Commonwealth of Puerto Rico
Tax Reform Project

Risk Register

November 24, 2014

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1 About this Report

The risk register document describes the potential barriers to success that the Commonwealth of Puerto Rico (Commonwealth) may encounter during the tax reform transformation.

A risk can be defined as a potentially negative event to which the probability of occurrence and impact are deemed to be sufficiently high that warrants advanced planning.

The risk register refers to activities that the Commonwealth may take to mitigate the potential impact of risks by taking actions that may reduce the likelihood and/or severity of the risk occurrence. Risk Management is the process to proactively identify, assess, monitor and control potential risks to the project or organization before the risk occurs.

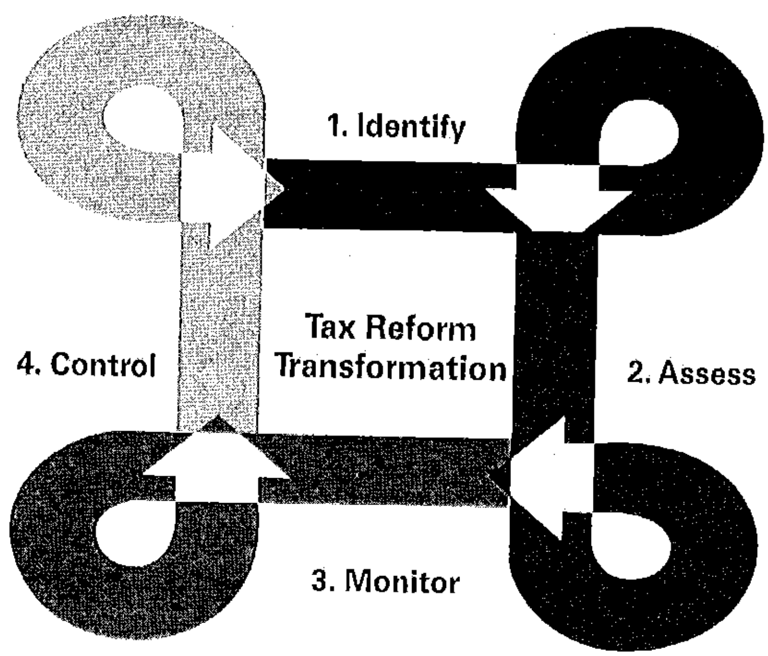
The objective of the risk register is to identify potential events before they occur, initiate an action plan to mitigate such risk, and reduce the impact of unplanned incidents on the tax transformation project(s).

2 Risk Management Process

The risk management process includes the four key steps: Identify, Assess, Monitor, and Control includes steps that define the process:

- The first step, ***risk identification***, includes recognizing present risks and continuous risk identification.
- The second step, ***risk assessment***, includes identifying risk groups, analyzing risk impacts and developing mitigation strategies.
- The third step, ***risk monitoring***, includes reviewing risk status and mitigation plan progress.
- The fourth step, ***risk control***, includes implementing mitigating solutions and strategies, or eliminating the risk altogether.

Figure 1. Continuous Risk Management Process



3 Potential Transformation Risks

Section 3 describes the key risks that the Commonwealth may encounter through the tax transformation projects. The potential risks that could impact the Tax Reform Project for Puerto Rico have been grouped into the following categories:

1. General Risks

- Local Municipality Support
- Competitive Tax Reforms Abroad
- Current Economic Instability
- Concerns Related to Public Corporations
- Population Loss

2. Tools and Technology

- Lack of Business Continuity Plan

3. Change Management

- Organizational Risk
- Lack of Communication to Internal Workforce
- Lack of Organizational Acceptance

4. Policy and Legislation

- Ad Hoc Legislative Changes
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5. Taxpayer Outreach

- Public Rejection of New Customer Service Tools
- Lack of Communication to External Stakeholders
- Taxpayer Education

