MCC is to:

1. Facilitate the management and oversight of tax credits;
2. Be an automated and interactive tool that will allow management of tax credits from their granting, including their use, transfer or assignment, claim, recapture and expiration;
3. Facilitate the exchange of information between Treasury and other government agencies;
4. Facilitate the preparation of reports by Treasury in connection with the fiscal impact of the tax credits; and
5. Provide data for the periodic review of the performance indicators of each tax credit.

The Secretary will establish the implementation date of the MCC. This date will segregate tax credits between Pre-MCC Credits and Post-MCC Credits.

Pre-MCC Credits will be those credits that were granted under the PR Code, the Puerto Rico Incentives Code, prior incentives acts or any other special act before the implementation date of the MCC. These credits can only be carried over during a period of three taxable years after the implementation date of the MCC. Upon the expiration of the 3-year period, taxpayers (including third party purchasers) will not be able to claim any unused balance of Pre-MCC Credits.

Post-MCC Credits are the credits to be granted after the implementation date of the MCC. To have the right to claim these credits, they must first be registered with the MCC.

### **Other Miscellaneous Provisions**

#### Filing After Death of Spouse

For taxable years beginning after December 31, 2022, if a taxpayer's spouse dies during the taxable year, the surviving spouse filing status for the entire taxable year will be "married," unless the taxpayer remarries within the same taxable year.

#### Optional Tax for Self-Employed Individuals

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For taxable years beginning after December 31, 2021, self-employed individuals that meet certain requirements may opt for the optional tax provided in Section 1021.06 of the PR Code even if said individual has a tax balance to be paid with the income tax return. However, the individual must pay the tax owed in full no later than the deadline for filing the income tax return, without considering applicable extensions.

### Employee Stock Purchase Plan

Act 52 amends Section 1040.08 of the PR Code regarding qualified stock options in an attempt to clarify that the price of the options offered under an Employee Stock Purchase Plan can be less than the market value of the stocks at the time the options were granted or exercised, up to the maximum amount allowed under U.S. Internal Revenue Code Section 423(b).

### Individuals with Foreign Financial Accounts

Act 52 enacted a new Section 1061.25 requiring that every individual resident of Puerto Rico must file, along with its income tax return, a statement under penalty of perjury with information as to any financial account held outside Puerto Rico or the United States in which he or she has a financial interest ("Statement"). The individual will not have to submit the Statement for a foreign financial account whose maximum value does not exceed \$10,000 during a taxable year.

Every taxpayer required to file the Statement who voluntarily fails to do so within the applicable term will be subject to a \$10,000 penalty and will incur in a misdemeanor.

### Requirement to File Financial Statements or other Documents with Returns of Group of Related Entities

For taxable years beginning after December 31, 2019, all entities that are members of a group of related entities with an aggregate business volume equal to or greater than \$10,000,000, and that individually have generated a business volume equal to or greater than \$3,000,000 dollars will be required to submit consolidated audited financial statements ("Consolidated AFS").

Entities that belong to a group of related entities with an aggregate business volume equal to or greater than \$10,000,000, but that individually generated less than \$3,000,000 dollars, are not required to file Consolidated AFS. However,

if they voluntarily file with their income tax returns a Report of Previously Agreed Upon Procedures or Compliance Attestation prepared by a Certified Public Accountant licensed in Puerto Rico, the limitations on deductions for the Individual Alternative Minimum Tax will not apply.

Disregarded Entities will not be required to file AFS with their income tax returns, but their business volume will be attributed to the owner for purposes of determining whether the owner should file AFS with the income tax return.

### Requirement to File Supplemental Information to AFS

If a business includes an AFS with its income tax return for a taxable year beginning after December 31, 2012, but before January 1, 2023, it will also be required to file all supplemental information and records used to prepare the AFS (even if the AFS is voluntarily filed). However, for taxable years beginning after December 31, 2022, only certain construction businesses, hospital units and financial institutions will be required to file with their income tax returns the supplemental information and records used to prepare the AFS.

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