

# *Kevane mailbag*

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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](http://www.kevane.com)

Our Kevane mailbag is your link to all 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 Google Play. We welcome your feedback at [kgt@pr.gt.com](mailto:kgt@pr.gt.com)

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## General Information

Please note that our offices will be closed on Monday, May 30, in observance of Memorial Day.

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# Audit Alert: FASB addresses presentation of restricted cash in cash flow statement

The Financial Accounting Standards Board issued [proposed ASU](#), Restricted Cash – a consensus of the FASB Emerging Issues Task Force, which addresses the presentation of restricted cash and changes in restricted cash on the statement of cash flows. The proposal aims to reduce the existing diversity in practice in how restricted cash and related changes are presented on the statement of cash flows.

The proposed ASU specifies that restricted cash and restricted cash equivalents should be included with cash and cash equivalents on the statement of cash flows, and that transfers between cash, cash equivalents, and restricted cash or restricted cash equivalents are not part of an entity's operating, investing, and financing activities, and should not be reported on the statement of cash flows.

Consequently, restricted cash and restricted cash equivalents would be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. If the total amount of cash, cash equivalents, and restricted cash or restricted cash equivalents on the statement of cash flows cannot be reconciled to a similarly titled line item or subtotal on the balance sheet, the entity would disclose the amounts of restricted cash or restricted cash equivalents either on the statement of cash flows or in the notes to the financial statements, including a description of the location of those amounts on the balance sheet.

An entity would also be required to provide a description of the provisions of the restrictions on cash and cash equivalents in the notes to the financial statements.

Entities would adopt the proposed ASU on a retrospective basis. The effective date will be determined after the EITF considers stakeholder feedback on the proposal.

The proposed ASU does not define “restricted cash” and “restricted cash equivalents.” As a result, public entities should continue to consider the guidance in SEC Regulation S-X.

Stakeholders have until June 27 to comment on the proposal. –

Source: Grant Thornton, *On The Horizon*, May 5, 2016

**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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May 10, 2016

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# Tax Alert: House of Representatives Bill will grant broader powers to the Secretary of the Treasury

On May 9, 2016 House Bill No. 2947 (“HB 2947”) was filed in the Puerto Rico House of Representatives. The legislative piece aims to curb perceived widespread and far-reaching tax evasion practices through the enactment of technical amendments to the 2011 Puerto Rico Internal Revenue Code (“Code”). Here we provide an overview of the proposed changes.

## Alternative Minimum Tax

For Puerto Rico corporate income tax purposes, the Alternative Minimum Tax equals the amount of the **tentative minimum tax** over the amount of the **normal corporate tax** plus the applicable surtax. Pursuant to Sec. 1022.03 of the Code, the tentative minimum tax is the greater of the following amounts:

- 30% of the excess of net alternative minimum income over the exempt amount, less any allowable credit for foreign taxes paid;
- 20 % of (i) the expenses paid to a related person, (ii) transferred costs or (iii) expense allocation, if these have not been subject to PR taxation or withholding at source, PLUS the attributable tax on tangible personal property purchases between related parties or property transfers from a Home Office located outside of PR to a Branch, at the prescribed graduated tax rates.

HB 2947 will amend Sec. 1022.03 in order to limit the above referenced 20% tax on related parties’ expenses to taxable years commenced before January 1, 2016. It also eliminates the

phrase “located outside of Puerto Rico” and, correspondingly, removes the exception to the application of the tangible property purchases tax when the seller/transferor is subject to PR taxation.

## Credit for tax withholding on salaries

As a general rule, the tax deducted and withheld under Sec. 1062.01 upon salaries earned by any individual can be taken as a credit against the individual’s final fiscal responsibility for any given year. Nonetheless, some persons - such as the directors of a corporation who were in office when the withheld taxes on salaries were not duly paid to the PR Treasury Department (“PRTD”) - cannot take the credit when the amounts withheld by the corporation or partnership as income tax have not been paid to the Secretary of the Treasury (“Secretary”).

HB 2947 adds company **officers** to the list of persons who cannot credit the withheld taxes on salaries if said tax was not paid to the PRTD.