6. General Administration

- Security Breach
- Ineffective Labor Force
- Continued Culture of Tax Evasion
- Inconsistent Enforcement Efforts
- Non-Adoption of a Semi-Autonomous Revenue Agency (SARA)

7. Project Implementation

- Over-reliance on Third Party Vendors
- Cost overruns/Budget Constraints

General Risks

1. Local Municipality Support

The Treasury Department should be mindful of the responsibilities granted to local municipalities in the tax administration process. For example, 18 of Puerto Rico's municipalities have entered into a collection agreement with the Treasury for reporting sales and use tax information for sales executed in their jurisdictions. The other 60 municipalities enjoy a degree of autonomy in collecting the sales and use tax of which 1.5% belongs to the municipality. Additionally, the Treasury allows merchants to report both the central sales and use tax and the municipal sales and use tax on the same return. Filing multiple returns across municipal lines in an effort to create uniformity across all 78 municipalities may result in administrative inefficiencies if not carefully implemented. The Treasury risks facing opposition if they ask local municipalities to take a more active role in the tax monitoring and collecting process. Implementation of uniformity measures may face additional challenges if the Treasury asks local municipalities to shoulder the additional costs related to uniform tax administration, especially if it occurs at a time when the Central Government is cutting financial support or services to the municipalities. The Treasury can mitigate this risk by centralizing tax collection efforts and establishing a revenue sharing mechanism that provides timely reimbursement of funds owed to municipalities. The Treasury will be confronted with taxpayer confusion and continued municipal administration inconsistencies if this risk is left unaddressed during implementation.

2. Competitive Tax Reforms Abroad

Puerto Rico's tax structure is less competitive in attracting global investment when compared to its peers. One objective of tax reform is to create economic development opportunities for the island by crafting a business-friendly tax environment. One risk to Puerto Rico's success in becoming a destination for foreign investment is the flexibility that other countries have in adjusting their already competitive tax structures. Currently, it can be argued that the global marketplace is fostering a worldwide "race to the bottom" in trying to attract jobs and companies from outside their borders. Countries are continuing to cut corporate taxes and are awarding other tax incentives to attract businesses. Puerto Rico's business climate is generally viewed as less competitive than countries like Singapore and Ireland. These countries can continue making adjustments to their tax systems to counter moves made by competing governments, forcing Puerto Rico to reconsider the reforms it is currently attempting to implement. The Commonwealth can mitigate this risk by installing a tax administration that is flexible to change and responsive to emerging global economic trends.

3. Current Economic Instability

Instability related to growing public debt has led to bond rating downgrades that threaten the vitality of the Puerto Rican economy. Sustained uncertainty in the market will continue to cause anxiety among investors and further damage Puerto Rico's reputation as a sound destination for investment. Additionally, as public debt grows, future borrowing capacity diminishes and interest rates increase. Higher financings costs and lack of borrowing capacity may cause delays in Tax Reform implementation because less public money will be available for the required investments/upgrades needed to realize the benefits of the Tax Reform options. The market risk can be mitigated by reestablishing confidence in the Puerto Rican economy. The leadership must show that the Commonwealth is willing to make the hard, but necessary decisions to put the Island's economy back on the right track to long term economic stability, even if it means exposing the elected leadership to political risk in the short term. Addressing investor confidence is critical because changes in the tax system are only one piece of making Puerto Rico competitive in the global marketplace. If issues surrounding public debt remain, then the Treasury will continue to operate in a sub-optimal business environment when implementing Tax Reform options. Poor economic conditions threaten the success of Tax Reform as a whole.

