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TAX INSIGHTS

Puerto Rico Issues New Rules for Disregarded Entities for Simpler Tax Filing

May 31st, 2024

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It's been almost two years since Act 52-2022 introduced a noteworthy change to Puerto Rico's income tax regime by adopting the Disregarded Entity (DE) treatment. This change aligns Puerto Rico's taxation treatment of single-member entities with the one established by the U.S. federal tax code for DE. Its purpose is to foster local parity for owners who have elected this option for their entities in the U.S. One key aspect to consider is that certain local rules for DEs may differ from the ones established in the U.S.

Back in 2022, the particularities regarding DEs were in the newborn stage. To clarify the tax implications of DE and provide the ground rules on the treatment of certain transactions with them, the Puerto Rico Department of the Treasury ("PRTD") issued Administrative Determinations 22-10 (DA 22-10) and 23-01 (DA 23-01). In our previous article, Puerto Rico Opens Its Doors to Disregarded Entities[1] we explained that despite the initial clarification, Act 52, and the issued guidance, some matters still needed clarification.

On January 30, 2024, the PRTD issued Circular Letter 24-02 (CL 24-02) to complement previous guidance and clarify aspects that remained open on the tax treatment of DEs. This letter addressed the following matters:

(i) The obligation of the DE to withhold the tax at source and file the corresponding withholding vouchers and informative returns.

(ii) How the DE owner can claim withheld taxes made to the DE and estimated tax payments made by the DE during the tax year on their income tax return.

(iii) How the DE owner married under the community property regime should report the operations of a DE when filing jointly with their spouse.

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[1] In this article, we provided an introductory discussion on DEs in Puerto Rico, including their eligibility requirements, general advantages and disadvantages, making the election, and other related matters mentioned in DA 22-10 and DA 23-01.

(iv) The effect of an entity's election of a DE with a fiscal year.

(v) The operations of a DE that are considered as "Principal Industry or Business" when the sole owner is an individual.

Additionally, CL 24-02 clarifies the treatment of:

(vi) DEs in a chain structure;

(vii) Optional tax under Sections 1021.06 and 1022.07 of the Puerto Rico Internal Revenue;

(viii) Credit for Contributions from the United States, Possessions, and Foreign Countries; and

(ix) Debt Certifications and Filling Requirements for LLCs with the DE election.

We have summarized these relevant topics in the table below to serve as a quick reference guide. We have segregated the implications of several topics between the entity and the owner.

Topic	Guidance	Practice Point
I. Withholding and Informative Return	**DE:** The DE is required to withhold taxes from salary payments and payments to contractors and other entities. The LLC is responsible for making the tax deposits and filing the informative returns. **Owner:** N/A	**Example:** A DE paid salary. According to the PRTD's Withholding on Income Tax at Source on Wages tables, the withholding obligation related to these salaries is $2,000. **Answer:** The DE must make the $2,000 salary tax withholdings, file the withholding vouchers, and deposit the withholding into its Sistema Unificado de Rentas Internas ("SURI") account.

II. Transactions between DEs and the owner	Guidance	Practice Point
a. Salary Payments	**DE:** Salary or Compensation payments made by the DE are not considered expenses for the DE. **Owner:** Salary or Compensation payments made by the DE to its sole owner are not considered income.	**Example:** Yarixa owns a bakery and elects to be treated as a DE. She pays herself a salary of $50,000 per year. **Answer:** **DE:** The DE cannot deduct the $50,000 salary as a business expense. **Owner:** The $50,000 salary is not considered income for Yarixa on her Individual Income Tax Return.

b. Payroll Taxes	**DE:** The DE must make employer's contributions and deposit taxes related to the owner's compensation such as unemployment insurance, social security, and medicare. **Owner:** The amounts paid by the DE as the owner's employer, such as unemployment insurance, social security, and medicare, may be claimed as a deduction.	**DE:** The DE must withhold and pay payroll taxes on the $50,000 salary, such as social security and medicare. **Owner:** Yarixa can deduct employer contributions on her Individual Income Tax Return.
c. Informative Return	**DE:** The DE must prepare an informative return for reportable payments made to the owner. **Owner:** N/A	**DE:** The DE must prepare an informative return for Yarixa's salary payment. **Owner:** N/A
d. Tax Return Reporting	**DE:** N/A **Owner:** The taxpayer must answer "Yes" to the question "Is the Payer/Withholding Agent a DE who prepares this Informative Return for its owner, or another DE controlled by its same owner?". Only any withheld tax item that has been included in the Form 480.6SP will be transferred to the corresponding line of the Income Tax Return.	**DE:** N/A **Owner:** When Yarixa files her Individual Income Tax Return, she will answer "Yes" to the question about the DE preparing the Informative Return. The reported salary amount on the informative return should not be included as income on Yarixa's Individual Income Tax Return.

III. Withholding at Source, Estimated Tax Payments, and Tax Credits Topic	Guidance
a. Withholding at Source	**DE:** The DE must report the withholding on an Informative Return. **Owner:** If the DE filed the informative return reporting the withholding, the owner can deduct the withholding at source in Schedule B of their Individual Income tax return.
b. Estimated Tax Payment	**DE:** N/A **Owner:** The owner can claim the estimated tax payment made by the DE in Schedule B of their Income Tax Return.

