THE NEW ERA OF FLOW-THROUGH TAXATION IN PUERTO RICO: OPPORTUNITIES AND CHALLENGES FOR CHOICE OF ENTITY STRATEGIES

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> *The distressingly complex and confusing nature of the provisions of subchapter K present a formidable obstacle to the comprehension of these provisions without the expenditure of a disproportionate amount of time and effort even by one who is sophisticated in tax matters with many years of experience in the tax field . . . . Surely, a statute has not achieved "simplicity" when its complex provisions may confidently be dealt with by at most only a comparatively small number of specialists who have been initiated into its mysteries.*[1]

> *Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.*[2]

I. Introduction

The origins of this story can be traced as far back as to the promises made during the campaign efforts leading to the 2008 general elections in Puerto Rico. However, it was not until February 4th, 2010, a significant date, in which a tax reform commission was appointed by the Governor of Puerto Rico and was quickly charged with the task of examining different alternatives to expeditously reform the Island's tax system.[3] Almost a year

[1] Foxman v. C.I.R., 41 T.C. 535, 551 n.9 (1964).
[2] Comm'r. v. Newman, 159 F.2d 848, 850-51 (2d Cir. 1947) (Judge Learned Hand dissenting).
[3] Yanira Hernández Cabiya, *Configurado el comité que redactará la reforma contributiva,* El Nuevo Día, Feb. 4, 2010, http://www.elnuevodia.com/Xstatic/endi/template/imprimir.aspx?

later, on January 31, 2011, a new Internal Revenue Code for Puerto Rico was enacted into law and became known as the Internal Revenue Code for a New Puerto Rico (hereinafter the "2011 PR Code").

Specifically, the statement of motives for Puerto Rico Act 1 of 2011 unequivocally points us to the general spirit encompassing the approval of the 2011 PR Code; "[h]istory has taught us that, indeed, a dollar in the hands of a citizen yields more than a dollar in the government's hands."[4] Furthermore, the statement of motives states that; "[b]y adopting this law, we put more money into the pockets of our workers, in recognition that the power to determine what is best for themselves and their loved ones is solely for them, and not the Government's."[5] Thus, we can note that the basic principle encompassing the approval of the 2011 PR Code was to provide *tax justice* for the common citizen of Puerto Rico by procuring a gradual reduction in the tax rates over the next couple of years.

The statement of motives of Puerto Rico Act 1 of 2011 sets forth an additional objective:

> [T]o facilitate doing business in Puerto Rico, this Act [Act 1 of 2011] reconciles the [tax] provisions relating to partnerships [in Puerto Rico] with the provisions of the federal code. For this reason, [Act 1] adds a new chapter for partnerships, which provides the new taxation rules for partnerships in Puerto Rico. This chapter provides that partnerships will not be taxed as separate entities from their partners and, hence, the partnership shall not be subject to income tax. The partners will be taxed on their corresponding share of income and expenses of the partnership.[6]

Therefore, it is important to understand that the secondary principle underlying the 2011 tax reform was to simplify or facilitate the process of conducting business transactions in Puerto Rico by modifying the applicable tax rules. In essence, the tax reform committee tried to achieve this objective by, as illustrated in the previous paragraph, harmonizing the tax

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id=667979&t=3 (informing that such committee was composed of "attorney Xenia Vélez as Director of the Executive Committee . . . Representative Antonio Silva, Senator Migdalia Padilla; Secretary of the Treasury Juan Carlos Puig; the President of the Government Development Bank, Carlos García; Secretary of Economic Development, José Ramón Pérez Riera, and the Governor's Chief of Staff Marcos Rodríguez Ema).

[4] 2011 P.R. Laws No. 1; as amended. Statement of Motives at 12. *See also* LUIS G. FORTUÑO, GOVERNOR OF THE COMMONWEALTH OF PUERTO RICO, Mensaje Especial sobre La Reforma Contributiva, Salud para Todos y Más Dinero en tu Bolsillo [Special message regarding the Tax Reform, Healthcare for All and More Money in your Pocket], Oct. 25, 2010, *available at* http://www.prfaa.com/espanol/docs/reformacontributiva/reformacontributiva2010.pdf.

[5] *Id.*

[6] *Id.* at 11.

consideration given in Puerto Rico to certain entities and transactions to the treatment given to those entities and transactions in the Federal Internal Revenue Code.[7] Thus, as done by other administrations in the past, the tax reform committee merely adopted the federal provisions pertaining to partnerships and partners by translating these provisions into Spanish and incorporating them into Chapter 7 of the 2011 PR Code. With certain exceptions, the 2011 PR Code came into effect as of January 1, 2011 (i.e. for taxable years commenced after December 31, 2010). Formerly, the applicable tax code in force was the Puerto Rico Internal Revenue Code of 1994[8] (hereinafter, the "1994 PR Code"), as amended, which was applicable to taxable years beginning after June 30, 1995. Additionally, it is important to note that at this time regulations promulgated and issued by the Puerto Rico Department of the Treasury based on the 1994 PR Code are still in effect until new regulations are promulgated under the 2011 PR Code.

Finally, it is important to understand that the Government of Puerto Rico currently enjoys and enforces a Primary Taxing Power. That is, the Island enjoys Fiscal Autonomy from that of the Government of the United States of America. Puerto Rico exercises this powerful tool of Primary Taxing Power by being the first and primary entity to tax the wealth generated within the island. ,This Primary Taxing Power arises from the constitutional developments that have characterized its relationship with the United States for more than a century.[9] Thus, it is because of this fiscal autonomy that the Government of Puerto Rico is able to develop, enact and enforce tax laws that are separately administered from those of the Government of the United States of America. This is the reason for having separate, but in some instances equal tax provisions in Puerto Rico, which in essence are inspired or copied from the provisions of the Federal Internal Revenue Code.

