AN OVERVIEW OF THE SPECIAL TAX RULES RELATED TO PUERTO RICO AND AN ANALYSIS OF THE TAX AND ECONOMIC POLICY IMPLICATIONS OF RECENT LEGISLATIVE OPTIONS

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of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet[1], prepared by the staff of the Joint Committee on Taxation, provides an overview of the special tax rules related to Puerto Rico and an analysis of the tax and economic policy implications of recent legislative options. This pamphlet was prepared at the request of Senate Finance Chairman Charles Grassley and Ranking Member Max Baucus. A copy of their request can be found in the Appendix of this pamphlet.

Part I of the document provides an executive summary of the pamphlet. Part II discusses the present law tax provisions related to Puerto Rico and other U.S. possessions. Part III covers the mechanics of the possession tax credit. Part IV traces the legislative history of the possession tax credit and summarizes the findings included in several government reports released over the last 20 years. Part V contains an economic analysis of U.S. Federal tax policy issues relating to economic development in Puerto Rico. Part VI is a description of the Puerto Rico statehood, commonwealth and independent party agendas. Part VII is an analysis of the tax and economic policy implications of recent proposals regarding the U.S. tax treatment of Puerto Rico.

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I. EXECUTIVE SUMMARY

A. Introduction

In October 2003, Senate Finance Chairman Grassley and Ranking Member Baucus, requested that the staff of the Joint Committee on Taxation (the "Joint Committee staff") prepare a report on legislative options concerning Puerto Rico. The request asked the Joint Committee staff to provide an analysis of the tax and economic policy implications of the legislative options, the revenue costs of such options, and a comparison of the options to present law relative to the States, the District of Columbia, and the other U.S. territories.[2] At the same time, the Chairman and Ranking Member requested that the Government Accountability Office ("GAO") report to the Finance Committee with respect to the Puerto Rico economy, the impact of U.S. Federal tax policy on Puerto Rico, and proposed U.S. tax legislation regarding Puerto Rico. The Chairman and Ranking Member requested that the Joint Committee staff complete its report following the completion of the GAO report. The GAO completed its report in May of 2006. While this pamphlet is an independent work-product of the Joint Committee staff, the legislative options included in this pamphlet represent specific proposals that have been advocated by various interested parties, including some members of Congress, with respect to stimulating economic growth in Puerto Rico. Such options do not represent recommendations of the Joint Committee staff.

B. Overview of the U.S. Tax and Non-Tax Rules Related to U.S. Possessions

The United States has five major possessions and commonwealths. The major possessions are American Samoa, Guam, and the U.S. Virgin Islands. The major commonwealths are Puerto Rico and the Northern Mariana Islands. Four of the five of the major possessions and commonwealths (hereafter referred to as "U.S. possessions") have a non-voting representative in the U.S. Congress.[3] Residents of U.S. possessions are U.S. citizens, with the exception of those individuals in American Samoa who are U.S. nationals, but not U.S. citizens.[4]

In general, all U.S. Federal statutory laws apply throughout the U.S. possessions unless specifically excepted. These rules include the minimum wage standard and the requirement to use U.S. flag ships. While U.S. statutory laws apply to the U.S. possessions, and residents of

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[2] See Appendix for a copy of this request.

[3] The Commonwealth of the Northern Mariana Islands is represented by a resident representative instead of a non-voting delegate in the U.S. House of Representatives. A bill introduced in the 109th Congress, H.R. 873, would give the Northern Mariana Islands a non-voting delegate equivalent to American Samoa, Guam, Puerto Rico, and the U.S. Virgin Islands.

[4] U.S. nationals may live in the United States without restriction and naturalize as U.S. citizens under the same rules as other resident aliens. The distinction between a U.S. national and a U.S. citizen is that a U.S. national cannot vote or hold elected office.

U.S. possessions are full U.S. citizens, for tax purposes the Internal Revenue Code ("the Code") generally treats the U.S. possessions as foreign countries. When the Code uses the term in a geographical sense, the "United States" includes only the 50 States and the District of Columbia.[5]

Income derived from Puerto Rico or other U.S. possessions is ordinarily treated as foreign-source income and entities organized in Puerto Rico or other U.S. possessions are generally treated as foreign persons. Because corporations organized under the laws of Puerto Rico or other U.S. possessions are foreign corporations, they can also be treated as controlled foreign corporations ("CFCs") for purposes of the U.S. anti-deferral regime known as subpart F. Under these anti-deferral rules, a domestic parent company may be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries in Puerto Rico or other U.S. possessions, regardless of whether the income has been distributed as a dividend to the domestic parent corporation.

C. Special Tax Rules Related to Puerto Rico

As a result of the hybrid domestic-foreign treatment of Puerto Rico persons, the general principles of U.S. taxation are qualified by many special rules applicable to U.S. citizens and residents of, and U.S. persons doing business in, Puerto Rico. In many cases, these special rules have the effect of dividing tax authority between the U.S. Federal government and the government of Puerto Rico. Other rules are designed to prevent U.S. Federal tax laws from negating tax incentives used by Puerto Rico to attract investors. The United States has also used tax incentives to assist Puerto Rico in obtaining employment producing investments by U.S. companies. The need for these special tax incentives has been attributed, in part, to the additional costs imposed on investing in Puerto Rico because of its status as a U.S. possession.[6]

Under prior U.S. law, certain domestic corporations with business operations in U.S. possessions could elect under Code section 936 to generally eliminate the U.S. tax (including the alternative minimum tax) on certain foreign source income which was related to their operations in the possessions.[7] The benefit conferred to companies under section 936 is commonly referred to as the possession tax credit. A majority of the corporations that benefited from the possession tax credit established operations in Puerto Rico. Companies with significant operations in Puerto Rico operated through a Puerto Rico branch of a domestic U.S. corporation. Such corporations were commonly referred to as "section 936 companies." Income that was not subject to U.S. tax

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[5] Sec. 7701(a)(9). All Code and section references are to the Internal Revenue Code of 1986, as amended.

[6] Staff of the Joint Committee on Taxation, 99th Cong., 2nd Sess., *General Explanation of the Tax Reform Act of 1986*, at 999-1000.

[7] Some companies may still qualify for tax benefits under section 936 or section 30A for some period of time after December 31, 2005, if their current taxable year began sometime before December 31, 2005.

under this provision included income that was derived either from the active conduct of a trade or business within a U.S. possession or from certain investments in the possessions or in certain Caribbean Basin countries which generated qualified possession source investment income ("QPSII"). The benefit of the possession tax credit was that it spared the electing corporation U.S. tax whether or not it paid income tax to the possession.

The Small Business Job Protection Act of 1996[8] ("Small Business Act") repealed the possession tax credit for tax years beginning after December 31, 1995. In doing so, the Small Business Act provided grandfather rules that allowed for a 10-year transition period. However, for tax years beginning after December 31, 1995, the Small Business Act stated that QPSII earned after July 1, 1996 no longer qualified for the possession tax credit. The Small Business Act also added an additional income limitation to the calculation of the possession tax credit.[9]

The Small Business Act added a new section 30A to the Code with respect to qualified income earned in Puerto Rico. This section allowed an economic activity credit that was applicable for tax years beginning after December 31, 1995 and before January 1, 2006. While in a separate section of the Code, the economic activity credit (section 30A) was calculated under the rules set forth for the possession tax credit (section 936). The possession tax credit applied generally to taxpayers operating in any U.S. possession. The economic activity credit was a special case of the possession tax credit, applicable only to taxpayers in Puerto Rico.

The possession tax credit and the economic activity credit were subject to either an economic activity limitation or an income limitation. A corporation subject to the economic activity limitation with respect to income earned in Puerto Rico claimed a credit under section 30A rather than under section 936. All other corporations claimed a possession tax credit under section 936.

For the past 10 years, domestic corporations with business operations in the U.S. possessions could claim the possession tax credit or the economic activity credit to reduce their U.S. tax on certain income related to operations in the possessions.[10] Both credits expired for taxable years beginning after December 31, 2005.

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[8] Pub. L. No. 104-188, August 20, 1988.

[9] A special rule applied to Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands. This rule allowed such applicable possessions to continue to get the full benefit of the possession tax credit, as in effect prior to repeal, until December 31, 2005. See sec. 936(j)(8).

[10] Dividends paid by a section 936 corporation to its U.S. shareholder could qualify for a dividends received deduction. In cases where at least 80 percent of the stock of the electing corporation was owned by a single domestic corporation, the electing corporation's possession source income generally could be distributed without incurring any regular U.S. income tax. However, such a dividend constituted adjusted current earnings of the shareholder for purposes of computing the alternative minimum tax.

D. Statehood, Commonwealth, and Independence Status

Proponents of Puerto Rico statehood advocate obtaining the full rights and benefits of U.S. citizenship for Puerto Rico persons, including full voting representation in Congress for Puerto Rico and its citizens. If Puerto Rico became a State of the United States, the Federal tax laws would apply fully and uniformly to Puerto Rico as in the 50 States and the District of Columbia, and Puerto Rico taxes would be subject to the same deduction rules as taxes of the 50 States and the District of Columbia for U.S. Federal income tax purposes. Individuals would benefit from U.S. Federal tax and spending programs and would be subject to U.S. Federal estate and gift taxes on all of their assets regardless of situs. It is likely that there would be significant tax issues raised by the transition to full Puerto Rico statehood.

