

Kevane mailbag

June 25, 2015 – Issue 51

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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.

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Audit 	In this issue we will view the current issues being discussed by the PCAOB regarding the use of the work of specialists. Read related information on page 2 .
Tax 	Do you incur in expenses or charges with related parties outside of Puerto Rico? You may need a waiver to be able to deduct those for Puerto Rico income tax purposes. Read more on page 3 .
Advisory 	When executed, “apps” offer government officials the structure and tools to work towards achieving fiscal stability, stimulate growth, address priorities and resolve complex economic and service issues. Access the article on page 5 .
Outsourcing 	Statutory requirements regarding the accrual and enjoyment of vacation and sick leave for non-exempt employees and outside salespersons in Puerto Rico are established in Act No. 180 of July 27, 1998. Read more on page 9 .
General Information 	Join us in a series of four webcasts that will help you understand the tax changes that will take place in Puerto Rico during 2015 and 2016, and their impact on your business operations. Click here for more details.

Audit Alert: PCAOB issues Staff Consultation Paper on using the work of specialists

More and more today we are using the work of the specialists either employed by the firm, engaged by the firm or the review of a company's specialist. This consultation paper seeks information to help address the potential need for improvement of the standards governing the use of the work of specialists.

Please follow along and double-click the underline items to see the Staff Consultation Paper and the Fact Sheet. Figures 2 of the Staff Consultation Paper summarizes the relationships of Specialist with an Auditor and in Figure 3 reviews the current Standards that Govern the Use of the Work of Specialists.

The PCAOB recently issued [Staff Consultation Paper 2015-01, *The Auditor's Use of the Work of Specialists*](#). The paper discusses the increase in the use of the work of specialists by auditors and raises the question as to whether more rigorous standards and specific procedures are necessary to assist auditors in responding to the risk of material misstatement when using specialists' work.

The PCAOB is seeking comments on possible alternatives to address the issues discussed and on potential changes to the standard, specifically regarding the objectivity and oversight of specialists and the use of their work. Comments are due July 31, 2015.

The Board also released an accompanying [Fact Sheet](#), "Staff Consultation Paper on the Auditor's Use of the Work of Specialists."

Source: Grant Thornton, *On The Horizon*, June 4, 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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June 10, 2015

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Tax Alert: Expenses or charges incurred with related parties outside of Puerto Rico

Do you incur in expenses or charges with related parties outside of Puerto Rico? You may need a waiver to be able to deduct those for Puerto Rico income tax purposes.

Recently approved Act 72-2015 incorporates significant changes to the sales and use tax in Puerto Rico and the adoption of a new chapter to the 2011 Puerto Rico Internal Revenue Code, as amended (PR Code) to transition our current consumption tax into a value added tax (VAT) system.

This could be a preliminary conclusion of the tax reform efforts that began with the filing of Bill 2329 on February 11, 2015, which was supposed to drastically transform our tax system with not only the adoption of a VAT but which would have also brought significant changes to the income tax arena, including the promised tax rates reliefs that never materialized.

In addition to the changes to our consumption tax system, Act 72-2015 also modified certain income tax aspects of the PR code. One of these new changes is an important modification of the treatment of **expenses or charges incurred by taxpayers with related parties that are not engaged in trade or business in Puerto Rico**. As a continuation to the trend initiated with Act 40-2012 and Act 72-2015, it limits the amount of the deduction of these expenses or charges for ordinary tax purposes, as well as it continues to consider them part of the **alternative minimum tax**

computations (AMT). Notwithstanding, the law continues to authorize the Secretary of Treasury to approve waivers to reduce the amount of the charges subject to the limitations for ordinary tax purposes, as well as for AMT purposes. We hope and expect this to be the initial development of adopting formal transfer pricing dispositions in Puerto Rico to regulate the transactions with related parties as most countries around the world continue to implement these rules.

In the following paragraphs we discuss the current particular treatment of these expenses for both ordinary tax and AMT purposes.

Ordinary tax

PR Code limits the deduction of the expenses or charges incurred by a taxpayer with a related party that is not engaged in trade or business in Puerto Rico, if such expenses are not subject to Puerto Rico taxes. On this regard, PR Code provides that 51% of these expenses are not allowed as a deduction for ordinary tax computation. However, Act 72-2015 establishes a limit to the amount of expenses that may be covered by the waivers that the Secretary is authorized to issue. The maximum allowed is limited to 60% of the total amount of expenses. The Secretary has not yet issued regulations under these new provisions and there are important details that need to be considered like for example: if a taxpayer obtains this 60% waiver, for how long would it be valid?