In this article, we will first describe the general notions regarding flow-through taxation and entity level taxation and we will include a discussion of the United States' version of flow-through taxation. Afterwards, we will describe the general change in the entities allowed to claim flow-through taxation for Puerto Rico tax purposes (i.e. who was allowed under the 1994 PR Code to claim flow-through taxation and what entities are now allowed under the 2011 PR Code) thus offering a general overview of the Special Partnership election and the Corporation of Individuals election

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[7] 26 U.S.C. §§.1-9834. *See also* I.R.C. §§ 701-777 (Subchapter K, "Partners and Partnerships").
[8] 1994 P.R. Laws No. 120; as amended.
[9] Felipe Rodríguez-Lafontaine, *Puerto Rico Act 154: The Beginning of the End? Effects of Act 154 on Future Economic Development*, 2 U.P.R. BUS. L. J. 216, 219 (2011) (discussing the conditions and historical events that granted the Primary Taxing Power bestowed on the Government of Puerto Rico). See also for a discussion of this topic Carlos Díaz Olivo, *The Fiscal Relationship Between Puerto Rico and the United States: A Historical Analysis*, 51 REV. COL. ABOG. P.R. 32 núm. 2-3, (1990) and Juan Carlos Méndez Torres, *The Internal Revenue Code's Role in Puerto Rico's Economic Development,* 15 J. INT'L TAX'N 22 (2004).

which were available in the 1994 PR Code. We will describe the recently enacted Chapter 7 ("Partnerships and Partners") of Subtitle A ("Income Taxes") of the 2011 PR Code. Shortly thereafter, we will discuss the consequences of these changes for business entities in Puerto Rico and will conclude with recommendations for future technical amendments.

II. DISCUSSION

A. Available Entities for Doing Business in Puerto Rico

The General Corporation Law of 2009, as amended, provides various alternatives in order to conduct trade or business in Puerto Rico. In my professional experience, the following entities are the most frequently organized under the laws of Puerto Rico:

- Corporation- The single most commonly used entity to conduct business in Puerto Rico.[10]

- Branch of a Foreign Corporation- A corporation not organized under the laws of Puerto Rico is considered a foreign corporation. A foreign corporation is required to register with the Department of State prior to conducting any business transactions in Puerto Rico by filing the Certificate of Authorization to do Business for a Foreign Corporation.[11]

- Closely Held Corporation- This is a corporation that shall have no more than 75 shareholders and its stock is subject to transfer restrictions and cannot be subject to a public offering. A closely held corporation will be subject to the laws of a regular corporation except for those provisions that are contrary to the special provisions applicable to closely held corporations.[12]

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[10] P.R. LAWS ANN. tit. 14, §§ 3501-3790 (2011).

[11] P.R. LAWS ANN. tit. 14, §§ 3801-3815 (2011). *See also* Puerto Rico Industrial Development Company, Recommended Tax Structures, http://www.offshorecorporation.com/puerto-rico/ (stating that "many companies have established their operations in Puerto Rico as profit centers to take advantage of special tax provisions." It is explained that a "U.S. Parent, under the Controlled Foreign Corporation ("CFC") structure, the Puerto Rico subsidiary, which will generate a maximum corporate income tax rate of 7% with no withholding tax, may use these profits to fund their foreign operations including the Puerto Rico operations." In the case of the European Union Parent under the European parent model, the European Union ("EU") parent has an affiliate in the Netherlands who in turn owns the Puerto Rico Corporation).

[12] P.R. LAWS ANN. tit. 14, §§ 3821-3839 (2011).

- Partnership- No less than two natural persons may organize this type of entity. As a general rule, each member of a partnership is liable for the debts of the business and is held liable for the partnership's obligations. Partnerships are subject to income taxes on the partnership's income. The liability for taxes applies regardless of whether the partnership's profits are distributed or retained.[13]

- Limited Liability Partnership- No less than two natural persons may organize this type of entity. This type of entity provides limited liability for its members. A limited liability partnership must register with the Department of State and renew such application on an annual basis.[14]

- Professional Service Corporation- This type of corporation is owned by professionals who perform a specific service and are licensed to do so. Only licensed individuals who perform these services may become stockholders.[15]

- Limited Liability Company- The limited liability company may be formed in Puerto Rico by filing the corresponding certificate at the Department of State. A foreign limited liability company may operate in Puerto Rico by requesting authorization to do business to the Department of State. This type of entity provides limited liability for its members.[16]

Business ventures before the approval of the 2011 PR Code could have chosen the entity classification they desired from a corporate law perspective because the type of entity chosen would not specifically dictate its tax treatment in Puerto Rico. Previously, the tax treatment depended only upon the business activities carried out by such entity in light of the provisions of the 1994 PR Code and other special laws, such as tax incentive laws.[17] These laws provided different tax benefits and/or consequences based on the type of business activities carried out.

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[13] P.R. LAWS ANN. tit. 31, §§ 4311-4324 (2011); P.R. LAWS ANN. tit. 10, § 1344 (2011).
[14] P.R. LAWS ANN. tit. 10, §§ 1861-1867 (2011).
[15] P.R. LAWS ANN. tit. 14, §§ 3921-3938 (2011).
[16] P.R. LAWS ANN. tit. 14, §§ 3951-4044 (2011).
[17] The first Industrial Incentives Act was 1953 P.R. Laws No. 6 of December 15, 1953, as amended, known as the "Industrial Tax Incentives Act of Puerto Rico of 1954" followed by 1978 P.R. Laws No. 26 of June 2, 1978, as amended, known as the "Industrial Tax Incentives Act of Puerto Rico of 1978", 1987 P.R. Laws No. 8 of January 24, 1987, as amended, known as the "Tax Incentives Act of Puerto Rico", 1997 P.R. Laws No. 135 of December 2, 1997, as amended, known as the "Tax Incentives Act of 1998" and the most recent installment of the Industrial Incentives Chapter in Puerto Rico 2008 P.R. Laws No. 73 of May 28, 2008, as amended, known as the "Economic Incentives Act for the Development of Puerto Rico".

B. Summary of Changes Introduced by the 2011 PR Code Regarding Flow Through Taxation.

The 2011 PR Code introduced several important changes to the Puerto Rican tax system, which present new planning opportunities for taxpayers. However, these same changes require, in some instances, immediate attention by entities operating in Puerto Rico because certain transition rules may result in unintended consequences for taxpayers if not managed in an adequately and timely manner.[18] For example, under the 1994 PR Code, major business entity forms (corporations, limited liability companies, partnerships, etc.) were taxed as corporations.[19] Previously, flow-through taxation was only available to entities through elections as either special partnerships or corporations of individuals. Additionally, it is very important to note that "under the 2011 PR Code no elections for special partnership status will be permitted for taxable years commencing after December 31, 2010."[20]

Specifically, "the 2011 PR Code defines partnerships separate from corporations and includes a new chapter for taxation of partnerships and their partners that incorporates rules similar to those found in the US Internal Revenue Code of 1986."[21] Additionally, "[u]nder the new rules, partnerships are not subject to tax on their income at the partnership level. Partners will be treated as undertaking the business of the partnership and will be subject to tax on partnership profits, whether or not such income is distributed."[22] Also, "although this will be the default treatment under the 2011 [PR] Code, partnerships in existence on January 1, 2011 may elect to continue to be treated as corporations for tax purposes."[23]

Finally, under de 2011 PR Code, LLCs will also be able to elect flow-through taxation. However, as a default, they will continue to be treated as corporations for tax purposes in the event that they do not choose flow-through taxation. If an LLC is treated as a flow through (or disregarded) entity under the law of another jurisdiction, it will also be treated as a partnership for Puerto Rico income tax purposes."[24]

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[18] *Choice of Entity Determinations Under the New Internal Revenue Code,* MCCONNELL VALDÉS TAX ALERT (McConnell Valdés LLC, San Juan, P.R.), Mar. 14, 2011, at 1, http://www.mcvpr.com/media/publication/80_Choice-of-Entity-Determination-under-new-Internal-Revenue-Code.pdf.