Proponents of Commonwealth status favor the continuation of the Commonwealth relationship with the United States. Proponents of Commonwealth status argue for the implementation of special U.S. and Puerto Rico incentives and programs to benefit Puerto Rico.

Proponents of Puerto Rico independence argue that Puerto Rico should be a separate country politically independent of the United States. Issues would likely arise under independence in the negotiation of new economic and tax arrangements between Puerto Rico and the United States, including issues relating to the taxation of dual citizens of Puerto Rico and the United States and the transitional status of Puerto Rico citizens under entitlement programs such as Social Security and Medicare.

E. Economic Analysis

When the possession tax credit was repealed in 1996, the Congress expressed its concern that the tax benefits provided by the credit were enjoyed by only the relatively small number of large U.S. corporations that operate in the possessions and that the tax cost of the benefits provided to these possessions corporations was borne by all U.S. taxpayers. In light of the then - current budget constraints, the Congress believed that the continuation of the tax exemption available to corporations under the possession tax credit was no longer appropriate. However, a number of policy makers are concerned that while living standards in Puerto Rico as traditionally measured are high in comparison to other Caribbean economies, they are low in comparison to the 50 States.

Economists assess policy proposals in terms of the proposal's effect on efficiency, equity, and growth. Analysis of efficiency typically involves assessing the extent to which the proposal leads to distortion in investment or consumption choices, as such distortion usually leads to wasted economic resources. In considering U.S. Federal tax policy and its role in the economic development of Puerto Rico, the policy challenge is to promote faster growth in Puerto Rico without materially harming growth in the States or other territories and without creating too much market distortion. An additional policy challenge is discerning when increased growth in Puerto Rico is self-sustaining, so that the distortions or unequal treatment created by a pro-development tax benefit do not become a permanent feature of the Code. Another consideration in evaluating U.S. Federal tax policy as a developmental tool is that some problems constraining development in Puerto Rico may not be tax problems. Issues such as labor supply and lack of infrastructure have been identified as key criteria in constraining Puerto Rico's economic growth.

In designing a new tax policy instrument aimed at enhancing development, there should be coordination between U.S. Federal tax policy and local tax policy in Puerto Rico. A policy designed for Puerto Rico to counteract a problem that is common to the United States is likely to induce businesses to relocate from the United States to Puerto Rico. A policy to foster economic development in Puerto Rico is likely to be more efficient if it can target problems that are unique to Puerto Rico. In addition, a permanent provision, as opposed to a temporarily-effective provision, may carry out the intended tax policy more effectively. Because many large investment plans implemented take many months to plan and execute, tax benefit legislation requiring taxpayers to make qualifying investments within a short period of time is more likely to result in the tax benefits being claimed by taxpayers who already were planning such investment in the absence of the legislation.

It may be difficult to distinguish businesses for which transition relief results in a windfall benefit from those businesses that require further implicit subsidy from the new tax benefit in order to maintain their operations. If one goal of development is to create a local economy that has self sustaining growth, and, if a tax benefit is provided to entice a taxpayer to retain his or her operation in Puerto Rico rather than relocating outside Puerto Rico, the Congress should continue to evaluate whether such tax benefit has become a permanent subsidy to the taxpayer and is inconsistent with self-sustaining growth.

F. Legislative Options

In general

The legislative options included in this pamphlet represent specific proposals that have been advocated by various interested parties, including some members of Congress, with respect to stimulating economic growth in Puerto Rico. The Joint Committee staff has provided a summary of the tax and economic policy implications of these legislative options in response to the Finance Committee's request. Such options do not represent recommendations of the Joint Committee staff.

The legislative options reviewed by the Joint Committee staff can be divided into three categories: individual proposals; corporate proposals; and a proposal related to revenue transfers.

Individual proposals

The Joint Committee staff reviewed two legislative proposals designed to provide certain tax benefits to individuals residing in Puerto Rico. Both proposals extend to residents of Puerto Rico refundable tax credits that are available under present law to individuals residing in the 50 States and the District of Columbia, but that under present law are not available, or are available only to a limited extent, to residents of Puerto Rico.

Extend earned income credit to residents of Puerto Rico

The first proposal extends the earned income credit to Puerto Rico residents. Under the proposal, low- and moderate-income workers residing in Puerto Rico (who generally are not eligible for the earned income credit under present law) are eligible to file a U.S. Federal income tax return and claim the earned income credit. Because the earned income credit is a refundable credit, if the amount of the credit exceeds the taxpayer's U.S. Federal income tax liability (as it will in the case of a Puerto Rico resident with only Puerto Rico-source income, whose U.S. Federal income tax liability is otherwise zero), the excess amount is payable directly to the taxpayer. While residents of Puerto Rico are generally not subject to U.S. Federal income taxation on their Puerto Rico-source income, under the proposal such income is taken into account (along with the individual's U.S.- and other foreign-source income, if any) for purposes of determining eligibility for the earned income credit.

Proponents argue that the earned income credit is designed to provide significant work incentives for low-income workers; thus, they believe that extension of the earned income credit to residents of Puerto Rico will increase employment in Puerto Rico. In addition, proponents argue that present law creates a tax incentive for low and moderate-income workers to relocate from Puerto Rico to the United States, and likewise a tax disincentive against such workers returning to Puerto Rico. Proponents argue that, by eliminating these effects, the proposal will help Puerto Rico attract and retain the skilled labor force necessary for economic development. Finally, proponents argue that, as U.S. citizens who share in most of the obligations and duties of all U.S. citizens, residents of Puerto Rico should be eligible for the earned income credit to the same extent as U.S. citizens residing in the United States.

Opponents dispute the argument that because the earned income credit provides incentives to seek employment it would therefore increase employment in Puerto Rico; they observe that Puerto Rico's high unemployment rate (which measures those actively seeking work but unable to find work) shows that many are currently willing to work and thus it is not unwillingness to supply labor, but rather inadequate demand for labor, that is the source of Puerto Rico's low employment levels. Opponents also argue that as residents of Puerto Rico are generally not subject to U.S. Federal income tax on their Puerto Rico-source income, neither should they be entitled to the earned income credit; under this view, extension of the earned income credit creates an undesirable policy result unless it is coupled with the repeal of section 933, the provision of the Code which exempts from U.S. Federal income taxation the Puerto Rico-source income of Puerto Rico residents. Opponents also argue that extending the earned income credit to Puerto Rico residents would impose a substantial administrative burden both on Puerto Rico residents and the IRS. They likewise argue that the Code is an inefficient mechanism for the delivery of such a benefit when residents of Puerto Rico who have little or no income sourced outside of Puerto Rico are not otherwise subject to U.S. Federal income tax filing requirements. Finally, opponents point out that the earned income credit has been the subject of controversy as a source of erroneous tax filings; opponents argue that any extension of the earned income credit will compound the existing filing problems.

Extend refundable child credit to residents of Puerto Rico with fewer than three children

Under the second proposal, income is no longer excluded from the definition of earned income for purposes of the refundable child credit merely because it is Puerto Rico-source income of a Puerto Rico resident. Thus, residents of Puerto Rico with one or two children (who currently are not generally eligible for the credit under either the earned income or the payroll tax formula) are eligible for the refundable child credit to the extent that the amount of their total earned income (i.e., Puerto Rico-source as well as U.S.- and foreign-source income) exceeds the relevant threshold. Residents of Puerto Rico with three or more children are able to calculate their refundable child credit using either the payroll tax formula or the earned income formula.

Because the refundable child credit is conditional upon having significant labor earnings, proponents argue that the refundable child credit, like the earned income credit, provides significant work incentives for low-income workers; thus, proponents believe that expansion of the refundable child credit to include more residents of Puerto Rico will increase employment in Puerto Rico. Proponents also argue that the present-law refundable child credit creates an incentive for low and moderate-income families to relocate from Puerto Rico to the United States, and that present law draws an irrational distinction between Puerto Rico residents with one or two children (who are generally unable to claim the refundable child credit) and those with three or more children (who qualify to calculate their refundable child credit under an alternative method, and are generally able to claim the credit to the extent they have significant wage earnings). Proponents argue that the proposal eliminates these effects by treating residents of Puerto Rico with one or two children in a similar manner to individuals who either relocate with their children to the United States or have three or more children.

As in the case of the earned income credit, opponents challenge the effectiveness of the refundable child credit in reducing unemployment in Puerto Rico, arguing that it will have little impact on the inadequate demand for labor. Opponents also argue that because residents of Puerto Rico are generally not subject to U.S. Federal income tax on their Puerto Rico-source income, neither should they be entitled to the refundable child credit. Under the proposal, Puerto Rico residents generally will remain exempt from U.S. Federal income taxation, while being enabled to claim the refundable child credit, even for upper-income Puerto Rico residents; opponents of the proposal consider such an outcome to be an inappropriate result that stems from applying only portions of the tax system to residents of Puerto Rico. Opponents argue that extension of the refundable child credit therefore creates an undesirable policy result, unless it is coupled with the repeal of section 933, the provision of the Code that exempts Puerto Rico-source income of Puerto Rico residents from U.S. taxation.