4. Concerns Related to Public Corporations

Continued inefficiencies in the fiscal condition and performance of Puerto Rico's public sector corporations – especially the Puerto Rico Electric Power Authority (Prepa), may offset the gains made in improving Puerto Rico's business climate through Tax Reform. Generally, companies heavily research the cost of doing business in various jurisdictions before making investment or expansion decisions. Unpredictable and rising energy costs make the cost of doing business in Puerto Rico more difficult, especially when considering that frequent strikes jeopardize uninterrupted service to the business community. The government can improve the business climate by finding alternative energy sources for energy production, raising rates to match the actual cost of energy production, or overhauling the organization's service delivery structure to gain efficiencies. If left unmitigated, Prepa may threaten one of the Treasury's main goals of Tax Reform: making Puerto Rico a competitive place to do business. Additionally, Prepa will continue to draw away critical general fund resources that could be used for investments in Treasury reformation or improvements.

5. Population Loss

The Island's population is projected to fall by 0.65 percent in 2014 – one of the steepest projected population declines among jurisdictions around the globe. Continued immigration of Puerto Ricans to the mainland results in a shrinking tax base and, consequently, tax revenues. The economic situation is the reason most cited by those departing the Island for the mainland. Additionally, those Puerto Ricans who leave may have the education, training and skills to fill new positions within the Treasury Department. Population loss threatens Tax Reform because as residents leave, the Commonwealth loses valuable revenue needed to improve the economic conditions in Puerto Rico by paying down public debt, improving infrastructure and investing in Treasury Department technology upgrades. The government can mitigate the migration by improving the economy and quality of life efforts, such as the education system, crime and public health. If left unmitigated, population loss can permanently damage the tax base and the availability of human capital needed to drive the economy of the future.

Tools and Technology

1. Lack of Business Continuity Plan

The Treasury Department has not established a Business Continuity Plan for Department operations in the event a natural or manmade disaster renders vital infrastructure inoperable. The lack of a clearly articulated and well-planned business continuity plan threatens the Department's day-to-day ability to collect revenue and administer taxes in an efficient manner. This risk may be mitigated through the design of a well-coordinated Business Continuity Plan that considers disaster recovery, data center damage, and expanding communications lines to create system-wide redundancy should the system face outages. If left unmitigated, the Department will continue to subject itself the risk of Department-wide failure on a daily basis.

Change Management

1. Organizational Risk

The Commonwealth and its leaders bear the burden of the consequences if Tax Reform is unsuccessful. Successful tax reform includes a seamless transition to new technologies, a better trained workforce to execute tax reforms and a cultural change focused on efficiency and customer service within the Treasury Department. The Governor and other elected leaders may face political backlash for poor implementation. Leadership changes have previously derailed tax reform initiatives and a poor rollout of present day tax reform may meet the same fate. Organizational risk can be mitigated by proactive efforts by the Governor and Treasury to get buy-in from the public during the Tax Reform planning stage.

2. Lack of Communication to Internal Workforce

Tax Reform's long term success is largely dependent upon receiving the support of internal stakeholders such as Treasury staff. Treasury Department officials are integral to Tax Reform's success because they are charged with the day-to-day responsibility of tax administration. Without early support from Treasury employees, the ability to affect long term organizational change becomes more difficult. Communication related risks can be mitigated by establishing open lines of communication between rank and file employees and management. Managers should show a willingness to inform their employees of the latest developments regarding the Tax Reform options and be open to receiving the feedback their employees provide. If no coordinated communication strategy is put in place, the Government risks undermining Tax Reform design and implementation.

3. Lack of Organizational Acceptance

A lack of organizational acceptance of the Tax Reform options once implementation begins puts the entire project at risk. All departments throughout the Treasury must make a concerted effort to execute the Secretary's vision for Tax Reform. Efficient tax administration and collection requires the interdependencies of numerous Treasury functions whether it be managerial, technological or clerical. The Department risks enduring a similar fate to previous tax reform proposals if it does not have the overall organizational capacity to effect and sustain change. Failure may result in political vulnerability, continued poor economic performance, quality of life issues for citizens related to limited tax receipts for government services, and an inefficient Treasury Department. The risk of failed organizational acceptance can be mitigated during the pre-implementation stage by personalizing the Tax Reform rather that broadcasting sweeping reforms using a top-down approach. Treasury can continue to foster employee participation in an effort to share implementation ownership across all levels of the organizational structure.