[19] *Id.*

[20] *Id.*

[21] *Id.*

[22] *Id.*

[23] *Id.*

[24] *Id.* at 2.

C. Difference between Flow-Through Taxation and Entity Level Taxation

As noted by Professor Ribstein "[t]ax is the most obvious non-organization law influence on business associations."[25] Professor Ribstein has also pointed out that:

> [T]ax rules can influence not only choice of business form but also the choice of specific governance rules within forms. For example, following the IRS ruling clarifying that LLCs could qualify for partnership tax treatment, LLCs had an incentive to avoid corporate characteristics other than limited liability – that is, centralized management, free transferability and continuity of life. This prodded lawmakers to avoid these features in the developing LLC statutory form. As soon as the IRS passed the check-the-box rule, LLC statutes changed to provide for more continuity by default.[26]

Additionally, "a 'corporation' for federal income tax purposes includes not only incorporated entities but also unincorporated 'associations'."[27] As stated by the Supreme Court of the United States, the federal tax classification of an entity is distinct from its classification under applicable local law.[28] Therefore, "this decoupling of tax classification from local law classification offered taxpayers an opportunity to argue against their own form in search of tax benefits."[29] Furthermore, it has been generally understood by tax experts that "tax consequences are dependent on the rights and obligations of taxpayers as those rights and obligations are defined by non-tax rules and regulations."[30] Specifically, "the creation, use or liquidation of an entity disregarded for tax purposes has an indirect (and "indirect" should not suggest insignificant) effect on the taxpayers whose non-tax relationships are affected by the entity."[31]

Thus, it is now important to describe what exactly flow-through taxation encompasses. Tax professionals use various terms or phrases to refer to the entities that are allowed this form of taxation, for example some common phrases include: pass-through entities, flow-through entities or

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[25] LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION 125 (1st ed. 2010).
[26] *Id.*
[27] Howard E. Abrams, Fred T. Witt & Lisa M. Zarlenga, *U.S. Income Portfolios: Other Pass-through Entities: Portfolio 704-1st: Disregarded Entities*, 704-1st T.M., Disregarded Entities (BNA).
[28] *Id.* (citing Morrissey v. Comm'r of Internal Revenue, 296 U.S. 344 (1935) (it was held that an unincorporated entity is taxable as an association if it more closely resembled a corporation than any other entity).
[29] *Id.*
[30] *Id.*
[31] *Id.*

disregarded entities. Therefore, what exactly is a *disregarded entity*? The answer to this question is that "[t]here is no statutory definition, but the phrase has come to mean an entity that is recognized under applicable state (or other local) law purposes but which is entirely ignored for federal income tax purposes."[32] However, where do partnerships fit in this scheme? Elliot Manning states that:

> Although there are many other business entities that are not taxable on all or part of their income, and serve as conduits, none do so as completely as partnerships. S corporations pass through income and deductions, but not liabilities, and, if they have a C corporation history, they are subject to additional taxes. Trusts and estates pass through distributed income, but are taxed on undistributed income, though grantor trusts pass through all income attributable to the grantor (or others with similar powers), and may be used as investment vehicles, including for pooled investments in tax-exempt securities. Similarly, regulated investment companies, real estate investment trusts, and real estate mortgage investment conduits pass through distributed capital gain, but not the tax attributes of other types of income. In addition, certain cooperatives avoid tax on patronage distributions to their members. Finally, the consolidated return provisions contain a mixture of entity and aggregate aspects in computing the tax results for consolidated groups.[33]

In the United States, a partnership is not a taxable entity. Its income, gain, loss, deductions, and credits are passed through to partners, who must account for them when computing their income tax. However, a partnership is considered an entity for purposes of engaging in transactions and holding property. A partnership can be considered both an entity separate from its partners or an aggregation of its partners without a separate existence. In general, an entity approach is used to compute and characterize taxable income, whereas an aggregate or conduit approach is used for the purpose of taxing the income. The application of the aggregate and entity principles in partnership taxation are intertwined:

> At the most fundamental aggregate level, a partnership, unlike a C corporation, is not a taxable entity; it is a conduit for its partners who pay all taxes attributable to partnership operations in their individual capacities. Not only the net results of partnership operations, but all tax-significant characteristics of those results pass

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[32] *Id.*

[33] Elliot Manning, *U.S. Income Portfolios: Partnerships: Portfolio 710-2nd: Partnerships – Conceptual Overview*, 710-2nd T.M., Partnerships – Conceptual Overview (BNA).

> through. As a matter of administrative convenience, the flow-through occurs only on the last day of the tax year of the partnership (and partner), but there are, predictably, limitations to prevent abuse. Although there is a similar flow-through for S corporations, the aggregate principle generally does not apply to other aspects of S corporation taxation. The partner's basis in the partnership interest is adjusted for the items of income, gain, loss, or deduction, thus preventing double taxation and double deduction.[34]

In contrast partnerships, as an entity (rather than an aggregate):

> [Are] a vehicle for determining the amount, character, and timing of the income, deductions, gains, losses, and credits generated by the partnership's activities, generally without regard to the identity, or tax characteristics, of its partners. For example, if a partnership sells an asset, the amount of the gain or loss realized on the sale is determined by reference to the partnership's inside basis in the asset and the amount realized by the partnership for the asset. The character of the gain or loss depends on the manner in which the asset was used in the partnership's activities. The year in which the gain or loss is reported is determined by reference to the partnership taxable year in which the asset was sold by the partnership. The partnership reports its transactions on Form 1065, U.S. Return of Partnership Income. The same principles generally apply to S corporations, except that they report on Form 1120S.[35]

III. ANALYSIS

A. Description of the General Changes in the Entities Allowed to Request Flow-Through Taxation for Puerto Rico Tax Purposes

As previously noted, in Puerto Rico, flow-through taxation under the 1994 PR Code was only available to entities through elections as either special partnerships or corporations of individuals.