Corporate proposals

As mentioned above, most U.S. companies with significant operations in Puerto Rico historically operated through a Puerto Rico branch of a domestic corporation to take advantage of the special tax benefits provided under section 936. Following the expiration of section 936, it may now be more advantageous for such companies to operate in Puerto Rico through a CFC structure, which allows the company to defer U.S. Federal income taxation on the CFC's earnings until those earnings are repatriated to the United States. However, some U.S. companies, particularly those with valuable intangible assets, contend that the current tax cost associated with converting from a domestic entity to a foreign entity under section 367 is so large as to overwhelm the present value of the current and future benefit of tax deferral.

The Joint Committee staff reviewed four legislative proposals designed to provide tax benefits to corporations. Two of these proposals would provide benefits to companies that remained in a section 936 structure with regard to their Puerto Rico operations and two of these proposals would benefit companies that converted their Puerto Rico activities into a CFC structure pursuant to the expiration of the section 936 credit.

Proposals that benefit companies in a section 936 structure

Extension of section 30A

The proposal to extend section 30A would modify the credit computed under the economic activity limit with respect to operations in Puerto Rico. First, the proposal would permanently extend the economic activity credit. Second, the proposal would eliminate the limitation that applies the credit only to certain corporations with pre-existing operations in Puerto Rico. Accordingly, under the proposal, the credit computed under the economic activity limit would be available with respect to corporations with new operations in Puerto Rico.

The section 30A proposal to extend and modify the credit computed under the economic activity limit is intended to provide an incentive for job creation and economic activity in Puerto Rico. The credit computed under the economic activity limit as provided in section 30A reduces the U.S. Federal income tax burden on economic activity located in Puerto Rico. By reducing the U.S Federal income tax burden, the credit may make it attractive for a business to locate in Puerto Rico, even if the costs of operation or transportation to or from the United States would otherwise make such an undertaking unprofitable. As such, the credit is a deliberate attempt to distort taxpayer behavior.

Generally, economists argue that distortions of taxpayer behavior, such as those that distort decisions regarding investment, labor choice, or choice of business location, reduce overall well-being by not putting labor and capital resources to their highest and best use. However, proponents of the credit argue that such a distortion of choice may increase aggregate economic welfare because Puerto Rico has so many underutilized resources, as evidenced by its chronic high unemployment rate.

Some criticize section 30A for the magnitude of the credit allowed. They observe that the credit rate on compensation is 60 percent and that, unlike most credits permitted under the Code, the taxpayer is not required to reduce the amount of compensation that may be deducted by the amount of credit claimed. Thus, a U.S. corporate taxpayer in the 35-percent marginal tax bracket would be able to recover 95 percent of compensation paid (the deduction for compensation valued at the 35-percent tax rate plus the 60-percent credit) in the form of a reduced income tax liability.

Section 199 proposal

The second proposal amends section 199 of the Code to include Puerto Rico within the definition of the United States for purposes of determining the domestic production gross receipts of certain eligible taxpayers. Under the proposal, a taxpayer is allowed to take into account its Puerto Rico business activity for purposes of calculating its domestic production gross receipts and qualified production activities income, but only if its gross receipts from Puerto Rico are currently taxable for U.S. Federal income tax purposes. Generally, a U.S. taxpayer will satisfy this condition by operating in flow-through form, such as through a branch or partnership in Puerto Rico.

Proponents of the proposal argue that Puerto Rico should be included within the scope of section 199 in order to provide the same tax treatment for manufacturing operations in Puerto Rico as in the United States; such proponents contend that a U.S. taxpayer operating a manufacturing facility in Puerto Rico in flow-through form will experience a higher level of U.S. Federal income tax on its operating profit than will an otherwise identical manufacturing operation located in the United States. However, opponents point to several key differences between Puerto Rico and the United States. First, businesses operating entirely within the United States lack the option of organizing in CFC form and benefiting from the deferral of U.S. income tax on active income. While the economic viability of converting to a CFC structure may be adversely affected by tax costs associated with section 367, taxpayers nevertheless retain the option to convert to CFC status, as well as to structure new or expanded Puerto Rico operations using a CFC. Opponents argue that the proposal encourages large U.S. companies operating in Puerto Rico to bifurcate their structures into part-"foreign" and part-"domestic" operations. Under such a strategy, a U.S. corporate group would move certain Puerto Rico activities into a CFC structure, while retaining other activities (e.g., certain intangible-related activities, which would generally be expected to trigger significant amounts of taxable gain under section 367 if transferred to a CFC) within its domestic structure.[11] This ability to maximize tax benefits through a bifurcated CFC and domestic corporation structure would be unique to Puerto Rico, and is unavailable to businesses operating exclusively in the United States.

Proposals that benefit companies in a CFC structure

Section 956 proposal

The section 956 proposal would reduce the disincentive for repatriating foreign earnings from Puerto Rico by allowing: (1) the deferral of foreign earnings invested in U.S. property (90-percent section 956 exception), or (2) a reduced rate of tax for repatriated foreign earnings (85-percent dividends received deduction). By providing companies with a partial reduction of U.S.

[11] It should be noted that this ability is a function of present law, and U.S. corporations that currently operate in Puerto Rico through a branch (rather than a separate CFC) may be motivated to establish a bifurcated structure regardless of whether the proposal is enacted.

taxes regardless of the amount of foreign taxes paid, both of these options would operate as tax-sparing mechanisms.

Under the 90-percent section 956 exception, companies could invest 90 percent of their qualified income in U.S. property without triggering the U.S. anti-deferral rules that result in current U.S. taxation. This means, for example, a CFC incorporated in Puerto Rico could enter into a loan with its U.S. parent and only 10 percent of the imputed dividend would be subject to U.S. Federal income tax. The other 90 percent of the loan amount would escape U.S. Federal income tax until the note is forgiven and such amount is actually distributed. In the interim, no interest would be imputed on the note. Thus, the provision provides the potential for permanent reinvestment in U.S. property with no interest charge. By maintaining deferral indefinitely, a taxpayer may achieve a result that is economically equivalent to 90-percent exemption of income, with no corresponding disallowance of expenses allocable to the exempt income, provided that the taxpayer does not actually repatriate the earnings. The result is a proposal that largely resembles a territorial-type exemption.

If companies opt for the 85-percent dividends received deduction, it would likely create two main behavioral responses. The first response would be an increase in the amount of investment in Puerto Rico because the proposal would create a higher after-tax rate of return on that investment by, in essence, exempting 85 percent of the dividends paid by the Puerto Rico corporation to its U.S. shareholders. The second behavioral response would be an increase in dividends from CFCs in Puerto Rico. Under the proposal, each $100 of dividends would result in only $15 of additional taxable income (through utilization of the 85 percent dividends received deduction) to the U.S. shareholder. Assuming the U.S. shareholder is subject to a 35 percent U.S. tax rate, the effective tax rate on the dividend would be only 5.25 percent (15 percent multiplied by 35 percent). These behavioral responses are not mutually exclusive and there is uncertainty about which behavioral response would dominate.

Section 245 proposal

Under the section 245 proposal, income earned in Puerto Rico (or in another U.S. possession) by a foreign subsidiary of a U.S. corporation may, subject to certain earnings and income based limitations, be distributed to the U.S. parent corporation free of U.S. tax. The income earned in Puerto Rico (or in another U.S. possession) therefore will be subject to tax, if at all, only in Puerto Rico (or the other possession).

The proposal is an extension of the present law dividends received deduction under section 245, but the effects of the proposal are different from the effects of present law. The present law dividends received deduction for dividends from either domestic corporations (under section 243) or foreign corporations (section 245) is intended to mitigate multiple levels of U.S. taxation of inter-corporate dividends. By contrast, the proposal provides a deduction for dividends attributable to income that will not have been subject to U.S. corporate tax. Evaluation of the proposal depends on a number of factors, including the extent to which tax rates affect investment decisions; the extent to which the proposal is structured in a manner that will encourage new investment rather than rewarding old investment or investment that would occur in the absence of the proposed rules; and whether possible inefficiencies caused by the proposal will be offset by beneficial welfare effects in the possessions.

Revenue transfer proposal

Repeal limitation on cover over of rum excise tax to Puerto Rico

The cover over proposal repeals the $10.50 per proof gallon limitation on the amount of excise taxes on rum covered over to Puerto Rico. Under the proposal, the full amount of excise taxes (currently $13.50 per proof gallon) imposed on rum brought into the United States from Puerto Rico, and the full amount of excise taxes attributable to rum imported into the United States from other countries that is allocated to Puerto Rico, are covered over to the Puerto Rico Treasury.

The special U.S.-Puerto Rico arrangement with respect to the cover over of rum excise taxes to some extent reflects the Commonwealth relationship. Therefore, some argue that it is difficult to ascertain the policy justification for limiting the rum cover over. Others argue that the cover over limitation helps to finance the cost of administering the program or that it is an appropriate adjustment of the cover over amount in light of the unusual nature of cover over generally, or simply U.S. revenue concerns. However, the repeated reenactment of the increase in the rum cover over limitation, sometimes on a retroactive basis, undercuts the reliability of payment to Puerto Rico of that portion of the cover over exceeding $10.50 per proof gallon and makes it more difficult for Puerto Rico to budget these revenues or to access the debt market in anticipation of these revenues.

