



Hacienda

Transition Report Summary

November 15th, 2020



Introduction

In the fall of 2017, Hurricanes Maria and Irma inflicted unprecedented damage on the physical infrastructure of Puerto Rico, leaving large segments of the population without power for weeks and in many cases months. In the summer of 2019, the island experienced a crisis of confidence in government institutions, and large-scale public protests which resulted in a resignation of a Governor and the implementation of an unprecedented succession plan. Just as the Island was recovering from political disruption and embarking on reconstruction at the end of 2019, Puerto Rico suffered the most serious earthquakes in recent memory, resulting in structural damage to buildings across southwestern Puerto Rico.

Finally, only two months later, Puerto Rico – along with the rest of the world – was confronted with the COVID-19 global pandemic. Overnight, the economy shut down except for the most critical activities as the Government took prudent steps to mitigate the risk of a catastrophic public health crisis. Unemployment has skyrocketed as many businesses have been forced to shut down, and the local and federal governments have quickly mobilized to provide support. Many projections indicate that the economic shock due to COVID-19 will be worse than that of the Great Recession.

This document provides the strategic path that Hacienda must follow in order to support the Government on the reconstruction of the island's infrastructure and the confidence of the people of Puerto Rico in their own government.



About Hacienda

Is responsible for administering public policy related to tax and financial matters, and the administration of public resources. Likewise, with the creation of the Traditional Lottery, the authorization of gambling in casinos in Puerto Rico, and the establishment of the Electronic Lottery, Hacienda has played an important role in the implementation of public policy on games of chance.

Mission and Vision

This defines Hacienda's business, its objectives and its approach to reach those objectives. Also, this describes the desired agency's future position. Additionally, is included the organization believes in and how our people are expected to behave—with each other, with our clients, and with other stakeholders.



Mission

Prepare and administer tax and fiscal policies in a fair, equitable, ethical, effective and efficient manner to promote the economic development of our people and educate our clients about them.

Collect, safeguard, account for and control the use of public resources by government agencies to ensure compliance with current laws and regulations.

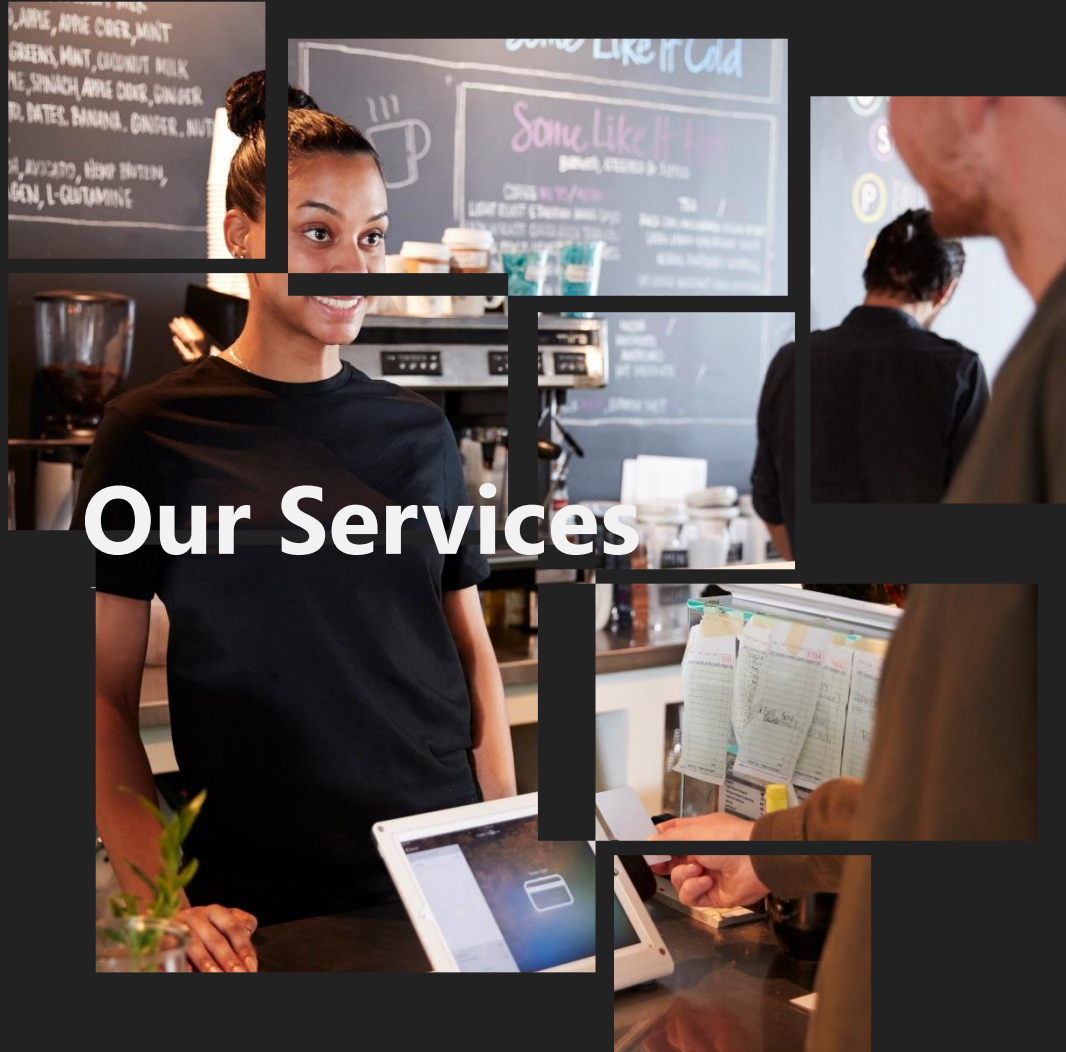
Our vision considers Hacienda to be a model of tax and fiscal administration worldwide through the recruitment and continuous improvement of talent, the application of agile, effective, efficient processes and providing an excellent service, using the most modern technology accessible to our clients and collaborators.

Our values encompasses the following:

- **Compromise** – We comply at all times with excellence our constitutional duties.
- **Integrity** - We ensure the purity of our processes and actions, protecting the public interest.
- **Justice** – We act in accordance with our legal system
- **Respect** – We enforce the rights and dignity of all our clients and collaborators..
- **Sensitivity** – We recognize the needs of our clients and collaborators
- **Reliability** – we make sure that the services we render are the best.
- **Transparency** – We ensure that our actions are widely publicized

Our Services

Hacienda is responsible for the cash flow management to other local agencies, tax collection, accounting, and economic policy formulation. Additionally, Hacienda is in charge of leading the operations for the local lottery programs. We are a trusted policy advisor to the Governor, formulating and recommending domestic financial, economic, and tax policy.



Our Services



Tax Collections

Internal Revenue Area is responsible to ensure taxpayers comply with the tax law through developing innovative approaches to understand, detect and resolve potential noncompliance to keep taxpayer confidence in our tax system strong. Also, governmental revenues derived by the lotteries in PR are administer by Hacienda.



Treasury Services

The Treasury Area is responsible to central payment services to the public on behalf of government agencies, identify and assist in the prevention of improper payments, while collecting debt owed to government agencies



Central Accounting

The Central Accounting Area provides timely, reliable, and transparent financial services and information. It is also responsible to record the government's financial data. It coordinates and produces annual financial statements.



Other Fiscal Services

Office of Economic Affairs and Information Technology Area are responsible of providing economic advice and manage the information system and provide shared-services, respectively.

Our Organization Structure

Organizational structure is a system used to define a hierarchy within an organization. It identifies each job, its function and where it reports to within the organization. This structure is developed to establish how an organization operates and assists an organization in obtaining its goals to allow for future growth. The structure is illustrated using an organizational chart.