## Merchant Registration Certificate

The Merchant Registration Certificate (“Certificate”) authorizes a merchant to engage in a trade or business in Puerto Rico and establishes the merchant’s obligation to serve as a withholding agent for Sales and Use Taxes purposes. HB 2947 proposes the amendment of Sec. 4060.01 of the Code to provide that the Certificate will be valid for a period of two (2) years, and that the Secretary must institute the procedural requirements for the renewal of said Certificate.



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Also, the proposed legislation envisions granting the Secretary the power to deny or revoke any Merchant Registration Certificate if the merchant has tax debts or unfiled tax returns.

#### Retail dealer of alcoholic beverages

Licenses for the retail sale of alcoholic beverages are issued annually and for each location or establishment where the licensee or prospective concessionaire will serve these.

HB 2947 proposes a fourth license, *Category D*, which will be issued to businesses that serve, or allow clients to self-serve, alcoholic drinks, for consumption within their establishment, which were not sold by these businesses.

The Bill also clarifies that, with the exception of maritime vessels with a fixed itinerary who are engaged in the transportation of passengers, the alcoholic beverage license for retail dealers will only be issued to businesses that are housed within a fixed structure.

Also, HB 2947 precludes the Secretary from issuing new licenses to businesses that are situated within a 100 meters from a school, church, religious facility or rehabilitation center, unless these entities give written consent to the issuance of the license.

Lastly, the Secretary is authorized to close or interrupt a merchant's business operation if it serves alcoholic beverages without the proper license or when the merchant serves alcoholic beverages that were not subject to the corresponding excise tax. Additionally, the Secretary may levy a \$10,000 administrative fine per case on those instances where a merchant served or distributed alcoholic beverages that were acquired from exempt persons, agencies or organization.

#### Definitions

Articles 10 and 11 of the Bill seek to clarify and/or define the following terms, in the context of the assessment and collection of tax deficiencies:

- (i) a “*tax*” includes any interest, surcharge and penalty, as well as amounts withheld by a withholding agent;
- (ii) the “*last known address*” comprises the taxpayer’s last known physical, postal or email address;
- (iii) a “*withholding agent*” is any person responsible for the collection, withholding and remittance of any tax imposed by the Code;
- (iv) a “*successor taxpayer*” is defined as a taxpayer who substitutes another taxpayer in light of a transfer of assets, and who will now be responsible for the payment of the transferor’s tax liability where there is a substantial similarity in the business’ operations and identity before and after the transfer.

#### Revocation and suspension of licenses

Under the proposed legislation, a Taxpayer whose business license has been revoked or suspended by the Secretary may request a reconsideration of the latter’s determination within five (5) working days.

#### Penalty for failure to withhold or deposit income taxes

The Bill posits that any person responsible for the collection and withholding of income taxes is holding these as a special trust fund for the benefit of the Government of Puerto Rico. Moreover, the amounts so held in trust will be assessed, levied and paid in the same way, and subject to the applicable limitations (including penalties), that are attributable to the taxes from where the fund came from.

Moreover, the proposed amendment excludes these taxes held in trust from the 4-year statute of limitations for the assessment of unpaid taxes, allowing the Secretary to perform the

tax assessment at any time and impose a penalty even after the taxpayer has paid the amount due.

In particular, taxpayers that fail to pay or deposit the withheld taxes for services rendered will be subject to a penalty of no less than 25% but no greater than 50% of the unpaid amount. In the case continued non-compliance, the penalty could run up to 100% of the unpaid amount.

Though the taxpayer may get a reprieve from the imposition of the penalty if it can be demonstrated that its non-compliance was attributable to elements beyond the taxpayer's control, the insufficiency of funds will not be considered an exculpatory situation.

#### Payment of license rights

In addition to the prescribed penalties and administrative fines, the Secretary will be able to impose a penalty to any taxpayer that fails to pay the corresponding fee for the procurement or renewal of a license equal to 10% of the sales made during the period where the business operated without the required license.

#### Sales and Use Tax and Value Added Tax

As noted above for regular taxes, taxpayers responsible for the collection and withholding of sales and use taxes ("SUT") and value added taxes ("VAT") are holding these as a special trust fund for the Government of Puerto Rico, and therefore, the withheld amounts within said trust will be assessed, collected and paid in the same way, and subject to the applicable limitations with respect to the taxes from which such fund arose.

