Kevane Grant Thornton Mailbag

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Dear clients and friends:

The Kevane Grant Thornton Mailbag is your link to all our communications related to the operations of businesses in Puerto Rico. Our purpose is to offer you with up-to-date information concerning audit, tax, advisory and accounting matters that might have an impact on individuals or in the way you conduct your business in Puerto Rico.

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Audit Alert: Determining the customer of the operation services in a service concession arrangement

On March 16, the FASB's Emerging Issues Task Force (EITF) reached a final consensus on Issue 16-C, "Determining the Customer of the Operation Services in a Service Concession Arrangement." The FASB will consider ratification of the consensus at a future meeting. If ratified, the consensus will be issued as an ASU.

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In a service concession arrangement (SCA), a grantor (typically a government or public sector entity) and an operating entity enter into a contract for the operating entity to operate the grantor's infrastructure (for example, a toll road) for a specified period of time. An SCA is within the scope of ASC 853, Service Concession Arrangements, when both:

- The grantor controls or has the ability to modify or approve (1) the services that the operating entity must provide using the grantor's infrastructure, (2) to whom the operating entity must provide the services, and (3) at what price.
- The grantor controls, through ownership, beneficial entitlement, or otherwise, any residual interest in the infrastructure at the end of the term of the arrangement (ASC 853-10-15-3).

In reaching its final consensus, the Task Force reaffirmed guidance in its consensus-for-exposure that was included in the proposed ASU, Determining the Customer of the Operation Services, issued in November 2016, stating that the grantor would be the customer in all cases for SCAs within the scope of ASC 853, because the operating entity does not own or lease the infrastructure and does not control the services to be provided to the third-party users.

The Task Force tentatively decided that the effective date of the new guidance would align with the guidance in ASC 606, Revenue from Contracts with Customers, and that entities would be allowed to early adopt the new guidance irrespective of their decision to early adopt ASC 606.

Source: Grant Thornton, *On the Horizon*, March 23, 2017.

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Tax Alert: Proposed changes to Act 154

On October 25, 2010, the Government of Puerto Rico enacted Act 154-2010 to establish a 4% Excise Tax on certain *personal property* and *services* transactions between related entities for taxable years commenced after December 31, 2010. The tax generally applies to foreign companies that have an office, or are treated as having a permanent place of business in Puerto Rico, and reaches certain threshold levels of production.

Act 154-2010

At the time, the Puerto Rico government stated that the tax would be transparent for those entities affected by it and, therefore, would be allowed by the U.S. Internal Revenue Services ("IRS") to claim it as a credit for federal income tax purposes.

On April 18, 2011, the IRS released Notice No. 2011-29, whereby the agency committed to evaluate the fiscal impact of Act 154-2010 but during said evaluation, it would not challenge taxpayer's claiming the 4% Excise Tax as a foreign tax credit.

Since its enactment, the tax has provided the government's coffers with almost $2 billion annually, creating what some analyst might consider an indirect government bail-out - a benefit that none of the States of the Union have ever had. Approximately 90% of the aforementioned $2 billion in revenues is contributed by roughly 10 companies, with an additional 20 providing the remaining 10%.

Presently, revenues derived from Act 154-2010 account for about 20% of the Puerto Rico General Fund

Originally slated to be eliminated by December 31, 2016, the Excise Tax was extended until December 31, 2027 by the administration of Gov. Ricardo Rosselló through Act No. 3 of 2017.

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Understanding that there is not a "one-size-fits-all" solution for the treatment of excise tax payments, the government is evaluating various alternatives under Act 154-2010.

The extension, though necessary in light of Puerto Rico worsening economic situation, creates some uncertainty as to the creditability of the excise tax payment in Puerto Rico for US tax purposes, since the IRS has not made further declarations on the matter, aside from Notice 2011-29 and the elements under which said Notice were issued have changed, in particular, the revised end-date for the excise tax (i.e. December 31, 2027).

Moreover, one must also consider the new political background. The Trump administration has vastly different economic and administrative views from the predecessor under which Notice 2011-29 was issued. It is quite possible that the IRS may very well re-visit their position if it's not congruent with the current administration's fiscal reform.

To complicate matters further, the Fiscal Oversight Board established by the Puerto Rico Oversight, Management, and Economic Stability Act ("PROMESA") has stressed to the Rosselló administration that both the government's budget as well as any economic plan must not take into consideration the revenues generated under Act 154-2010.