1. *Special Partnership Elections*

A special partnership is one that meets certain requirements and has elected not to pay any income tax on its income, but instead, to have the partners pay the tax on it, even though the corresponding income is not distributed. Eligibility depends on the nature of the partnership's income.[36]

[34] *Id.*
[35] *Id.*
[36] Puerto Rico Internal Revenue Code (P.R. I.R.C.), P.R. LAWS ANN. tit. 13 § 8630 (2011).

Additionally, a corporation engaged in an eligible activity in the magnitude required may elect special partnership treatment.[37] Special partnership treatment is available only if the electing partnership or corporation qualifies for such treatment. To qualify, the partnership or corporation must meet the following requirements: (1) derive during each taxable year at least 70% of its gross income from sources within Puerto Rico; and (2) derive at least 70% percent of its gross income from one of the following business activities:

- construction;
- land development;
- the substantial rehabilitation of buildings and structures;
- sale or rental of buildings or structures;
- manufacturing which generates substantial employment;
- tourism (including income from the operation of casinos);
- agriculture;
- exporting products or services to foreign countries;
- the production of long feature films;
- or a business for the construction, operation or maintenance of public roads and its adjoining facilities.[38]

The election of the special partnership status was made by filing a sworn statement with the Secretary of the Treasury within 90 days following the commencement of the partnership's or corporation's first taxable year for which the election is to be effective, or within 90 days following the creation, conversion or organization of the special partnership.[39]

2. Corporation of Individuals or an N Corporation Status

In essence, a corporation of individuals or an N corporation is a corporation or partnership that is eligible to choose N corporation status and whose shareholders or partners have all consented to the corporation's or partnership's choice of N corporation status.[40] Also, with limited exceptions, an N corporation is not taxed at the corporate level.[41] In its place, its items of income, loss, deduction and credit are passed through to, and taken into account by, its shareholders or partners in computing their individual tax liabilities.[42] In order to qualify, the corporation (or partnership) must meet *all* of the following requirements:

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[37] *Id.* § 8697(a)(3)(B).
[38] *Id.* § 8630.
[39] *Id.* § 8642(a).
[40] *Id.* § 8681(a)(2).
[41] *Id.* § 8682(a).
[42] *Id.* § 8683(a).

- It must be a domestic corporation (created under the laws of Commonwealth of Puerto Rico), or a U.S. corporation (created under the laws of any state of the United States or the District of Columbia), engaged in trade or business solely in Puerto Rico and it is not one of the following:
  - Taxable as an insurance company;
  - Taxable as a registered investment company;
  - Taxable as an employees-owned special corporation;
  - A corporation enjoying tax exemption under any of the industrial tax incentives acts;
  - A corporation exempt under P.R. I.R.C. §1101;
  - A financial institution under P.R. I.R.C. §1024(f)(4);
  - Or an entity licensed by the Commissioner of Financial Institutions pursuant to Act No. 3 of October 6, 1987, known as the Investment Capital Fund Act, as amended.
- It has no more than 75 shareholders (a husband and wife and their estates are treated as one shareholder);
- All shareholders must be individuals, decedent's estates, bankruptcy estates, voting trusts, or certain other qualified trusts;
- It must have only one class of stock.[43]

The election of N corporation status is made by having the electing corporation file a Form AS2640.1, signed by its authorized officer, with the required shareholder consents, together with the corresponding filing fee.[44] An N election for a tax year may be made during the preceding tax year, or by the 15th day of the fourth month of the tax year for which it is to be effective.[45] For each year an election is in effect, an N corporation is generally exempt from all income tax imposed on corporations.[46] As previously mentioned, instead, its items of income, loss, deduction and credit are passed through to, and taken into account by its shareholders or partners in computing their individual tax liabilities.[47]

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[43] P.R. I.R.C., P.R. LAWS ANN. tit. 13 § 8681(c) (2011).
[44] *Id.* § 8681(a); P.R. P.R. I.R.C. Reg. No. 5622, § 1391-1 (1998).
[45] P.R. I.R.C., P.R. LAWS ANN. tit. 13 § 8681(b)(1) (2011).
[46] *Id.* § 8682(a).
[47] *Id.*

B. Description of Chapter 7 ("Partnerships and Partners") of Subtitle A ("Income Taxes") of the 2011 PR Code.

1. Roadmap of the Provisions of Chapter 7

The taxation of partnerships, or better said, the rules setting forth flow-through taxation are set forth in Chapter 7 (Partnerships and Partners) of Subtitle A (Income Taxes) of the 2011 PR Code. Chapter 7 is composed of a general definitions section and five subchapters. Thus, the organization of Chapter 7 results as follows:

§ 1070.01 - Definitions

Subchapter A: Levying of Tax

§ 1071.01 - Levying of Tax on Partners and Not the Partnership
§ 1071.02 - Income and Credits of the Partners
§ 1071.03 - Partnership Computations
§ 1071.04 - Distributive Share of Partners
§ 1071.05 - Determination of the Basis of a Partner's Share
§ 1071.06 - Tax Years of Partners and Partnership
§ 1071.07 - Transactions between Partner and Partnership
§ 1071.08 - Partnership Continuity
§ 1071.09 - Organization and Syndication Expenses

Subchapter B: Computation of Contributions

§ 1072.01 - Non-recognition of Gain or Loss in Contribution of Property
§ 1072.02 - Basis of Contributing Partner's Interest
§ 1072.03 - Basis of Property Contributed to the Partnership
§ 1072.04 - Nature of Gain or Loss in the Contribution of Unrealized Credits, Items of Inventory and Capital Loss Property to a Partnership

Subchapter C: Computation of Distributions

§ 1073.01 -Recognition of Gain or Loss in Distributions Made by Partnerships
§ 1073.02 - Basis of Distributed Property Other than Cash
§ 1073.03 - Basis of the Interest of a Partner Receiving a Distribution
§ 1073.04 - Adjustment to the Partnership's Undistributed Property Basis with a §1075.04 Election or Substantial Reduction in Basis
§ 1073.05 - Nature of Gain or Loss in the Disposition of Distributed Property
§ 1073.06 - Payments to a Retiring Partner or Successors of a Deceased Partner

§ 1073.07 - Recognition of Pretax gain in the Case of Certain Distributions to the Contributing Partner

Subchapter D: Computation of Sales or Exchanges

§ 1074.01 - Recognition and Nature of the Gain or Loss in Sale or Exchange
§ 1074.02 - Basis of the Interest of a Partner Acquiring an Interest
§ 1074.03 - Special Rules in the Case of Constructive Losses and § 1075.04 Election