Policy and Legislation

1. Ad Hoc Legislative Changes

Ad hoc legislative changes, such as the Recovery Act, can damage the market's confidence in Puerto Rico's ability to emerge from the current recession. A coordinated, bipartisan legislative agenda between the Governor's Office and the Legislative Assembly assures the market that everyone is working towards long term solutions rather than short term fixes. Market confidence has a direct impact on Puerto Rico's future competitiveness and economic success. The Governor can mitigate the risk of ad hoc legislative changes that deviate from his plans for economic recovery by using his executive powers to veto misguided legislation or by proactively identifying a legislative agenda and making incremental advances to implement it. Additionally, the Governor should institute the changes by executive authority where Constitutional. If left unmitigated, the risk of ad hoc legislative changes imperils the tax design and tax implementation options of Tax Reform. Legislative changes may overturn options meant to put Puerto Rico back onto a path of economic stability or lead to expensive litigation.

2. Impact of Policy Decisions

Decisions by elected officials and high-level policymakers can have wide-ranging effects on revenue projections and the market as a whole. Puerto Rico is currently exploring options to simplify the tax system, make it more equitable and provide an environment that is business friendly in an effort to attract job opportunities for its citizens. Tax Reform options provided by KPMG are dependent upon the current legislative environment and an understanding that the Commonwealth is committed to maintaining a long-term outlook on economic recovery after policy options are provided. Decisions that jeopardize potential revenues such as enacting new laws, agreeing to new tax exemptions or agreements with corporate interest groups may have a negative impact on Tax Reform efforts. The leadership can mitigate the risks associated with short-term policy changes by establishing a clear list of tax priorities and being resistant to lobbying efforts from interest groups.

Taxpayer Outreach

1. Public Rejection of New Customer Service Tools

The Tax Reform initiative attempts to create a tax system that is efficient and fair. Analysis has shown that the Treasury can benefit from using technology to permit taxpayers to file tax returns online – avoiding manual filling of tax returns altogether. It allows the Treasury to capture tax information in a clear, uniform and timely manner. The Treasury runs the risk of expending critical resources by developing systems that give citizens the opportunity to utilize technology when interacting with the Department without being able to guarantee that online tools will be accepted by the public. Additionally, computer access may be limited in certain areas of the island. The Department may mitigate this risk by launching a public campaign educating Puerto Ricans of the ease associated with filing tax returns online. Additionally, the Government can make online filing mandatory without offering the public the option to file manually. The Treasury may explore alternate access points to online filing, especially around filing deadlines, such as mobile tax filing operations, offering computer access at other public buildings, or automatic tax filing based on government calculations for each taxpayer. If this risk is not addressed, the Treasury faces the possibility of a lower tax filing compliance rate and lower revenues during the implementation stage.

2. Lack of Public Relations Plan for External Stakeholders

Tax Reform's long term success is largely dependent upon receiving the support of external stakeholders such as taxpayers, the business community and media. Strong, consistent messaging from Puerto Rico's leadership regarding the benefits of the proposed Tax Reform options and the potential consequences of continuing business as usual will show all stakeholders that emerging from the current economic recession requires making shared sacrifices. Offering transparency, especially in tax reporting and monitoring, will build the confidence that the public sector is willing to make the difficult decisions necessary to improve the quality of life and provide the level of services that all citizens deserve. Finally, government officials must maintain consistent messaging to media outlets to ensure that accurate information is being reported to citizens and the market alike. Contradictions or perceived discord among public officials will only undermine Tax Reform efforts and fragment the support required to assist Puerto Rico in emerging from its recession. Communication related risks can be mitigated by establishing a strong working relationship with members of the media and developing a designated avenue in which the government can control the message related to Tax Reform. Examples include a Tax Reform website or community outreach events like town halls, etc. The public relations campaign must be educational to all stakeholders, even if it requires expending valuable government monetary resources. Additionally, ongoing dialogue between the business community and government will help develop a true public-private partnership that conveys a common message that all sectors are working together to improve the economic environment in Puerto Rico. If no coordinated communication strategy is put in place, the Government risks decreasing the chances of Tax Reform's success.

