

**Special points of interest:**

- FASB Interpretation No. 48 on Accounting for Uncertainty in Income Taxes
- Amendments to the Real Estate Investments Trusts provisions of the Puerto Rico Internal Revenue Code
- Recent tax legislation

**Inside this issue:**

<b>FIN 48: You can run, but you can't hide</b>	<b>1</b>
<b>The Sales and Use Tax Corner</b>	<b>1</b>
<b>Amendments to the REITS</b>	<b>2</b>
<b>Recent Tax Legislation</b>	<b>3</b>
<b>Government Resolution Services</b>	<b>4</b>
<b>Taxand continues its global expansion</b>	<b>4</b>
<b>Profile</b>	<b>5</b>

### *FIN 48: You can run, but you can't hide*

**By Juan C. Zaragoza**

We are sure that by the time you read this newsletter you have faced the harsh reality of the impact of the Financial Accounting Standards Board ("FASB") Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement 109 ("FIN 48"), on your company's financial statements.

FIN 48, which is effective for fiscal years beginning after December 15, 2006 (i.e. 2007 for calendar year companies) provides a new model for financial statement recognition and measurement of income tax positions (so don't worry about any of your property, municipal license or excise tax issues). In addition, it requires a different and more burdensome approach for accounting for income tax contingencies. Unlike the liability approach provided by SFAS No. 5, Accounting for Contingencies (which would still

apply to those property, municipal license or excise tax issues you didn't want to think about), FIN 48 employs an asset-benefit recognition approach which must be applied to all "material tax positions". In a nutshell, only such positions whose ultimate success is determined to be "more likely than not" may be recognized (i.e. no reserve or liability needed) for financial statement purposes.

One of FIN 48 main challenges is that it assumes that Management will be able to identify all of the companies' "material tax positions". Well, that's not as easy as it sounds. This reminds me of the following words, "The deficiency or tax assessment is not in the tax return, it's outside the return". That's what a seasoned Treasury auditor told me several years ago, during my years at Treasury. This maxim, in essence establishes that the real money is in the issues that you can not identify from the face of a return rather than



those evident from the face of the return. This maxim also applies to FIN 48, this time from an exposure standpoint.

How do you ensure completeness on the recognition and identification portion of the process? Will a look at the tax returns be enough? Would you need to take a closer look to the chart of accounts, especially

**Continues on page 2**

### **The Sales and Use Tax Corner**

**By Z&A Editorial Staff**

Bill Number 3291 of the House of Representatives was approved on March 6, 2007 and referred to the Senate on March 12, 2007. On the same date, it was referred to the Finance Committee of the Senate for evaluation. If the Bill is finally

approved by the Senate and converted into law by the Governor, certain durable medical equipment acquired by hospital facilities enjoying tax exemption pursuant to Act 168 of June 30, 1968, as amended, will be exempt from the sales and use tax. The Bill, extends the exemption to hospital facilities enjoying

exemption under section 1101 (4) or 1101 (6) of the Code. In addition, the Bill grants exemption to certain medical equipment and devices that would have been eligible for reimbursement from Medicare, Medicaid, the Government Health Card or health insurance.

## Amendments to the REITS

By **Edgardo Sanabria**

Major amendments were introduced to the Real Estate Investments Trusts (REITS) provisions of the Puerto Rico Internal Revenue Code of 1994, as amended, (Code) with the enactment of Act Number 226 of December 26, 2006 (the Act).

### Background

On January 13, 2000, Act Number 25 was enacted to create new REITS provisions which were codified under a new Subchapter P of the Code.

The objective of the new provisions was to promote the economic activity and development normally associated with the real estate business. This initiative, however, totally failed as

#### **FIN 48: You can run... Continued from page 1**

those accounts whose name doesn't reflect what they are used for? Should that look be made by someone other than your Audit Firm? What will happen if three years down the road, Treasury audits the company and identifies some material issues that were not identified as part of the FIN 48 process? Will these be considered a material weakness from an internal control standpoint?

Keep in mind that a tax professional's ability to identify tax issues is commensurate with his (her) knowledge of the tax law and of the business.

