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Code Sections: 1076.01

Act: 1-2011

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## **Text**

In your letter of March 30, 2016, you requested certain rulings on behalf of the Taxpayer and its members, regarding the conversion from a corporation of individuals under Subchapter E of Chapter 11 of Subtitle A of the Puerto Rico Internal Revenue Code of 2011, as amended ("Code"), to a partnership under Chapter 7 of Subtitle A of the Code.

### **I. STATEMENTS OF FACTS**

You represented that as part of a corporate restructuring plan, the Taxpayer determined to convert the Corporation's legal structure into a limited liability company ("Conversion") organized under the laws of Puerto Rico in accordance with Articles 10.16 and 19.16 of the Puerto Rico General Corporations Act, Act No. 164 of December 16<sup>th</sup>, 2009, as amended ("Corporations Act"). Said Conversion was duly executed on the Execution Date and was effective on the Effective Date. However, the existence of the Taxpayer is deemed to have commenced on the date of filing of the Articles of Incorporation of the Corporation with the Puerto Rico State Department.

You further represented that before the Conversion, for tax purposes, a year prior to the Effective Date, the Taxpayer elected to be treated as a corporation of individuals pursuant to the provisions of Section 1115.02 of the Code ("E-Corp Election").

It was also represented that the Taxpayer believes that it will be beneficial to take advantage of the flexibility provided by the Code to the limited liability companies, as defined and provided by Section 1010.01(a)(3) of the Code, and elected to be classified and treated for income tax purposes as a partnership under the provisions of partnerships and partners of Chapter 7, Subtitle A of the Code effective on the Effective Date (the "Partnership Election").

### **II. RULINGS REQUESTED**

1. The Conversion qualifies as a tax free reorganization pursuant to Section 1034.04(g)(1)(F) of the Code.

2. The Taxpayer's E-Corp. Election does not terminate as a result of the tax free reorganization pursuant to Section 1034.04(g)(1)(F) of the Code.
3. Effective on the Effective Date, the Taxpayer, an entity with E-Corp. Election, is reclassified and converted for tax purposes into a Partnership under Chapter 7 of the Code.
4. There is no gain or loss for the Taxpayer and its stockholders as a result of the conversion and reclassification from an E-Corp. Election to a partnership pursuant to the provisions of Chapter 7, Subtitle A of the Code.
5. The tax basis of the assets and liabilities as well as the holding period of such assets and tax attributes received by the partnership in said transaction is the same that the corporation of individuals has just prior to the conversion and reclassification.
6. The basis of the members of the Taxpayer after the conversion and reclassification is the basis of the member before said transaction.

### III. LAW AND ANALYSIS

Chapter 7 of the Code provides a separate income tax regime for partnerships doing business in Puerto Rico. As a general rule, partnerships are not subject to tax in Puerto Rico on their net income. Instead, each partner is subject to tax on its distributable share of net income of the partnership's net income. Certain entities are mandatorily subject to Chapter 7 of the Code and other entities may elect to be subject to Chapter 7 of the Code.

Section 1076.01 of the Code provides the transition rules for the application of Chapter 7 of Subtitle A of the Code. This section is generally applicable to entities that, by the application of the Code or in a voluntary manner, convert from a corporation to a partnership, and provides the applicable conversion rules. The Department issued on February 14, 2012, and May 28, 2012, Administrative Determinations No. 12-04 ("DA 12-04") and 12-09 ("DA 12-09"), respectively, to further explain the partnership conversion rules.

Part III., A. of AD 12-04 specifically states that the conversion rules stated in Section 1076.01 do not apply to partnerships or limited liability companies ("LLCs") that at the effective date of the Code had in effect an election as a special partnership or as corporation of individuals. Instead, this Department determined that partnerships or LLCs that had in effect an election as a special partnership or corporation of individuals at the effective date of the Code, may request a conversion to a partnership under Chapter 7 of Subtitle A of the Code. Under such conversion, the "new partnership" receives, in a tax-free transaction, the assets and liabilities with the same tax basis, holding period of such assets and tax attributes of the special partnership or corporation of individuals. Notwithstanding, the new partnership shall be subject to Section 1115.08

of the Code under the same terms and conditions to which the partnership or LLC was subject immediately before the conversion. The partnership or LLC with election to be taxed as a special partnership or corporation of individuals applicable as of the effective date of the Code that subsequently elects to convert into a partnership for tax purposes must request such conversion by filing a request for an administrative determination. Such request must be submitted within the first ninety (90) days starting from the beginning of the taxable year for which the conversion is requested.