3. Taxpayer Education

Inaccurate perceptions of Tax Reform's motives and goals will produce social and political risks if not properly explained to taxpayers. Political rivals and interest groups may be quick to point out the regressivity of new taxes while failing to mention the benefits of Tax Reform, including eliminating the tax burden of low income residents altogether or providing additional social services to those in need. To mitigate the risk, the Government should utilize the public relations campaign mentioned above to explain the benefits that Tax Reform will have on low-income Puerto Ricans and the steps being taken to protect their interests.

General Administration

1. Security Breach

As the Department makes more technological advances, they must remain vigilant of the risk of being a target for hackers or outside users trying to obtain the personal and confidential information of taxpayers. Installing proper security mechanisms directly affects issues related to the public perception of the tax collection process. Repercussions of failed security measures will reflect poorly on the Department, its leadership, the elected officials who are responsible for the Department and the overall success of Tax Reform. This risk can be avoided by instituting security measures that mirror those used by their Treasury counterparts around the world. If left unaddressed, security breaches may occur during Tax Reform implementation.

2. Ineffective Labor Force

Unfortunately the recession of the last 8 years has left the Commonwealth of Puerto Rico with an aging and weak labor market (low labor force and high unemployment rates). Young workers are having difficulty finding job opportunities and lack the real world experience to build their professional skillsets. As a result, the pool of young, motivated, and educated workers may be limited when trying to fill skilled positions or finding new employees with relevant experience. Tax Reform is dependent upon having the people required to execute the options offered to make Puerto Rico competitive in the global marketplace and to modernize the Treasury's tax administration practices. The Treasury may mitigate the talent risk by offering competitive compensation packages to Puerto Ricans employed in the private sector in an effort to bolster the overall talent composition of their workforce. Additionally, the Treasury can launch extensive training of current employees to maximize the ability of the existing workforce. The Treasury should beginning exploring partnerships with institutions of higher learning in an effort create career paths within the Treasury for new college graduates beginning with summer internships and potentially resulting in fulltime employment. An example of the higher education-government partnership can be found in the "Agenda for an Economic Recovery" where plans call for students who have received financial aid to be required to do two years in the public sector after graduation. Tax Reform will face significant implementation obstacles if personnel is not upgraded or properly trained.

3. Continued Culture of Tax Evasion

Tax evasion related to Puerto Rico's large underground economy can be partially attributed to tax law complexity and difficulty in sanctioning tax evaders. Estimates of the underground economy hover around 23% of GNP according to the Brookings Institution and Center for a New Economy. Continued tax evasion negatively impacts the

Commonwealth's tax receipts and remains a threat to Tax Reform. The Treasury Department faces the risk that citizens, especially merchants, will continue to skirt tax laws even under a simplified tax regime. In order to mitigate the risk of tax evasion, the Commonwealth must devise stringent tracking mechanisms for sales of goods and services, centralize tax return administration, and develop stronger penal deterrents for convicted tax evaders. The Treasury may not be able to fully recognize the benefits of tax reform after implementing KPMG's options if it does not make strides in preventing future tax evasion.

4. **Inconsistent Enforcement Efforts**

Currently, the Treasury currently collects approximately 60% of the tax revenues that it is owed. Part of Tax Reform includes putting into place aggressive policies to crack down on tax evaders, including publishing the names of those who fail to pay their taxes, assessing tax penalties and even imprisonment. These efforts, and others like them, must be enforced regularly and consistently in order for the Treasury to realize the full benefits of Tax Reform. The Treasury can mitigate the risk of inconsistent enforcement by allowing the IRA to operate as a separate entity within the Treasury where it is free to establish its own enforcement framework and policies. The Treasury will continue to face a culture of tax evasion if it does not enforce its tax laws.