Therefore, maybe that's the place to start, by choosing the right firm to assist you with this process.

the new provisions were not properly focused and were full of limitations as to the eligible real estate investments. For example, the following real estate investments were not eligible:

- Investments in hotel properties, shopping centers and shopping malls.
- Properties built prior to July 1, 1999 (except for those owned by the government and sold to the private sector).
- Substantial refurbishing made after June 30 1999 on hotel properties, shopping centers and shopping malls built prior to July 1, 1999.

Moreover, the preferential income tax rate provided to the beneficiaries or investors of the REITS prior to the enactment of the Act was 17%, which was much higher than the preferential income tax rates provided under the Code to investors or holders of other investment instruments.

### The recently enacted amendments

The Act was enacted to amend the provisions of Subchapter P with the objective of getting rid of the substantial limitations originally enacted in 2000. The business community understands that the amendments will certainly boost the REITS to such extent that they will finally have the power to impulse our economy as it was expected when the original provisions were enacted.

### The new REITS provisions

After the amendments introduced to the Subchapter P provisions of the Code, the

Puerto Rico REITS provisions became very similar to the United States Internal Revenue Code's REITS provisions (§§856-860). Nonetheless, there are certain differences. The most significant amendments made are the following:

- A minimum of 50 investors (shareholders) are required.
- Subject to certain limitations, entities affiliated to a REIT are allowed to lease properties owned by the REIT.
- Dividends (distributions) paid by REITS are subject to a preferential income tax rate of 10%, instead of the former 17%.
- All properties acquired by REITS after January 1, 2007 must be acquired in a taxable transaction (not including eligible assets acquired from the Government of Puerto Rico) in Puerto Rico (i.e., purchase of assets, shares of stock or partnership participations). Accordingly, conversions of existing entities in non-taxable exchanges are not allowed.
- Wholly-owned subsidiaries of REITS are treated as disregarded entities. Therefore, assets, liabilities, income items, deductions and credits of the subsidiary are considered as those of the REITS.
- Old provisions dealing with non eligible properties were repealed. Basically, every real estate property is now eligible to be owned by a REIT regardless of when it was built.



**The business community understands that the amendments introduced with the enactment of Act Number 226 will certainly boost the REITS to such extent that they will finally have the power to impulse our economy as it was expected when the original provisions were enacted.**



**Continues on page 3**

## Recent tax legislation

By Rafael A. Carazo

### I. New Rules Regarding the Deposit of Puerto Rico Income Tax Withheld on Wages

Act # 18, enacted on March 6, 2007, amended the provisions of the Puerto Rico Internal Revenue Code (the "Code") related to the rules applicable to the deposit of Puerto Rico income tax withheld on wages (the "Deposit Rules"). Act #18 reinstated, as the Deposit Rules, the rules applicable to the deposit of Social Security taxes withheld on wages that were in effect prior to July 4, 2006. According to the Internal Revenue Circular Letter No. 07-05, issued by the Secretary of the Treasury the new Deposit Rules will apply to the deposit of the tax withheld on

#### Amendments to the REITS Continued from page 2

##### Other considerations

The election to be treated as a REIT can be made by any entity (corporation, company, partnership, trust or association) upon the filing of the income tax return of the year for which the election is to be effective. Once made, it may be revoked during the first 90 days of the taxable year for which the revocation is to be effective. A REIT will, in general, be treated as a nontaxable entity as long as it distributes every year 90% of its net income. It is also provided, that five or fewer individuals cannot be the owners of more than 50% of the value of the shares of the REIT at any time. Finally, income received from certain prohibited transactions may be subject to a 100% penalty tax.

wages paid after March 31, 2007.

### II. Reduction in the Excise Tax Rates Applicable to Motor Vehicles

The excise tax rates applicable to motor vehicles introduced into Puerto Rico after March 15, 2007, were reduced by Act # 19 enacted on March 16, 2007. Act # 19 grants an excise tax saving to all brackets on the applicable tax table, except for the lowest bracket. The excise tax savings range from \$46 to \$7,070 at the highest marginal tax bracket. Moreover, Act # 19 provides that the reduction applies as well to the motor vehicles in inventory, if the applicable excise tax has not been paid because the grace period for payment granted by the excise tax law provisions has not expired. If, however, the excise tax on motor vehicles in inventory was already paid, Act # 19 grants a credit for the difference resulting from the use of the new tax rates. The credit is only available to reduce future excise taxes.

