Kevane mailbag

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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 continue from our July 2015 the conversation regarding principal versus agent discussion. This time we will review the Board proposed guidance on this issue. Read related information on page 2.
Tax	The Department of Treasury has established guidelines for the applicability of the SUT on services rendered by a merchant to other registered merchants. Read more on page 3.
Advisory	With current M&A activity rising significantly worldwide, business owners may want to take a more holistic approach to growth by means of identifying new business opportunities. Growth through strategic acquisition is a great way to build value and position a business for future success. Access the article on page 8.
Outsourcing	Businesses and individuals insured with the Workmen's Compensation Insurance Fund must meet payment requirements on time in order to be considered insured. Read more on page 12.
General Information	**Client satisfaction survey** If you have received our survey in relation with audit services provided, we would like to receive your comments. Committed to providing quality services, we have an ongoing monitoring program to measure the level of satisfaction of services provided. Your comments are important to continue improving our services and experiences in working with you. Thank you!

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Audit Alert: Board issues proposed guidance on principal versus agent considerations

FASB

All decisions reached at Board meetings are tentative and may be changed at future meetings. Decisions are included in an Exposure Draft only after a formal written ballot. Decisions reflected in Exposure Drafts are often changed in redeliberations by the Board based on information received in comment letters, at public roundtable discussions, and from other sources. Board decisions become final after a formal written ballot to issue a final Accounting Standards Update.

The FASB issued proposed ASU, Principal versus Agent Considerations (Reporting Revenue Gross versus Net), which clarifies and enhances the implementation guidance on principal versus agent considerations within ASC 606, Revenue from Contracts with Customers.

Comments are due by October 15.

Under the proposal, when another party is involved in providing goods or services to a customer, an entity should determine whether the nature of its promise is either (1) a performance obligation to provide the specified goods or services itself (that is, the entity is acting as a principal), or (2) an arrangement for the other party to provide those specified goods or services (that is, the entity is acting as an agent). A principal recognizes revenue in the gross amount of consideration to which the entity expects to be entitled in exchange for the specified goods or services, while an agent recognizes revenue in the amount of any fee or commission to which it expects to be entitled for arranging for the good or service to be provided to the customer.

The proposed guidance clarifies that to determine the nature of its promise, an entity should:

1. Identify the specified goods or services to be provided to the customer

2. Assess whether it controls each specified good or service before it is transferred to the customer.

An entity is a principal if it controls the specified good or service before it transfers that good or service to the customer. Under the proposal, a specified good or service is a distinct good or service promised to the customer. Therefore, if a contract includes more than one specified good or service, the entity may be a principal for some specified goods or services and an agent for others.

The proposed ASU would also reframe the indicators of an agent in ASC 606 by providing a list of indicators that the entity is acting as principal. It would also clarify that the indicators' purpose is to support or assist in the control assessment.

Source: Grant Thornton, *On The Horizon*, September 10, 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: Guidelines and applicability of IVU to B2B and DP services

On August 31, 2015, the Puerto Rico Department of Treasury ("PRTD") released Administrative Determination 15-17 ("AD 15-17") to establish guidelines for the applicability of sales and use tax ("SUT") on services rendered by a merchant to other registered merchants ("B2B"), as well as on services rendered by designated professionals ("DP").

Previously, the Puerto Rico Internal Revenue Code ("Code") was amended by Act 72-2015 to increase the SUT rate from 7% to 11.5% (a combined state and municipal SUT) on taxable services (hereinafter named "Basic SUT") and to impose a new special tax of 4% (municipal tax of 1% does not apply) for services rendered from October 1, 2015 thru March 31, 2016 (hereinafter called "Special SUT"). Said Special SUT is applicable to services rendered either as B2B or by DP.

Following is a summary of the guidelines:

I. Definitions

(a) **Taxable services subject to Basic SUT** means: Services rendered to any person, except DP or B2B (with certain exceptions[1]), and by a tax return specialist.

b) **DP subject to Special SUT** means: legal services and professional services regulated by their respective Examining Boards under the Puerto Rico Department of State. Also, starting on October 1, 2015, tax return specialists will be included under such term. It should be noted that with regards to services rendered by tax return specialists, only services related to the preparation of returns and claims of refund are considered DP. Please note that the Puerto Rico Legislature is presently considering a proposed amendment to modify the tax imposed on legal services. The PRTD clarifies on AD 15-17 that if the provider of the services has a volume of business of $50,000 or less, the service will continue to be exempt.

c) **B2B subject to Special SUT** means: Services between two duly registered merchants. The commissions generated from sales of items (either taxable or not) and services rendered by a subcontractor to a contractor, are considered as B2B services.