That may prove a tall order since its inception every administration has readily depended on Act 154-2010 collections for budgetary purposes. Considering that a small decrease in intercompany transactions, or worse the cessation of operations of one of the 10 that account for 90% of the revenues would result in a considerable reduction to the available funds, taking it out altogether from all planning projection will test the creativity, mettle and resolve of the administration to deal with the imposed economic realities.

Mindful of the present political landscape, and with the insecurity as to the perpetuation of the favorable treatment for excise tax payments against federal income tax and the Island's current situation, the administration of Gov. Rosselló is discussing various alternatives to Act 154-2010, understanding that there is not a "one-size-fits-all" solution and that they must find a more permanent solution to the Act 154-2010 challenge. Among the various alternatives to Act 154-2010, the following or a combination thereof, have been considered:

1. a modified version of the income source rules;
2. an increased income tax on exempted income;
3. an income tax withholding on royalties or cost allocation payments;
4. a withholding income tax on profit distributions.

No matter which alternative is undertaken, the goal is to provide greater certainty and simplicity by moving the excise tax into a new vehicle that will afford companies doing business in Puerto Rico full creditability for U.S. tax purposes by fiscal year 2019. Nonetheless, said creditability must not come at the expense of economic growth for Puerto Rico.

It is clear that Puerto Rico has its work cut out for it. With a looming Tax Reform at the federal level, there is uncertainty as to how will Puerto Rico be considered for federal tax purposes. Will it be treated as a domestic jurisdiction for tax reasons or will it remain a foreign one? Given the undefined state of affairs, the Puerto Rico government is weighing both outcomes and drafting legislation to both ends in order to have a measured response and blueprint to each alternative.

Note: As highlighted in our July 1, 2016 Tax Alert, PROMESA seeks to provide Puerto Rico with fiscal and economic discipline through the creation of a control board, among other things. Virtually every fiscal decision by the Government of Puerto Rico will be made or approved by the Oversight Board created by PROMESA. On this regard, the board has authority to prevent the execution or enforcement of a contract, rule, executive order or regulation to the extent that it is inconsistent with the approved fiscal plan.

Please contact our Tax Department should additional information is required regarding this or any other tax issue. We will be glad to assist you.

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Advisory Alert: Working capital -how to find extra cash for growth

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Introduction

Most middle-market businesses are satisfied with their current working capital performance. But is their satisfaction justified? At many companies, if there's enough money to meet payroll and pay the bills, the discussion on working capital ends. That is a missed opportunity, as even modest improvements in working capital performance can free up millions of dollars for strategic investments in organizational priorities. Furthermore, the development of a strong and pervasive working capital culture lays the groundwork for a more efficient organization that generates higher growth and improved profitability. These are among the findings of a recent survey on working capital management by the National Center for the Middle Market (NCMM), sponsored by Grant Thornton.[1]

Working capital management solutions that improve your entire business

1. Build a culture of working capital management

The key to success is establishing a culture of working capital management. Organizations are not created with a cash culture. They need to create one and nurture it.

Three steps organizations can take toward building a cash culture are:

- **Determine where the company currently stands in terms of cash culture**

  What tools and data are available and which are employed? What infrastructure is in place to support working capital policies and procedures?

- **Decide on organizational best practices**

  For instance, top managers should meet regularly — in some companies as often as once a week — to discuss working capital management.

- **Dedicate time to improve the cash culture continuously.**

  For instance, periodic reviews of policies and procedures are critical: customers need to be pursued on payment, and vendor terms need to be reviewed regularly. The key to create conditions for steady progress is to pursue continuity and to repeat the process regularly since no company gets to best-in-class in a month.

Organizations are not created with a cash culture. They need to create one and nurture it.

2. Integrate all aspects of working capital

Traditionally, the principal elements of working capital are accounts payable (A/P), accounts receivable (A/R) and inventory. Yet rather than focusing on each one of these separately, companies need to take an integrated approach to working capital, as there are nuances around each aspect of working capital, including the industry in which each company operates and its life cycle stage.

Two measures to implement today to free up cash are:

- Benchmark A/P and A/R practices.
  This will help your company achieve faster receipt of cash and free up the finance department for higher-value work streams. One way to do this is to focus on improving the number of outstanding days as a key performance indicator (KPI). Improving this indicator for both A/P and A/R often entails upgrading internal policies and procedures, as well as the company's communication with customers and vendors.

- Perform an in-depth analysis of inventory.
  This will maximize profitability through improved business operations, such as stock reductions or improvement of the entire supply chain. e.g., Which vendors are being used? Why are they being used? And how do vendor choices make geographical sense? Additionally, this analysis can lead the company to re-examine its long-term strategy, marketing and positioning within its industry segment, including product categories and mix, and the stock keeping units (SKUs) for maximum profitability.