### III. Cement Used as Raw Material by Manufacturing Plants is Exempt from the Payment of the Sales and Use Tax

Act #117 of July 4, 2006, which introduced into Puerto Rico the sales and use tax (the "Sales Tax"), exempted from said tax the raw materials used by manufacturing plants, except the cement. Thus, the cement used as raw material in a manufacturing process was subject to the Sales Tax and to the excise tax applicable thereto. The end result was that in certain circumstances, the cement was subject to taxes three (3) times. To eliminate that result,

Act # 22, enacted on March 8, 2007, amended the Code to exempt from the Sales Tax the cement used as raw material in a manufacturing process.

To clarify the extent of the exemption, the Secretary issued Internal Revenue Informative Bulletin Num. 07-08, which indicates that the exemption does not apply to the cement used in the construction of buildings or structures, and provides examples of the manufacturing processes to which it applies.

### IV. Reinstatement of the Excise Tax on Sugar

Act #117 repealed the excise tax imposed on sugar effective November 15, 2007, the effective date of the Sales Tax. Since the funds collected by said excise tax were earmarked for specific government programs, its repeal resulted in the reduction of the funds received by such programs. To correct that unintended result, Act #22 of March 8, 2007, reinstated the excise tax imposed on sugar effective November 15, 2006.

### V. Income Tax Treatment of Disability Payments Clarified and Treatment of Compensation for Mental Anguish Modified

Effective July 4, 2006, Act #117 amended the Code to:

- a. clearly establish that disability payments, regardless of whether the disability is occupational or not, are excluded from gross income and, therefore, exempt from Puerto Rico income taxes, and

*Continues on Page 4*



#### In a nutshell...

1. Act # 18 of 2007 amended the provisions of the Puerto Rico Internal Revenue Code related to the rules applicable to the deposit of Puerto Rico income tax withheld on wages.
2. Act # 19 of 2007 reduced the excise tax rates applicable to motor vehicles introduced into Puerto Rico after March 15, 2007.
3. Act #22 of 2007 exempts from the Sales and Use Tax, the cement used as raw material by manufacturing plants.
4. Act #22 of 2007, reinstates the excise tax imposed on sugar effective November 15, 2006.
5. Act # 117 amended the Code to clarify Income Tax treatment of disability payments as well as to modify the treatment of compensation for mental anguish.

## *Government resolution services help you avoid wasting valuable time trying to get things solved at the government agencies*

### **By Z&A Editorial Staff**

If you are frustrated and feeling like losing your nerves trying to get things solved at the government agencies, you are not alone. Everyday thousands of executives at companies like yours ask themselves two questions: Why should I distract my focus from my core business to waste time in waiting lines? Is there someone who can assist me effectively and efficiently through the government's maze?

As per the first question, the reality is that today's complex and bureaucratic governmental structures in Puerto Rico and United States make organizations to waste significant amounts of time and money handling issues with the different agencies. Organizations are forced to deplete their resources by the time spent solving problems, instead of

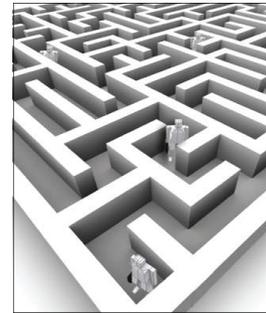
being used in managing their business. Fortunately, the answer to the second question shows that there is no need to be that way.

Carlos R. González, Principal in charge of Integral Corporate Solutions, Z&A's government resolution services division, remarks that "despite new technologies and service quality oriented processes adopted by some agencies, obtaining certifications and permits is still cumbersome". In fact, based on the nature of the business the number of permits, certifications and general issues that need to be solved can be exponential.