For VAT purposes, the proposed legislation explains that the insufficiency of funds will not be considered a "circumstance beyond the merchant's control" that could exonerate the merchant's failure to assess, collect and remit the corresponding VAT.

It is interesting to note that prior to HB 2947, the PR Legislature approved and submitted for the Governor's signature, a bill eliminating the proposed Value Added Tax ("VAT"). Thus, the Bill's changes to the VAT dispositions may turn out to be academic.

#### Secretary's new prerogatives and responsibilities

Among the new powers afforded to the Secretary the bill includes the ability to examine the taxpayer's books and/or documents or summon witnesses and tax preparers without the need to notify the taxpayer or begin a formal investigative inquiry.

Also, in the case of corporations, partnerships, limited liability companies or any other juridical entity that owe taxes to the PRTD, the Secretary will be also authorized to publish the name of the shareholders, partners, members or owners of said entities.

Moreover, the Secretary may close a business location lacking a current Merchant Registration Certificate or right after its revocation, and order that it remains closed for a period not to exceed 90 days or during the merchant's non-compliance period.

In terms of responsibilities, the Secretary must now publish on or before December 31 all approved and denied (i) private administrative determinations and (ii) private letter rulings issued to taxpayers during the year. These private documents will be published without identifying the taxpayers.

#### Tax liens

As general rule, if a taxpayer fails or refuses to pay his/her tax responsibility within the periods prescribed in the Code, the Secretary can proceed to collect those taxes by attachment and sale of the taxpayer's non-exempt property. The unpaid tax constitutes a lien in favor of the Government of Puerto Rico upon all personal or real property of the debtor, and as such the Secretary may require

any person holding any property, property rights, credits or money payable to the taxpayer, on any account, including salaries, accounts receivable or **bank deposits** belonging or payable to the taxpayer, not exempt from attachment, to withhold from such property or rights the amounts that the Secretary notifies him of for the purpose of covering the tax debt pending payment.

HB 2947 stipulates that the term “bank deposits” includes the taxpayer’s savings accounts, certificate of deposits and on-demand accounts on either a bank or a cooperative.

#### Liability for taxes collected

As noted, amounts held by a withholding agent in the special fund in trust for the Government of Puerto Rico, will be assessed, collected and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose.

Nonetheless, whereas under the current Code’s provision, this assessment can only be done within a 10-year period, HB 2947 proposes the elimination of this 10-year statute of limitations and the inclusion of penalties as part of the assessment amount.

#### Cooperatives

The Bill also aims to amend the 2002 Savings & Loan Cooperatives Act (Act 255-2002) and the Cooperatives Act (239-2004) in order to authorize the Secretary to seize the capital shares, deposits and other assets in the hands of cooperative members or partners for the payment of tax debts.

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# Advisory Alert: Turnaround “apps” for the public sector - the Operations platform

## Introduction

This is the third of a series of articles covering our strategic framework for executing turnarounds in the public sector. Our framework is based on 4 turnaround platforms or “apps” that cover the following key areas:

- Strategy
- Operations
- Finance
- Leadership

Our [previous article](#) covered the **Strategy** app. On this piece, we will be focusing on the **Operations** platform.

## The operations platform

Operational improvement is the next step in restructuring. It addresses those activities the organization has determined are core to its purpose and supports its strategy. Operational improvement can encompass many elements. This paper focuses on three of them; namely, scope of service, organizational design and process design. These three elements are analyzed in terms of the cost side of the restructuring equation. Note, however, that there can be operational improvements that will enhance revenue.

At this stage of the restructuring process, the adviser needs to be well armed with information and analysis. Benchmarking headcounts, salaries and benefits for employees against comparable communities in the state, region and nation can reveal

extraordinary opportunities for restructuring government units. Moreover, efficiency ratios of full-time employees to units of service provided suggest areas for consolidation and reduction. There will always be a debate about the true value of the services of public employees, and their dedication to serving the community is respected. Ultimately, the goal is to reduce costs by eliminating activities or changing how the work is performed in a manner that maintains or even enhances the delivery of the services.