[1] Taxable services are those that are currently subject to 11.5% even when rendered to other business (i.e. collection services, bank charges, security services. etc.)

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September 17, 2015

Notwithstanding , certain bank charges, collection services, security services, cleaning, laundry and waste collections services, non capitalizable repair and maintenance services, telecommunication services and operating leases of motor vehicles are excluded from B2B services pursuant to Section 4010.01(nn)(2) of the Code and shall be taxed under the Basic SUT.

II. Exemptions

AD 15-17 provides a list of services that remain exempt for Basic SUT purposes (e.g. services provided by the government of PR or United States, educational services, interest and other charges for the use of money, etc.), It also states that these exemptions and exclusion are applicable to both the B2B services and the DP services.

III. Determination

A. Taxation on services rendered to a duly registered merchant as well as on services rendered by designated professionals

Services rendered after October 1, 2015 by DP and B2B will be subject to the Special SUT, provided that these are not covered by any exemption or exclusion. This means that all services covered by the B2B exemption will now be subject taxed at a 4%.

Also, services rendered by a non-resident to a PR resident shall be subject to Basic SUT or Special SUT, as applicable.

In order to clarify, AD 15-17 discusses the following transactions:

- ✓ **Repair and Maintenance Services:** Circular Letter ("CL") 13-13 enumerates which services have been covered for B2B exemption and are therefore subject to Special SUT. Those services include: repair and maintenance of motor vehicles, software maintenance such as patches, upgrades, troubleshooting, capitalizable repairs, inspections of equipment and machinery, lifts or fire system.

- ✓ **Bank Charges:** AD 13-16 enumerates which bank charges are exempt for SUT purposes. Therefore, since such bank charges are exempt for SUT, they will also be exempt for Special SUT.

- ✓ **Telecommunication Services:** Pursuant to Section 4010.01(kk)(2), certain telecommunication services are excluded for the definition of telecommunication services, except if those services are rendered to a duly registered merchant, in which case shall be subject to Special SUT. Internet access and regulatory charges are exempt for both, Basic and Special SUT.

B. Collection, remission and payment

In this section, the AD 15-17 discusses aspects related to the collection, remittance and payment of the Special SUT. It provides special attention to the following:

1- Special SUT shall be collected, remitted and paid according to Subtitle D of the Code. However, if the service provider has a volume of business of $50,000 or less[2], then the service remains exempt. There will be no duty to collect and pay the tax.

2- In the case of services provided by a non-resident to a person in PR, the person responsible for the payment of the SUT is the person that receives the service in PR. The applicable tax rate depends of the type of service received. If the service is a B2B (even if the provider is not registered) or a DP, the applicable rate is 4%. However, if the services are originally not covered under such exemption, the applicable rate is 11.5%. Please note that the services provided by a non-resident are not covered by the exemption in the case of merchants with an annual volume of business of $50,000 or less.

3- In the case of services rendered between members of a controlled group (as defined in Section 1010.04) or related entities (as defined in section 1010.05 of the Code), the services (either taxable or not) shall be exempt if both entities are engaged in trade or business in Puerto Rico as well as duly registered.

Also, if the services are provided by a member of a controlled group or related entity not engaged in trade or business in Puerto Rico, those services shall be subject to Special SUT. In this case, the entity engaged in trade or business in PR is the responsible for the payment of SUT.

4- Mixed Transactions: Transaction composed of two or more services subject to different taxable rates, where: (1) one of them is essential to providing the other service, (2) was provided exclusively in relation to this service and (3) the goal is to provide specifically that service. In this case, the applicable rate will be the one applicable to the type of service which is the real reason for the transaction. Meaning that if the final objective is providing a B2B service, the applicable rate will be 4%.

5- Any person entitled to buy taxable items without paying tax shall provide to the seller a Certificate for Exempt Purchases (Form SC 2916). Those include agencies or instrumentalities of the Commonwealth of Puerto Rico or United States government, associations of residents or condominiums, housing cooperative associations or social interest housing projects.

