

Kevane mailbag

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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.

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General Information Due to Holiday festivities our offices will be closed on November 26 and 27, 2015. We will reopen our offices on regular hours, Monday, November 30, 2015.

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Audit Alert: FASB discusses financial statements presentation of not-for-profit entities

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.

At its meeting on [October 28](#), one of the items discussed by the FASB was financial statements of not-for-profit entities.

Highlights of the Board's discussion follows:

The Board discussed feedback received on the proposed ASU, *Presentation of Financial Statements of Not-for-Profit Entities*, and tentatively decided to divide its redeliberations into two work streams.

Under the **first work stream**, the Board would reconsider the following issues, which are improvements that the Board might finalize in the near term that do not depend on other projects:

- Net asset classification scheme, including disclosure of board-designated funds, underwater endowments, and the placed-in-service option for expirations of capital restrictions.

- Expenses, including expenses by nature and an analysis of expenses by function and

- nature; netting of external and direct internal investment expenses against investment return; disclosure of netted investment expenses; and enhanced disclosures about cost allocations.

- Improvement of disclosures by not-for-profit entities that choose to present operating measures and information useful in assessing liquidity.

- Methods of presenting operating cash flows.

The **second work stream** would include proposed changes that are likely to require more time to resolve because they either involve consideration of alternatives that the Board did not previously consider or are related to similar issues being addressed in other projects. These changes include:

- An assessment of operating measures, including whether to require intermediate measures, how to define the measures and what would be included in the measures and stakeholder-suggested alternative disaggregation approaches

- Realignment of certain line items in the statement of cash flows.

Source: Grant Thornton, *On The Horizon*, November 5, 2015

Please contact us should we may be of further assistance in relation to this or any other matter.



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Tax Alert: Wages limitation to officer-owners rendering services to an eligible export services

On October 13, 2015, the Secretary of the Treasury (the “Secretary”) issued Administrative Determination 15-22 (“AD 15-22”) which provides guidance on the imputation of wages to stockholders or partners that receive income for services rendered to a company that benefits from a tax exemption grant under the Act to Promote the Export of Services (Act 20-2012), the Act Regulating International Financial Entities (Act 273-2012) and the International Insurers and Reinsurers Act (Act 399-2004), collectively known as the Exportation of Services Legislation.

Previous to AD 15-22, the only reference to what constituted a “reasonable annual salary” attributable to a stockholder or partner of a Company under a tax exemption grant was Administrative Determination 10-06 (“AD 10-06”), which was issued before the approval of the above mentioned Acts. AD 10-06 dictated that the compensation of employees of service units benefiting from a tax exemption decree under Act 135-1997 or Act 73-2008, who hold a proprietary interest of at least 5% in the service units, will be the lower of \$250,000 annually or 30% percent of the shareholder or partner share in the earnings and profits of the service unit for the taxable year.

By offering a preferential income tax rate (among other incentives), the Exportation Services Legislation aims to transform Puerto Rico into an International Services Centre by enticing the establishment of foreign services

companies and job creation in the Puerto Rico economy.

Nonetheless, compensation for the rendering of services for markets outside of Puerto Rico under these exemption vehicles has often been problematic since the same officers who render the services are usually shareholders or partners of the company, and their compensation is designed to include basic salary, commissions and profit sharing, as well as the distribution of dividends or profits that are exempt from income tax.

For this reason, the Secretary has set forth the parameters it will follow for the imputation of wages to stockholders and partners who are at the same time officers (i.e. “Officer-Owner”) of a company whose operations are covered by a tax exemption grant under Exportation of Services Legislation, in case it is deemed necessary.

AD 15-22 defines an **Officer-Owner** as any stockholder or partner who, at the end of the taxable year, maintains a proprietary interest on an Eligible Export Services Company and meets the following requirements:

1. Devotes no less than 80% of its time to the eligible activity covered under the Exportation of Services Legislation; and
2. Is a resident of Puerto Rico, as such term is defined on Section 1010.01(a)(30) of the Puerto Rico Internal Revenue Code of 2011, as amended (the “Code”), during the applicable taxable year.



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Meanwhile, an **Eligible Export Services Company** is defined as any export services company where more than 80% of all its gross income is derived from the rendering of eligible export services that are covered under any of the Exportation of Services Legislation, including its Controlled Group or Related Entities, as defined in Sections 1010.04 and 1010.05 of the Code.