## Operations app #1:

### Scope of service

What are the fundamental tasks of the given program or service? A police force is charged with providing public safety, a broad vision of service encompassing activities that range



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from crime prevention and law enforcement to neighborhood patrols and community outreach. Over time, it is easy for a department's scope of services to be expanded beyond its original scope, creating an unintended economic burden. The cost and benefit of such an effort need to be considered against the mission or scope of the local department and the needs of the community. Often, it will be possible for the government unit to stay true to its mission while reducing services.

### Operations app #2:

#### Organizational design

The organization of employees can have an enormous impact on the economic efficiency of a government unit. The scope of service app described above has a direct bearing on the organizational design of any government unit. Form follows function. And, as form follows function, expense follows form: labor expenses are often among the largest, if not the largest, component of any government budget. Currently, many cash-strapped governments are providing services beyond their ability to fund these services on a sustainable basis. Elected officials and government managers have been and continue to be forced to reduce services and right size their organizations. An organizational design that was crafted 20 years ago may no longer match the entity's scope and mission.

The organizational chart of a government unit may reveal many layers of middle management. In the private sector, such vertical structures create hierarchies that often lead to inefficient allocations of work and resources, as well as poor communication. Selectively removing some middle management — delayering — flattens the organizational structure and pushes decision-making downward, improving morale and substantially reducing expenses. Stronger communication and efficiency from the top to

the bottom of the organization are the ultimate results. If delayering is done within the strategic framework, the results will be enhanced service delivery for less cost.

The police department of Raleigh, N.C., has undertaken a major restructuring effort in recent years to address new crime-fighting priorities in the community. The organizational design has been reoriented to focus on gangs, youth crimes, and drug offenses. The department added a Youth and Family Services Unit that deploys juvenile officers to proactively work with families to address gang issues and prevent school dropout.

In the experience of restructuring professionals, almost any business thrives with a flatter organization structure. Decision-making is simplified, creating a sense of empowerment and effectiveness. By decentralizing the decision-making process in their department, the Raleigh police force is able to provide officers with the credibility needed to fulfill their mission in the community. Obviously, such decentralization must be balanced for all of the tasks at hand while recognizing a hierarchy is still required for rapid decision-making in emergency situations.

Another common technique used in rightsizing activities is the “paintbrush” approach: managers determine how much needs to be cut from the expense line as a percentage of total costs, and they instruct subordinates to cut 10 percent, 20 percent or 30 percent as they see fit. Often, the decisions as to which expenses (i.e. headcount) to reduce is done without adherence to a common strategy and standardized decision criteria. Because of this, unintended consequences can compromise the unit's mission and create an adverse ripple effect throughout the organization. This approach is easiest for management but ignores the

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importance and relevance of different activities. We do not recommend this type of approach because the long-term damage can be great.

### Operations app #3:

#### Process design

The organizational design of a government unit will dictate who performs what tasks. Process design considers how the task is performed. Expense savings may be achieved by streamlining and consolidating processes. This may include developing technology solutions to replace labor-intensive activities, combining similar tasks from across the organization into a central services function, and outsourcing to third parties. Improvements that come about from these types of changes provide the organization with more flexibility to control costs and improve service delivery over the long term. This is commonly known as “business process reengineering”. Done well, the benefits are long term and long lasting. The challenges are that implementation can be slow and internal compromises reached during negotiations among the affected parties can lead to sub optimization of the project.

This is particularly relevant in governments with a history of collective bargaining contracts that evolved to include complex work rule requirements. These work rules may not be aligned with the organization’s current needs or capabilities. Antiquated or redundant job classifications such as “book mender,” “spray painter,” “spray painter sprayer” and “spray painter helper” may provide opportunities to simplify the operations. In the current and prospective economic environment, a balanced approach to determining service delivery, and the corresponding costs, will require flexibility by all segments of the labor force, including those covered by collective bargaining agreements.

In the US, sharing services with neighboring local municipalities has become favored in the redesign of government. Communities have combined emergency dispatch services, reduced redundancy in local police and fire services in adjacent towns, and formed buying cooperatives. Further, cities, counties and states should consider partnering with the private sector including nonprofits and charities, in cases where both private and public sectors provide similar services. This is a particularly powerful approach to social service offerings such as youth programs, immigrant services and safety net programs for the most needy.