Proposed changes on Organization Structure

“In order to carry out the transformation of the governmental apparatus, it is essential to invest in our governance. The same consists of three elements: people, processes and technology.”

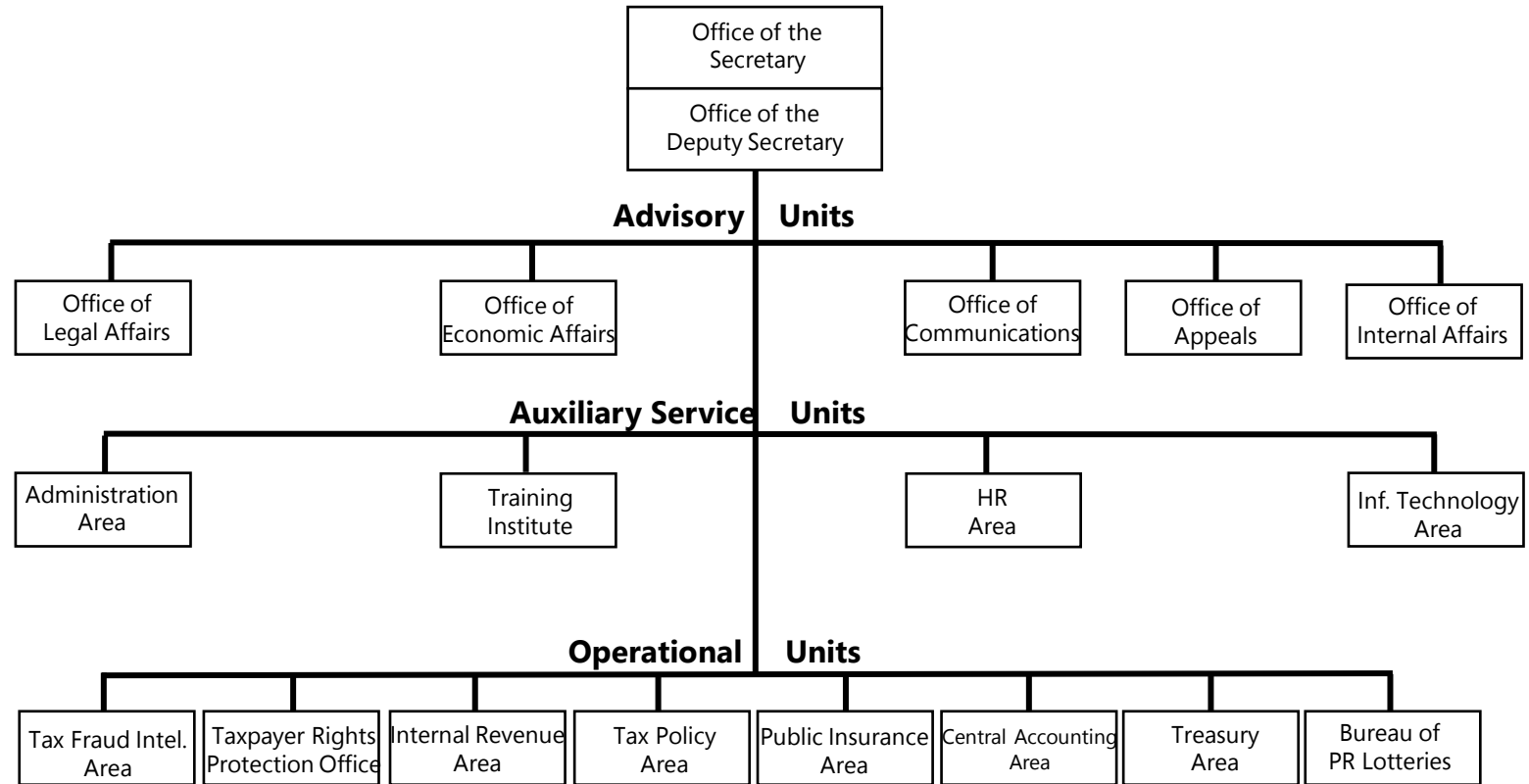
Francisco Parés Alicea

Fiscal Management Oversight Board's Public Hearing held on July 1st, 2020

Hacienda has a great team of advisers who guide and advise under their respective specialties, most of them are part of the advisory units.

In addition, it counts with the Auxiliary Services areas that provide support to Hacienda, such as: Administration Area, Human Resources and Labor Affairs Area and Information Technology Area.

Also, Hacienda services mostly ran by the operational units such as Tax Fraud Intelligence area, Taxpayer Rights Protection Office, Internal Revenue Area, Tax Policy Area, Public Insurance Area, Central Government Accounting Area, Treasury and Bureau Area of the Puerto Rico Lottery

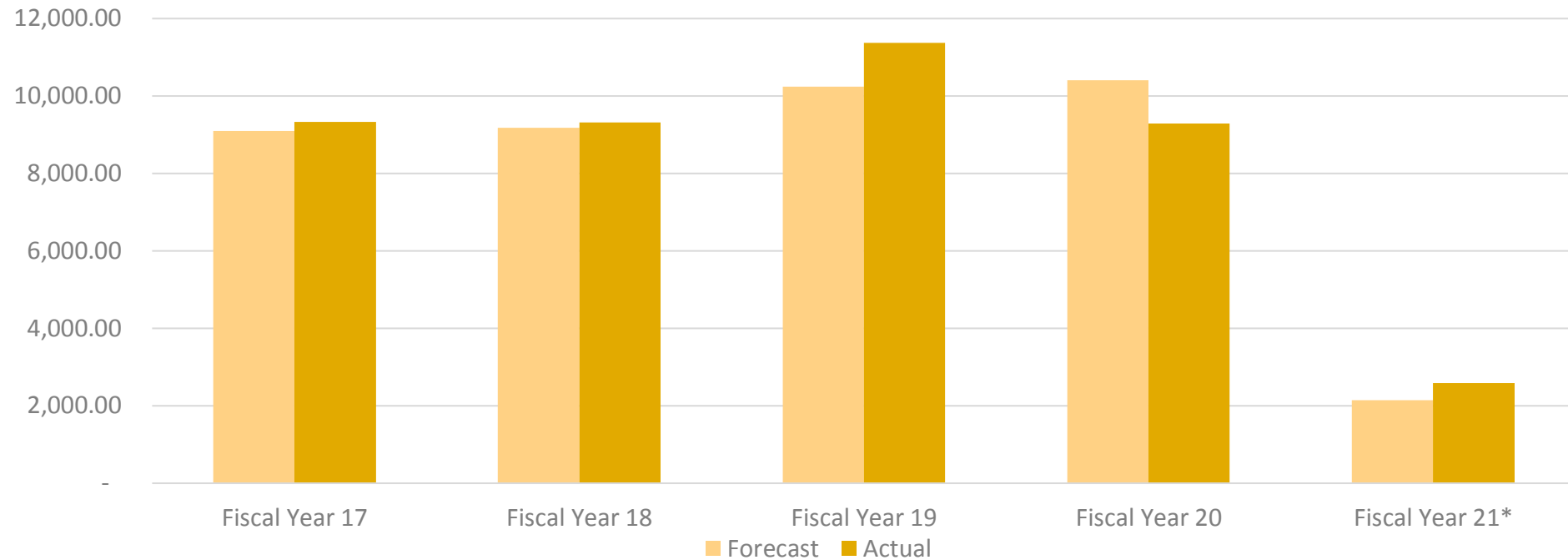


Current results

Organizational structure is a system used to define a hierarchy within an organization. It identifies each job, its function and where it reports to within the organization. This structure is developed to establish how an organization operates and assists an organization in obtaining its goals to allow for future growth. The structure is illustrated using an organizational chart.

Total General Fund Revenue Collections vs Forecasts

Accumulated collections for the last five year has surpassed forecasts by \$832.30 millions.