Then, hiring a government resolution service professional well familiarized with the internal procedures of the governmental agencies turns to be a well thought investment. As an example, Integral Corporate

Solutions consulting team combines over twenty years of collective experience and hands-on expertise as certified public accountants, former governmental officials and tax specialists. "We at Integral deal with over sixteen state and federal agencies, representing our clients before them to obtain the certifications the agencies require, solving time consuming problems the client would rather not tackle and obtaining those permits desperately needed to run the business. Our knowledge and experience assure our clients that their needs will be handled efficiently and cost effectively", emphasized González.

Visit [www.icspr.com](http://www.icspr.com) for additional information on how Integral Corporate Solutions can tackle the government maze for you or contact one of its



**Everyday thousands of executives at companies like yours ask themselves two questions: Why should I distract my focus from my core business to waste time in waiting lines? Is there someone who can assist me effectively and efficiently through the government's maze?**

### **Recent Tax Legislation... Continued from page 3**

- b. specify that only the compensation received by an individual on account of physical injuries will be excluded from gross income; prior to that amendment, the compensation received for mental damages or anguish was also exempted from income taxes.

To explain these amendments the Secretary issued Administrative Determination 07-01 in January 2007.

- (1) Code Section 6181
- (2) Code Section 1022(b)(5)

## **Taxand continues its global expansion**

### **By Z&A Editorial Staff**

**T**axand Global Alliance, the leading provider of completely independent tax consulting services, now includes more than 1,500 tax professionals, including more than 260 international partners, with firms in 36 countries. "Taxand's remarkable growth has exceeded our highest expectations", says Frederic Donnedieu de Vabres, who coordinates Taxand globally, adding that "our success is a testament to the quality of our professionals and our strategic model".

Taxand is becoming a key provider of global tax services that can not be ignored. Today,

Taxand member firms work together to provide global companies with international tax services, including tax planning for cross-border transactions and tax litigation support.

"Not only do we have a close relationship with clients in our local country and a deep understanding of their culture and needs, but we also offer seamless global tax services demanded by multinational companies seeking tax advice from professionals who have no audit-based conflicts of interests", says Juan Zaragoza, co-founder and partner of Zaragoza & Alvarado LLP, the only member in Puerto Rico of Taxand Global Alliance.

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## Tax is our business.®

Zaragoza & Alvarado LLP is a Limited Liability Partnership organized under the laws of Puerto Rico and is engaged in providing tax and business advisory services. We are the first truly multidisciplinary tax and business advisory professional services firm in Puerto Rico, unencumbered by the constraints of association with an auditing firm, and the regulatory and disclosure rules of the Securities and Exchange Commission.

Backed up by years of unmatched hands-on experience in public accounting, government and corporate tax, our team of tax consultants is redefining the market by providing professional tax and business advisory services through its "top-heavy" structure, designed specifically to provide high level tax consulting to our clients on a more personalized basis.

Zaragoza & Alvarado LLP is a proud member of Taxand Global Alliance, the leading provider of completely independent tax consulting services.

## Taxand Global Alliance



Taxand Global Alliance is the leading provider of completely independent tax consulting services, with more than 1,500 tax professionals, including more than 260 international partners in 36 countries.

Globalization and complexity impose deep expertise, specialization and flexibility. That is the reason why independent and specialized tax firms decided on February 9th 2005 to create Taxand Global Alliance, in order to serve local and international clients.

### The Taxand Advantage

While Taxand is new to the industry, Taxand professionals are not. We bring deep knowledge, proven track records and decades of experience in tax services. One of the major advantages of Taxand is independence. We do not have independence conflicts which might threaten our objectivity or compromise the integrity of a client's operations or decisions.

We optimize clients' businesses by anticipating, measuring and managing tax implications of their day-to-day operations and strategic decisions.

Specialization is key. Business operations and global tax legislation are getting more and more complex. Deep tax expertise is needed to help clients identify, measure, and manage tax implications and risks within their operations. Our model is to specialize our people on Tax only and liaise with any other expertise (Legal, M&A, Finance, Risk Management, Technology...) whenever it is needed by clients.

Different from other international networks such as international law firms or big four firms, our core practice is tax, so every investment we make is in the tax practice rather than in other competencies that may seem more important to other firms.