II. PRESENT LAW TAX PROVISIONS RELATED TO PUERTO RICO AND OTHER U.S. POSSESSIONS

A. Overview of U.S. Tax Provisions Relating to Puerto Rico

1. In general

When the Code uses the term in a geographical sense, the "United States" includes only the 50 states and the District of Columbia.[12] Income derived from Puerto Rico or other U.S. possessions is ordinarily treated as foreign source income and entities organized in Puerto Rico or other U.S. possessions are generally treated as foreign persons.[13] Since corporations organized under the laws of Puerto Rico are foreign corporations, they can be treated as CFCs for purposes of the U.S. anti-deferral regime known as subpart F. Although Puerto Rico is treated as a foreign country for U.S. tax purposes, a person born in Puerto Rico is typically treated as a U.S. citizen for U.S. tax purposes. In addition, Puerto Rico is subject to U.S. statutory rules, such as the minimum wage standard and the requirement to use U.S. flag ships.

As a result of the hybrid foreign-domestic treatment, the general principles of U.S. taxation are qualified by many special rules applicable to U.S. citizens and residents of and U.S. persons doing business in Puerto Rico. In many cases, these special rules have the effect of dividing tax authority between the U.S. Federal government and the government of Puerto Rico. Other rules are designed to prevent U.S. Federal tax laws from negating tax incentives used by Puerto Rico to attract investors. The United States has also used tax incentives to assist Puerto Rico in obtaining employment producing investments by U.S. companies. The need for these special tax incentives has been attributed, in part, to the additional costs imposed on investing in Puerto Rico because of its status as a U.S. possession.[14]

2. Taxation of individuals

Income Tax

U.S. citizens and residents

The United States generally imposes income tax on the worldwide income of U.S. citizens and residents. Thus, all income earned by a U.S. citizen or resident, whether from sources inside or outside the United States, is taxable whether or not the individual lives within the United States. All U.S. citizens and residents whose gross income for a taxable year is not

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[12] Sec. 7701(a)(9).

[13] Sec. 7701(a)(4) and (5).

[14] Staff of the Joint Committee on Taxation, 99th Cong., 2nd Sess., *General Explanation of the Tax Reform Act of 1986*, at 999-1000.

less than the sum of the personal exemption amount and the basic standard deduction are required to file an annual U.S. individual income tax return.

The taxable income of a U.S. citizen or resident is equal to the taxpayer's total worldwide income less certain exclusions, exemptions, and deductions. A foreign tax credit, with limitations, may be claimed for foreign income taxes paid or accrued, or, alternatively, foreign taxes may be treated as a deduction.

Section 911 of the Code provides that a U.S. citizen or resident with a tax home in a foreign country may under certain circumstances elect to exclude an amount of foreign earned income from gross income. The maximum exclusion generally is limited to $82,400 per year (for 2006) plus certain housing costs.[15] No deductions, exclusions, or credits are allowed for amounts allocable to this excluded income.

Under section 877 of the Code, an individual who relinquishes his or her U.S. citizenship or terminates his or her U.S. residency may be subject to an alternative tax regime for income tax purposes for the 10 taxable years ending after citizenship relinquishment or residency termination. The alternative tax regime applies to such individuals if they meet certain income and net-worth thresholds or they fail to comply with certain U.S. Federal tax obligations.[16]

U.S. individuals residing in Puerto Rico

Under the Jones Act,[17] Puerto Rico is deemed to be a part of the United States for purposes of acquiring U.S. citizenship by place of birth. Thus, a person born in Puerto Rico is typically a U.S. citizen for U.S. tax purposes. However, section 933 of the Code provides that income derived from sources within Puerto Rico by an individual who is a bona fide resident of Puerto Rico for an entire taxable year generally is excludable from U.S. gross income and thus exempt from U.S. taxation, even if such resident is a U.S. citizen. Except for personal exemptions, deductions and credits allocable to amounts that can be excluded under section 933 are disallowed.

Income excludible from U.S. gross income under section 933 is generally subject to taxation by Puerto Rico. Items of income earned from sources outside of Puerto Rico by U.S.

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[15] The Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA"), Pub. L. No. 109-222 (2006), made certain changes to the section 911 exclusion, including accelerating to 2006 the inflation adjustment to the foreign earned income exclusion limitation (resulting in the $82,400 amount, an increase from 2005 limitation of $80,000) and placing an objective limitation on the amount of housing costs that may be excluded or deducted. For a description of the TIPRA changes, see H.R. Conf. Rep. No. 109-455, at 307-10 (2006).

[16] The alternative tax regime applies only if it results in a higher U.S. tax liability than would otherwise be determined if the individual were taxed as a nonresident alien.

[17] 39 Stat. 951 (1917).

citizens who reside in Puerto Rico generally are subject to U.S. taxation. The principles that generally apply for determining income from sources within and without the United States also generally apply in determining income from sources within and without a possession. In addition, the principles for determining whether income is effectively connected with the conduct of a U.S. trade or business are applicable for purposes of determining whether income is effectively connected to the conduct of a possession trade or business. However, except as provided in regulations, any income treated as U.S. source income or as effectively connected with the conduct of a U.S. trade or business is not treated as income from within any possession or as effectively connected with a trade or business within any such possession.[18]

A "bona fide resident" of Puerto Rico is an individual that meets a two-part test for the taxable year. First, the individual must be present in Puerto Rico for at least 183 days in the taxable year. Second, the individual must (1) not have a tax home[19] outside Puerto Rico during the taxable year and (2) not have a closer connection[20] to the United States or a foreign country during such year.[21] There are certain exceptions for persons whose presence outside of Puerto Rico for extended periods of time lacks a tax avoidance purpose.

For purposes of the foreign earned income and housing exclusion under section 911, the term "foreign country" does not include possessions of the United States including American Samoa, Guam, the U.S. Virgin Islands, Puerto Rico, or the Commonwealth of the Northern Mariana Islands.[22] Thus, U.S. citizens resident in one of these areas are not eligible for the section 911 exclusion.

Section 877 of the Code provides that U.S. citizens who relinquish their citizenship and U.S. residents who terminate their long-term residency are subject to an alternative tax regime for a period of 10 years if they meet certain income and net-worth thresholds or they fail to comply with certain U.S. Federal tax obligations. U.S. citizens and residents that leave the United States and establish residency in Puerto Rico are not considered to have relinquished their U.S. citizenship or terminated their U.S. residency; however, U.S. citizens and residents of Puerto Rico that leave Puerto Rico and establish residency in a foreign country would be subject to the rules governing the alternative tax regime.

[18] Sec. 937(b).

[19] Determined under the principles of sec. 911(d)(3).

[20] Determined under the principles of sec. 7701(b)(3)(B)(ii).

[21] Sec. 937(a).

[22] Treas. Reg. §1.911-2(g),(h).

Estate and gift tax

U.S. citizens and residents

U.S. citizens and residents are subject to estate tax on the transfer of their worldwide estate at the time of death. The taxable estate is equal to the decedent's worldwide gross estate, less allowable deductions (including the marital deduction). Certain credits are allowed, including the unified credit, which directly reduce the amount of the estate tax. The Economic Growth and Tax Relief Reconciliation Act of 2001[23] ("EGTRRA") repealed the estate tax for estates of decedents dying after December 31, 2009. However, EGTRRA included a "sunset" provision, pursuant to which EGTRRA's provisions, including estate tax repeal, do not apply to decedents dying after December 31, 2010.

U.S. citizens and residents are subject to gift tax on transfers of property by gift made directly or indirectly, in trust or otherwise. Thus, the gift tax applies to transfers of property, regardless of where such property is situated. The amount of a taxable gift is determined by the fair market value of the property on the date of the gift and an annual exclusion (adjusted periodically for inflation) applies to the transfer. EGTRRA did not repeal the gift tax for any year.

U.S. individuals residing in Puerto Rico

Under a special rule, a U.S. citizen residing in a possession is treated as a nonresident alien for estate and gift tax purposes if their U.S. citizenship was acquired solely by reason of birth or residence within the possession.[24]

The estate of a nonresident alien generally is taxed at the same estate tax rates applicable to U.S. citizens, but the taxable estate includes only property situated within the United States that is owned by the decedent at death (and certain property transferred during life subject to reserved interests or powers). This estate generally includes the value at death of all real and personal tangible property situated in the United States and certain intangible property, such as stock of a domestic corporation, considered to be situated in the United States. The estate of a nonresident alien is allowed a unified credit of $13,000 and under treaty may instead be allowed a pro rata portion of the generally applicable unified credit.

Nonresident alien individuals are subject to gift tax with respect to certain transfers by gift of U.S.-situated property. Such property includes real estate and tangible property located within the United States. Nonresident aliens generally are not subject to U.S. gift tax on the transfer of intangibles, such as stock or securities, regardless of where such property is situated.

[23] Pub. L. No. 107-16, June 7, 2001.

[24] Sec. 2209.

Estate and gift transfers by residents of Puerto Rico that are exempt from Federal estate and gift taxation under these provisions (e.g., transfers of property not situated in the United States) generally are subject to estate and gift taxation in Puerto Rico. Estates of decedents qualifying under this rule are allowed a credit against the estate tax equal to the greater of $13,000 or that proportion of $46,800 which the value the decedent's gross estate situated in the United States bears to the value of the entire gross estate wherever situated.

3. Taxation of corporations

U.S. corporations

U.S. corporations are subject to U.S. income tax on their worldwide income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income is generally deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries. The main anti-deferral regimes in this context are the CFC rules of subpart F[25] and the passive foreign investment company rules.[26] A foreign tax credit is generally available to offset, in whole or in part, the U.S. tax owed on this foreign-source income, whether earned directly by the domestic corporation, repatriated as an actual dividend, or included under one of the anti-deferral regimes, subject to certain limitations.