Subchapter E: Miscellaneous Provisions

§ 1075.01 - Inventory Items and Unrealized Credits
§ 1075.02 - Treatment of Certain Debts
§ 1075.03 - Payments to a Partner's Successor
§ 1075.04 - Form of Making Optional Election to Adjust the Basis of Partnership Property
§ 1075.05 - Basis Apportionment Rules
§ 1076.01 - Effect of Application of the Provisions of Chapter 7

"[T]he term 'partnership' includes a syndicate, group, common fund, joint enterprise or any other unincorporated organization through or by way of which any business, financial transaction or enterprise is carried on, and which is not, a corporation, trust or estate."[48] It also includes those LLCs that, under the provisions of § 1010.01(a)(3), are taxed under the provisions of Chapter 7. Also, "the term 'partner' means any member of a partnership" and "includes a member of a LLC subject to tax under the provisions of Chapter 7."[49]

Specifically, Subchapter A (Levying of Tax) sets forth all the relevant provisions regarding the taxations of partnerships and partners in Puerto Rico. Accordingly, "a partnership subject to the provisions of Chapter 7 shall not be subject to the income tax levied by subtitle A of the 2011 PR Code."[50] Thus, "[p]ersons carrying on a business as partners shall be liable for the income tax solely in their personal or individual capacities."[51] Additionally, "any partner of a partnership engaged in a trade or business in Puerto Rico shall be deemed to be engaged in a trade or business in Puerto Rico with

[48] 2011 P.R. Laws No. 1; as amended by 2011 P.R. Laws No. 232 and codified as the 2011 P.R. I.R.C., § 1070.01(a).
[49] *Id.* § 1070.01(b).
[50] *Id.* § 1071.01.
[51] *Id.*

respect to his distributive share in the income, gain, loss, deduction or credit of the partnership."[52]

Thus, when determining his tax liability, each partner shall separately take into account his distributive share in the partnership for any taxable year ending within or simultaneously with the partner's tax year, with respect to:

(1) gains and losses in the sale or exchange of capital assets held by the partnership for not more than six (6) months;
(2) gains and losses in the sale or exchange of capital assets held by the partnership for more than six (6) months;
(3) gains and losses in the sale or exchange of properties described in Section 1034.01(i);
(4) gains and losses in the sale or exchange of all assets in an exempt business under the Puerto Rico Tourism Development Act of 1993, the Puerto Rico Tourism Development Act of 2010, and any similar successor law;
(5) charitable donations (subject to the provisions of Section 1033.10);
(6) dividends subject to the provisions of Section 1023.06;
(7) tax withheld on dividends under paragraph (6);
(8) taxes described in Sections 1051.01, 1062.02, 1062.03 and 1062.04;
(9) income or loss derived from activities covered by an exemption allowance or decree, as the case may be, under the Puerto Rico Tourism Development Act of 1993, the Puerto Rico Tourism Development Act of 2010, the Puerto Rico Economic Development Incentives Act of 2008 and any similar successor law;
(10) net income or loss of the partnership, excluding items whose separate consideration is required under other paragraphs of this subsection, and
(11) other items of income, gains, losses, deductions or credits, as established by the Secretary by regulation.[53]

Additionally, it is very important to understand that "the nature of any item of income, gain, loss, deduction or credit included in the distributive share of a partner shall be determined as if such item were realized directly at the source at which it was realized by the partnership or shall be accrued in the same way as it was accrued by the partnership."[54] Also, "in any case where it is necessary to determine the gross income of a partner, said gross

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[52] *Id.*
[53] 2011 P.R. I.R.C., § 1071.02(a).
[54] *Id.* § 1071.02(b).

income shall include his distributive share in the gross income of the partnership."[55]

At an entity level, the net taxable income of a partnership for any taxable year shall be determined as in the case of an individual, except that:

> (1) the items described in Section 1071.02(a) shall be reported separately;
> (2) and the following deductions shall not be allowed to the partnership:
> (A) the deduction for personal exemptions under Section 1033.18 (a);
> (B) net operating loss under the provisions of Section 1033.14;
> (C) taxes under the provisions of Section 1033.04 with respect to the taxes described in Section 1051.01;
> (D) the deductions allowed by Section 1033.15
> (3) it shall be entitled to the accelerated depreciation provided in Section 1040.12.[56]

The remaining provisions of Chapter 7 are designed to regulate the relationship between the partnership and the partners. Specifically, it controls their basis for contributions and distributions to and from the partnership, the corresponding basis in such property and the effects of subsequent dispositions of said property, which was in the hands of the partnership for purposes of conducting the partnership business. Therefore, it is extremely important to note that through the 2011 PR Code we have adopted the vastly complicated and extensively regulated provisions of Subchapter K of the Federal Internal Revenue Code. Thus, we have adopted the same provisions of § 704(b) whereas "all allocations [to partners] must have substantial economic effect."[58] If an allocation does not have substantial economic effect, a partner's distributive share of partnership items is determined in accordance to the partner's interest in the partnership. From this point on, Puerto Rico's Department of the Treasury will have to allow taxpayers to follow, as a substantive authority, the regulations and administrative decisions issued by the Internal Revenue Service or otherwise mount an enormous effort to promulgate similar guidance through their own regulations and administrative determinations.

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[55] *Id.* § 1071.02(c).
[56] 2011 P.R. I.R.C., § 1071.03.
[58] I.R.C., § 704(b).

2. *Elections to Be or Not to Be a Flow-Through Entity*

a. Existing Entities

In the case of existing partnerships, these entities may, "following the requirements prescribed by the Secretary of the Treasury, either by regulation, administrative determination or circular letter for such purpose, elect to continue to be treated as a corporation and will continue to file its income tax return in the same form and manner as a corporation."[59] In the case of existing LLCs, they are defined as those entities:

> [O]rganized under Chapter XIX of Act No. 164 of December 16, 2009, as amended, known as the "General Corporations Act," or those organized under the similar laws of any U.S. state of America or a foreign country. For the purposes of th[e 2011 PR Code], LLCs shall be taxed in the same form and manner as corporations; provided, however, that they may elect to be treated as partnerships for tax purposes under the rules applicable to partnerships and partners under Chapter 7 of this Subtitle, even when they are single-member companies. The Secretary shall establish by regulation the form and manner of making said election and the filing deadline thereof.[60]

For purposes of the 2011 PR Code, LLCs are subject to income tax in the same manner as regular corporations, unless they elect to be treated as partnerships under the rules set forth by Chapter 7 of the 2011 PR Code (regulations will be issued providing guidance on how to make the election). However, in the case of any LLC:

> [T]hat, by way of an election or provision of law or regulation under the Federal Internal Revenue Code of 1986, Title 26 of the United States Code, as amended, or similar provision of a foreign country, is treated as a partnership or whose income and expenses are attributed to its members for purposes of the federal or foreign income tax, shall be treated as a partnership for purposes of this Subtitle, subject to the provisions of Chapter 7, and shall not be eligible to be taxed as a corporation. [61]

Therefore, it is very important to visualize that in the case of foreign LLCs that have elected to be disregarded entities for federal tax purposes, the 2011 PR Code requires that the entity be treated in the same manner in

[59] 2011 P.R. I.R.C., § 1061.03(e).
[60] *Id.* § 1010.01(a)(3).
[61] *Id.* § 1010.01(a)(3)(a).