AD 15-22 states that an Officer-Owner should receive a reasonable annual salary that is commensurate with the services he/she renders to an Eligible Export Services Company in which he/she maintains a proprietary interest at the end of the taxable year.

To that end, AD 15-22 sets forth a \$350,000 ceiling on the annual wages attributable to an Officer-Owner; one hundred thousand dollars (\$100,000) more than the ceiling established back in 2010 for officers under Acts 73-2008 and 135-1997.

Therefore, pursuant to these guidelines, and under the Secretary's sole discretion, an Officer-Owner that earns less than \$350,000 for services rendered to an Eligible Export Services Company in which he/she maintains **a proprietary interest at the end of the taxable year**, may be subject to an evaluation of the reasonableness of the income received from services rendered to the Eligible Export Services Company.

The evaluation will take into consideration the facts and circumstances of each case, the functions performed by the Officer-Owner within the hierarchy of the organization and the market trends as they relate to wages in comparable positions. As a result, the Secretary may impose additional wages up to a maximum of \$350,000 in order to clearly reflect the income of said Officer-Owner.

All tax exemption grants issued under the Exportation of Services Legislation at the issuance date of AD 15-22 and thereafter will be subject to the provisions established therein.

Nonetheless, please note that in contradistinction to AD 15-22, AD 10-06 established both a dollar (i.e. \$250,000) as well as a percentage threshold (i.e. 30%). Though the Treasury Department has not commented on this difference, it stands to reason that AD 10-06's \$250K or 30% formula could be extrapolated to benefit industries under the Exportation of Services Legislation, with the only difference being the higher dollar amount contemplated on AD15-22.

We highly recommend a proper and careful analysis of the Officer-Owners' compensation structure within the Eligible Export Services Company's operations, in light of these guidelines set forth by the Secretary in AD 15-22.

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: Five tips on buying a distressed business

How to make the most of acquiring a financially troubled business – or its assets

With the ‘easy credit’ party well and truly over, and businesses facing uncertainty in the face of the difficult economic climate, many opportunities are arising for companies to buy distressed businesses – businesses which are financially troubled – or their assets, at discounted prices. With the recession being so drawn out, even companies with strong financial reserves have fallen into trouble. In particular, construction, retail and healthcare services have seen a lot of accelerated M&A, although distressed purchases are taking place across all sectors. Identifying, assessing and completing a distressed purchase opportunity can be a daunting process, nevertheless presents a number of risks and potential problems not always found in a traditional acquisition. So how can you acquire a distressed business or some of its assets successfully?

We’ve highlighted five tips to help you cash in on this valuable opportunity.

- 1. Understand who you are buying from**
Many distressed businesses will be owned by a bank, or a bank will be the key stakeholder driving the sale. When buying a business’s non-core assets, the process can be fairly straightforward and the selling business may well want to accelerate the sale.

When buying a whole entity where the bank is effectively the owner, the process can be longer and more complicated,

however. Banks will likely have different priorities from those of corporate sellers, and it may even be that a distressed company is being sold by a syndicate of banks, which will add complexity.

Being clear about who the seller is and understanding their priorities is vital.



- 2. Ensure you have the right fix**

If you can genuinely understand what the going concern issue is then you will be far better placed to make an assessment of whether you have the right solution for turning that business around.

Ask yourself: have you got what is required to fix the company, either through operational improvement capability, having the cash to resolve any funding issues, or through restructuring in a way that this company or the bank couldn’t or didn’t have the appetite to.



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Ensuring you can fix the business and turn it around avoids ending up in the same predicament in six months' time – or worse, putting your own business at risk.



3. Pitch your offer with the right structure at the right level

Even though you are buying a distressed business, there may well be other buyers interested, so it's essential to pitch your offer appropriately.

Your offer will be based on the information you've been presented with, and this will not always – if ever – be complete. As such, be clear on the assumptions you have made and agree on an appropriate period for due diligence. This will allow you to adjust your value assessment, and ultimately your offer, if information or assumptions are proved incorrect. Eleventh-hour price chipping (reducing your offer at the last minute) does happen, but be aware that reputations are quickly damaged and this may limit future opportunities.

