

Kevane mailbag

January 29, 2015 – Issue 46








Kevane Grant Thornton LLP
 33 Calle Bolivia Ste 400
 San Juan, Puerto Rico 00917-2013
 T + 1 787 754 1915 F + 1 787 751 1284
www.kevane.com

The Kevane mailbag is your link to our communications related to the operations of businesses in Puerto Rico. Our purpose is to offer you up-to-date information concerning tax, accounting and any other matters that might have an impact on the way you conduct business in Puerto Rico.

The Alerts contained in our mailbags can also be accessed through our website under the Publications tab\Professional Articles section or by downloading our business and tax application for mobile, tablets and iPad for free through the App Store and the Google Play. Search for Kevane Grant Thornton.

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Icon	Content
Audit 	The Financial Accounting Standard Board (FASB) has issued private company guidance on accounting for intangible assets. Read related information on page 2 .
Tax 	The government of Puerto Rico is working on the creation of a new tax reform that could have a direct impact in the sales and use tax. The reform proposal rests on the Value Added Tax as the main source of collection, which represents a shift from taxing productivity to a tax based on consumption. Read more about this matter on page 3 .
Advisory 	Valuation plays a central role in Chapter 11 bankruptcy negotiations and is key to a fresh start. Read more in “Life after bankruptcy begins with a “fresh start” — Fresh start valuation and accounting”. Access the article on page 5 .
Outsourcing 	The Internal Revenue Service has released the 2015 Social security and Medicare wages base limits. Read about this topic on page 9 .
General information 	We are excited to share with you that you can now follow us on social networks through Facebook and LinkedIn. Stay updated on news, publications, and events. Click the following icons to become a follower of our pages.  

Audit Alert: Private company guidance issued on intangible assets in a business combination

At the end of 2014, the [FASB released ASU 2014-18, Accounting for Identifiable Intangible Assets in a Business Combination – a consensus of the Private Company Council](#). Under the ASU, private companies, as defined in the Codification, can elect to no longer recognize acquired intangible assets pertaining to noncompete agreements and customer relationships separately from goodwill, except for customer-related intangible assets that can be separately sold or licensed independently from other assets of the business. Examples of customer-related intangibles that may be independently sold or licensed and thus require separate accounting include mortgage servicing rights, commodity supply contracts, core deposits, and customer information lists. Besides *business combinations*, the ASU also applies to *fresh start accounting* situations and to the *assessment of differences between the carrying amount of an investment and the underlying equity in an investee's net assets when applying the equity method of accounting*.

If a private company elects the ASU's accounting alternative, it must also elect (or have already elected) to adopt the alternative in ASU 2014-02, *Accounting for Goodwill*, which requires, among other things, the amortization of goodwill. However, private companies that elect or have elected to adopt the alternative in ASU 2014-02 are not required to adopt the alternative in ASU 2014-18.

If a private company chooses to elect the accounting alternative in ASU 2014-18, it must apply the guidance on the first occurrence (and on all subsequent occurrences in a fiscal year beginning after December 15, 2015).

Any noncompete or customer-related intangibles that exist as of the beginning of the period of adoption of this ASU must continue to be separately measured and accounted for; they cannot be absorbed into goodwill.

For more information on ASU 2014-18, refer to [FASB in Focus](#), "Accounting Standards Update for Private Companies Accounting for Identifiable Intangible Assets in a Business Combination."

Source: Grant Thornton, *On The Horizon*, January 6, 2015

We are committed to keep you updated of all developments that may affect the way you do business in Puerto Rico. Please contact us should we may be of further assistance in relation to this or any other matter.



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Tax Alert: Value Added Tax vs. Sales and Use Tax in Puerto Rico

The government of Puerto Rico is working on the draft of a new tax reform that will have a direct impact in the Sales and Use Tax (known by its Spanish acronym “IVU”). The reform proposal will rest on the Value Added Tax (known by its Spanish acronym “IVA”) as the main source of collection, which represents a shift from taxing productivity to a tax based on consumption.

The following information compares the general tax structure under both systems:

Value Added Tax (“IVA”)

Generally, the IVA is a tax that is levied at each stage in the chain of production and distribution from raw materials to the final sale based on the value added at each stage.

It is expected that IVA will apply to most goods and services except for the following:

- exported goods and services
- financial services
- rental Housing

Normally, the amount of IVA that the user pays is based on the cost of the product and is allowed to claim a credit for the IVA that has been paid before.