6- Billing: Every service provider should detail the invoice to show the services rendered separately from the reimbursed expenses. In this case, the amounts that represent the reimbursed expenses shall not be subject to Special SUT. Please be aware that additional

[2] Volume of Business means the aggregate volume generated during the prior taxable year which concluded on or before August 31, 2015.

charges, such as *"out of pocket"* or *"administrative fees"*, indirectly related to the service, and services rendered by employees, shall not be treated as reimbursed expenses.

7- Accounting Method: Pursuant to Section 4041.01 of the Code, every merchant shall use the same accounting method used to report its income on the income tax return. Notwithstanding, a transition rule applies for merchants engaged in providing DP services, which are allowed to use basic cash method for SUT purposes, regardless of the method used for income tax returns. Please note that the election should be made with the monthly SUT return for October 2015, which is due on or before November 20, 2015.

Also, the PRTD issued on June 24, 2015, AD 15-10 to clarifies that the services rendered before October 1, 2015 as B2B, as well as by DP, shall not be subject to Special SUT, as long as the invoice is issued and sent to client no later than October 20, 2015. If the services are rendered after September 30, 2015 or billed after October 20, 2015, they shall be subject to Special SUT.

8- Credit for taxes paid by a reseller merchant: The amount of credit that a reseller is entitled to take should not include any portion related with the Special SUT paid, although has been paid for the reseller.

9- Withholding of income tax at source on payment for services rendered: Pursuant to Section 1062.03 of the Code, every person, natural or juridical, that is engaged in trade or business in PR, shall deduct, withhold and pay 7% on the amount paid to a service provider. The merchant who pays for a service must only deduct and withhold 7% on the amount that represents billed services, excluding SUT and reimbursed expenses. On the other hand, the service provider shall collect and remit the SUT.

10- It establishes a new Monthly return to remit the Special SUT. Such return shall be filed and the corresponding tax liability paid by electronic means, through the following link: https://comerciantes.hacienda.pr.gov/

Merchants who have the duty to file the Declaration of Imports (Form SC 2915 D) and/or Monthly Sales and Use Tax Return (Form SC 2915 A), shall also file a Monthly Special SUT return, whenever it provides DP or B2B services.

Those merchants that do not have access to the internet or a computer, may visit any of the district offices of the Sales and

Use Tax Bureau, where computers will be available for completing the filing process.

11- Every merchant engaged in providing DP services, must update its Merchant's Registry Certificate, according to the process established in CL 15-12.

12- Preexisting contracts to provide services to other merchants and designated professional services: Pursuant to Sections 4070.01(c) or (d) of the Code and CL 15-11 and 15-10, as applicable, the services provided as B2B or by a DP, as part of a preexisting contract, shall be exempt for the Special SUT (for a period of twelve months or the term of the contract, whichever is lesser), as long as it has been granted before July 1, 2015 and covered by a written authorization from the Secretary of the Treasury. Both the service provider and recipient of the service should request a certification and/or qualification of the contract no later than September 30, 2015. Please pay attention to due dates and process established on CL 15-10 and 15-11.

13- CL 13-16 clarifies that businesses covered by a tax grant decree under special legislation, will be subject to the SUT payment on services that are not covered by B2B. Some of those entities were covered under Acts 73-2008, 168-1968, 74-2010, etc. Starting on October 1, 2015, such entities will be subject to the Special SUT on services received, previously covered by B2B exemption.

Please note that entities engaged in the operation of air transportation services and covered under the provisions of Act 135-1945, will be exempt from the Basic SUT and Special SUT on goods and services acquired.

14- Previous publications issued by PRTD, with regards to the applicability of the SUT on taxable services will remain valid as long as they are not incompatible with the Code, as amended, and with the current AD. Those publications include: **CL** 13-04, 13-09, 13-13, 13-14, 13-16; **AD**13-13, 13-16 and 15-09.

Any publication issued by PRTD indicating that the services covered under B2B exemption were exempt, will be understood to be amended to indicate that will now be subject to Special SUT.

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: Growing your business through acquisition

Introduction

As the economy continues in economic downturn, businesses are looking for answers to achieve growth, and simply looking to grow the bottom line is not enough anymore. As a business owner, you want to take a more holistic approach to growth—identifying new business opportunities, extending existing customer relationships and/or improving internally. Perhaps this is an opportunity to make an acquisition that can boost your competitive advantage in the long run. Growth through strategic acquisition is a great way to build value and position a business for future success.