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Currently, for years commenced before January 1, 2015, the PR Code provides a maximum of 100% total waiver valid for two (2) years. Furthermore, our interpretation of the effectiveness of the waiver provided by this new provision is that a taxpayer that obtains the maximum waiver (i.e. 60%) would be allowed to deduct 79.6% of the expenses or charges incurred by the taxpayers with related parties that are not engaged in trade or business in Puerto Rico. If 60% is excluded, the remaining 40% is subject to the 51% disallowance. Therefore the amount available as a deduction if the total waiver is obtained is 60%, plus 49% (100% less 51% disallowed) of the remaining 40%. This is our interpretation and will be validated when the regulations are issued or by direct consultation with the Secretary of Treasury.

In addition, any expense or charges incurred by a taxpayer with a related party that is not engaged in trade or business in Puerto Rico would not be considered to determine the amount of the net operating loss (NOL) carryover in case the taxpayer incurs in a loss for tax purposes. Notwithstanding, any expenses or charges for which the Secretary of Treasury has issued a waiver would be allowed as a deduction as well for purposes of the NOL deduction carryover computation.

Alternative Minimum Tax

Currently, the AMT to be paid by a corporation depends on the results of two computations. The first of the two computations is the result of multiplying the AMT income by the AMT rate of 30%. The second computation is the sum of two additional calculations.

- purchases of personal property made by a taxpayer with a related party that are not engaged in trade or business in Puerto Rico multiplied by rates that vary from 2.5% to 6.5% depending of the taxpayer's gross revenues, plus

- 20% of the expenses or charges incurred by taxpayers with related parties that are not engaged on trade or business in Puerto Rico (same expenses to which the 51% deduction disallowance)

As in the case for the ordinary tax deduction, the Secretary of Treasury may approve a waiver to exclude up to 60% of these expenses or charges subject to the 20% AMT.

The treatment of expenses (not subject to taxation in Puerto Rico) with related parties that are not engaged in trade or business in Puerto Rico has continue to evolve as a significant area which needs careful evaluation to properly determine its implications in the current tax system. The opportunity of requesting a waiver should definitively need to be considered as part of the ongoing tax planning that our complex tax structure demands.

On this regard, Senate Bill 1433 has been filled. This Bill is proposing technical amendments to Act 72-2015. Among the proposed amendments, the waivers are being limited to three years and in the case of banks they would be allowed to exclude up to 100% of the expenses, not 60% as the rest of the taxpayers.

In addition, if the technical amendments are approved as presented, the waivers should be requested within the first applicable taxable year. Therefore, it is crucial to evaluate this opportunity as soon as possible.

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

Advisory Alert: Turnaround “apps” for the public sector

Introduction

In an age where problems have become increasingly complex, the need for more sophisticated and practical solutions has become the priority. Nonetheless, solutions can also come in simple and cost effective ways such as “apps”.

Government leaders, too, are looking for solutions: they need the turnaround solutions that will restore fiscal stability, stimulate growth and solve government problems. Puerto Rico is no exception to this need. With the major economic and public policy challenges faced, the government now more than ever has the need for pragmatic solutions that would turnaround the current situation.

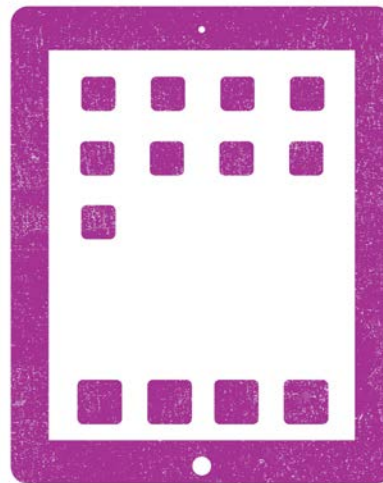
Grant Thornton has developed a whitepaper describing some turnaround “apps” — proven successful models in the corporate world — that can be applied in the public sector with relative ease.

The platforms

A successful restructuring process calls for a clear action plan. Restructuring activities must be objective and analytical – in other words, apolitical. Nevertheless, to be successful, an appreciation of the political landscape is required.

Despite the fact that every restructuring project is unique and must be approached with a fresh perspective, there are some main components or applications that together, create a strategic framework for executing turnarounds in the public sector.

- Strategy
- Operations
- Finance
- Leadership



When executed, this set of “apps” offer government officials the structure and tools to work towards achieving fiscal stability, stimulate growth, address priorities and resolve complex economic and service issues in their respective political environments.