The following example presents the results with a hypothetical IVA tax rate of 10%:

1. A manufacturer pays \$110 for raw materials. This includes \$100 for the cost of the raw material plus an IVA of 10%. The raw material supplier remits \$10 to the

Puerto Rico Treasury Department (“PRTD”).

2. The manufacturer establishes a fix price of \$150 for the assembled personal property, which will be subject to IVA ($\$150 \times 10\% = \15). The retailer pays \$165 for the merchandise including the IVA. The manufacturer is allowed to claim a credit from the IVA that he paid to the supplier and remits \$5 to the PRTD (calculated as $\$150 \times 10\% = \$15 - \$10 = \5).
3. Finally, the retailer establishes a fix price of \$200 for the personal property and sells it to a consumer for \$220, which already includes the IVA. The retailer remits \$5 to the PRTD (calculated as $\$200 \times 10\% = \$20 - \$15 = \5). It is allowed to claim a credit from the IVA that he paid to the manufacturer.

Sales and Use Tax (“IVU”)

Under the IVU, the tax is collected at the end consumer’s point of purchase and on imports of tangible personal property into Puerto Rico.

Every merchant engaged in any business that sells taxable items is responsible to collect the IVU as a withholding agent.



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The IVU rate is 7% and in general applies to the following items with certain exceptions:

- tangible personal property
- taxable services
- admission rights
- bundled transactions

The following example was prepared using the current IVU tax rate of 7%:

1. The manufacturer purchases \$100 worth of raw materials from the supplier. However, a manufacturer is exempt from the payment of IVU on the purchase of raw materials.
2. The manufacturer sells the personal property to a retailer for \$150. The retailer is subject to an IVU payment in the amount of \$10.50 (calculated as $\$150 \times 7\% = \10.50). However, if the retailer has the Reseller Certificate, it may claim a credit for the IVU paid on the purchase of taxable items for resale. The credit is limited to 75% of the liability on the sales tax return.
3. The retailer sells the personal property to a consumer for \$200. The consumer is subject to an IVU payment in the amount of \$14 (calculated as $\$200 \times 7\% = \14).

The Tax Reform Bill is expected to be filed during the month of February. As part of our commitment to keep you up-to-date with recent developments, we will issue Tax Alerts with the proposed changes as soon as the information becomes available.



Please contact our Tax Department should you require additional information regarding this or any other tax issue; we will be glad to assist you.

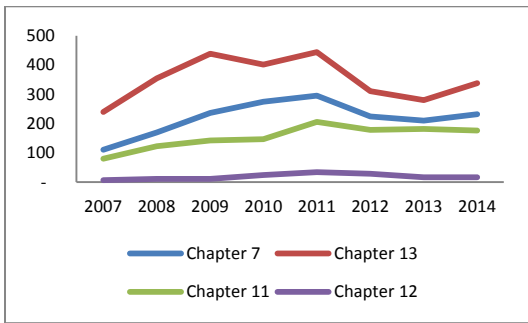
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Advisory Alert: Life after bankruptcy begins with a “fresh start” — Fresh start valuation and accounting

Commercial filings under federal bankruptcy law in Puerto Rico during calendar year 2014 totaled 762¹ filings, an increase of 76 filings or 10.6%, when compared to 2013.

The following graph presents trends in commercial bankruptcy number of filings from 2007 to 2014, by filing type.

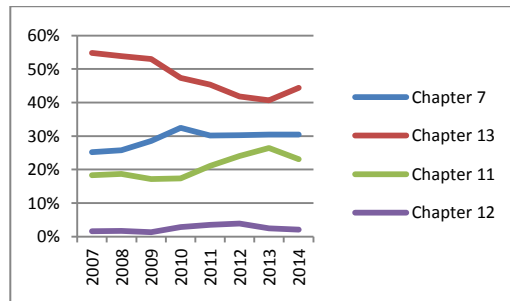


As seen above, after downward trends during 2012 and 2013, commercial chapter 7 (liquidation) and commercial chapter 13 (primarily reorganization of DBA’s) filings increased during 2014.

Also, after increases in 2007 through 2011, the number of Chapter 11 commercial filings has remained relatively steady since 2012.

As a percentage of total commercial filings, Chapter 11 filings during 2014 show a decrease, however the percentage continues

above 20% since the end of 2011, as illustrated in the following graph:



Valuation plays a central role in Chapter 11 bankruptcy negotiations and is key to a fresh start.