5. **Non-Adoption of a Semi-Autonomous Revenue Agency (SARA)**

Due to the Treasury Department's oversight, the Internal Revenue Area (IRA) lacks the autonomy to create its own budget, foster a high performance culture, and escape the natural political influence of the Treasury. The organizational dependency deprives the Commonwealth of a dedicated agency committed solely to independent tax administration and collection like its peers around the globe. Generally, the public views the current IRA as an inefficient organization that acts out of political expedience. The Department jeopardizes the public's faith in Tax Reform if it fails to implement a SARA because it signals to the public that the Treasury is adhering to "business as usual." The Treasury can mitigate this risk by creating a SARA with the primary mission of increasing collections, enforcing non-compliance, and influencing taxpayer behavior and perception of how taxes are managed. Deploying a SARA may improve operational efficiency, stabilize and professionalize the IRA staff, ensure better resource management and provide transparency and integrity regarding tax administration. The Treasury may continue to face tax evasion and low tax compliance rates if it does not establish a non-political, independent tax administration agency.

Project Implementation

1. Over-reliance on Third Party Vendors

Generally, the Department relies extensively on third party vendors and independent contractors to perform various important IT functions, including implementing required system-wide updates that are a result of policy changes. A lack of in-house expertise may cause delays in overall Tax Reform implementation and a number of other activities because outside staff may not be available to tend to Department technology issues in a timely manner. The over-reliance on third parties has a significant impact on the Tax Reform options. This risk may be mitigated through aggressive training sessions of Department personnel and hiring skilled/qualified employees to close the Department's talent gap as compared to its third party vendors. If left unmitigated, this risk may manifest during the technology implementation process when system-wide improvements are required.

2. Cost Overruns/Budget Constraints

The current state of Treasury operations requires significant investments in technology and workforce development in order to realize a more efficient Treasury Department. The Commonwealth's financial condition leaves limited resources for Tax Reform expenditures. Generally, large scale organizational transformation is inherently high risk and the potential for failure grows when dealing with a weak labor force. If implementation faces initial delays resulting in added costs not originally budgeted, then the Treasury will face the difficult, and potentially unpopular decision, of either expending more money to fulfill promised reforms or delaying aspects of Tax Reform. Treasury may mitigate these risks by building a budget that leaves room for contingency planning and by setting out clear, incremental performance goals for project implementation. Tax Reform risks overall failure if the implementation budget is not properly planned and financial contingencies are not taken into account.