Puerto Rico under the provisions of Chapter 7. These LLCs will be forcefully converted to disregarded entities and will be subject to numerous adjustments in order to correctly convert to flow-through treatment. However, this exception will not apply to LLCs that are covered by an "exemption decree issued under Act No. 73 of May 28, 2008, known as the 'Puerto Rico Economic Development Incentives Act,' or any prior law of a similar nature, or under Act No. 78 of September 10, 1993, known as the 'Puerto Rico Tourism Development Act,' as amended, and any other prior or subsequent law of a similar nature."[62]

b. New Entities

All newly created partnerships will, without exception, be subject to the flow-through provisions of Chapter 7 of the 2011 PR Code. This treatment is derived from the fact that the Code only provides the exception for partnerships already in existence as of the effective date of this Code. Hence, it is extremely important to keep this fact in mind when choosing the entity to conduct business transactions in Puerto Rico. In the case of new LLCs, if the entity is a domestic LLC then it will be taxed as a corporation by default unless it elects to be subject to the provisions of Chapter 7. However, foreign LLCs will be subject to the same tax treatment received in the United States.

c. Forced Conversions? Considerations for Partnerships and LLCs Converting to Pass-Through Entities

The 2011 PR Code explains the consequences for those foreign LLCs and partnerships that were previously taxed under the 1994 PR Code as corporations, but that are now forced under the 2011 PR Code to be treated as flow-through entities.[63]Consequently, these foreign LLCs and partnerships will be deemed as liquidated on the last day of the taxable year that began before January 1, 2011, and immediately thereafter, that the partners or members transfer their assets and liabilities to its members in the dissolution of the LLC and immediately after, the members transfer the previously distributed assets and liabilities to the newly formed partnership. No gain or loss will be recognized by the LLC or its partners/members on such liquidation/ reincorporation.[64]

The 2011 PR Code provides a process for accounting for additional adjustments and specific elections that had been utilized in the past by these

[62] 2011 P.R. I.R.C., § 1010.01(a)(3)(B).
[63] *Id.* § 1076.01.
[64] *Id.*

entities under the 1994 PR Code.[65] Specifically, in the case of LLCs that used Last In First Out (hereinafter LIFO) flexible depreciation or Accelerated Cost Recovery System (hereinafter ACRS) depreciation, long-term completed contract or the installment sales method for its last year as a corporation, must include a recapture amount as income with respect to these items.[66] Any tax related to these recaptures is payable with the final corporate income tax return, except for LIFO recapture which is payable in three equal installments over three tax years. In general, this recapture is payable with the Corporation Income Tax Return that is due April 15 of each year for calendar year taxpayers.

Additional adjustments are required for accumulated earning and profits. Specifically, it is established that all accumulated earnings and profits are deemed as distributed during the first two years of the LLC being treated as a partnership.[67] In addition, the LLC or partnership that was treated as a corporation may be subject to a built-in gains tax at the corporate level during the ten-year period (the *recognition period*) beginning on the first day of the corporation's first tax year as a partnership.[68] The tax is intended to affect unrealized gain, which arose before the conversion from a corporation to a partnership.[69] In general, any appreciation on an asset held prior to the liquidation/reincorporation will be subject to a corporate level tax, when and if, actually realized during the 10-year recognition period. The tax equals the highest corporate rate multiplied by the net recognized built-in gain.[70]

d. Election to Continue Being Taxed Under the Provisions of the 1994 PR Code

Based on the discussion above, it must be noted that the unexpected results of these transitory provisions can be avoided. Specifically, the 2011 PR Code states as follows:

> (a) Any taxpayer that is a corporation, including limited liability companies, shall be granted the option to compute the tax and file the return corresponding to its first tax year beginning after December 31, 2010 and before January 1, 2012, and during the 4 subsequent tax years, pursuant to the relevant provisions of [the 1994 PR Code], in effect as of December 31, 2010.

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[65] *Id.* (requiring the adjustments under 2011 P.R. I.R.C., § 1115.03(d), (e), (f), (g) and (h), and 2011 P.R. I.R.C., §1115.08).
[66] 2011 P.R. I.R.C., § 1115.03.
[67] *Id.*
[68] 2011 P.R. I.R.C., § 1115.08 (Built in gains tax).
[69] *Id.*
[70] *Id.*

> (b) Any partnership organized prior to the effective date of the Code, for purposes of Subtitle A, shall be allowed the option to compute the tax and file the return corresponding to its first tax year beginning after December 31, 2010 and before January 1, 2012, and during the 4 subsequent tax years, pursuant to the relevant provisions of [the 1994 PR Code], in effect on December 31, 2010.
>
> (c) The taxpayer shall elect the option provided in this section by filing the return for the first tax year beginning after December 31, 2010 and before January 1, 2012. Once the option is elected, it shall be final and irrevocable for the tax year in which the election was made and for each of the 4 subsequent tax years.[71]

Thus, taxpayers have the option to opt-out of the application of the 2011 Code and remain subject to the rules of the 1994 PR Code. Opting out may be achieved by electing it when filing the income tax return for taxable year 2011.[72] The election however is irrevocable for taxable years 2011, 2012, 2013, 2014 and 2015.[73]

3. Guidance Issued by the Puerto Rico Department of the Treasury: Administrative Determination 12-04

On February 14, 2012, the Puerto Rico Department of the Treasury ("PRDT") issued Administrative Determination 12-04[74] to establish guidelines for the election and conversion into a partnership.

a. Statutory Conversions

A partnership or LLC that during the taxable year that ended before January 1, 2011 was subject to tax as a corporation under the provisions of the 1994 PR Code and during the first taxable year commencing after December 31, 2011 is subject to tax as a partnership, will be treated as if it transferred its assets and liabilities to its partners in liquidation and, immediately thereafter, the partners contributed such assets and liabilities to a new partnership.

The provisions of the 2011 PR Code establish that no gain or loss is recognized on the aforesaid transaction, thus the new partnership receives such assets and liabilities with a carryover basis and holding periods.