The American Jobs Creation Act of 2004[27] ("AJCA") offers a temporary election to reduce U.S. taxes on repatriated dividends from CFCs provided that certain conditions are met. In general, this reduction consists of an 85 percent deduction of cash dividends received during a taxable year by a U.S. corporation from a CFC (a Puerto Rico corporation can qualify as a CFC). If a U.S. corporation is in the 35 percent income tax bracket, the 85 percent deduction will yield an effective tax rate of 5.25 percent.

Puerto Rico corporations

In general, a corporation organized under the laws of Puerto Rico is a foreign corporation for U.S. tax purposes. The United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Generally, this would include a 30 percent tax on the gross amount of its fixed, determinable, annual or periodic income from U.S. sources and a net basis tax at regular rates on income effectively connected with the conduct of a U.S. trade or business. Under AJCA, the withholding tax rate on U.S. source dividends paid to a corporation created or

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[25] Secs. 951-964.

[26] Secs. 1291-1298.

[27] Pub. L. No. 108-357, October 22, 2004.

organized in Puerto Rico is lowered from 30 percent to 10 percent, to create parity with the generally applicable 10 percent withholding tax imposed by Puerto Rico on Puerto Rico-source dividends paid to U.S. corporations. The lower rate applies only if the same local ownership and activity requirements are met that are applicable to corporations organized in other possessions receiving dividends from corporations organized in the United States. If Puerto Rico increases its 10 percent withholding tax imposed on dividends paid to U.S. corporations, the U.S. income tax withholding rate on dividends paid to Puerto Rico corporations will be increased to 30 percent.

The Puerto Rico government has implemented a series of tax incentives to encourage the establishment of new companies in Puerto Rico. The most significant of these incentives are contained in the Puerto Rico Tax Incentives Act of 1998.[28]

The possession tax credit (section 936)

Under prior U.S. law, certain domestic corporations with business operations in U.S. possessions could elect under Code section 936 to generally eliminate the U.S. tax (including the alternative minimum tax) on certain foreign source income which was related to their operations in the possessions.[29] A majority of the corporations that benefited from the possession tax credit established operations in Puerto Rico. Income that was not subject to U.S. tax under this provision included income that was derived either from the active conduct of a trade or business within a U.S. possession or from certain investments in the possessions or in certain Caribbean Basin countries which generated qualified possession source investment income. The benefit of the possession tax credit was that the electing corporation was not subject to U.S. tax despite whether or not it paid income tax to the possession ("tax sparing"). The possession tax credit was repealed in 1996, but grandfather rules allowed for a ten-year transition period.[30]

4. Employment taxes

U.S. employers and employees

In the United States, Federal Insurance Contribution Act ("FICA") and Federal Unemployment Tax Act ("FUTA") taxes (collectively referred to as "employment taxes") are generally imposed in an amount equal to a percentage of wages paid by the employer with

[28] For a detailed discussion of the Puerto Rico Tax Incentives Act of 1998, see Part II.B. "Overview of Puerto Rico Tax Law" of this pamphlet.

[29] Some companies may still qualify for tax benefits under section 936 or section 30A for some period of time after December 31, 2005, if their current taxable year began sometime before December 31, 2005.

[30] For a detailed description of the possession tax credit, see Part III. "Mechanics of the Possession Tax Credit" of this pamphlet.

respect to employment.[31] FICA tax consists of two parts: (1) old age, survivor and disability insurance ("OASDI"), which correlates to the Social Security program that provides monthly benefits after retirement, disability, or death; and (2) Medicare hospital insurance ("HI"). The OASDI tax rate is 6.2 percent on both the employee and employer (for a total rate of 12.4 percent). The OASDI tax rate applies to wages up to the OASDI wage base ($94,200 for 2006). The HI tax rate is 1.45 percent on both the employee and the employer (for a total rate of 2.9 percent). Unlike the OASDI tax, the HI tax is not limited to a specific amount of wages, but applies to all wages. Under FUTA, employers must pay a tax of 6.2 percent of wages up to the FUTA wage base of $7,000. For FICA and FUTA tax purposes, wages generally includes all remuneration for employment unless a specific exception applies.

<u>Puerto Rico employers and employees</u>

Employers and employees in Puerto Rico are also subject to FICA and FUTA.[32] Certain statutory exceptions from the definition of wages for FICA and FUTA purposes do not apply in the case of employers and employees in Puerto Rico. For example, the exceptions from the definition of wages for amounts under an educational assistance program or a dependent care assistance program[33] do not apply since the exceptions are by reason of specific Code sections (i.e., sections 127 and 129) which are not applicable in the case of Puerto Rico employers and employees.

5. Excise taxes

<u>U.S. excise taxes on Puerto Rico goods imported into the United States</u>

U.S. excise taxes generally do not apply within Puerto Rico. However, U.S. excise taxes equal to the taxes on domestically produced articles are imposed on articles of Puerto Rico manufacture brought into the United States from Puerto Rico and withdrawn for consumption or sale.

<u>Cover over of excise taxes on Puerto Rico products</u>

Revenues collected by the United States from the excise taxes imposed on certain articles coming into the United States from Puerto Rico generally are "covered over" (i.e., paid) to the Puerto Rico Treasury. With respect to otherwise eligible excise taxes imposed on articles not containing distilled spirits, revenues are covered over to Puerto Rico only if the cost or value of materials produced in Puerto Rico plus the direct costs of processing operations performed in Puerto Rico equal at least 50 percent of the value of the article at the time it is brought into the United States. Moreover, no cover over is permitted on such articles if Puerto Rico provides a

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[31] Secs. 3101, 3111 and 3301.

[32] Secs. 3121(e) and 3306(j).

[33] Secs. 3121(a)(18) and 3306(b)(13).

direct or indirect subsidy with respect to the article which is of a different kind or in an amount greater than the subsidies which Puerto Rico generally offers to industries producing articles not subject to Federal excise tax.

With respect to Federal excise taxes imposed on articles containing distilled spirits that are manufactured in Puerto Rico and shipped into the United States, revenues are covered over to the Puerto Rico Treasury only if at least 92 percent of the alcoholic content of such articles is attributable to rum. The amount of excise taxes covered over to Puerto Rico from such articles cannot exceed $10.50 per proof gallon. That limitation has been suspended over most of the last decade. Most recently, the Working Families Tax Relief Act of 2004[34] temporarily suspended the $10.50 per proof gallon limitation on the amount of excise taxes on rum covered over to Puerto Rico and the Virgin Islands. That law extended the cover over amount of $13.25 per proof gallon for rum brought into the United States after December 31, 2003, and before January 1, 2006. On January 1, 2006, the cover over amount reverted to $10.50 per proof gallon.

A special excise tax rule also applies when articles manufactured in the United States are shipped to Puerto Rico. In such cases, the articles are exempt from Federal excise taxes and, upon being entered in Puerto Rico, are subject to a tax equal in rate and amount to the excise tax imposed in Puerto Rico upon similar articles of Puerto Rico manufacture.

Cover over of excise taxes on rum imported from other countries

A provision of the Code added by the Caribbean Basin Economic Recovery Act[35] provides a special rule for excise taxes collected on rum imported into the United States from any country. Such excise taxes are covered over to the treasuries of Puerto Rico and the Virgin Islands, under a formula prescribed by the Treasury Department for the division of such tax collections between Puerto Rico and the Virgin Islands. This formula currently results in approximately 88 percent of revenues from rum excise taxes being covered over to Puerto Rico and the remainder of such revenues being covered over to the Virgin Islands.

6. Taxation of Puerto Rico obligations

Section 103 of the Code provides that the interest on a bond issued by Puerto Rico or its municipalities generally is exempt from U.S. income tax in the same manner as interest on a bond issued by a State. The exemption does not apply to any bond that is a non-qualified private activity bond (within the meaning of section 141).

7. Low-income housing credit

A low-income housing credit is allowed against U.S. income tax liability. The credit is allowed in annual installments over 10 years to the owners of qualified low-income rental

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[34] Pub. L. No. 108-311, October 4, 2004.

[35] Pub. L. No. 98-67, August, 5, 1983.

housing, including housing located in a U.S. possession. In addition to maintaining prescribed percentages of low-income units and satisfying other requirements, the building owners must receive a credit allocation from the appropriate credit authority (such as a State or Puerto Rico), except in the case of housing projects financed with tax-exempt bonds.

8. Tax treaties

In addition to the U.S. and foreign statutory rules for the taxation of foreign income of U.S. persons and U.S. income of foreign persons, bilateral income tax treaties limit the amount of income tax that may be imposed by one treaty partner on residents of the other treaty partner. For example, treaties often reduce or eliminate withholding taxes imposed by a treaty country on certain types of income, such as dividends, interest and royalties, paid to residents of the other treaty country. Treaties also include provisions governing the creditability of taxes imposed by the treaty country in which income is earned in computing the amount of tax owed to the other country by its residents with respect to that income. Treaties further provide procedures under which inconsistent positions taken by the treaty countries on a single item of income or deduction may be mutually resolved by the two countries.