Furthermore, Part III., A., 3. of AD 12-09 provides that when an entity organized as a corporation converts, in accordance with the General Corporations Law, into an LLC in a transaction that complies with the requirements of Section 1034.04(g)(1)(F) of the Code ("Type F Reorganization"), the resulting LLC shall not be treated as a new LLC. Therefore, if after the conversion, said LLC elects to be treated, for income tax purposes, as a partnership the provisions of Section 1076.01(b) of the Code, as described in AD 12-04, shall generally apply. However, if the corporation to be converted into an LLC in a transaction that complies with the requirements of Section 1034.04(g)(1)(F) of the Code has in effect a special partnership or corporation of individuals election at the time of the conversion and such LLC elects to be treated, for purposes of the Code, as a partnership, starting on the date of such conversion, it shall request the same by filing a request for an administrative determination, on or before the last day of the third month following its date of conversion. This requisite was similarly required under AD 12-04 to partnerships or LLC's with an election to be taxed as a special partnership or corporation of individuals applicable as of the effective date of the Code that subsequently elected to convert into a partnership for tax purposes.

Section 1034.04(g)(1)(F) of the Code states that a mere change in identity, form, or place of organization of one corporation, however effected, constitutes a reorganization for purposes of Section 1034.04 of the Code. This reorganization is known as a Type F Reorganization. Article 1112(g)-2(g) of the Regulations under Section 1112 of the Internal Revenue Code of 1994, as amended, precursor of Section 1034.04 of the Code, states that in addition to complying with the other requirements relating to reorganizations, in a Type F reorganization it is essential that there be a continuity of the same business and operations that were carried on by the corporation prior to the change. This regulation is still in effect under Section 1034.04 of the Code since said regulation corresponds to the provisions of the Code that are identical to the corresponding provision, pursuant to Section 6091.01 of the Code.

Neither the Code nor its applicable regulations specifically provide that an election to be taxed as a corporation of individuals is transferred to the new entity in a Type F Reorganization. However, Article 19.16(g) of the Puerto Rico General Corporations Act, Act No. 164 of December 16<sup>th</sup>, 2009, as amended ("Corporation Act") states that in the case of a conversion to an LLC the entity is not required to liquidate its business or pay its debts and distribute its assets. It is not deemed that the conversion constitutes the dissolution of the entity and, instead, it constitutes a continuation of the entity. When an entity is converting to an LLC it is considered, for all purposes of Puerto Rico laws, as the same entity that is converting. Therefore, an entity with an election to be taxed as a

corporation of individual that converts to an LLC, in a transaction that qualifies as a Type F Reorganization, continues with such election, unless such election is revoked either voluntarily or involuntarily under Section 1115.02(d) of the Code.

The Taxpayer had a corporation of individual election effective at the time of the Conversion, which qualified as a Type F Reorganization. Therefore, the conversion rules stated in Section 1076.01 of the Code are not applicable to the Taxpayer, pursuant to AD 12-09 and AD 12-04. Instead, the provisions of AD 12-09 and AD 12-04, as set forth herein, are applicable to the Conversion and subsequent Partnership Election.

#### **IV. CONCLUSION**

Based solely on the facts submitted for our consideration, the income tax provisions of the Code and the applicable Regulations, and as provided under ad 12-04 and AD 12-09 this Department rules as follows:

1. The Conversion of the Taxpayer to an LLC qualifies as a tax free reorganization pursuant to Section 1034.04(g)(1)(F) of the Code.
2. The Taxpayer's E-Corp. Election does not terminate as a result of the tax free reorganization pursuant to Sections 1034.04(g)(1)(F) of the Code and 1115.02(d) of the Code.
3. Effective on the Effective Date, the Taxpayer's E-Corp. Election is considered revoked. On that same date, it shall be considered that the Taxpayer made the corresponding election to be taxed as a partnership under the provisions of Chapter 7 of Subtitle A of the Code.
4. No gain or loss shall be recognized by the Taxpayer as a result of its conversion from an LLC with an E-Corp. Election to a partnership pursuant to the provisions of Chapter 7 of Subtitle A of the Code, AD 12-04 and AD 12-09. Nevertheless, the Taxpayer will be subject to the recognition of any income resulting from the application of the provisions of Section 1115.08 of the Code under the same terms and conditions to which the corporation was subject immediately before the Conversion.
5. The tax basis of the assets and liabilities, as well as the holding period of such assets, and tax attributes received by the partnership in the transaction, is the same that the corporation of individuals had just prior to the Conversion.
6. The basis of the members of the Taxpayer after the Conversion is the basis of each member in the corporation of individuals before said Conversion.

Copy of this letter ruling shall be attached to the Puerto Rico income tax return of the Taxpayer for the year of the conversion.

No opinion is expressed as to the tax treatment of the above transactions under any other provision of the Code, the applicable regulations, or as to the tax treatment of any condition existing at the time of the transactions, or any effect resulting therefrom, that is not specifically covered by this ruling. This ruling is based on the factual representations as described above. Any misrepresentation or hiding of a material fact shall render this ruling null and void. The opinion expressed herein shall be valid only upon the continued existence of the facts as submitted for our consideration. This letter ruling is directed only to the Taxpayer requesting it and may not be used or cited as precedent.

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