It is crucial to emphasize that there is neither a shortcut to success nor a one-size-fits-all solution. Focusing only on one aspect of the framework will not result in a sustainable solution. Likewise, leadership will not sustain by itself without the thorough and balanced application of the other components.



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Strategy platform

The corporate world and governmental institutions share one trait alike: they both have a mission. In the case of government, its mission is defined in local charters and constitutions. Government leaders interpret the mission and establish strategy by setting forth public policy projects but still, government units “need to adopt corporate-like strategic planning in order to allocate scarce resources and manage constituents’ expectations most effectively.”

Strategy app #1: Determining core services

Defining and prioritizing a government’s necessary and not-so-necessary services should be at the center of any restructuring effort. Governments need to first engage in a strategic assessment of those services they must provide and those that choose to provide. In the case of those services mandated by either law or public policy, the scope or extent of the services (to what level) shall be determined.

Strategy app #2: Core competencies and priorities

Analyzing the many tasks within the activities that government provides exclusively or its core competencies, such as public safety and public works, helps prioritize scarce resources.

The effectiveness of these programs and core competencies is evaluated based on empirical metrics. Essential programs particular to a community or proposed initiatives must face the scrutiny of prioritization such as: the annual cost of the program, how many jobs it provides in the community, will it help improve general population indexes, what are the opportunity costs of not providing the program, and is there an alternative to it.

In addition, services that are “nonessential but enriching for the community” can provide an opportunity for a government to perform like a business. Therefore, allowing it to generate

profits from these services and create more benefits for its constituents.

Operations platform

Managing an effective operation is essential to a government unit. As with any organization, efforts must be placed towards those activities that the organization has determined as core to its purpose and support its strategy. Operational improvements include a wide variety of elements; including among others, organizational and process design.

Operations app #1: Scope of service

What are the fundamental tasks of the given program or service? Analyzing a government agency’s depth and breadth of programs and services enables choices to be made that allow an organization to stay true to its mission while identifying services that can be pared down or consolidated.

Operations app #2: Organizational design

The organization of employees can have an enormous impact on the economic efficiency of a government unit. Thoughtfully and selectively de-layering the organization can flatten the hierarchical or vertical structure, simplifies the decision-making process, improves morale, cuts expenses substantially, creates better communication channels and increases overall efficiency.

Operations app #3: Process design

Process design considers how services are performed. Significant expense savings may be achieved by streamlining and consolidating processes through various techniques such as developing technology solutions, combining similar tasks and outsourcing functions. This is commonly known as “business process reengineering”.

Operational improvement decisions must be based on “data and analysis” not on political choice. A single set of data must be available to all stakeholders.

Finance platform

Financial distress is considered as the primary reason for the need of a restructuring process. Structural imbalance between revenues and expenditures in the general fund is the government equivalent of unprofitable operations in the private sector.

Statutory requirements for a balanced budget which prohibit unbalanced operations, requirements have found ways to be met through funding current operating losses with long-term debt.

Finance app #1: Long-term financial planning

Government entities and distressed businesses often share the absence of long-term financial plans. Long-term planning forces government leaders to foresight; think beyond the next election cycle and anticipate economic challenges that may arise, which in turn will lead to an appreciation for developing contingency plans and establishing cash reserves.

Transparency is often considered a challenge within public finances and “readily understandable financial reporting”. It is recommended to institute “clear and consistent information based on generally accepted accounting principles” which in retrospect allows a more democratic and organized planning process.

The Government Finance Officers Association wrote about building a financially resilient government through long-term financial planning¹ and referenced Jamais Cascio, a senior fellow at the Institute for Ethics and Emerging Technologies, who

1

<http://gfoa.org/sites/default/files/GFOABuildingFinanciallyResilientGovernment.pdf>

identifies the following eight essential characteristics of any resilient system:

- Diversity – Avoid a single point of failure or reliance on a single solution
- Redundancy – Have more than one path of escape
- Decentralization – Centralized systems look strong until they fail catastrophically
- Transparency – Share plans and preparations, and listen when flaws are pointed out
- Collaboration – Work together to become stronger
- Falling gracefully – Failure happens
- Flexibility – Be ready to change when plans fail; do not count on stability
- Foresight – Think and prepare



Finance app #2: Cash flow planning

Understanding liquidity in the context of government operations is important to ensuring that essential activities can occur without interruptions. A heightened sense of importance around working capital management is of critical value. A rolling 12-month cash flow forecast, much like the 13-

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week rolling cash flow tool used in the private sector could help government officials achieve an effective use of working capital.