There are no bilateral tax treaties between Puerto Rico and any foreign country. In addition, U.S. treaties typically do not include Puerto Rico in the definition of "United States" for treaty purposes.[36] Moreover, although Puerto Rico individuals are typically U.S. citizens, U.S. treaties often do not extend to them the same reductions of foreign source country tax to which a resident of one of the 50 States or the District of Columbia is entitled under a U.S. tax treaty.[37]

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[36] One reason for this treatment may be that Puerto Rico has its own tax code and thus the Treasury Department would have to negotiate treaty benefits on behalf of two separate tax systems. A further explanation of current treaty policy may be that Puerto Rico and other U.S. possessions largely resemble developing countries, offering tax holidays and other economic incentives to promote local investment. Developing country treaties generally do not include the same provisions as non-developing country treaties and, in most cases, developing country treaties preserve some level of source country withholding tax. The articles that comprise the United States Model Treaty typically aim to reduce or eliminate source country withholding rates on interest, dividends, and royalties. Thus, if the Treasury Department were to negotiate tax treaties that included both the United States and U.S. possessions it may have difficulty maintaining a consistent policy standard.

However, see the 1990 Protocol to the *Convention Between the United States of America and the Kingdom of Spain for the Avoidance of the Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income*, where paragraph 3 (relating to Article 3 of the Convention) states that the United States and Spain "agreed to initiate, as soon as possible, the negotiation of a protocol to extend the application [of the Convention] to Puerto Rico, taking into account the special features of the taxes applied by Puerto Rico."

[37] Compare Article 4 (Fiscal Domicile) of the *Convention Between the Government of the United States of America and the Government of the People's Republic of Bangladesh for the Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income*, Senate Treaty Doc.

B. Overview of Puerto Rico Tax Law, Compiled by the Library of Congress[38]

1. Introduction

The Puerto Rico revenue system consists of an income tax (corporate and individual), a property tax (Commonwealth and municipal), and several excise taxes. The Puerto Rico government has implemented a series of tax incentives to encourage the establishment of new companies. The most significant of these incentives are contained in the Puerto Rico Tax Incentives Act of 1998.

The Puerto Rico income tax is imposed by the Puerto Rico Internal Revenue Code ("IRC") of 1994, as amended, applicable to taxable years beginning after June 30, 1995.[39] Formerly, income tax was imposed by the Income Tax Act of 1954, as amended.[40]

All residents and every corporation and partnership (except those expressly exempted or those not engaged in a trade or business in Puerto Rico) are subject to tax on income, regardless of its source, and every nonresident individual is subject to tax on income from sources within Puerto Rico or for services performed in Puerto Rico.[41]

109-5 to Article 4 (Residence) of the *Convention Between the Government of the United States of America and the Government of The United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains*, Senate Treaty Doc. 107-19, where paragraph 1 of the U.S. income tax treaty with Bangladesh provides that a "resident of a contracting state" can include an individual subject to tax [in the United States] based on citizenship and the U.S. income tax treaty with the United Kingdom carves out [certain of] such individuals by maintaining that a resident of the United States must also meet the requirements of paragraph 2.

[38] This section, "Overview of Puerto Rico Tax Law," is an independent document prepared by the Library of Congress. The Joint Committee staff requested the assistance of the Library of Congress to help provide a more complete context for reviewing potential tax changes and context for prior law.

[39] Income Taxes, 1 Puerto Rico Tax Rep. (CCH) ¶ 10-001, at 10,051 (2005).

[40] *Id.*

[41] *Id.*

2. Domestic or resident corporations

Tax base and rates

Under section 1015 of the IRC, a tax of 20 percent of normal-tax net income of corporations must be imposed, collected, and paid for each taxable year.[42] Section 1015 of the IRC provides that this rule is not applicable to some corporations.[43] Normal-tax net income is defined as the net income minus the credit for dividends received.[44] Alternatively, a tax of 22 percent of the net income derived from operations covered under certain tax incentive acts may be applicable.[45]

In addition, a surtax net taxable income is imposed on corporations at the rates set out in the following chart:[46]

If the surtax net income is:	The tax will be:
Not more than $75,000	5 percent
Over $75,000 but not over $125,000	$3,750 plus 15 percent of excess over $75,000
Over $125,000 but not over $175,000	$11,250 plus 16 percent of excess over $125,000
Over $175,000 but not over $225,000	$19,250 plus 17 percent of excess over $175,000
Over $225,000 but not over $275,000	$27,750 plus 18 percent of excess over $225,000
Over $275,000	$36,750 plus 19 percent of excess over $275,000

[42] Código de Rentas Internas según enmendado al 31 de diciembre de 2004, sec. 1015 (b) 1 [Internal Revenue Code, as amended though Dec. 31, 2004], http://www.hacienda.gobierno.pr/publicaciones/cod_rentas_internas.html (last visited Apr. 17, 2006). The hyperlink in this footnote connects to the official web site of the Puerto Rico Department of Treasury.

[43] Corporations subject to the tax imposed by Subchapter G, corporations of individuals subject to the provisions of Subchapter N, and foreign corporations not involved in the conduct of a trade or business in Puerto Rico and subject to the tax imposed by section 1231 (a).

[44] Código de Rentas Internas según enmendado al 31 de diciembre de 2004, sec. 1015 (a), [Internal Revenue Code, as amended though Dec. 31, 2004], http://www.hacienda.gobierno.pr/publicaciones/cod_rentas_internas.html (last visited Apr. 17, 2006). The hyperlink in this footnote connects to the official web site of the Puerto Rico Department of Treasury.

[45] *Id.* Sec. 1015 (b) 2.

[46] *Id.* Sec. 1016 (b) 1.

Surtax net taxable income is the normal-tax net income minus the surtax credit.[47] The surtax credit is generally equal to $25,000.[48] The graduated surtax rates are phased out for corporations with taxable income in excess of $500,000.[49] The net effect of the phase out is that a flat tax rate of 39 percent applies to corporations with taxable income equal to or exceeding $905,000.[50]

<u>Alternative minimum tax</u>

Corporations may be required to pay an alternative minimum tax ("AMT") in lieu of the normal tax on net income.[51] AMT aims to prevent a corporation that has substantial economic income from using preferential deductions, exclusions, and credits to significantly reduce or eliminate its Puerto Rico tax liability.[52] To achieve this goal, AMT is structured as a separate tax system with its own allowable deductions and credit limitations.[53]

AMT is imposed at a flat rate of 22 percent if a corporation's alternative minimum taxable income ("AMTI") exceeds $50,000.[54] The $50,000 exemption is reduced by 25 percent of the amount by which the AMTI exceeds $500,000.[55] Consequently, a corporation with AMTI over $700,000 is not entitled to any exemption.[56]

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[47] ERNST & YOUNG, DOING BUSINESS IN PUERTO RICO 49 (2004), *available at* http://www.pridco.com/english/research_center/doingbusiness/business_in_puerto_rico.pdf (last visited Apr. 17, 2006). The hyperlink in this footnote connects to the official web site of the Puerto Rico Industrial Development Company (PRIDCO).

[48] *Id.*

[49] *Id.*

[50] *Id.*

[51] Código de Rentas Internas según enmendado al 31 de diciembre de 2004, sec. 1017, [Internal Revenue Code, as amended though Dec. 31, 2004], http://www.hacienda.gobierno.pr/publicaciones/cod_rentas_internas.html (last visited Apr. 17, 2006). The hyperlink in this footnote connects to the official web site of the Puerto Rico Department of Treasury.

[52] ERNST & YOUNG, *supra* note 46.

[53] *Id.*

[54] *Id.*

[55] *Id.*

[56] *Id.*

AMTI is computed by making adjustments to regular taxable income, before adding certain tax-preference items.[57] The required adjustments attempt to convert preferential deductions allowed under the regular tax rate system (for example, deductions for accelerated depreciation) into less favorable deductions under the AMT system.[58] In addition, AMTI is increased by 50 percent of the amount by which a corporation's book income exceeds its AMTI, before deducting any net operating loss for AMT purposes.[59] AMT net operating losses and AMT foreign tax credits generally may not be used to reduce AMT by more than 90 percent.[60] The amount of AMT due is the amount by which AMT exceeds the regular tax.[61] If an AMT payment is due, the net amount of AMT paid may be credited against the regular tax in succeeding years if a corporation's regular tax exceeds its AMT.[62]

Deductions

In general, all ordinary and necessary expenses incurred in carrying on a trade or business are deductible against gross income.[63] Deductible business expenses generally include, but are not limited to, salaries and wages, bad debts, rents, state and local income taxes, foreign income taxes (unless the taxpayer elects to claim a foreign tax credit), property taxes, interest, travel expenses, business-related meals and entertainment expenses, pension fund contributions, and depreciation and amortization.[64] However, these deductions are subject to statutory limitations.[65]

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[57] *Id.*

[58] *Id.*

[59] *Id.*

[60] *Id.*

[61] *Id.*

[62] *Id.*

[63] Código de Rentas Internas según enmendado al 31 de diciembre de 2004, sec. 1023, (Internal Revenue Code, as amended though Dec. 31, 2004), http://www.hacienda.gobierno.pr/publicaciones/cod_rentas_internas.html (last visited Apr. 17, 2006). The hyperlink in this footnote connects to the official web site of the Puerto Rico Department of Treasury.

[64] ERNST & YOUNG, *supra* note 46, at 55 (2004).

