



## TAX INSIGHTS

### Tax Considerations in Puerto Rico for Mergers and Acquisitions

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In the pursuit of business expansion, businesses have a wide array of options when deciding their approach on how to achieve their goals. Mergers and acquisitions (“M&A”) offer the opportunity to rapidly expand business operations while decreasing the risks associated with starting a new operation or expanding from scratch.

However, M&As are not immune to tax implications for the parties involved in the transaction. As such, when considering M&A transactions, it is important to evaluate all of its implications in order to determine which type of deal is right for you. This article provides a summary of important key points that should be pondered when conducting M&A transactions.

#### Structuring the Transaction: Asset vs. Stock Purchases

The first choice when engaging in an M&A transaction is deciding if the transaction should be arranged as an asset purchase or a stock purchase:

- **Asset Purchase:** In this scenario, the buyer acquires specific assets, such as equipment, real estate, or intellectual property, from the seller. From the seller’s perspective, a gain or loss will be recognized on the transaction based on the consideration received and the entity’s tax basis in the assets sold. Furthermore, depending on the nature of the assets sold, the transaction will be taxed as

ordinary income or capital gain. It is important to note that under the successor business regime, even in asset purchases, buyers may inherit tax liabilities from the seller if they continue operations that are substantially similar to the acquired business.

- **Stock or Membership Interest Purchase:** In this scenario, the buyer obtains ownership of the target company by purchasing its stock or membership interest, thus inheriting the existing tax structure and obligations. Sellers will recognize a gain or loss based on the stock transaction, which is generally taxed as a capital gain.

### Successor Liability Risks in Puerto Rico

In Puerto Rico, successor liability is clearly defined under the Internal Revenue Code (“PR Code”). Consequently, buyers may unintentionally assume the seller’s unpaid tax obligations, particularly if business operations continue substantially unchanged after the acquisition.

- **Income and Sales and Use Taxes (“SUT”):** In stock transactions, buyers automatically inherit the existing tax debts of the entity. In asset transactions, if operations continue with significant business continuity, buyers may also face similar tax liabilities.
- **Municipal License Taxes (“MLT”):** In asset transactions, buyers need to secure new municipal licenses, while in stock transactions, the existing license remains valid. However, in both cases any unpaid municipal license taxes may become the responsibility of the successor.
- **Property Taxes:** Unpaid property taxes are attached as liens to real and personal property. Buyers may inherit these liens upon the transfer of property unless they are settled before the transaction is finalized.

### Strategies to Mitigate Successor Tax Liability

Businesses can take proactive steps to reduce successor liability and any potential exposures through the following methods:

- **Due Diligence:** Early identification and disclosure of existing tax liabilities are crucial. Review past filings, compliance status, and any ongoing audits to

evaluate potential risks. In addition to obtaining and cross-checking financial records and audited financial statements (if available) with tax returns, areas of focus for due diligence should include:

- **Income Tax Compliance:** Buyers should review income tax returns to ensure accurate reporting and payment. It is recommended that the buyer obtains an Income Tax Debt & Filing Certificate from the Puerto Rico Treasury Department ("PRTD") to confirm that no outstanding liabilities exist.
- **Withholding and Payroll Taxes:** Assess the target's adherence to withholding requirements for wages, dividends, interest, and contractor payments.
- **Sales and Use Tax ("SUT"):** Buyers must ensure compliance with timely filing and payment. It is recommended that debt and filing certifications are obtained. In addition to ensuring compliance at the state level (including self-assessments of the tax when necessary), it is equally important for buyers to verify that the seller also adheres to municipal level filings. Moreover, it is vital for buyers to ensure that the seller possesses all the necessary documentation to support any exempt transactions reported to the tax authorities.
- **Municipal License Taxes:** Obtain debt and filing confirmations from each of the Municipalities in which the target operates. Furthermore, it is recommended that Volume of Business Declarations are cross-checked with Income Tax Returns to confirm that all income has been properly recognized for MLT purposes. Any taxpayer deciding to continue operations as a successor business must recognize the volume of business of the previous taxpayer. On the other hand, new businesses will be required to comply with all the registration requirements of the municipality in which the operations will be carried out.
- **Property Taxes:** Obtain debt and filing certifications from the Municipal Revenue Collection Center ("CRIM"). Confirm the target's compliance with property taxes applicable to real estate and personal property.

Furthermore, if possible, obtain independent appraisals for real property and asset depreciation schedules.

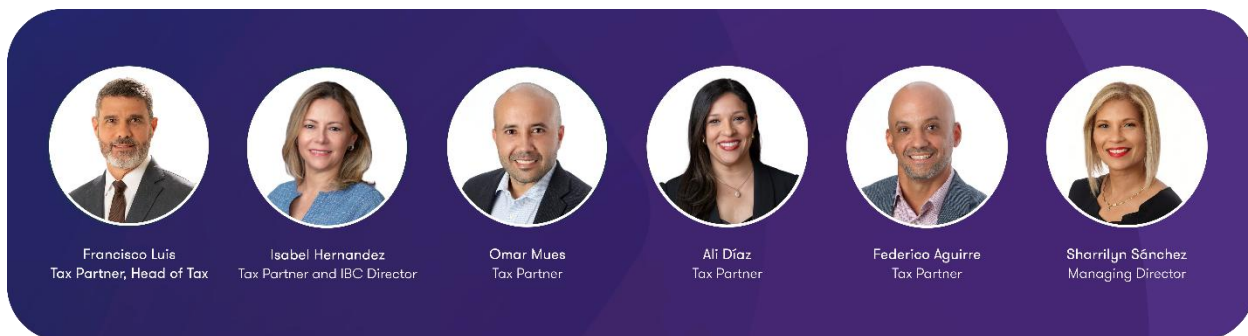
- **Tax Incentives and Grants:** Many businesses benefit from incentives under Act 60-2019 or previous Acts (e.g., Acts 20, 22, 73, etc.). It is essential for buyers to verify compliance with the terms of these incentives and to inform the Office of Tax Incentives of any changes in ownership.
- **Strategic Transaction Structuring:** Explore structuring transactions in a way that distinctly separates business continuity, possibly through the creation of new entities, differences in operations, clients, and markets to limit exposure to successor liability.
- **Financial Safeguards:** Establish escrow or withholding arrangements within the M&A transaction agreement to retain a portion of the purchase price until any potential tax liabilities are resolved. Additionally, include indemnification clauses to safeguard against unexpected liabilities after the transaction closes.
- **Closing Conditions:** Require seller compliance with tax obligations as a condition for closing, ensuring timely filings, tax payments, and the absence of unresolved deficiency notices.

## In conclusion

M&A transactions present growth opportunities for businesses. The right way to approach an M&A is not a one-size-fits-all and ultimately, it should be customized to both the requirements of the specific transaction and the goals of the buyer and seller alike. Whether opting for an asset or stock purchase, understanding the specific tax implications and conducting thorough due diligence is critical for success.

By remaining proactive and consulting a tax advisor who handles M&A transactions, businesses can avoid many potential tax exposures while discovering opportunities that are advantageous to both buyers and sellers in an M&A transaction.

As always, we are committed to keeping you up to date with all tax-related developments. Please contact our Tax Department for additional information regarding this or any other tax issue. We will be glad to assist you.



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