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[Puerto Rico Sales-Tax Switch Leaves Muni Buyers in Dark.]

Investors holding Puerto Rico's $15 billion of sales-tax bonds, the struggling island's main financing tool since 2006, are being left in the dark as officials work to expand the levy.

Officials are looking to swap a 7 percent sales tax for a value-added levy at each phase of a product's distribution, part of a strategy to cut personal and corporate-income taxes, the commonwealth's Government Development Bank said on an Oct. 30 investor call. The changes are intended to boost revenue and an economy that's struggled to grow for almost nine years.

Although the bonds account for 20 percent of the island's debt, lawmakers haven't filed a bill outlining potential changes, and the GDB hasn't released the rate for the new levy or an estimate of how much revenue it would generate. Investors want more details before buying or selling, said Robert Amodeo, who helps oversee $30 billion at Western Asset Management Co.

"There's not a lot of selling pressure, but there's really no one stepping up to buy it either," said Amodeo, head of munis in New York. "There's just not enough information in the market to take a strong position."

Cofina Reliance

Slowing issuance across the $3.7 trillion municipal market is also making bondholders reluctant to reduce holdings. Puerto Rico has relied on the sales-tax bonds, known by the Spanish acronym Cofina, since lawmakers implemented the levy in 2006. The debt's credit ratings are higher than the island's general-obligation grade.

Borrowings from Puerto Rico, which are tax-exempt nationwide, have traded at distressed levels for more than a year on concern that the commonwealth and its agencies won't be able to repay $73 billion of debt.

An index tracking the economy has shrunk by about 19 percent since July 2005, according to the GDB. Standard & Poor's said in a release today that it may lower Puerto Rico's rating again in the coming year if a weakening economy causes a "significant" budget deficit.

The territory's securities have lured hedge funds seeking junk yields, helping Puerto Rico beat the bonds of all but one U.S. state. Securities from the commonwealth have gained about 12 this year, beating the broader market's 8 percent advance, according to Barclays Plc data. Only South Dakota's 14 percent return is better among states.

Junk Drop

Ratings companies dropped Puerto Rico to speculative grade in February. After lawmakers passed legislation in June that would allow certain public agencies — excluding Cofina debt — to ask bondholders to take a loss, Moody's Investors Service and Fitch Ratings also cut the sales-tax bonds to junk.

Moody’s and Fitch rate senior Cofina debt three steps below investment grade. S&P ranks the credit two steps above junk.

The commonwealth is allowed to replace the tax receipts securing the bonds with a different revenue stream, according to bond documents. Yet it’s rare in the municipal market for obligors to switch the pledge behind so much debt, said Bob Donahue, managing director at Concord, Massachusetts-based research firm Municipal Market Advisors.

“I can’t think of too many bonds — especially ones with $15 billion outstanding — that have gone through such a massive restructuring of the security pledge,” he said.

No Hiding

Any changes to the tax would protect the Cofina revenue and pledge, Melba Acosta, GDB’s president, said on the Oct. 30 call. Puerto Rico expects to collect $1.4 billion of sales-tax receipts in the year through June 2015. The first $670 million goes toward debt service, with the remainder flowing to the general fund.

Receipts would probably increase with a value-added tax, based on modeling by KPMG LLP, because the levy would be imposed at each stage of production and distribution, Acosta said in an e-mail.

The new approach “is expected to generate significantly more revenue than is currently generated by the current sales and use tax,” Acosta said in the e-mail.

Investors agree. A value-added tax on distributors and suppliers should boost revenue by reducing evasion, Amodeo and Donahue said.

“You’re not hitting Mom and Pop at the end of the chain,” Donahue said. “You’re hitting the companies and they can only hide so much.”

Broader Base

Retailers that don’t impose the sales tax or fail to report receipts reduce the government’s revenue. The tax’s collection rate has historically been about 60 percent, according to Moody’s. Puerto Rico last year budgeted a capture rate of 88 percent on highly regulated companies and 68 percent for other businesses, S&P said in an October 2013 report.

“If it broadens the goods and services that are subject to the tax that pays the bonds, that should be a positive,” said Bill Black, who manages Invesco Ltd.’s $7.3 billion High Yield Municipal Fund in Oakbrook Terrace, Illinois.

That optimism has yet to filter through to trading.

The most actively traded Cofinas in the past week, securities maturing in August 2046, changed hands today at an average price of about 80 cents on the dollar, to yield about 6.5 percent, or 3.5 percentage points above benchmark munis, data compiled by Bloomberg show. The price is below the 2014 peak of 87.3 cents on May 23.

Without knowing the new tax rate and estimated receipts, it’s difficult for investors to decide on the bonds, Black said.

“It does certainly make us cautious about either adding or reducing our position,” Black said. “We just don’t have enough information.”

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