Targeting the right acquisition, valuation, tax structure, financing structure, due diligence, corporate integration: these are just a few of the issues involved. And no matter how well, and how intimately, an owner understands his/her own business, assessing the market value of competitors or of businesses in parallel markets can be a complex undertaking.

For these reasons, the desire to grow often remains frustrated. Owners may be daunted by the complexity of the task at hand, not knowing how to proceed, or they may forge ahead on their own and, because of one or two poor decisions, either lose a deal or acquire a business that may fail. Owners who are in a growth mode need to understand the acquisition process—from targeting to structuring the new business entity to integration.

Pre-integration

Getting your own house in order

When we think of grooming a business, we usually think of preparing it for sale. Similar to the planning process for selling your house, it's important to make sure everything is in the best shape possible in order to increase buyer appeal and maximize the sale price. Though it's not always sufficiently emphasized, it's just as crucial that you get your house in order before you make an acquisition, and this could take from six months to several years.

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You must be sure that your organization is strong enough to absorb another company. Management depth and capacity, capital availability, tax issues and balance sheet strength: these are just some of the areas that should be addressed in preparation for acquiring a business. If an acquisition plan fails, it may not just mean that the new company fails and things revert to the way they were; once the integration process has been undertaken and systems, procedures and structures have been merged, failure could impact the original business as well.

Often, seller appeal is an issue too. A vendor will be more inclined to sell his/her life's work and business legacy to an organization felt that can carry it on successfully.

Issues can mean opportunity

From an acquisition standpoint, opportunities become available when target businesses face issues, such as succession or a need for capital, that encourage, force or trigger a sale. The proportion of businesses expecting a change in ownership in the next three years rose from 11% to 14% over the past year. Although the rise is mainly seen in mature economies such as North America where it rose to 21% from 11% in last year, businesses in Latin America also expect change with 12% of businesses planning to sell up in the next three years[1].

Acquisition as an exit strategy

While there are relatively obvious reasons to grow your business—increasing earnings/income and maintaining competitive advantage, for example—the idea of growing your business as part of a long-term exit strategy is often overlooked. Growth is an important part of a company's history that needs to be told to a potential acquirer in order to attract interest. Growth through acquisition not only adds scale to a business, it demonstrates that the company's management team has the wherewithal to properly implement a growth strategy. Companies that are perceived as stable corporate entities—that have depth of management, intellectual property and barriers to entry, for example—stand to command higher selling prices.

The acquisition process

Once you've evaluated your motivations for acquiring a business and have made sure your current business is strong enough to absorb another company—what's next? There are a number of steps in the often complicated process of acquiring a business, but here are some of the key considerations you'll want to be aware of:

Targeting

Successfully targeting the right acquisition starts with an industry analysis, followed by an assessment of specific targets according to a number of criteria, including size, geographic location, profitability, growth rate, products and services, and management strengths and weaknesses. This process is one way of avoiding simply growing for growth's sake. It helps to ensure that the target has the capacity to both add to the acquiring company's strengths and mitigate its weaknesses.

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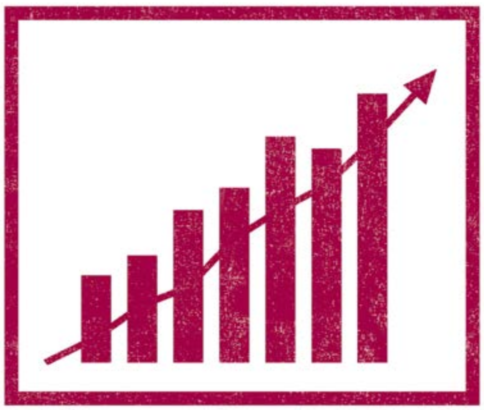
[1] *International business report 2015: Global M&A snapshot 2015. Transaction momentum building. http://www.grantthornton.global/globalassets/1.-member-firms/global/insights/ibr-charts/ibr2015_ma_report_final.pdf* Grant Thornton International, Ltd, 2015



Fit

For successful growth to take place via acquisition, the acquired business must complement the existing business or otherwise fit very closely within a well thought-out acquisition strategy. If the new business cannot be effectively integrated with the old, the benefit of the acquisition could be minimal or worse yet a corporate failure could occur. Generally, fit can be evaluated using criteria such as corporate culture and strength of management together with an assessment of complementary products, customers, geographic coverage, sales methods, technologies and potential efficiencies in the supply chain.

