TAX INSIGHTS

The tax implications of business structures

How changing or choosing a particular business structure can influence your tax situation.

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Choosing the right business structure is one of the most important decisions any entrepreneur or business owner needs to make. This decision will not only affect the daily operations of the business but will also have a direct impact on how income, deductions, and overall tax obligations are treated. In Puerto Rico, the tax laws are unique and while there are similarities with the federal tax regulations in the United States, they have distinctive characteristics that can significantly influence your tax situation.

Understanding these different tax rules is essential, as the tax treatment of a particular legal entity can mean the difference between a higher tax burden or the opportunity to take advantage of tax credits, incentives and tax exemptions available on the island. In addition, choosing the right business structure can also affect access to credit, attracting investors, and managing the personal risk of the owners. This article delves into the different business structures available in Puerto Rico, their tax implications, and the key factors you should consider optimizing the tax burden and establishing a solid foundation for the growth of your business.

What are the different business structures available in Puerto Rico?

A "business structure" refers to how a company is legally organized, and it can have implications regarding its management, liability and taxation. The structuring of a business commences with selecting the choice of entity. The following are the most common choices of entities used in Puerto Rico:

I. Sole Proprietorship

a. The simplest form of business, where the business and the owner are legally the same entity. The business is owned and operated by a single individual who is responsible for all aspects of the business, including debts and liabilities.

II. Partnerships

a. Involves two or more individuals or entities who share ownership and management responsibilities.

III. Corporations

a. A separate legal entity from its owners (shareholders), offering limited liability protection.

IV. Limited Liability Company (LLC)

a. A flexible business structure that can combine the liability protection of a corporation with the tax flexibility of choosing between corporation, passthrough entity or disregarded entity tax treatment. The LLCs can have one or more members (owners).

What are the income tax implications of each business structure?

After selecting the entity type for a business, an election should be made to determine how such entity should be taxed for income tax purposes.

I. Sole Proprietorship

a. The income or loss from the business is reported on the owner's personal tax return. The business's profits are taxed at the individual's income tax rate.

II. Partnership

a. Partnerships are passthrough entities; therefore, the partnership itself does not pay taxes directly. Instead, profits or losses are passed through to the partners, who report them on their income tax returns.

III. Corporation

a. Corporations are subject to corporate income tax at the corporate level. Then, if profits are distributed as dividends to shareholders, those dividends are taxed again at the owner’s level (double taxation).

IV. LLC

a. LLCs shall be subject to tax in the same form and manner as corporations; however, they may elect to be treated for tax purposes as passthrough entity or as disregarded entity[1] when they have a single member who is a resident individual.

Double Taxation: What you need to know

Double taxation occurs when a company is taxed on its profits at the corporate level, and then again when those profits are distributed to shareholders in the form of dividends.

How Double Taxation Works:

- ✓ Corporate level: The business itself is taxed on its profits. As of 2024, corporate tax rates in Puerto Rico can range from 18.5% to 37.5%, depending on the amount of taxable income.
- ✓ Shareholder level: When profits are distributed to shareholders in the form of dividends are typically subject to an additional tax. In Puerto Rico, dividends paid to resident shareholders are subject to a 15% tax, but this rate can be lower under certain circumstances.

How to Avoid Double Taxation:

- ✓ Electing income tax treatment as a Passthrough Entity: This structure avoids double taxation because the profits of the business are not taxed at the corporate level; instead, is passed through to the owners, who report it and pay taxes on their income tax returns.
- ✓ Utilize Special Tax Incentives: Puerto Rico offers various tax incentives that could help reduce the effective tax rate and minimize double taxation. Act 60-2019, also known as the Puerto Rico Incentives Code, provides significant tax incentives to businesses in certain industries. For example:
    - o Export Services and Manufacturing Tax Incentives: Corporations with a tax exemption grant and engaging in qualifying activities pay only a 4% income tax rate, significantly reducing their tax burden.
- ✓ Implement Dividend Planning: Planning dividend distributions can help reduce the tax burden on shareholders. One strategy could be reinvesting profits instead of paying out profits as dividends. This strategy defers taxation at the individual level. Caution should be taken about accumulating earnings without a clear business purpose, as this may lead to other potential implications.

Considerations for choosing the right business structure

Choosing the right business structure impacts not only taxes but also business growth, operations, and access to capital. Here are few considerations to keep in mind when selecting the business structure:

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[1] Disregarded entities are not required to file a separate income tax return, instead, the owner of the entity will be required to report the income, expenses, gains and losses arising from the operations of the disregarded entity in their income tax return.