Leadership platform

A successful turnaround requires a strong leadership guided by the values of courage, decisiveness, credibility, tolerance, persuasion and an unwavering commitment to achieve the most good for the most constituents.

Leadership app #1: Turnaround coach

In private sector turnarounds, an “outsider” with no stake in the outcome of the restructuring other than to create stability and return the business to profitability is often brought in. But an elected or appointed government unit leader cannot simply cede authority to an outsider; but he or she may do well to hire an “auxiliary authority” in the form of a turnaround adviser who can rise above political considerations and stay focused on strategy, operations and finance.

Having a turnaround advisor who assists government officials by providing unbiased advice can help government leaders stay focused on strategy, operations and finance separate and apart from political considerations. Moreover, an experienced outside adviser can ensure that the fact gathering and data analysis process, an important component in reaching agreement on restructuring activities, is done in a way that avoids political tinkering.

Leadership app #2: Pain sharing

Reaching consensus in a turnaround can be difficult and normally requires each party to agree to concessions for the sake of the greater good, a process known as “sharing the pain” in restructuring industry parlance. While the public sector is not always incented to “share the pain,” if the goal is to effect lasting and permanent change in a difficult situation, taking a strategic approach to prioritizing

programs and services and implementing a give-and-take approach in negotiations, can yield a successful outcome.

Conclusion

The ever increasing complexities of governing and economic markets require a new, fresh and unbiased approach to leadership. But the expectation that “new problems can be solved by continuing to repeat the standard operating practices of the past” will only result in frustration and turnaround “solutions” that do not benefit the most constituents.

The current system as it is calls for immediate action. Public office leaders must face, rather sooner than later, the fiscal crisis. The platform fundamentals of strategy, operations, finance and leadership provide a reasoned and structured framework to tackling crises as well as instituting necessary long-term changes.

To download a copy of the full white paper of the *Turnaround apps for the public sector*, please click [here](#).

Call us to make an appointment with one of our experienced advisors. We will be glad to assist you.



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Outsourcing Alert: Act No. 180 vacation and sick leave accruals in Puerto Rico

The statutory requirements for the accruals of vacation and sick leave that apply to non-exempt employees in Puerto Rico are determined by the Act No. 180 of July 27, 1998.

Accrual rate of vacation and sick leave:

Effective August 1, 1995, employees who work more than 115 hours per month, and who are covered under the Act No. 180, have the right to accrue vacation at a rate of 1 ¼ days per month and sick leave at a rate of 1 day per month.

Employees hired before August 1, 1995, are covered by the vacation and sick leave mandatory decree applicable instead of those provided by Act No. 180, irrespective of the fact that these are higher or lower benefits.

Accrual of vacation under Act No. 180 is at the rate of one and one quarter (1 1/4) day per month, for a total of fifteen (15) days per year.

Accrual of sick leave under Act No. 180 is at the rate of one (1) day per month, for a total of twelve (12) days per year. In order to enjoy of these accruals the employee works at least one hundred and fifteen (115) hours during the month during which the accrual takes place.

The use of vacation and sick time will be considered time actually worked for purposes of accrual of these benefits.

Vacations

Vacation days may be enjoyed after the first full year of employment on a consecutive or fragmented manner. Mutual agreement between the employer and the employee is required to fragment the vacations; nonetheless, the employee will always maintain a right to enjoy at least five (5) consecutive working days of vacation leave per year.

Sick Leave

The employee must notify about his/her illness as soon as possible and not later than the same day of his/her absence to work. Sick leave not taken by the employee during the year will remain accrued for successive years up to a maximum of fifteen (15) days.



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Latest Amendments

The Act 160 of 2014 was enacted to amend the Act 180. As result of this amendment, an employee may file a claim for damages if the employer:

- fails to allow an employee to take vacation leave consecutively for at least, five consecutive working days during the year,
- liquidates accumulated vacation leave in excess of ten days without the written request of the employee
- allows an employee to accumulate up to two years of vacation leave without an agreement with the employee, among other specific prohibitions.

Link-Department of Labor & Human Resources Portal –

<http://www.trabajo.pr.gov/index.asp>

Act 180 -

<http://www.trabajo.pr.gov/pdf/num180.pdf>

Mandatory Decree List -

http://www.trabajo.pr.gov/rl_decretosmandatorios.asp

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