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[71] 2011 P.R. I.R.C., § 1022.06.
[72] *Id.*
[73] *Id.*
[74] Puerto Rico Treasury Department Administrative Determination No. 12-04 (Feb. 14, 2012), available at http://www.hacienda.gobierno.pr/downloads/pdf/determinaciones/12-04.pdf.

However, such a conversion is subject to built-in gain provisions, and recapture rules on utilization of: LIFO, flexible depreciation, accelerated depreciation, long term contracts and installment sales. Furthermore, any accumulated earnings and profits as of the last day of the taxable year commencing before January 1, 2011, are deemed distributed.

Notwithstanding the above, if a partner in the partnership or LLC is a corporation that possesses at least 80% of the total combined voting power of all classes of stock entitled to vote and owns at least 80% of the total number of all other shares, then the transaction can be treated as an exempt liquidation. In such circumstances, the recapture rules, built-in gain provisions, and deemed distribution of accumulated earnings and profits do not apply. Moreover, all tax attributes shall carry over to the corporate partner. If the corporate partner is foreign (organized outside Puerto Rico) a ruling must be requested from the PRDT on or before June 30, 2012.

b. Election to Remain as Corporation Under 2011 PR Code

Partnerships existing as of January 1, 2011, that were subject to tax as a corporation under the 1994 PR Code, can elect to remain as a corporation under the 2011 PR Code. The election is made by attaching Form SC-6044, Entity Classification Election, to the income tax return. The election will be in effect as long as the partnership continues to exist.

c. Voluntary Conversion

A partnership that elected to be taxed as a corporation under the 2011 PR Code, or has an Option 94, can thereafter elect to convert into a flow-through partnership. An election, nevertheless, must be filed with PRDT on or before the last day of the third month of the taxable year for which the election is effective.

Also, an LLC subject to tax as a corporation under the 2011 PR Code can thereafter elect to convert itself into a flow-through partnership. An election must be filed with PRDT on or before the fifteenth day of the fourth month of the taxable year for which the election is effective. As a general rule, the liquidation/ reincorporation into a partnership is a fully taxable transaction. As such, recapture rules, built-in gain provisions, and deemed distribution of accumulated earnings and profits do not apply.

However, if a partner in the partnership is a corporation that possesses at least 80% of the total combined voting power of all classes of stock entitled to vote and owns at least 80% of the total number of all other shares, then the transaction can be treated as an exempt liquidation. In such circumstances, the recapture rules, built-in gain provisions, and deemed distribution of accumulated earnings and profits do not apply. Additionally,

tax attributes shall carry over to the corporate partner. If the corporate partner is foreign, a ruling must be requested from the PRDT.

d. LLCs One-Year Grace Period

An LLC that during its first taxable year commencing after December 31, 2011 is treated as a partnership must attach Form SC-6044, attesting to the statutory conversion, to its income tax return. Furthermore, an LLC may elect to be treated as a corporation only for the first taxable year commencing after December 31, 2011, thus deferring partnership treatment.

The election is made by filing Puerto Rico Department of the Treasury's Form SC-6044 with the income tax return for such year. Afterwards, it will be converted into a partnership in a taxable liquidation/reincorporation transaction.

e. Conversion of Special Partnerships (SE) and Corporations of Individuals (CI)

A partnership or LLC with a valid Special Partnership (hereinafter SE) or Corporations of Individuals (hereinafter CI) election can convert into a partnership. In this event, the SE or CI will be treated as contributing the assets and liabilities into the new partnership in an exempt transaction. Consequently, such assets will have carryover basis and the tax attributes of the SE or CI will transfer to the new partnership.

To have an effective conversion, the partnership or LLC must request a PRDT ruling during the first ninety (90) days of the taxable year for which the conversion is effective. Conversions for 2011 taxable years are due on or before April 30, 2012.

e. LLCs F Reorganization Election

An LLC that was treated as a corporation pursuant to the 1994 PR Code, but because of the provisions of 2011 PR Code must be treated as a partnership, can convert into a corporation in an F reorganization. The reorganization must take place on or before December 31, 2012, and a ruling request must be filed no later than ninety (90) days after the reorganization. The ruling must request retroactive effect.

f. New Filing Due Dates - Partnerships

The 2011 PR Code states that "any partnership shall file a return for each tax year stating the items of gross income and deductions allowed, the names, addresses and account numbers of the partners who are to share in the gain or loss of the partnership for said tax year, and the amounts of said

gain or loss."[75] Furthermore, "returns filed [...] on a calendar year basis shall be filed no later than March 15 following the calendar year end and returns filed on a fiscal year basis shall be filed no later than the fifteenth (15th) day of the third (3rd) month following the close of the partnership tax year."[76] Additionally,

any partnership required to file a return for any tax year shall, no later than last day of the third (3rd) month following the end of its tax year, supply each person who is a partner in said partnership a report containing the information to be included on the partner's return, including the partner's distributive share, the initial contribution and any additional contributions made by the partner to the partnership equity, the distributions made by the partnership and any other additional information required by regulation.[77]

However,

an automatic extension shall be granted to file the return required, provided that the rules and regulations prescribed by the Secretary to allow said extension are met and this automatic extension shall be allowed for a period of three (3) months from the date provided in subsection (a) for the filing of the return, provided that the partnership makes a request to such effect no later than said return filing date.[78]

g. New Filing Due Dates - LLCs

Similarly the 2011 PR Code states that any limited liability company shall file a return for each tax year, stating the items of gross income and deductions, the names, addresses and account numbers of the members who are to share in the gain or loss of the limited liability company for said tax year, and the amounts of said gain or loss.[79] Thus, the "returns filed under this section on a calendar year basis shall be filed no later than March 15 following the calendar year close."[80] Also, any limited liability company required to file a return for any tax year shall, no later than the last day of the third (3rd) month following the close of its tax year, supply each person who is a member of said LLC with a report containing the information required to be included on the member's return, including the member's distributive share, the initial contribution and any additional contributions made by the member to the equity of the limited liability company, distributions made by the LLC and any other additional information required by regulation.[81]

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[75] 2011 P.R. I.R.C., § 1061.03(a).
[76] *Id.*
[77] 2011 P.R. I.R.C., § 1061.03(b).
[78] 2011 P.R. I.R.C., § 1061.03(c).
[79] 2011 P.R. I.R.C., § 1061.04(a).
[80] *Id.*
[81] 2011 P.R. I.R.C., § 1061.04(b).