Let’s examine the following questions:

What happens after the filing of the Chapter 11 bankruptcy petition, and how does valuation serve as the touchstone in the process?

In Chapter 11 reorganization, the objective of management and its advisors is developing a plan of reorganization (the “Plan”) that will be confirmed by the Bankruptcy Court, leading to emergence from bankruptcy protection and a return to competitive operations — life after bankruptcy.



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¹ Source: Boletín de Puerto Rico.

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At its simplest, Chapter 11 reorganization is a formal, court-supervised process to:

- provide temporary protection from creditors;
- maximize the value of the company, primarily through eliminating excess debt, exiting unprofitable operations, and/or revising contractual relationships;
- establish the value of the reorganized company; and
- allocate that value among the various parties having a claim against the company.

In a successful reorganization, the debtor company and its advisors prepare the Plan and a disclosure statement that groups the creditors into classes and includes an estimate of company value. The Plan becomes effective if, and when, the debtor solicits a sufficient number of votes in support of the Plan.

Central to the reorganization objective and confirmation of the Plan is the **reorganization value**, or the estimated enterprise value of the debtor company — the economic measure of what the market believes the ongoing operation is worth. Central to the reorganization value are issues such as:

- What is future cash flow capacity of the firm?
- What is the future risk profile of the firm, represented by the discount rate applied to future cash flows?
- What are the appropriate valuation multiples to be applied to firm measures such as revenue and EBITDA?

The reorganization value is crucial to creditors, since it indicates who will be paid, and how much will be paid. When the reorganization value is determined, it will establish whether or not:

- a primary secured creditor will obtain periodic payments on its restructured loan, or equity in the reorganized firm;
- general unsecured creditors might receive some return on their pre-petition claims; and
- holders of former equity interests will retain any continuing stake in the reorganized firm.

Although it is the responsibility (and exclusive right for a specified period) of the debtor's management to file the Plan and disclosure statement, in rare cases, other parties in interest (typically creditors) may petition to file an alternate reorganization plan. Generally, competing plans arise from differing views on what the company is worth.

Fresh start valuation and accounting – what is it and why is it important?

Confirmation of the Plan leads to another requirement for valuation in the bankruptcy process – fresh start valuation and accounting. Upon emergence from bankruptcy, management is required to apply the provisions of fresh start accounting to its financial statement in accordance with Generally Accepted Accounting Principles (“GAAP”). Under fresh start accounting, a new reporting entity, the “successor company,” is created, and the recorded amounts of assets and liabilities are adjusted to reflect their fair value. As a result, the historical financial statements of the pre-bankruptcy firm are generally not comparable to those of the successor company.

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Entities, whether public or private, must comply with Section 852 of the Financial Accounting Standards Board's ("FASB") Accounting Standards Codification ("ASC"), Reorganizations. Fresh start accounting was previously covered under the AICPA's Statement of Position 90-7 ("SOP 90-7"), Financial Reporting by Entities in Reorganization under the Bankruptcy Code.

Section 852 calls for reorganizing entities to apply fair value concepts to determine both the reorganization value and new basis of financial, tangible, and intangible² assets in financial reporting.

For financial accounting purposes, the reorganized firm is treated similarly to a newly acquired entity. The reorganization value is allocated to company assets in compliance with ASC Section 805, Business Combinations (previously Statement of Financial Accounting Standards ["SFAS"] No. 141R). Determination of asset values also must integrate the concepts of ASC Section 820, Fair Value Measurements and Disclosures (formerly SFAS 157).

² On December 23, 2014, the FASB issued ASU 2014-18, which provides alternative accounting for a **private company** that recognizes or considers the fair value of identifiable intangible assets upon the adoption of fresh-start accounting. The accounting alternative is effective prospectively upon the first eligible transaction entered into in an annual period beginning after December 15, 2015 (with early adoption permitted), and will apply to all future transactions after the adoption date. The alternative will help private companies reduce the cost and complexity of accounting for a business combination and other eligible transactions because many customer-related intangible (CRI) assets and all non-compete agreements (NCAs) would not be recognized separately and would be subsumed into goodwill.

Of particular importance, though, is that determining the fair value of assets can be complicated in circumstances where a company is invested in tangible assets of a declining or displaced industry, which could be impacted by functional or economic obsolescence, or when the distress encountered by the company prior to and during bankruptcy could have created negative associations that would impact intangible value. Valuation involving these factors must be robust to withstand review by third parties.