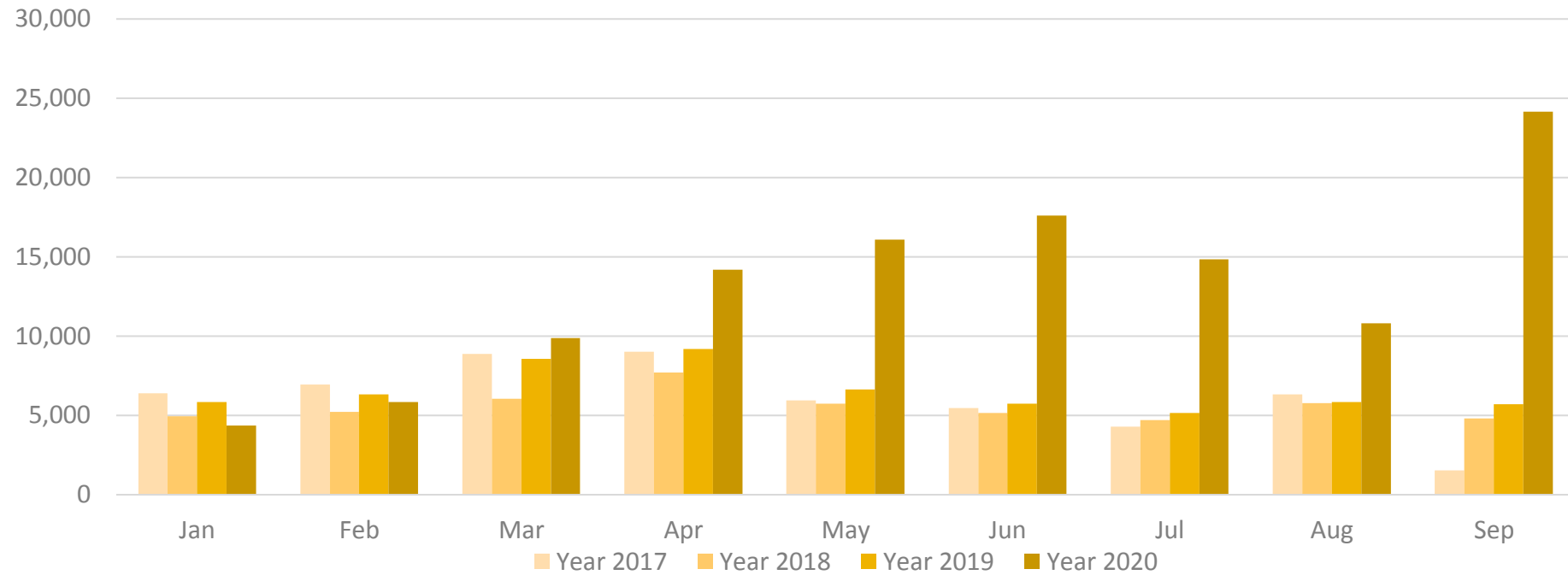


* Amount corresponds for collections as of September 30th, 2020.



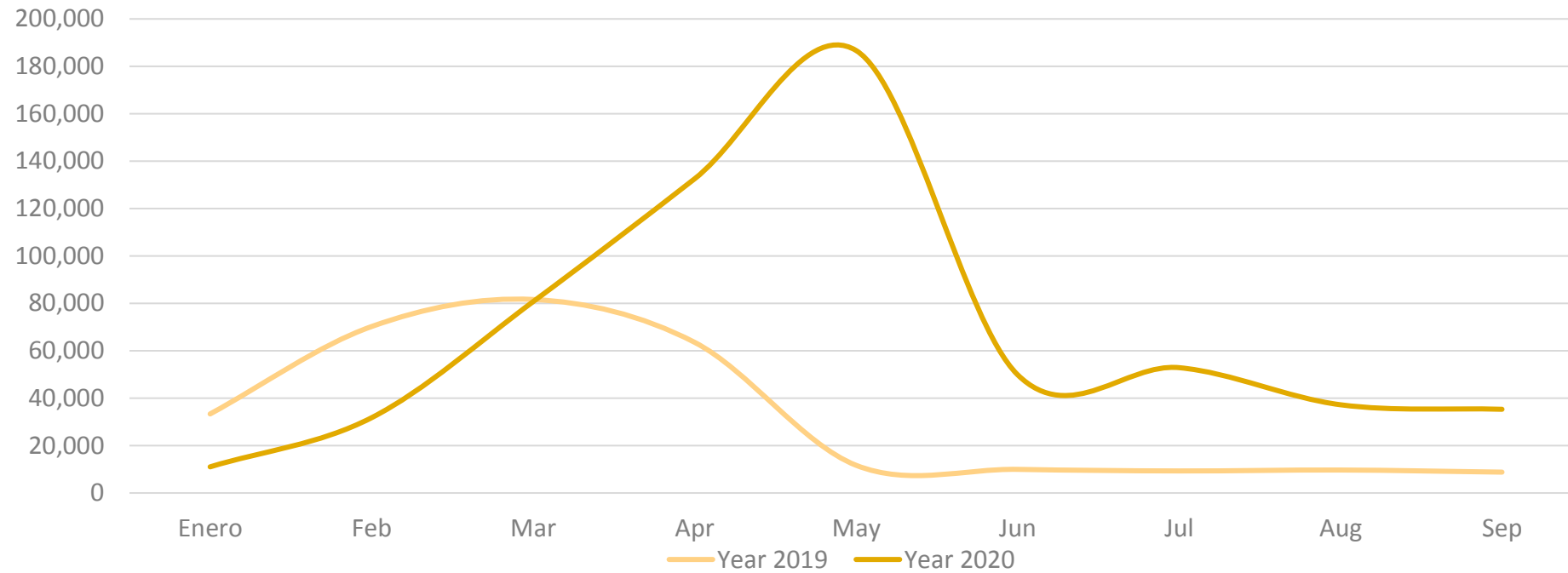
Commercial Locations Registered on SURI

This graphic compares the amount of new registered commercial locations on SURI.