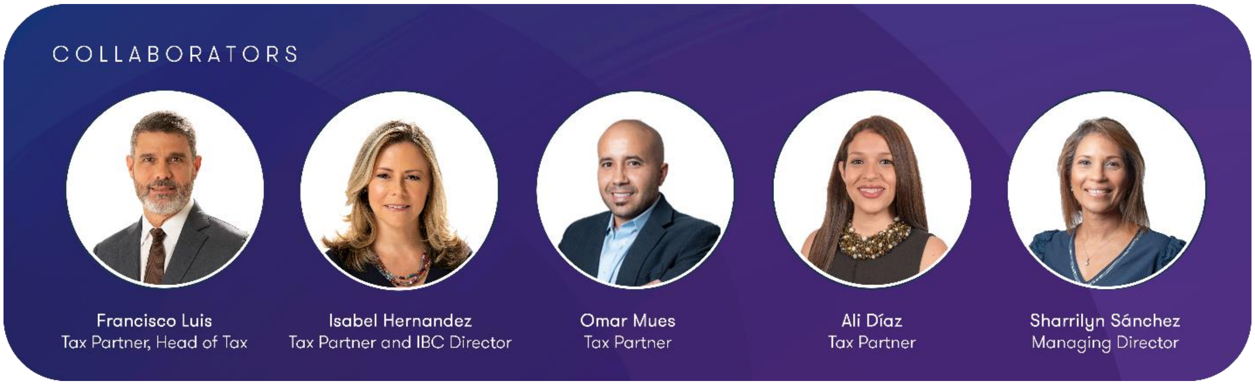
c. Tax Credits	**DE:** The DE can transfer the Tax Credit to the owner. **Owner:** The owner can claim the Tax Credit available for the entity but needs to take into consideration if the Tax Credit is **Post "TCM", as known as the Tax Credit Manager, or Pre "TCM"**. The credits transferred are subject to certain credit use restrictions discussed in the PR Internal Revenue Code.

IV. Married Under the regime of community property	Guidance
a. Common Enterprise (Joint Venture)	**DE:** N/A **Owner:** If both taxpayers file a Joint Individual Income Tax Return they need to complete schedules K, L, M, or N, as applicable.
b. Qualified Common Enterprises	**DE:** N/A **Owner:** If both taxpayers actively participate in the LLC, they are required to report their share of the income and expenses of the DE according to the internal documents of the LLC. If one of the taxpayers did not actively participate in the business and in those cases where the LLC internal document did not indicate the percentage of participation, each taxpayer must report 50% of the income and expenses of the DE. If the spouses decide to file their Tax Returns separately, the same treatment will apply. However, in these cases, any withholding or estimated tax payment made by the DE must be claimed by each of the spouses on their Tax Return in the same proportion as they reported the income and expenses of the entity.

Other Supplemental Topics	Guidance	Practice Point
V. Effect of DE election by an entity with a Fiscal Year	**DE:** A change in the tax treatment to DE will be considered as a liquidation of the entity on the last day of the tax year before the year of effectiveness of the election. The tax year of the LLC will be the same as that of its sole owner. If the election is not effective for the first day of the LLC's tax year, a Short-Year Return must be filed for the period from the beginning of its last tax year before the election is effective to the day before the effective date of the DE election. **Owner:** N/A	**Example:** ABC LLC is taxed as a corporation and uses a fiscal year ending on June 30 of each year. The taxpayer, a sole owner of ABC, is an individual resident of Puerto Rico who uses the calendar year as its tax year. **Answer:** ABC elects to be treated as a DE for the tax year beginning January 1, 2023. In this case, ABC must file a Corporation Return for the tax year beginning July 1, 2022, and ending December 31, 2022.
VI. On-chain DEs	If the sole member of a chain of LLCs is a resident individual, or in the case of a foreign LLC an individual or corporation, all LLCs in the chain may elect to be treated as DEs.	N/A
VII. Optional Tax	**DE:** DEs cannot choose to be taxed under the Optional Tax at the entity level. **Owner:** The sole owner of a DE can elect to pay taxes under the Optional Tax, but they must consider the gross income of all their Disregarded Entities.	N/A
VIII. Credit for U.S., U.S. Possessions, and Foreign Countries Taxes	**DE:** N/A **Owner:** The income taxes paid by DEs to the United States, possessions of the United States, and foreign countries may be claimed as a credit by their owner.	N/A
IX. Certifications of Debt and Filing of Returns of an LLC with Election of Disregarded Entity	LLCs that elect to be treated as DEs can request a Debt Certification or Tax Return Filing Certification under the name of the DE. The Debt Certification will only show the LLC's tax debts and any income tax debt for tax periods in which it was not treated as a DE. The Tax Return Filing Certification will show as "Not Applicable" the tax periods for which the LLC was elected to be treated as a DE.	N/A

Bottom line

The recent publications issued by the Puerto Rico Treasury on DEs offer valuable insights and considerations for taxpayers evaluating business structuring options. Careful evaluation is essential when determining the most appropriate business structure for your specific needs. Our team of tax professionals is available to assist you in evaluating whether a DE is the optimal choice for your organization. Please contact our Tax Department should you require additional information regarding this or any other tax issue.



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