Bear in mind also that sellers won't always go for the highest offer.

If, for example, the enterprise value is likely to break in the bank debt (so the bank is the beneficiary of any consideration) and there are two offers on the table, of which one is higher value but has a deferred element (meaning the bank will have to stay in the game for a few years to realize that benefit), then it may well opt for the lower, more secure offer.

Again, it's important to understand the type of offer that is most likely to appeal to the seller.

4. Consider your fundraising options at an early stage

Fundraising for a distressed asset can be more complex than for an asset that has clear value. If you go to a standard bank, they will want to assess the value of that asset.

A good analogy is where people buy properties that are in a derelict state and want to obtain a mortgage to get that property into a good state. The buyer can see the potential and the end value, but convincing a bank to lend can be more difficult than it is for a standard property.

Getting funding in place before making an offer will help your purchase because sellers like certainty. Secured funding will add materially to your credibility as a bidder. If you try to acquire a distressed asset without funds in place, it will put you at a disadvantage.

5. Understand what or who you are buying

One of the potential risk areas where some acquirers have fallen down, and are sometimes not properly advised, is around 'management'.

Some buyers will assume that the existing management is locked in and will stay. If management leaves, however, it could impact on relationships with key customers

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or suppliers. This is particularly important in the service industry, where those relationships are fundamental to business value – and there's not a tangible 'asset'. Check carefully any such agreements and consider how you will incentivise management to work with you towards future success.

Similarly, if you are looking to replace a management team with one of your own, you may want to make sure that the removal of the existing team is appropriately taken care of, and that redundancy terms and costs are clearly dealt with in your offer. This area can give rise to costly mistakes.

In Summary

It is clear that there are many benefits to be gained from a carefully planned and well thought-through distressed purchase. It's important to gain a firm grasp of the assets you are buying and to approach the acquisition in a coordinated manner.

With the purchasing process for distressed businesses frequently being more time pressured than traditional acquisitions, and with a specific sub-set of risks, Grant Thornton has been working with a number of clients to guide them through the process, from beginning to end.

Other opportunities and things to watch out for

Distressed purchases offer:

- a less competitive purchase process
- opportunity to pick up a bargain
- opportunity to renegotiate contracts
- opportunity to cherry pick assets
- opportunity to drop liabilities
- opportunity to obtain positive PR
- a catalyst for change.

However, it is important that you are:

- careful about post completion funding, in particular working capital
- prepared for loss of trade credit and retention of title issues in stock
- aware of quality of information
- aware that lack of time equals lack of due diligence, along with the lack of warrantee and indemnities provided means that a commercial view is required.

Bibliography

Hart, W. (2012, November 12). Five tips on buying a distressed business. Retrieved November 12, 2015, from <http://www.grant-thornton.co.uk/en/Thinking/FD-Intelligence/Issues/Five-tips-on-buying-a-distressed-business/>

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Outsourcing Alert: Do you know that you are employer at home?

Currently, many people are contracting household services to reduce their domestic chores. Many of these people do not know that this turns them into employers in their own homes.

What are the benefits of being protected by the Household Maintenance Policy?

In Puerto Rico those employers who keep their Household Maintenance Policy updated by submitting the Payroll Declaration on or before July 20th, and paying the premiums within the time frame established by the CFSE (State Insurance Fund Corporation), will be protected with employer immunity should someone performing work in their homes suffer an accident or injury. In addition the CFSE will provide the injured worker the necessary medical treatment for his or her prompt rehabilitation. The CFSE will also grant economic compensation to the worker in accordance with the regulations of Workmen's Accident Compensation Act.

Who can obtain this insurance and what is the policy's cost?

All household heads even if they do not own the residence or building. The minimum annual cost is \$99 for the regular or permanent policy, but the payment will depend on the invested payroll in the worker's or contracted worker's salary, the duration of the job performed, the type or work and the worker's risk exposure.

Applicant's requirements to formalize a permanent home policy:

- must complete a policy quote request
- provide the Social Security Number
- present an identification with photo.

Being insured benefits both employer and the employee. Moreover, you will be protected by the employer immunity guarantee.

Links:

<http://web.fondopr.com/es/patronos/polizas-requisitos-formalizar-las-mismas/poliza-permanente-o-regular>



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