Valuation

Owners are often not able to objectively value other businesses relative to their own. They tend to place a much lower value on a competing business than they would on their own, even one in the same market and with virtually the same business profile. This disconnect is perhaps inevitable given the personal connection to their own company, so it's certainly wise for an owner pursuing an acquisition to gain an in-depth understanding of the market comparables and relevant valuation methodologies. A better understanding of business valuation can help an acquirer avoid making an unrealistically low bid or overpaying.

Synergies

Much is made of the idea of "synergies" when an acquisition is being negotiated. This is simply the idea that when two companies come together, the whole is greater than the sum of the two parts. It's certainly important in the valuation process: A strategic buyer who is pursuing a company that they feel will truly complement their own may, and probably should, be willing to pay more to make that happen.

Tax

As always, tax forms an integral part of most commercial transactions, and the acquisition of a business is no different. Correctly structuring the transaction from a tax perspective could yield many benefits in the future.

Financing

This is relevant where the acquisition will be debt financed. It's important to first put together a deal that makes strategic sense for your organization. If lenders are convinced that the deal is solid, financing opportunities should be easier to secure. You should understand, however, that the capital structure for the acquisition will affect the price that you'll be able to pay, as well as the future cash flow available from the acquisition.

Due diligence

Of course, a due diligence investigation must be undertaken. This process—a thorough analysis that looks at all financial, legal and operational aspects of the company in question— provides the buyer with objective evidence that the company is, in fact, what it appears to be. The information gathered also plays a key role in the valuation process.

Integration

Another aspect of acquisition which is too often overlooked is what happens after the purchase is made. You own a new business: How do you make it part of your organization? How do you incorporate your expanded resource and skill bases to maximize benefit and efficiency? Remember, post-acquisition integration is as important as the due diligence process—start early and spend time planning before the transaction closes.

Integration can be a real impediment to the success of an acquisition. No matter how good the company or how perfect a fit it seems to be, if it can't be successfully integrated into your current company, little or no benefit will be realized. There are numerous aspects to the integration process: business cultures and workforces must be merged; financial restructuring may be required; credit agreements may have to be revisited; compensation and incentives will have to be reconciled. Before you move forward with an acquisition, the integration strategy should be carefully considered and planned for.

Summing it all up

Acquiring a business is a major decision often fraught with complex issues and questions: Is this the right time to consider a business acquisition? Is my current business strong enough to absorb another business? How do I locate the right business to buy? What should I pay? How will I structure the financing? While no buyer is likely to take these decisions lightly, it's also true that the acquisition process should involve thorough and careful analysis and evaluation, from targeting a business to orchestrating the purchase to facilitating the integration process.

Whether you're looking to prepare your business for sale by building it up now or whether you're looking to build earnings/profit/income over the long term by increasing your company's competitive advantage, this may be a good time to act. It's not just something to think about—it's something to think about now.

Bibliography

Wright, G., Brunton, S., Wagner, D. (2013, May). *Growing your business through acquisition.* Adapted from Grant Thornton Canada LLP: http://www.grantthornton.ca/resources/insights/white_papers/Growing_your_business_May2013_electronic.pdf

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Outsourcing Alert: CFSE Final Statement and Preliminary Premium

The Corporación del Fondo del Seguro del Estado (CFSE by its Spanish acronym) issued the Workers' Compensation Premium Notice for the Final Premium Statement of the fiscal year 2014-2015 and the Preliminary Premium 2015-2016.

Every insured employer must meet payment requirements of any outstanding balance during the first or second semester of the Preliminary Premium 2015-2016. Failure to pay full amount of premiums within the specified terms, will result in the suspension of the insurance coverage. Employers may qualify for a 30 day-extension of unpaid balance upon written request to the CFSE. Payments can be made in cash at the appropriate Regional Office or by mail, using personal check, money order or certified check. In addition, payments can be made by electronic transfer or through the interactive website using electronic checks.

Employers who have not received the Workers' Compensation Premium Notice should contact the appropriate CFSE Regional Office or can access their own CFSE interactive account, to prevent the suspension of the insurance coverage.

Links:

CFSE Website
https://www.prsifc.com/Default.aspx?ReturnUrl=%2fCMS%2fDefault.aspx

CFSE Online Account
https://www.prsifc.com/Login.aspx

CFSE Forms
https://www.prsifc.com/App_Content/Area_4_8.aspx

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