Appendix A: Summary of Risk Assessment Plan

	RISK GROUP	RISK	ANALYSIS & IMPACT OF RISK
1	General	*Local Municipality Support*	Local municipalities may reject Tax Reforms favored by State Government that place onerous tax collection responsibilities on local governments.
2	General	*Competitive Tax Reforms Abroad*	Tax structure and business climate in Puerto Rico is generally viewed as less competitive than its peers in the global marketplace. Other jurisdictions remain flexible and adjust to the changing economic landscape in order to attract investment and remain competitive. Lack of change in tax administration and unresponsiveness to emerging economic trends may further diminish Puerto Rico's competitiveness in attracting investment.
3	General	*Current Economic Instability*	Uncertainty and instability in the market will discourage investors to invest in Puerto Rico. The capacity for future borrowing greatly diminishes and increases financing costs as public debt grows.
4	General	*Concerns Related to Public Corporations*	Unpredictable public entity performance impacts the decision making process for companies considering doing business in Puerto Rico. Left unmitigated, public corporations like Prepa will continue to draw away critical general fund resources that could be used for Tax Reform implementation.
5	General	*Population Loss*	Economic instability is increasing immigration to mainland which in turn results in a shrinking tax base and revenues.
6	Tools and Technology	*Lack of Business Continuity Plan*	Lack of a Business Continuity Plan threatens the Treasury Department's day-to-day operations in the event a natural or manmade disaster renders vital infrastructure inoperable.
7	Change Management	*Organizational Risk*	Lack of pre-implementation support and buy in for Tax Reform from stakeholder groups may derail tax reform initiatives.
8	Change Management	*Lack of Communication to Internal Workforce*	Lack of communication to Treasury employees and stakeholder groups on the benefits of Tax Reform and the leadership's vision for an improved Treasury department can result in a disconnected and unsupportive workforce.
9	Change Management	*Lack of Organizational Acceptance*	Capacity and acceptance to change in the organization is imperative for successful Tax Reform. Lack of organizational acceptence may result in political vulnerability and operational inefficiencies.
10	Policy and Legislation	*Ad Hoc Legislative Changes*	Ad hoc legislative changes that do not account for the potential impact that new laws will have on market confidence pose a serious risk to Tax Reform efforts and Puerto Rico's competitiveness.
11	Policy and Legislation	*Impact of Policy Decisions*	The Commonwealth must implement operational efficiency measures and close interest group tax loopholes to ensure that the revenue streams provided through Tax Reform adequately fund necessary government operations.

	RISK GROUP	RISK	ANALYSIS & IMPACT OF RISK
12	Taxpayer Outreach	*Public Rejection of New Customer Service Tools*	Much of Tax Reform is dependent upon the public's willingness to utilize the new, electronic means of interacting with the Treasury and filing tax returns. Operational efficiencies will be slow to produce results if taxpayers do not buy into the benefit of using technology to improve customer service.
13	Taxpayer Outreach	*Lack of Communication to External Stakeholders*	The citizens, business community and media all play an important role in realizing the benefits of Tax Reform. Strong, consistent messaging from leadership is critical to garnering public buy-in to the benefits of Tax Reform.
14	Taxpayer Outreach	*Taxpayer Education*	Inaccurate perceptions of Tax Reform's motives and goals will produce social and political risks if not properly explained to taxpayers. Political rivals and interest groups may be quick to point out the regressivity of new taxes while failing to mention the benefits of Tax Reform, including eliminating the tax burden of low income residents or providing additional social services to those in need.
15	General Administration	*Security Breach*	Adding new technological capacity to the Treasury's operations may make the Department a target for hackers and other bad actors. There is a risk that personal and confidential information may be obtained if the proper safeguards are not put into place.
16	General Administration	*Ineffective Labor Force*	The recommendations for organizational reforms are predicated upon the ability for the Treasury to hire new, qualified employees or train existing staff to meet the demands of an improved Treasury Department. There is a risk that the proper employee technical or managerial skills will not materialize as Tax Reform is implemented.
17	General Administration	*Continued Culture of Tax Evasion*	Tax evasion can be partly contributed to the complex tax system and lack of taxpayer tracking mechanisms in place in Puerto Rico. There is a risk that taxpayers will not be persuaded to pay taxes if the system is too complex to promote compliance or if there is no threat of enforcement.
18	General Administration	*Inconsistent Enforcement Efforts*	There is a risk that the Treasury Department will not receive the additional revenue anticipated as part of Tax Reform if they do not improve the 60% tax collection rate.
19	General Administration	*Non-Adoption of SARA*	Lack of a functioning Semi-Autonomous Revenue Agency may prevent efficiencies in taxpayer services, hinder collection efforts, damage public confidence in the Treasury, and increase levels of corruption and tax evasion under a new tax regime.
20	Project Implementation	*Over-reliance on Third Party Vendors*	Another major potential risk to Treasury operations is the extensive dependency upon third party vendors and independent contractors to perform important IT functions.
21	Project Implementation	*Cost Overruns/Budget Constraints*	A major risk includes the inability to make the Treasury software upgrades required to realize the Tax Reform's operational improvements due to lack of funding.