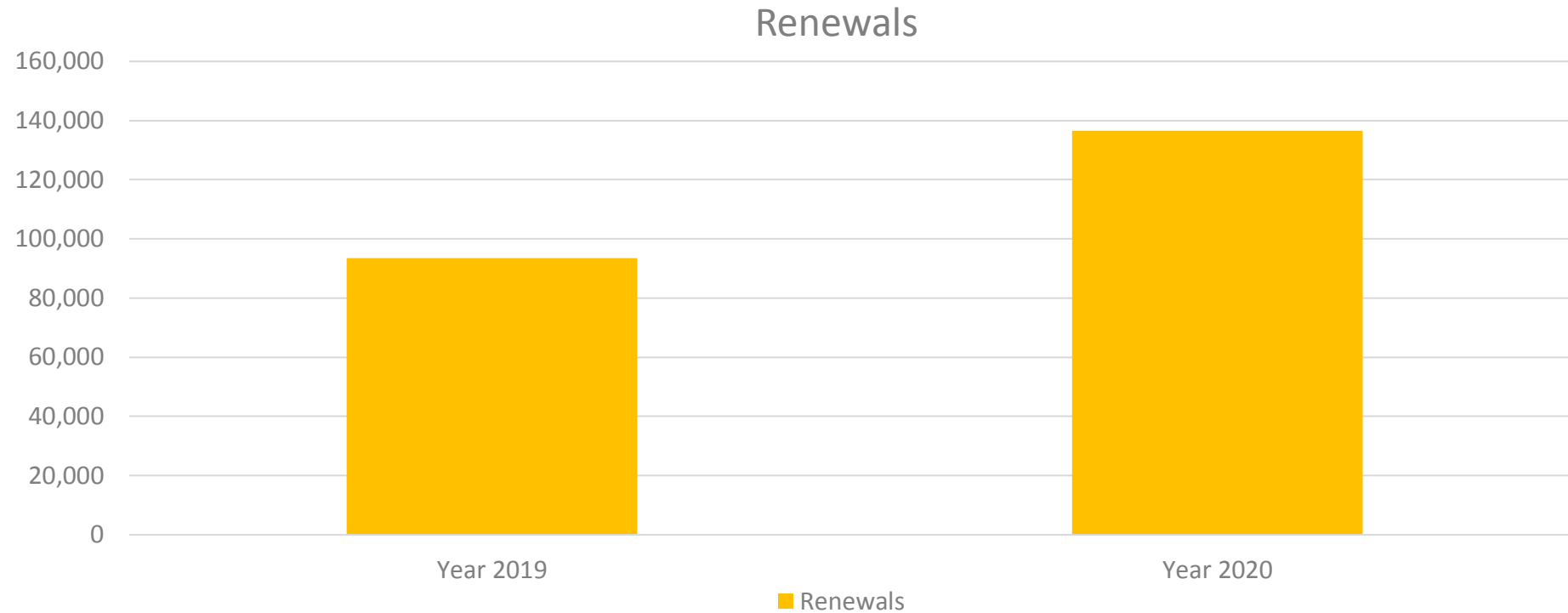
SURI Web-Logons per Month

This graphic compares the amount of log-on in SURI for natural years 2019 and 2020 per month.



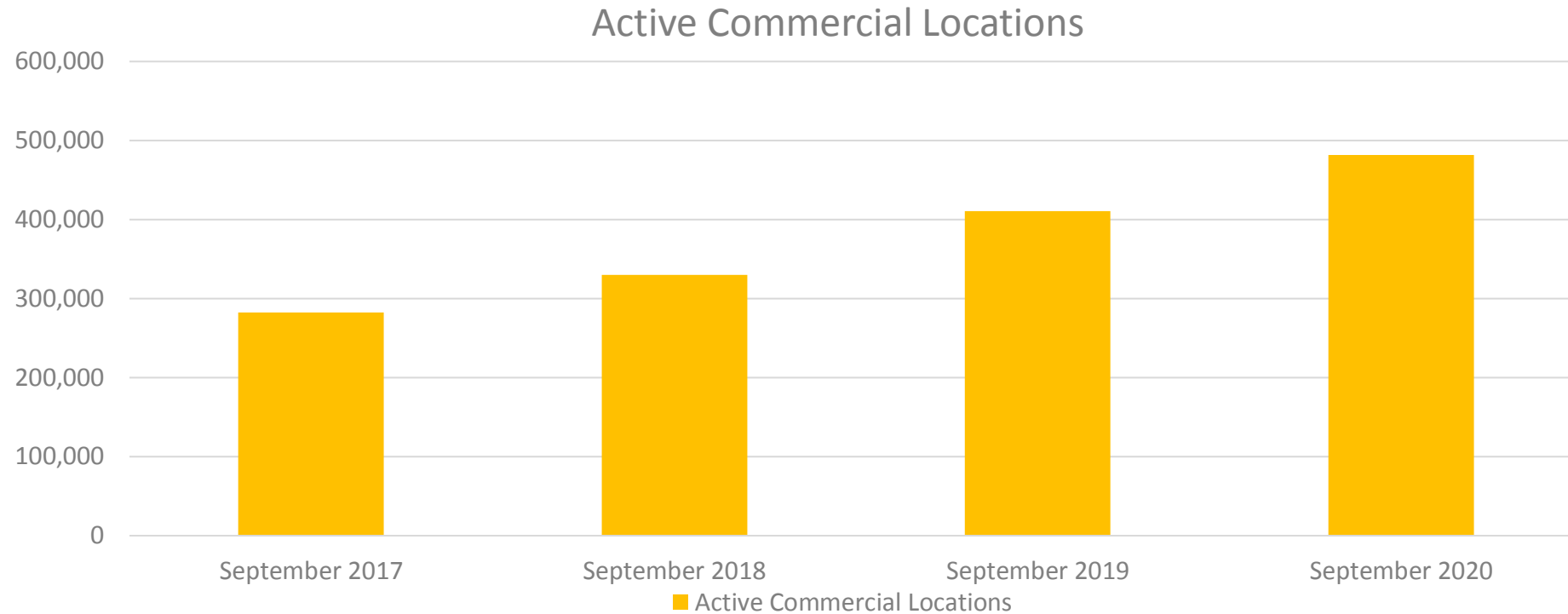
Merchant's Certificate Renewals

This graphic compares the amount Merchant's Certificate Renewal.



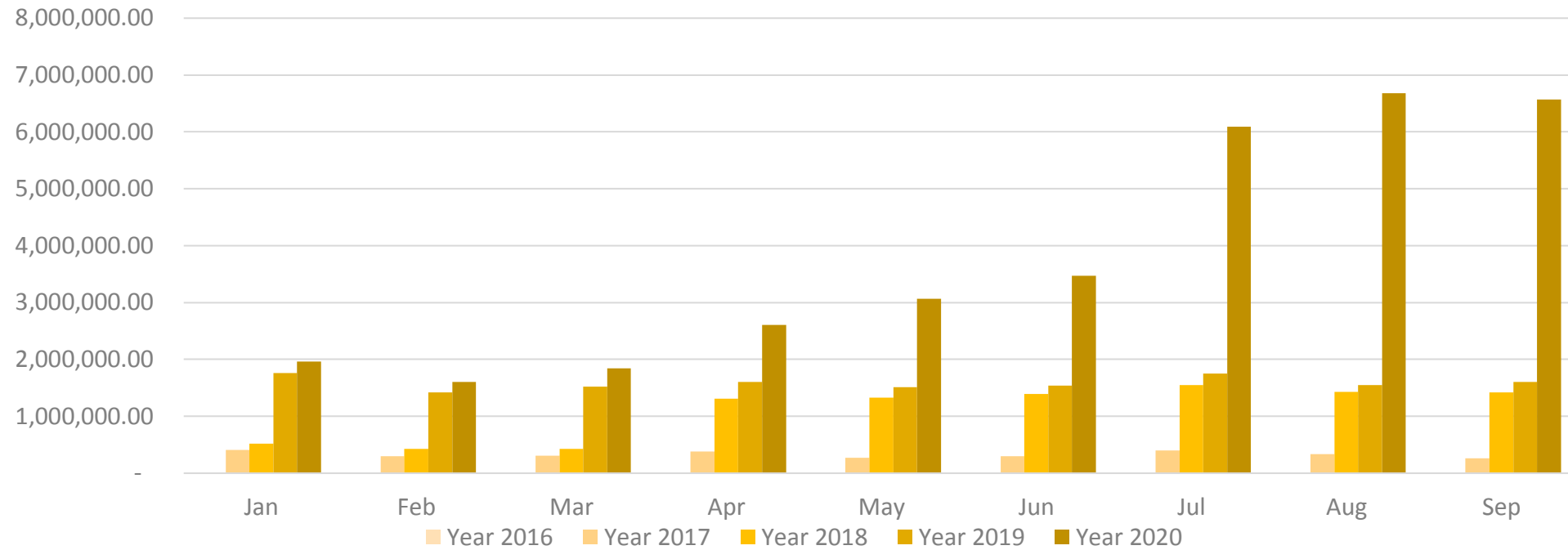
Active Merchant's Commercial Locations

This graphic compares the amount of active Merchant's Commercial Locations as of September 2017, 2018, 2019 and 2020 respectively.