As in the case of partnerships, "an automatic extension shall be granted to file the return, provided that the rules and regulations prescribed by the Secretary to allow said extension are met and the automatic extension shall be allowed for a period of three (3) months from the date provided in subsection (a) for the filing of the return, provided that the LLC makes a request to such effect no later than said return filing date."[82]

Hence, it is important to note that previously, under the provisions of the 1994 PR Code, both partnerships and LLCs had until April 15th to file their corresponding income tax returns. Additionally, these entities could request an extension of time to file their returns which granted 90 additional days and thus moved their filing due date until July 15th. These new provisions will certainly create difficulties for partners and members wishing to file their final individual income tax return by April 15th, because the vast majority of partnerships and LLCs may not have the adequate financial information necessary to complete an accurate return by this date and thus, extensions will be requested.

h. New Filing Requirements - Estimated Income Tax for Partnerships and LLCs

The partnership or LLC shall determine and pay an amount equal to: (1) thirty-three percent (33%) of the estimated amount of the distributive share in the income of the partnership or LLC of a member or partner who is an individual, estate or trust; and in the case of a corporation, an amount equal to thirty percent (30%) of the estimated amount of the distributive share of income of the partnership or LLC.[83] Thus, the 2011 PR Code establishes that to these ends, the estimated tax shall be ninety percent (90%) of the tax of said taxable year or the total of the determined tax, as it may appear on the income tax return filed for the preceding taxable year, whichever is less.[84]

It is very important to keep in mind that because from now on estimated taxes will be filed on behalf of the member/partner and not the LLC/partnership, any existing overpayments within the partnership/LLC which arose before the conversion to a pass-through entity, will not be available to be used as estimated tax payments made on behalf of the member, unless, a ruling request is filed with the Secretary of the Treasury.

LLCs and partnerships shall file a return and pay the tax determined no later than the fifteenth (15th) day of the fourth (4th), sixth (6th), ninth (9th) and twelfth (12th) month of the tax year of said partnership or LLC. Any balance left unpaid at the end of the fiscal year must be paid no later

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[82] 2011 P.R. I.R.C., § 1061.04(c).
[83] 2011 P.R. I.R.C., § 1061.21.
[84] 2011 P.R. I.R.C., § 6041.10.

than the fifteenth (15th) day of the fourth (4th) month following the close of the tax year.[85] If the partnership or LLC fails to make the withholding, the amount that should have been determined and paid shall be charged directly to the LLC unless the member pays the tax directly to the Secretary. Any person who fails to comply with his liability to determine and pay the income tax, shall be subject to penalties. Particularly, in the case that a payment of the estimated tax fails to be paid within the prescribed term or an incomplete payment of an estimated tax payment is carried out, the ten percent (10%) of the unpaid amount of said term shall be added.[86] An exception may be found if it is shown, to the satisfaction of the Secretary, that the owing is due to a reasonable cause and not to voluntary negligence. Finally, when it is demonstrated to the Secretary's satisfaction, or when the Secretary determines, that the withholding would cause an undue burden, without practical purpose, because the amounts so withheld would have to be refunded to the taxpayer or because said withholding would be excessive, the Secretary may, under the rules and regulations prescribed, release the withholding agent from making such withholding in whole or part.

i. New Income Sourcing Rules for Partners and Members

It is of great importance to mention that pursuant to the new provisions of the 2011 PR Code, all partners and members of a partnership or and LLC treated as a partnership which are engaged in trade or business in Puerto Rico, will be treated as engaged in trade or business in Puerto Rico with respect to their distributive share in the partnership.[87] This is very important because, previously, the 1994 PR Code did not consider non-resident individuals as engaged in trade or business due to the mere fact of holding an interest in a partnership or an LLC engaged in trade or business in Puerto Rico. Therefore, based on this new provision in the 2011 PR Code, these partners and members would be subject to filing an individual income tax return in Puerto Rico in order to subject their distributive share of partnership or LLC income to tax in Puerto Rico. However, recently amended sec. 1062.07 states that the tax obligation set forth in sec. 1071.01 may be satisfied with a withholding at source. Nevertheless, this situation still creates various problems for foreign partnerships and LLCs since these entities will be required to withhold and remit the tax to the Department of the Treasury and prepare and distribute informative returns to all their partners and members for the amounts withheld.

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[85] 2011 P.R. I.R.C., § 1062.07.
[86] *Id.*
[87] 2011 P.R. I.R.C., § 1071.01.

IV. CONCLUSION

In sum, with these new opportunities there may come some new and additional risks. A careful assessment of current business structures and the impact of the 2011 PR Code must be undertaken in order to avoid unexpected tax consequences relating to the new flow-through provisions. As noted in our discussion, the enactment of these provisions broadens the range of activities and entities eligible for flow-through treatment when compared to the 1994 PR Code and, as stated, presents new planning opportunities for taxpayers. These changes may, nonetheless, be far from elective for some taxpayers. As transitory rules, existing partnerships and LLCs that had been taxed as corporations and either do not elect to continue such treatment or are ineligible to elect such treatment, will be treated as having been liquidated as of their last taxable year under the 1994 PR Code. This forced conversion may bring undue hardship to many entities and business ventures. Thus, as stated by Robert Carroll:

> In evaluating how to go about reforming our tax system it is useful to start with a set of objectives. It is easy enough to agree on a broad set of principles such as a tax system that is simple, fair and pro-growth. But, as we begin to scratch the surface, to dig more deeply, a more complex and fundamental set of issues need be addressed. For example, should the tax system focus on taxing income or consumption, what constitutes a fair distribution of the tax burden, and to what extent should citizens be relieved of having to remit taxes to the government at all?[88]

In order to correctly conclude if the amendments introduced by the 2011 PR Code effectively facilitate doing business in Puerto Rico, we must question if, in fact, the actual application and enforcement of the provisions results in a tax system that is simple, fair and stimulates growth. At this time we can only wait and see if the new flow-through provisions can become an example of how the Government of Puerto Rico using its current fiscal autonomy powers to affect the overall economic wellbeing of its people and its economy in a positive way.

However, it is still amazing to see how much things can change in a relatively short amount of time. Even though much has changed, these changes come with numerous opportunities. Specifically, these changes level the playing field for many young practicing certified public accountants and

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[88] Tax: Fundamentals in Advance of Reform, Before the S. Comm. On Finance, 110th Cong. (April 15, 2008) (statement of Robert J. Carroll, Vice President for Economic Policy, Tax Foundation; Executive-in-Residence, School of Public Affairs, American University).

tax attorneys who will now be in the same position as many experienced professionals for whom the provisions of Chapter 7 and flow-through taxation may always constitute a mystery. Therefore, it is the time to take advantage of these new set of circumstances and contribute to the development of flow-through entities in Puerto Rico in order to develop another tool that can positively impact the overall economic wellbeing of our people and our economy.