[65] *Id.*

Cost recovery provisions

A reasonable allowance may be deducted from gross income for the exhaustion, wear and tear, and obsolescence of property used in trade or business.[66] The depreciation methods allowed under Puerto Rico tax law are accelerated and flexible depreciation.[67]

Deductions for accelerated depreciation are allowed only for assets acquired in tax years beginning on or after July 1, 1995.[68] Deductions for flexible depreciation are allowed only for assets acquired in tax years beginning before July 1, 1995.[69]

The flexible depreciation method is limited to businesses engaged in the following activities: agriculture, construction, land development, substantial rehabilitation of buildings, selling or leasing buildings or structures, manufacturing, tourism, and shipping.[70]

Businesses enjoying a tax exemption under the provisions of Puerto Rico Tax Incentives Acts, discussed later in this section of the report, are precluded from using the flexible depreciation method.[71] The amount of the flexible depreciation deduction is limited to a percentage of taxable income.[72]

In general, the maximum depreciable cost for an automobile is $25,000, which may be depreciated over a useful life of 3 to 5 years.[73]

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[66] Código de Rentas Internas según enmendado al 31 de diciembre de 2004, sec. 1023 (k), [Internal Revenue Code, as amended though Dec. 31, 2004], http://www.hacienda.gobierno.pr/publicaciones/cod_rentas_internas.html (last visited Apr. 17, 2006). The hyperlink in this footnote connects to the official Web site of the Puerto Rico Department of Treasury.

[67] *Id.* Sec. 1117 & 1118.

[68] *Id.* Secs. 1023 (k) & 1118 (a)1.

[69] *Id.* Secs. 1023 (k) & 1117 (d)1.

[70] *Id.* Sec. 1117 (d)1.

[71] ERNST & YOUNG, *supra* note 46, at 56 (2004).

[72] *Id.*

[73] Código de Rentas Internas según enmendado al 31 de diciembre de 2004, sec. 1023 (k) 3, [Internal Revenue Code, as amended though Dec. 31, 2004], http://www.hacienda.gobierno.pr/publicaciones/cod_rentas_internas.html (last visited Apr. 17, 2006). The hyperlink in this footnote connects to the official Web site of the Puerto Rico Department of Treasury.

3. Nonresident foreign companies

Foreign corporations that are not engaged in a Puerto Rico trade or business are referred to as nonresident foreign corporations.[74] Nonresident foreign corporations generally are subject to Puerto Rico income tax on their Puerto Rico-source gross income at the following tax rates:

A rate of 10 percent applies to dividends.[75]

- A rate of 29 percent applies to royalties to a corporation organized in the United States or in a foreign country.[76]
- A rate of 29 percent applies to all other fixed or determinable, annual, or periodical gains, profits, and income.[77]
- A rate of 29 percent applies to net capital gains.[78]

4. Taxation of individuals

Residents of Puerto Rico are subject to Puerto Rico tax on their worldwide income.[79] Nonresidents are subject to taxes on income that derives from Puerto Rico sources and on income treated as effectively connected with the conduct of a trade or business in Puerto Rico.[80]

An individual's regular tax liability is determined under one of the following tax rate tables, depending on the taxpayer's filing status.[81]

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[74] ERNST & YOUNG, *supra* note 46, at 50 (2004).

[75] Código de Rentas Internas según enmendado al 31 de diciembre de 2004, sec. 1231 (a)1,A,ii, [Internal Revenue Code, as amended though Dec. 31, 2004], http://www.hacienda.gobierno.pr/publicaciones/cod_rentas_internas.html (last visited Apr. 18, 2006). The hyperlink in this footnote connects to the official web site of the Puerto Rico Department of Treasury.

[76] ERNST & YOUNG, *supra* note 46, at 50 (2004).

[77] Código de Rentas Internas según enmendado al 31 de diciembre de 2004, sec. 1231 (a)1,A,i, [Internal Revenue Code, as amended though Dec. 31, 2004], http://www.hacienda.gobierno.pr/publicaciones/cod_rentas_internas.html (last visited Apr. 18, 2006). The hyperlink in this footnote connects to the official web site of the Puerto Rico Department of Treasury.

[78] *Id.*

[79] ERNST & YOUNG, *supra* note 46, at 77.

[80] Reglamento No. 5718 del Código de Rentas Internas [Internal Revenue Code Regulation No. 5718], art. 1011-2, http://www.hacienda.gobierno.pr/pdf/reglamentos/5718.pdf (last visited Apr. 18, 2006). The hyperlink in this footnote connects to the official web site of the Puerto Rico Department of Treasury.

This table applies to the following categories of taxpayers: single, head of household, married filing jointly, and married not living with spouse:[82]

Tax for taxable years starting after December 31, 2000

If the net taxable income is:	The tax will be:
Not greater than $2,000	7 percent
Greater than $2,000 but not greater than $17,000	$140 plus 10 percent of the excess over $2,000
In excess of $17,000 but not in excess of $30,000	$1,640 plus 15 percent of the excess over $17,000
In excess of $30,000 but not in excess of $50,000	$3,590 plus 28 percent of the excess over $30,000
In excess of $50,000	$9,190 plus 33 percent of the excess over $50,000

This table provides the rates for taxpayers who are married, living with spouse and filing separately:[83]

Tax for taxable years starting after December 31, 2000

If the net taxable income is:	The tax will be:
Not greater than $1,000	7 percent
Greater than $1,000 but not greater than $8,500	$70 plus 10 percent of the excess over $1,000
In excess of $8,500 but not in excess of $15,000	$820 plus 15 percent of the excess over $8,500
In excess of $15,000 but not in excess of $25,000	$1,795 plus 28 percent of the excess over $15,000
In excess of $25,000	$4,595 plus 33 percent of the excess over $25,000

The rates above apply to residents and nonresident aliens engaged in a trade or business in Puerto Rico.[84] In general, a nonresident alien who performs personal services as an employee

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[81] Código de Rentas Internas según enmendado al 31 de diciembre de 2004, sec. 1011 (a) 3, [Internal Revenue Code, as amended though Dec. 31, 2004], http://www.hacienda.gobierno.pr/publicaciones/cod_rentas_internas.html (last visited Apr. 18, 2006). The hyperlink in this footnote connects to the official web site of the Puerto Rico Department of Treasury.

[82] *Id.* Sec. 1011 (a) 3 (A).

[83] *Id.* Sec. 1011 (a) 3 (B).

[84] ERNST & YOUNG, *supra* note 46, at 82-83.

in Puerto Rico at any time during the tax year is considered to be engaged in a Puerto Rico trade or business.[85]

Nonresident aliens who are not engaged in a trade or business in Puerto Rico generally are taxed at a rate of 29 percent on Puerto Rico-source income that is fixed or determinable, annual or periodical gains, profits and income.[86] This assessment includes investment income, including interest, dividends, rental income, and capital gains.[87] To enhance the collection of these taxes, all persons paying Puerto Rico-source income are required to deduct and withhold the appropriate amounts of Puerto Rico tax from payments to nonresidents.[88]

5. Revenues from income tax

The Office of Management and Budget in Puerto Rico estimates that revenue from income tax paid by individuals and corporations during the 2004-2005 fiscal year was roughly $4,756,800,000.[89]

6. Special rates of tax, deductions and credits

In general

The Puerto Rico government has implemented a series of tax incentives to encourage the establishment of new companies in Puerto Rico. The most significant of these incentives are contained in the Puerto Rico Tax Incentives Act of 1998 (the 1998 Act).[90]

Puerto Rico Tax Incentives Act of 1998

The Puerto Rico Tax Incentives Act of 1998 ("the 1998 Act") offers tax exemptions to eligible businesses engaged in the manufacture or production of articles in Puerto Rico and to

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[85] *Id.* at 83.

[86] *Id.*

[87] *Id.*

[88] *Id.*

[89] Resumen del Presupuesto, Recursos Consolidados del Gobierno de Puerto Rico, 7 [Budget Summary, Puerto Rico Government Consolidated Resources], http://www.presupuesto.gobierno.pr/Tomo_I/Resumen/recursosConsolidados.pdf (last visited Apr. 20, 2006). The hyperlink in this footnote connects to the official web site of the Puerto Rico Office of Management and Budget.

[90] Ley de Incentivos Contributivos de 1998 [Tax Incentives Act of 1998], http://www.estado.gobierno.pr/OECI/Leyes/Ley135-esp.pdf (last visited Apr. 19, 2006). The hyperlink in this footnote connects to the official web site of the Puerto Rico State Department.

entities intending to perform, on a commercial scale in Puerto Rico, services destined for foreign markets, entities engaged in the development of port operations and transshipment facilities, and entities engaged in partial recycling processes.[91] In general, eligible businesses include companies that are new to Puerto Rico and existing companies that plan to expand their operations by more than 25 percent.[92]

Companies that qualify under the 1998 Act are entitled to the following tax incentives:

- The maximum corporate income tax rate is reduced to a flat tax rate ranging from two percent to seven percent on industrial development income ("IDI").[93] The IDI is the net income of the exempt business derived from its exempt operations, stipulated investment income, and the dividend income or the partnership profits derived from these sources.[94]
- Apparel, textile, shoe, leather products and fish canning industries are eligible for a special tax exemption rate of four percent.[95] In exceptional cases, according to the importance of the investment project the rate could be lowered to a minimum of two percent.[96]
- Certain industrial projects that are considered core pioneer industrial activities by the Puerto Rico government could be eligible for a corporate income tax rate ranging from zero percent to two percent.[97] Core pioneer industries are those that employ innovative technology never used in Puerto Rico before January 1, 2000.[98]
- Eligible manufacturing industries may qualify for one of the following alternatives: (1) a deduction of 15 percent of annual production payroll up to 50 percent of

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[91] ERNST & YOUNG, *supra* note 46, at 22.