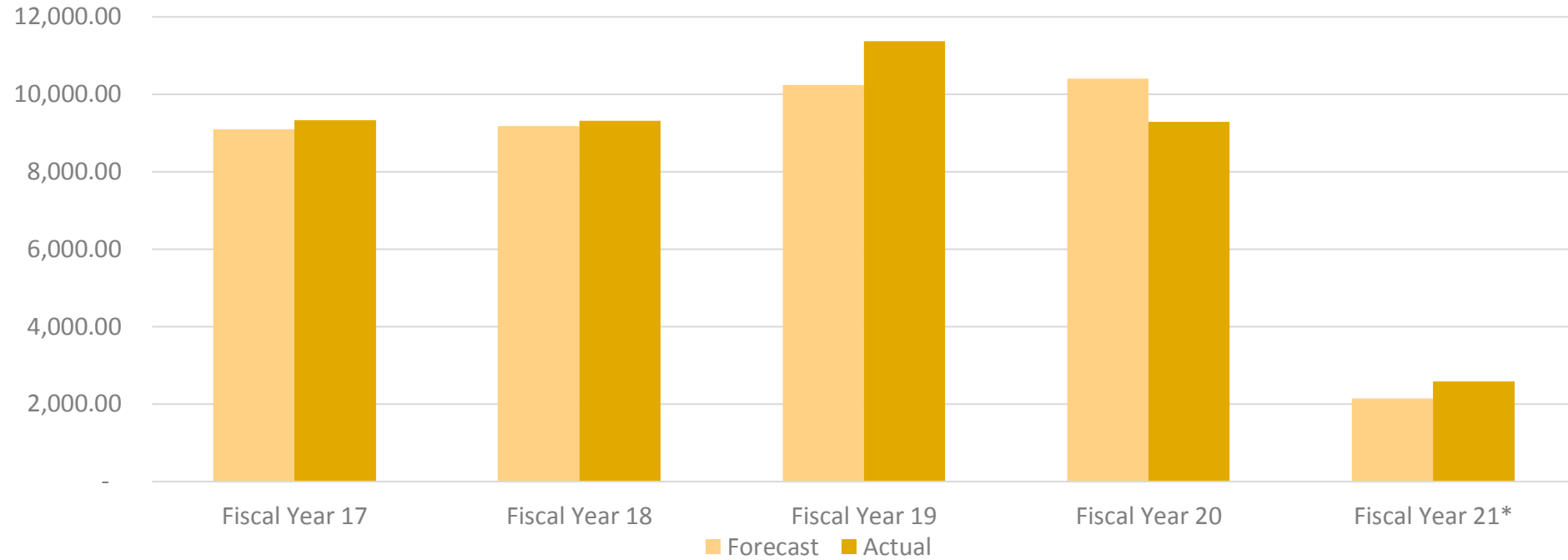
SUT Collections on Online Sales

This graphic compares the amount of Sales & Use Tax collected on online sales.



Total General Fund Revenue Collections vs Forecasts

Accumulated collections for the last five year has surpassed forecasts by \$832.30
(amount in millions)



* Amount corresponds for collections as of September 30th, 2020.



Amount of Refunds Under COVID 19

“In order to carry out the transformation of the governmental apparatus, it is essential to invest in our governance. The same consists of three elements: people, processes and technology.”

Francisco Parés Alicea

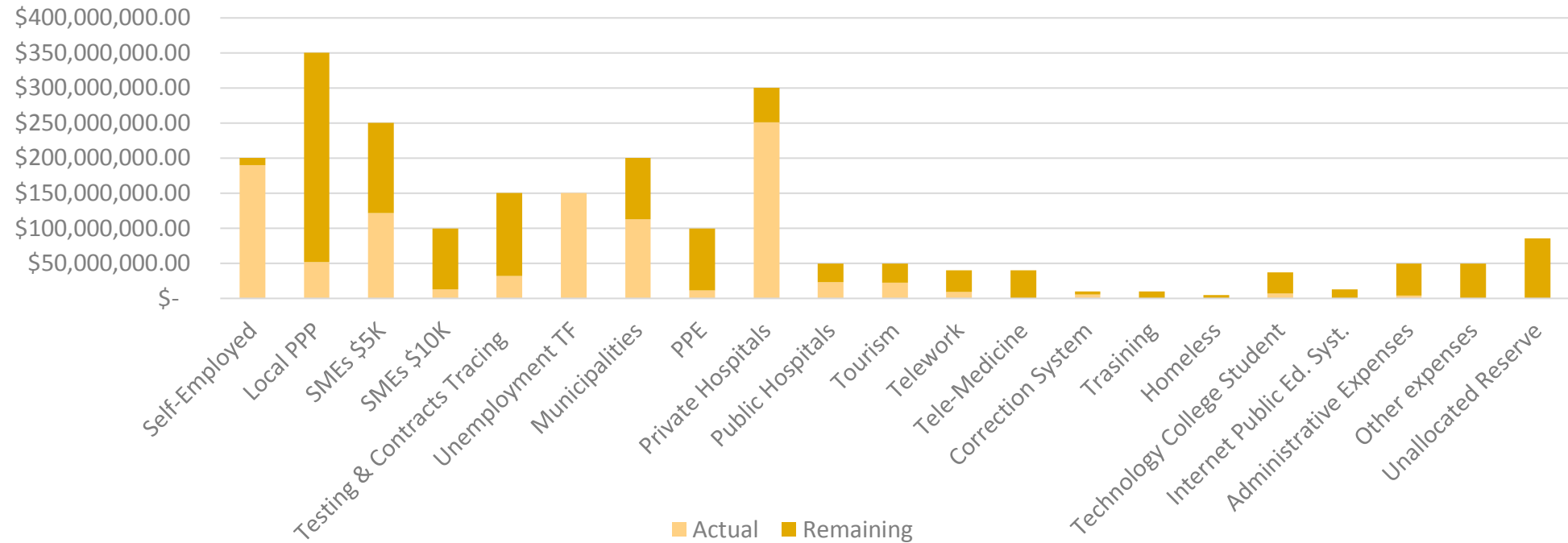
Fiscal Management Oversight Board's Public Hearing held on July 1st, 2020

Type	Filed Returns	Count of Returns	Refunds (\$)	Pending Refunds	Pending Refunds (\$)
Individual 2019	1,035,176	610,747	\$ 604,220,059.98	10,224	\$ 26,336,795.85
Corporations 2019	47,514			1,152	\$ 7,448,598.22
Seniors					
2016		125,570	\$ 30,387,067.59		
2017		119,549	\$ 28,844,732.99		
2018		37,876	\$ 18,141,428.50	1,071	\$ 555,536.00
2019		<u>157,347</u>	<u>\$ 38,701,761.32</u>	<u>488</u>	<u>\$ 129,575.00</u>
Taxpayer (Logon)	15,012				
Specialist	125,444				
Taxpayers (Non-Logon)	<u>40,898</u>				
Sub-Total	181,354	440,342	\$ 116,074,990.40	1,559	\$ 685,111.00
TOTAL	1,264,044	1,491,431	\$ 836,370,040.78	12,935	\$ 34,470,505.07



CARES Act Funds Utilization

Actual disbursement of \$2,240 million of CARES Act funds.



Proposed US Treasury Regulation

REG-101657-20

On behalf of the Government of Puerto Rico will provide following comments to the United States Government relative to the proposed regulations relating to the Foreign Tax Credit [REG-101657-20].

It is the position of the Government of Puerto Rico that the proposed rules should not apply to the taxes imposed under Act No. 154 of 2010, as amended, both for policy and for technical reasons and we hope that Treasury will agree on both counts.



Background

The Internal Revenue Service (“IRS”) published the Notice of proposed rulemaking REG-101657-20, which covers new definitions with respect to foreign income taxes and taxes paid “in lieu of an income tax.”