3. Ensure that working capital management cascades from the top down

Take the following 3 steps to move forward with working capital management:

- Gain the commitment of top management.
  A cash culture is driven from the top down.
- Align staff incentives to improvements.
  Working capital must be part of the KPIs and other measures for evaluating staff.
- Provide the necessary data based on the answers to the following questions:
  — Does the data exist?
  — Is it being communicated in ways that lower-level employees can understand?
  — Is it being shared among all stakeholders?

4. Digitalize the enterprise

The survey found that relatively few companies are happy with their digitalization efforts for working capital.

Two areas that can see added benefits from digitization are:

I. Receivables

The collection of receivables may be expedited by providing early pay discounts or other incentives to customers. Alternatively, this can be achieved through technology offerings — such as automated clearing houses and other auto-pay options. Companies that still rely heavily on paper for their payables could adopt vendor management systems to create ways to save money.

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II. Inventories

To optimize inventories (e.g., to support decisions related to target inventory levels and order timing), many systems can be improved by new technology or, at a minimum, by strategic data analysis. Some industries, such as automotive, are more advanced in their drive toward a more fully integrated supply chain. However, many sectors lag and have ample room for improvement. The initial investment for these systems can sometimes be high, but there are also smaller steps companies can take to achieve digital gains. As mentioned above, identifying potential action steps and focusing on an iterative process may be a great solution.

Source: https://www.grantthornton.com/library/survey-reports/CFO-survey/2017/ncmm-working-capital-management.aspx

Conclusion

The art of the possible

The effort to improve working capital should be tempered by a heavy dose of realism. Gains in working capital metrics that appear achievable in theory are often impossible to produce in practice — and sometimes not even desirable. Putting working capital management on the back burner, however, stalls improvements in free cash that would ultimately allow the company to pursue other strategic goals, including increasing returns, making acquisitions and paying down debt. It also curtails an in-depth investigation of each working capital element — especially inventory — that could dramatically improve business operations and boost ROI.

To avoid working capital complacency, companies would benefit from instilling a culture of working capital management that requires a sustained commitment at every level of the organization. Steady gains in working capital management can yield efficiencies along the entire supply chain, effect improvements in product categories and mix, and optimize SKUs for maximum profitability.

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Outsourcing Alert:
Withholding exemption certificate - Form 499 R-4

The Withholding Exemption Certificate (Form 499 R-4) is the document used by the employee to notify his/her employer of the personal exemption, exemption for dependents and the allowance based on deductions to determine the income tax to be withheld from the employee's wages.

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Form 499 R-4

The Withholding Exemption Certificate (Form 499 R-4) is the document used by the employee to notify his/her employer of the personal exemption, exemption for dependents and the allowance based on deductions to determine the income tax to be withheld from the employee's wages.

Young individuals' resident of Puerto Rico whose ages fluctuates between 16 and 26 years at the end of the taxable year, are entitled to an exemption on the first $40,000 of gross income from wages. To claim this exemption, the employee must include the date of birth.

Personal Exemption

- Individual tax payer (single person, married that granted prenuptial agreement of total separation of assets or married not living with the spouse).

- Married – if you are married and choose the optional computation, the personal exemption will be considered on a 50% basis for each spouse.

- Veterans – every veteran is entitled to claim an additional personal exemption.

Exemption for Dependents

The number of dependents, shall be the same as the number claimed in the personal income tax return. If the employee has joint custody and have not released the claim to this exemption, only the 50% of the exemption will be considered.

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Taxpayers have the option to consider which method to use to determine the number of allowances

Allowance based on deductions

You have the option to consider in the withholding computation, the deductions that you will be able to claim on your tax return, such as home mortgage interest, charitable contribution, medical expenses, interest paid on student loans or retirement systems, contributions to IRA's and Educational IRA's, Contributions to health savings accounts, casualty loss on your principal residence and loss of personal property as result of certain casualties.

Any employee may elect for his/her employer to withhold an amount in addition to the one required.

The employer shall consider the information provided by the employee on this Certificate in order to make the withholding according to the Employer's Guide on the Withholding of Income Tax at Source on Wages for the corresponding taxable year.

Links – Puerto Rico Department of Treasury
http://www.hacienda.gobierno.pr/sites/default/files/documentos/499_r-4_2.pdf

http://www.hacienda.gobierno.pr/sites/default/files/documentos/499_r-4_1.pdf

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