It may even mean that outsourcing to a third party provides a better service for less cost. Outsourcing is an approach that has come in and out of vogue over many years. It is not a panacea and often requires strong management to ensure that the third-party contractor delivers on the promise. In fact, even redesigning the outsourcing process — the bidding procedures for such public contracts — can yield savings by increasing competitiveness for selection.

In private sector restructuring, administrative and internal tasks are areas ripe for business process reengineering. Often, conscientious employees perform tasks simply because they always have. One company kept so many different logs to keep track of business activities that they had someone whose job it was to check all 14 logs on a daily basis. When all log-keeping was stopped for a week, it quickly became apparent that one or two of the logs were important and the rest were busywork. Taking the approach of just stopping an activity for a short period of time will quickly reveal its relevance and importance. These situations are particularly evident in organizations whose business has been relatively static over time, including some government units. Clearly, a county cannot stop plowing the snow during a

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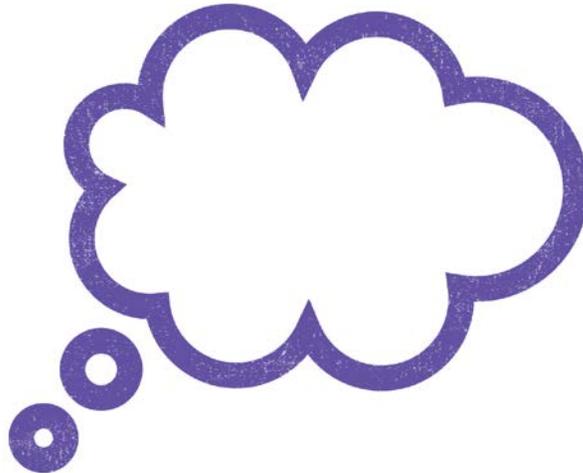
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blizzard, but it can stop many back-office and administrative tasks for a brief period to determine if they are truly necessary.

Operational improvement decisions must be based on data and analysis, and be applied in a bi-partisan manner. The effect on individuals, citizens and the government entity itself can be significant; tough choices can be justified only when the reasoning is sound and beyond reproach. As noted earlier, analytical preparation is critical. In both the private sector and the public sector, most people will reach the same decision if they are provided with the same facts and analysis; that is, a single set of data must be available to all stakeholders and leaders of the restructuring process must provide all parties with the same analysis. While this may sound obvious, it is not the standard by which all restructurings occur.

In our next article we will talk about turnaround “apps” for governments in the **Finance platform**.

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# Outsourcing Alert: New Fair Labor Standards Act overtime exemption rules

On May 18, 2016, President Obama and Secretary of Labor announced the publication of the Department of Labor's final rule updating the overtime regulations, which will automatically extend overtime pay protections to over 4 million workers within the first year of implementation.

## New Fair Labor Standards Act overtime exemption rules

- Sets the standard salary level at the 40th percentile of earnings of full-time salaried workers in the lowest-wage Census Region, currently the South (\$913 per week; \$47,476 annually for a full-year worker
- Sets the total annual compensation requirement for highly compensated employees (HCE) subject to a minimal duties test to the annual equivalent of the 90th percentile of full-time salaried workers nationally, or from the current \$100,000 to \$134,004 a year.
- The Department of Labor will increase the salary threshold every three years, beginning January 1, 2020. Based on current projections, the salary threshold is estimated to be \$51,168 and the HCE threshold is estimated to be \$147,524 in 2020.

Considering the significant impact of this new regulation, employers must set a plan to meet the coming changes. It is time to examine the payroll records to determine which employees are currently treated as exempt and which, if

any, would not meet the new salary threshold.

After this review, salaries increases, re-classification of employees to non-exempt, monitoring overtime and tracking of worked hours, are some of the elements to be taken into consideration.

Employers must evaluate the impact these possible salary increases may cause and be prepared for adjustments in pricing of goods or services, or other financial adjustments deemed necessary to accommodate these changes.

These changes are effective December 1, 2016, and applicability to Puerto Rico could change depending on current developments in legislation the US Congress is working on which will impact Puerto Rico's government debt. The latest version of the project dated May 18, 2016 excludes Puerto Rico.

Link-US Department of Labor – Wage & Hour Division

<https://www.dol.gov/whd/overtime/final2016/>

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