The Government of Puerto Rico has analyzed the proposed regulations and is concerned about the potential economic impact these will have on their application to Puerto Rico.

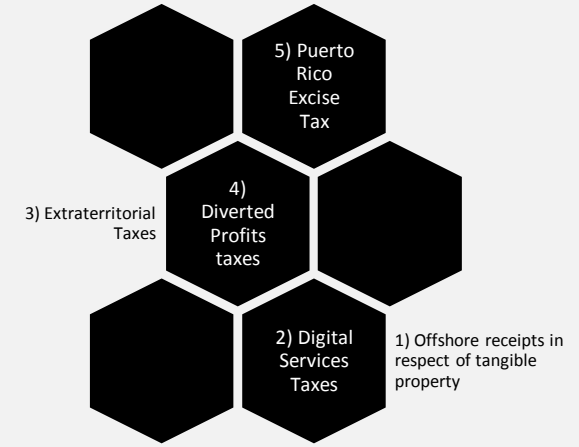
Primary Requirements to be a creditable foreign tax

- Proposed regulations retain general definition of a creditable foreign tax in Treas. Reg. §1.901-2 as one that has the predominant character of an income tax in the U.S. sense, but revise rules for making that determination.
- Proposed regulations add a new **“Jurisdictional Nexus”** rule, which requires a sufficient nexus between the foreign country and the taxpayer’s activities or investment of capital or other assets that give rise to the income being taxed.
- Taxes on nonresidents must satisfy one of 3 tests:
 - Income subject to tax is attributable to nonresident’s activities in the foreign country and not based, e.g., on location of customers
 - Income is taxable because it arises from sources in the foreign country (foreign sourcing rules must be “reasonably similar” to US rules**
 - Income is from sale or disposition of property that is real property located in foreign country or moveable property associated with a taxable presence

Additional Requirements

- Prop. Reg. §1.901-2** provides that taxes imposed on residents based on worldwide income of residents may satisfy the Jurisdictional Nexus requirement provided that any allocation of income to or from the resident under foreign transfer pricing rules is made under arm’s length principles
 - Seemingly focused on extraterritorial tax regimes such as digital services taxes, where income of a nonresident is taxed based on location of customers in the foreign country, but may also apply to other tax regimes
- Proposed regulations provide that a surtax on an income tax is a creditable foreign tax
- Prop. Reg. §1.903-1** tightens requirements to qualify as an “in lieu of” tax. In addition to meeting the jurisdictional nexus requirement, taxpayer must establish that:
 - the foreign country made a **“deliberate and cognizant choice to impose the in lieu of tax instead of a net income tax,”** and that
 - the imposition of the in lieu of tax bears a close connection to the failure to impose the net income tax

Which tax regimes may be covered?



Desirable Actions

Decipher the appropriate and less costly scenario for the emigration of the excise tax to an income tax regime that is not considered as a voluntary tax, and that can coexist with the administrative determinations of the Treasury on Section 901 of the Federal Internal Revenue Code so that these contributions can be credited by taxpayers and avoid the cost of double taxation.

Steps to solve the challenges of Law 154-2010

Will achieve the government's financial stability by protecting and promoting economic activity on the island and the coexistence of current collections with federal regulations on contributions paid abroad.



Obtain clarification of the proposed regulation's language to allow a transition period from the excise tax to an income tax regime by the Federal Treasury.



Evaluate the changes to our local ordinance so that a renegotiation of the decrees' terms is feasible.



Renegotiate the decrees' terms to equalize the collections redistributed in the same industry with the most transparent economic impact.

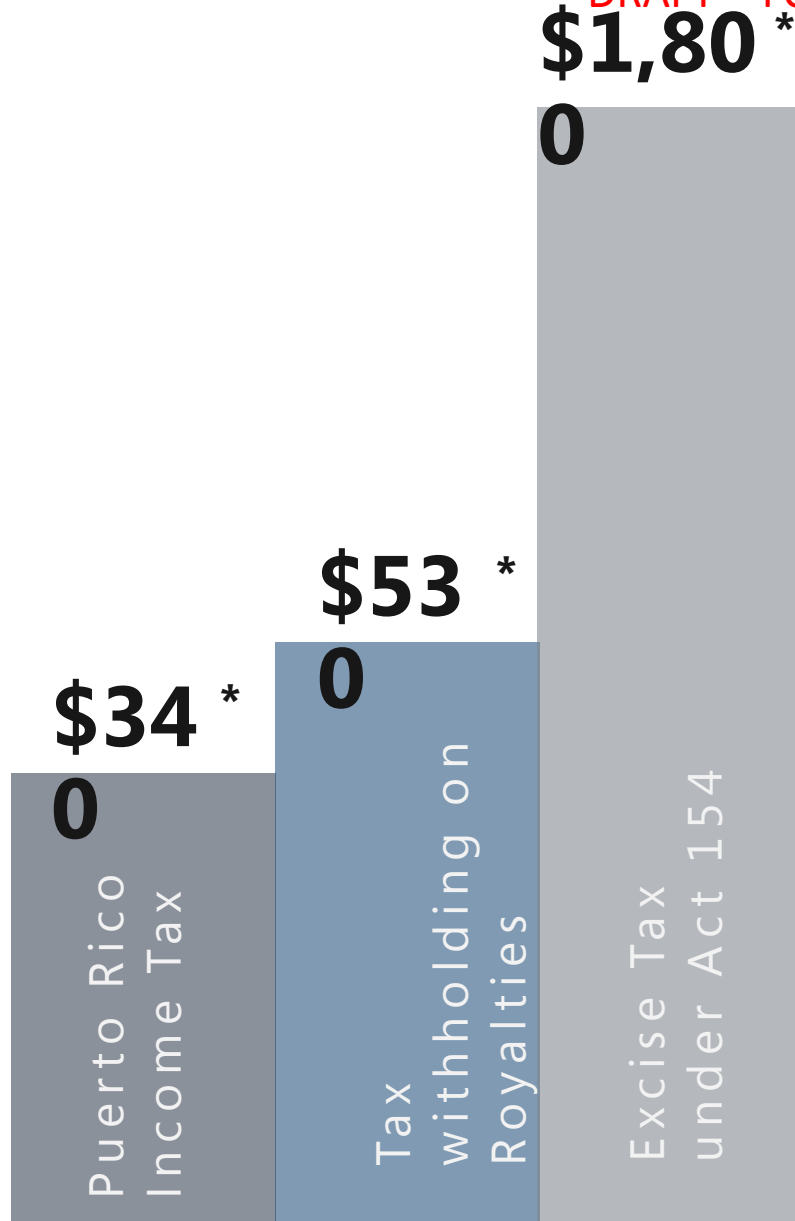


Encourage the increase in manufacturing activity on the island. Propose that this industry be encouraged through federal legislation.