Fresh start valuation and accounting follows the reorganization process and establishes the financial reporting foundation that will serve as the company's blueprint for life after bankruptcy. The quality of the valuation can make a significant impact on the determination of value and not all valuations are created equal.

What are the implications of "fresh start" valuation?

Although the firm will assume a financial reporting position that will maximize depreciation and amortization through a re-set of the tangible and intangible asset basis, the de facto stock acquisition treatment for tax reporting in fresh start will likely result in differences between financial and tax reporting. Previously fully depreciated assets used in operations will again have a depreciable tax basis that throws off depreciation. Previously unrecognized internally developed intangible assets will be recorded on the balance sheet and generate prospective amortization. After completion of the fresh start valuation, the generation of a deferred tax liability could result in the creation of goodwill on the reorganized company's balance sheet.

Of additional concern is the circumstance where the entity's operations encompass more than one reporting unit. The fresh start valuation must then proceed to establish the fair values of the tangible and intangible assets in a manner that is cognizant of the future impairment testing of long-lived assets or goodwill under ASC 360-10-30, *Property, Plant and Equipment*, or ASC 350, *Intangibles - Goodwill and Other*, respectively

Several factors will also impact the cost structure of the post-bankruptcy company. During reorganization, the company has the opportunity to shed itself of leases with financially unfavorable terms, a true advantage where lease costs are material.

Interest expense, a significant pre-bankruptcy cost, may be significantly reduced, leading to cash preservation. Unprofitable operations may be exited. The post-emergence company will be newly competitive in a manner that may lead rival companies that forestalled bankruptcy to find themselves in a condition of "bankruptcy envy." Perhaps, however, the lingering damage of bankruptcy to customers' perceptions will weed out the formerly weak performers. Every bankruptcy cycle presents these same questions – what value remains in distressed and/or over-levered companies, and how will the market respond to reorganization?

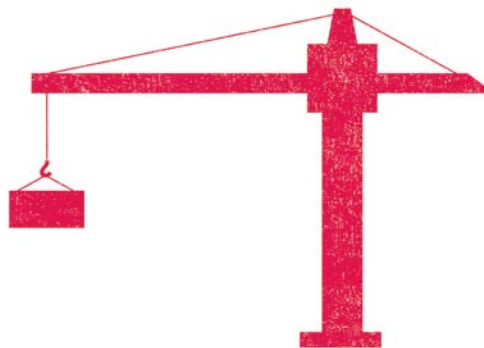
The bottom line

Bankruptcies have been and most likely will continue to be on the rise for some time, and while this unprecedented environment is challenging, it presents many opportunities for those who understand how to strategically manage the process. In some cases, post-bankruptcy companies gain a competitive advantage as they emerge in a solvent position.

Insightful valuation analytics during this process are key to the best possible outcome and provide a solid foundation for a fresh start.

There are many tough questions presented by the bankruptcy process that can best be addressed by trusted advisors who specialize in restructuring, reorganization and valuation.

Our advisory services professionals stand ready to help you address the issues of life before, during and after the bankruptcy process. We help our clients with today's toughest business issues and offer the experience and expertise of fully cross-functional teams to help get you back on the road to opportunity.



Call us to make an appointment with one of our experienced advisors. Consultations are completely confidential.

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Outsourcing Alert: 2015 Social Security and Medicare wages base limits

Social Security Tax 2015

The Internal Revenue Service has published the new wages base limits effective January 1, 2015.

The employee and employers tax rate for social security is 6.2%, unchanged from 2014. The social security wage base limit increases to \$118,500.

For employee and employers Medicare tax rate is 1.45%, also unchanged from 2014. There is no wage base limit for Medicare tax.

Social security and Medicare taxes apply to the wages of household workers to whom you pay \$1,900 or more in cash or an equivalent form of compensation. Social security and Medicare taxes apply to election workers who are paid \$1,600 or more in cash or an equivalent form of compensation.

Additional Medicare Tax Withholding

In addition to withholding Medicare Tax at 1.45%, employers must withhold a 0.9% Additional Medicare Tax from wages paid to an employee in excess of \$200,000 in a calendar year. You are required to begin withholding Additional Medicare Tax in the pay period in which you pay wages in excess of \$200,000 to an employee and continue to withhold it each pay period until the end of the calendar year.

Additional Medicare Tax is only imposed on the employee.

Link-IRS

<http://www.irs.gov/pub/irs-pdf/n1036.pdf>



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