- ✓ Liability protection: Certain structures like LLCs and Corporations provide personal liability protection for owners. This means your personal assets are generally protected from business debts and lawsuits, while sole proprietorships do not provide liability protection.
- ✓ Tax implications: Depending on the business structure, the tax implications may be different.
- ✓ Raising capital: LLCs and Corporations are typically more effective at raising funds, whether through investors or loans, compared to sole proprietorships.
- ✓ Operational flexibility: LLCs offer greater management flexibility, while corporations require a more formal governmental structure.
- ✓ Succession planning: LLCs and Corporations are often easier to transfer or sell because they are legally distinct from their owners. Sole Proprietorship is harder to transfer, as it's tied directly to the owner.
- ✓ Legal and Regulatory Requirements: LLCs and Corporations have more requirements and filings. Sole Proprietorships or businesses under a disregarded entity regime generally have fewer regulatory requirements but may still require business licenses or permits.
- ✓ Term of business: LLCs and Corporations tend to be better suited for long-term goals, while sole proprietorships are more ideal for short-term and smaller operations.

Tax Implications for changing business structure

Changing the structure of your business can help you achieve various objectives, such as reducing your tax burden, protecting personal assets from business liabilities, supporting growth, or providing employee benefits. Clearly defining your goals is essential in selecting the most appropriate structure.

- ✓ Depending on how the conversion is structured, it could qualify as either:
    - o Taxable transaction: If the conversion involves the sale or transfer of assets, the event could trigger a tax liability. The tax implications include recognition of gain or loss on the transfer of assets, depending on whether the business assets are sold or exchanged. This transfer could trigger capital gains tax if assets have appreciated in value.
    - o Non-taxable transaction: Certain business entity conversions, such as a merger, consolidation, or reorganization of businesses, may be considered non-taxable events if they qualify under the exchanges solely in-kind principle.

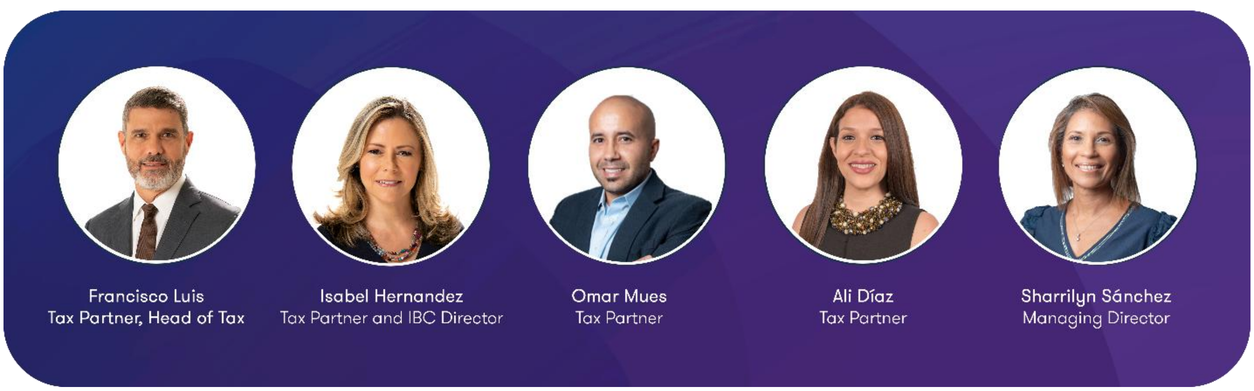
Steps and considerations when changing your business structure

- ✓ Assess your business needs: Consider why you want to change your structure. Is it to reduce taxes, protect personal assets, or prepare for business growth? Identifying your goals and weighing them against any associated costs is crucial in selecting the most appropriate structure.

- ✓ Consult a professional: It is strongly recommended to consult with a tax advisor, attorney, or business consultant before making any changes. They can assist in ensuring that the new structure aligns with your business objectives and guide you through the legal and tax implications involved, and any other compliance issues.
- ✓ Submit the required documents: Depending on the chosen structure, you must file the appropriate documents and meet the necessary requirements. Furthermore, it will be necessary for you to notify the relevant agencies.

While the simplicity of a sole proprietorship may be attractive at first, as your business grows, other structures like LLCs or Corporations can offer greater advantages. Choosing the right business structure requires a balance between liability protection, tax efficiency, administrative simplicity, long-term goals, among others. Although changing the business structure provides the opportunity to optimize the tax burden and facilitate growth, all relevant factors should be taken into consideration to make the correct decision. Before making any decision, it is essential to consult with a tax professional or legal advisor to understand all the tax implications and ensure that your decision aligns with your goals. By selecting the right structure and making informed decisions, you can establish a strong and secure framework for your business.

We are committed to keeping you informed of all the latest developments in laws and regulations that affect businesses in Puerto Rico. We can help you navigate the complex tax landscape to ensure that you are taking advantage of all the available benefits. Contact us today to learn more about how we can help you.



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