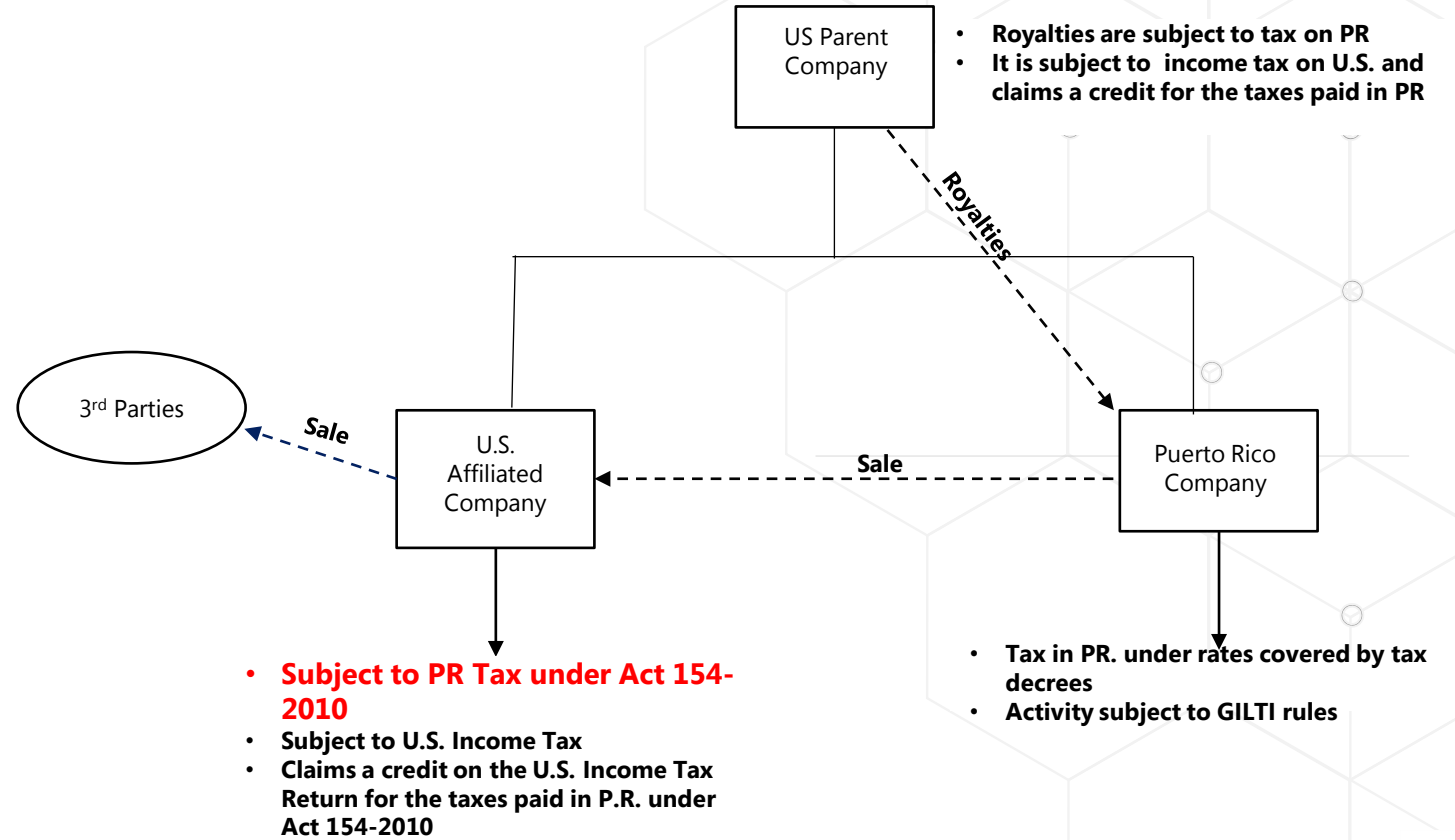
DRAFT – FOR DISCUSSION PURPOSES ONLY

Our Goals

Decipher the appropriate and less costly scenario for the emigration of the excise tax to an income tax regime that is not considered as a **voluntary tax**, and that can coexist with the administrative determinations of the Treasury on Section 901 of the Federal Internal Revenue Code so that these contributions can be credited by taxpayers and avoid the cost of double taxation.



* Amounts in millions



First Step

On behalf of the Government of Puerto Rico, Hacienda will provide the following comments to the United States Government relative to the proposed regulations relating to the Foreign Tax Credit [REG-101657-20].

It is the position of the Government of Puerto Rico that the proposed rules should not apply to the taxes imposed under Act No. 154 of 2010, as amended, both for policy and for technical reasons and we hope that Treasury will agree on both counts.

The Proposed Regulation Should Not Apply as a Policy Matter to US Territories

- The proposed regulations is to address the digital goods taxes that began to proliferate in the OECD and that are now becoming a part of the tax systems of a growing number of nations in which American companies do business.
- Government of PR believes that the vast differences between the relationship between Puerto Rico and the United States and the relationship between foreign sovereign nations and the United States by itself supports the position that the proposed rules should not apply to any US territory.
- The foreign countries that are imposing digital goods taxes on US companies are truly foreign and the taxes they collect go to foreign Treasury departments for use in supporting foreign government programs. The United States does not benefit from the imposition of these taxes and they do nothing to improve the US Government or the lives of Americans.
- By contrast, the Act 154 taxes are imposed by an American territorial government for the purpose of supporting government operations that benefit American citizens. In practical terms, these taxes have the same economic impact as taxes imposed by any US state or local government.
- Application of the proposed language would be to deprive an American territory of close to one fourth of its budget, potentially cause US companies to leave Puerto Rico with a sharp increase in unemployment.

The Proposed Regulation Should Not Apply as a Technical Matter

- The origins of Puerto Rico’s current income tax system can be traced to the Puerto Rico Income Tax Act of 1954, as amended (the “1954 PRITA”). The 1954 PRITA was modeled after the U.S. Internal Revenue Code of 1939. The 1954 PRITA contained rules that substantially mirrored the source of income rules found in the US Code.
- The 1954 PRITA was substituted in 1994 by the Puerto Rico Internal Revenue Code of 1994, as amended (the “1994 PRIRC”). However similar international taxation provisions from the 1954 were maintained.
- Act No. 154, amended the PR ECI Rules to add the so called a “modified source rule” (the “MSR”) which expanded the scope of PR source income by providing that a portion of the gains, profits, and income that the foreign corporation derived from the sale or exchange outside PR of personal property manufactured or produced in whole or in part within PR by the related person was treated as PR source income that was effectively connected with the conduct of a Puerto Rican trade or business. In order to ease the burdens in administrating the MSR, Act No. 154 imposes an excise tax on purchases made by the purchasing foreign corporation from the related sellers in Puerto Rico whose gross receipts exceed \$75,000,000.
- PR income tax imposed under the MSR should continue to qualify as a creditable tax under Sections 901 because the MSR can be viewed as satisfying the jurisdictional nexus requirement described in proposed §1.901-2(c).
- The same reading occurs under Section 903 with respect the Act 154 Excise Tax as it could be viewed as continue to qualify to be creditable under Section 903 because the MSR would meet jurisdictional nexus requirement.

Amendments to the Proposed Regulations

- Puerto Rico’s international rules “are consistent with the rules under section 864(c) for taxing income effectively connected with a US trade or business. In this sense, the MSR should be viewed as an expansion of the Puerto Rico’s ECI rules, as recognized by the IRS in Notice 2011-29, and is designed to allocate income reasonably attributable to business or sources within Puerto Rico.
- For reliance and certainty Hacienda will submit the following underlined amendments to proposed regulation §1.901-2(c)(1)(i) and §1.903-1(e) to confirm the treatment of the income tax imposed by Puerto Rico under the MSR for purposes of Section 901 and the continued reliance of Notice 2011-29 during a transition period for purposes of Section 903:
 1. **§1.901-2(c)(1)(i)** - Income attribution based on activities nexus. The income that is taxable in the foreign country is limited to income that is attributable, under reasonable principles, to the nonresident’s activities within the foreign country (including the nonresident’s functions, assets, and risks located in the foreign country), without taking into account as a significant factor the location of customers, users, or any other similar destination-based criterion. For purposes of the preceding sentence, attribution of income under reasonable principles includes rules similar to those for determining effectively connected income under section 864(c). The attribution of income of a nonresident under the laws of a possession (territory) of the United States will be treated as meeting the requirements of this paragraph (c)(1)(i).
 2. **§1.903-1(e)** - Applicability date. This section applies to foreign taxes paid or accrued in taxable years beginning on or after [the date final regulations are filed with the **Federal Register**]. However, foreign taxes imposed by a possession (territory) of the United States that have been covered by a Notice or announcement issued by the IRS under Section 903 prior to October 1, 2020, shall continue to be covered by the Notice or announcement until the end of the third taxable year beginning on or after [the date final regulations are filed with the **Federal Register**].



Additional Steps

Government of Puerto Rico should continue to work on the evaluation of the changes to our local ordinance so that a renegotiation of the decrees' terms is feasible. Renegotiate the decrees' terms to equalize the collections redistributed in the same industry with the most transparent economic impact. Encourage the increase in manufacturing activity on the island. Propose that this industry be encouraged through federal legislation.

Steps to solve the challenges of Law 154-2010

Will achieve the government's financial stability by protecting and promoting economic activity on the island and the coexistence of current collections with federal regulations on contributions paid abroad.



Obtain clarification of the proposed regulation's language to allow a transition period from the excise tax to an income tax regime by the Federal Treasury.



Evaluate the changes to our local ordinance so that a renegotiation of the decrees' terms is feasible.



Renegotiate the decrees' terms to equalize the collections redistributed in the same industry with the most transparent economic impact.



Encourage the increase in manufacturing activity on the island. Propose that this industry be encouraged through federal legislation.

First Issuance Commonwealth of Puerto Rico's Basic Financial Statements FY 2018

Status Report

Work on the issuance of FY2018 is underway. Issuance efforts are classified in various work-streams, each one with different milestones. Work-streams are:

- Pension liability calculation (GASB 68): Final state of review
- GASB 75 review is underway.
- Entities that issue FS: an oversight plan has been developed to monitor their progress towards issuance.
- Audit Support: PBC items were provided to KPMG

Summary – FY 2018 Audit Process – Expected Issuance April 2021

Pension Liability Calculation

- GASB 68/75 report is expected to be issued by KPMG during the next couple of weeks
- An analysis of the materiality of the Pension Liability for each entity that issues FS was performed. Based on the analysis, a group of entities could issue its FS without the GASB 68 adjustment and it will not have an adverse impact on the CWPR FS issuance. This strategy was pursued to accelerate the FS issuance of many entities and avoid unnecessary delays in the CWPR issuance process.
- A draft of the actuarial report was provided. The most significant changes expected to the draft are on the following entities:
 - Hacienda
 - Senate
 - Controller
 - GDB
- For the other entities that are considered material, the journal entries will be prepared with the draft report and will later be compared to the final report to ascertain it remained unchanged.

Entities that issues AFS

- A Work Plan Questionnaire was requested and based on the dates provided we monitor the entity and the auditor's compliance with such dates.
- Weekly or Biweekly communication are being established based on risk of non-compliance.
- The entities issuances status is as follows:
 - Issued Final – 28
 - Pending - 47
 - Pending re-issuance – 5
 - Audit work completed – 11
 - Pending GASB 68 – 4
 - Pending Audit Work – 26
 - Pending Prior Year Issuance – 1

<u>Issued-pending reissuance:</u>	<u>Pending audit work:</u>
1 AACA	1 ADEA
2 911 Service Board	2 Cardiovascular Center
3 PRHIA	3 APP
4 WPR	4 DDEC
5 COSSEC	5 ERA
	6 Farm Insurance Corp
<u>Audit work completed (pending FS Draft):</u>	7 GDB
1 EDB	8 OMEP
2 Fine Arts	9 Ponce Authority
3 Institute of PR Culture	10 Ponce Ports
4 Land Authority	11 PBA
5 Comptroller's Office	12 Maritime Transport Authority
6 Electronic Lottery	13 Council on Education
7 FAFAA	14 PREPA
8 Land Administration	15 PRIDCO
9 Maritime Shipping Adm	16 PRIFA
10 Culebra Conservation	17 PRITA
11 Solid Waste	18 Safe Drinking Water
12 Senate	19 PR Tourism
	20 Trade & Export
<u>Audit work substantially completed (pending GASB 68):</u>	21 Water Pollution
1 PRASA	22 Special Communities
2 ASEM	23 State Ins. Fund Corporation
3 AMA	24 Sup Capitol Bldg
4 PR Ports	25 TRS
	26 Comprehensive Cancer Center
	<u>Pending prior year issuances (2015-2017):</u>
	1 JRS

Audit Support

- Audit Support is divided into two components the transactional component in which management performs account and transactions analyses and the financial reporting component in which management ascertains transactions are properly reported and prepares the Basic Financial Statements document Every requested item's status maintained in the PBC list provided by the external auditors On a weekly basis, management meets with the external auditors to discuss the PBC List status and to agree revise all delivery dates
- Critical audit areas such as Audit Procedures at the Police Department and the Legal Reserve Analysis have already commenced Weekly calls and onsite visits are scheduled to monitor progress on these areas and to timely intervene if needed to comply with established deadlines For both areas a Work Plan was developed These work plans were discussed with Police and DOJ management as well as KPMG

Treasury Update

Summary of Most Important Treasury Aspects

“In order to carry out the transformation of the governmental apparatus, it is essential to invest in our governance. The same consists of three elements: people, processes and technology.”

Francisco Parés Alicea

Fiscal Management Oversight Board's Public Hearing held on July 1st, 2020

Concept	11/12/20
TSA	\$9,131,209,086.34
Pending Suppliers Payments	\$7,475,358.99
Refund Payments	Amounts already issued
Accounts Centralization	In progress
EBT	In progress

Our Goals

The primary goal for the Government of Puerto Rico must focus on achieving the strongest and most consistent economic growth in order to alleviate poverty, stimulate development and achieve other goals to mixed success. Therefore, Hacienda's primary goal is to support the economic development through other certain operational goals.

Our Goals

Hacienda's main goal is to support the economic development through other certain operational goals.

Implementation Goals

1. Implement Fiscal Policies

Timely taxpayer guidance, instructions, and tax forms; Improved compliance and service efforts through a centralized and modernized governmental operation.



2. Transform Government-wide Financial Stewardship

Provide all State agencies with access to a greater range of financial data to increase transparency and support data driven decision making; Attain reduced reporting costs, and more measurable returns on investments.



3. Transform Overall Outreach

Enhance the scope of the outreach and education to increase the confidence of the people on the services performed by Hacienda.



4. Achieve Operational Excellence

Foster a culture of innovation through hiring, engaging and optimizing a diverse workforce with the competencies to accomplish our mission.



Supporting Goals

SWOT Analysis

“SWOT is cool, but strategic thinkers know that there is a point which:

- **Strengths become weaknesses**
- **Weakness become strengths**
- **Opportunities become threats**
- **Threats become opportunities**

Strategic entrepreneurs and leader find the insights hiding behind SWOT.

Richie Norton

Strengths and weaknesses are internal to the company. They can be changed over time but not without some work. Opportunities and threats are external (think: suppliers, competitors, prices)—they are out there in the environment, they are happening whether we like it or not.

Structural Capability

- Exceptional Technological infrastructure
- Social Media
- Technical Knowledge
- Good business relations with private Sector



Lack of optimal resources

- Lack of execution time
- Low headcount
- Lack of training for full digitalized services (in certain instances)
- Other agencies without the technological resources depends from Hacienda
- Exponential increase of headcount's absence level
- Untrained personnel

Context and Digitalization

- COVID-19 provides certain flexibility towards situational management
- Focus strictly on operational management
- Digitalization of almost all services
- Become a leader in services performed through technology
- Legislation pieces that improve or enhance Hacienda's operations

External Factors

- Most vulnerable people might not enjoy the digitalized services
- Constant operational interruptions due to COVID-19
- Taxpayers lack of access to technological equipment
- Lack of control over the preparation of the operational budget
- Legislation pieces that adversely affects Hacienda's operations