[92] *Id.* at 22-23.

[93] Ley de Incentivos Contributivos de 1998, sec. 10102 [Tax Incentives Act of 1998], http://www.estado.gobierno.pr/OECI/Leyes/Ley135-esp.pdf (last visited Apr. 19, 2006). The hyperlink in this footnote connects to the official web site of the Puerto Rico State Department.

[94] ERNST & YOUNG, *supra* note 46, at 23.

[95] Commonwealth of Puerto Rico, *Corporate Income Tax Incentives,A. Tax Rates*, http://www.pridco.com/english/tax_&_business_incentives/tax_incentives/3.12corp_tax_incentives.html (last visited Apr. 19, 2006). The hyperlink in this footnote connects to the official web site of the Puerto Rico Industrial Development Company (PRIDCO).

[96] *Id.*

[97] *Id.*

[98] *Id.*

industrial development income when the latter is under $30,000 per production worker; or (2) a deduction of the first $100,000 of the industrial development income, if it is under $500,000 and the company keeps an average of 15 or more employees.[99]

- The Tax Incentives Act offers a 100 percent tax deduction on training expenses related to exempt businesses.[100] This special deduction covers training aimed at improving productivity, quality control, and other qualitative aspects included in the human resource sector.[101]
- A deduction is granted for research and development expenses for new or improved products or industrial processes.[102] This deduction will not apply to any cash amount received as a donation, subsidy, or incentive from the Commonwealth of Puerto Rico for the same purposes.[103]
- Every exempt business will be eligible to deduct, in a selected year, the expenditures incurred in the purchase, acquisition, or construction of a building, structure, or machinery and equipment, as long as these expenditures have not been subjected to prior depreciation and are used to produce articles or services for which the Commonwealth of Puerto Rico has allowed tax exemptions under the Tax Incentives Act.[104]
- The Tax Incentives Act provides a credit for the purchase of products manufactured by unrelated parties in Puerto Rico.[105] As this credit is created to stimulate demand for local products, it will be allowed only for the amount exceeding the company's mean purchase of local products for the previous three years.[106] This credit may be carried over to subsequent taxable years, until it is exhausted.[107]
- Exempt businesses that produce high technology products, introduced to the market after January 1, 2000, may request from the Secretary of State a credit of the amount exceeding $100 million of annual taxes withheld for the payment of rights, rents,

[99] *Id.* Deductions, Payroll.

[100] *Id.* Deductions, Training.

[101] *Id.*

[102] *Id.* Deductions, R & D.

[103] *Id.*

[104] *Id.* Deductions, Buildings, Machinery & Equipment.

[105] *Id.* Credits, Locally Manufactured Goods.

[106] *Id.*

[107] *Id.*

royalties, and licenses related to the production of those goods.[108] This credit will apply to taxes imposed only to the high tech goods produced by the exempt activity.[109]

<u>Other tax incentives acts</u>

Other Puerto Rico legislation grants tax exemptions to enterprises engaged in specified economic activities. For example, under the Puerto Rico Tourist Development Act of 1993, as amended, qualified tourist activities may enjoy a 90 percent to 100 percent exemption from income tax and municipal license tax, a 100 percent exemption from excise tax, and a 90 percent exemption from real and personal property taxes.[110] In addition, under the Agricultural Tax Incentives Act of 1995, as amended, bona fide farmers may enjoy a 90 percent exemption from income tax, and a 100 percent exemption from municipal license tax, excise tax, and real and personal property taxes.[111]

7. Puerto Rico excise and other taxes

In addition to an income tax imposed to individuals and corporations, the Puerto Rico revenue system consists of a property tax (Commonwealth and municipal) and numerous excise taxes. An outline of these taxes follows.

Real Property Taxes[112]

Basis – Rates	Due Date
Municipalities – authorized to levy a basic tax of up to 6 percent annually on the assessed value of real property located within their territorial limits.	Payment – Semiannually in advance on July 1 and January 1 of each year. The Municipal Revenues Collection Center collects both Commonwealth and municipal taxes.
Commonwealth – Special tax of 1.03 percent is levied on real property not exempt from taxation.	

[108] *Id*. Credits, High Technology Goods.

[109] *Id.*

[110] ERNST & YOUNG, *supra* note 46, at 25.

[111] *Id.*

[112] Tax System Summary, 1 Puerto Rico Tax Rep. (CCH) ¶ 5-005, at 6,362 (2005).

Alcoholic Beverages Tax[113]

Basis - Rates	Due Dates and Payment Method
Distilled Spirits obtained from fermentation and distillation of any product other than those derived from sugar cane; below 100 degrees proof, \$31.29 per measured gal.; 100 degrees proof or more, \$31.29 per proof gal. Distilled spirits obtained through fermentation and distillation of products derived from sugar cane: below 100 degrees proof, \$15.12 per measured gal.; 100 degrees proof or more, \$15.12 per proof gal.	Payment Method – By check or legal tender against receipts which have been correlatively and/or alphabetically pre-numbered.
Imported champagne and sparkling or carbonated wines – Not over 24 percent alcohol by volume, \$13.75 per measured gal.; from must concentrated wines, \$5.50 per measured gal.	Payment Due for Distillers – Before spirits are removed from distillery. Payment Due for Rectifiers Receiving Distilled Spirits on Which No Taxes Have Been Paid - Before products are removed from bonded warehouse. Payment Due for Manufacturers – Before manufactured products are removed from factory. Payment Due for Distilled Spirits or Alcoholic Beverages Brought Into Puerto Rico – Before they are taken from the custody of the customs house, post office, express company, or any public or private carrier bringing them into Puerto Rico.
Wines Not Over 24 percent alcohol by volume - Substandard and imitation wines, \$1.65 per measured gal.; imported wines and ciders, \$11.35 per measured gal.; wines from tropical fruits, 62 cents per measured gal.; must concentrated wines, \$4.13 per measured gal. Beer, Malt Extract and Similar Products – ½ of 1 percent alcohol but not over 1½ percent alcohol, 70 cents per measured gal.; over 1½ percent alcohol - \$4.05 per measured gal. if in containers holding less than 5 measured gal., \$4.12 if in containers holding 5 or more measured gal.	
Licenses - \$15 to \$7,200 based on classification of business.	Payment due at the time license is obtained or renewed, no later than October 31 of each year. Ten percent discount of license fees if payment is made between the fifteenth and the thirtieth day of September of the corresponding year.

[113] *Id.* at 6,363.

Gasoline Tax[114]

Basis - Rates	Due Date
Sixteen cents per gal.; aviation fuel 3 cents per gallon; 8 cents per gal. on gas oil or diesel oil.	Payment – At time gasoline is imported into Puerto Rico or upon first taxable event if refined in Puerto Rico.

Motor Vehicle Excise Taxes[115]

Basis - Rates	Due Date
Automobiles, a tax ranging from 13 percent to 40 percent of the taxable price; truck tractors, 17 percent of taxable price; buses, 20 percent; trucks, 10 percent. Excise tax must be at least $750.	When imported into Puerto Rico or upon first taxable event if manufactured in Puerto Rico.

[114] *Id.* at 6,364.

[115] *Id.*

Admissions Tax[116]

Basis - Rate	Due Date
Ten percent of admission fee.	Person in charge of public show remits tax collected to Secretary of Treasury on Tuesday of each week for all public shows held between.

Cigarette Tax[117]

Basis - Rate	Due Date
Rated at $6.15 per 100 cigarettes.	Before first taxable event. Extension of time not to exceed 15 days from date of delivery when cigarettes are imported from the U.S.

Other Excise Taxes[118]

Basis – Rate	Due Dates
Articles – Sugar is taxed at 14 cents per pound. Articles that are not covered by a specific statute and are not exempt are taxed at 5 percent of Puerto Rico taxable price. Hydraulic cement is taxable at 6 cent per cwt.	For goods brought into Puerto Rico other than by mail, the tax must be paid before goods are delivered to taxpayer. For goods brought into Puerto Rico by mail, the tax is payable no later than second working day following day in which possession is taken. Tax on articles carried into Puerto Rico by person must be paid no later than second working day after day of arrival. For articles of local manufacture, the tax is payable by tenth day of month following month in which first taxable event occurs.
Transactions – Occupancy (hotel rooms, apartment hotels, guest houses), 9 percent of occupancy rental. If the hotel has a casino the rate is 11 percent. Sales of jewelry, 5 percent of the retail price. Winnings – Racing pools and any other gaming where races are held, 20 percent of the amount won. Prizes won by horse owners in races, 6 percent of amount of each price. Printed forms used in pool gamings at Puerto Rico hippodromes, 5 cents per betting form.	Transactions – Occupancy taxes are payable tenth day of each month. Gambling winnings, prizes won by horse owners and printed forms for pool gaming are payable second working day following day races were held.

116 *Id.*

117 *Id.*

118 *Id.* at 6,365.

Insurance Companies Tax[119]

Basis - Rates	Due Dates
Premium Tax – Life and Disability Insurances – 4 percent of premiums after deducting dividends, returned premiums and amounts refunded or the amount of reductions in premiums allowed to holders of industrial life policies for payment of premiums direct to an office of the insurer. Annuity Contracts – 1 percent of consideration received on direct business after deduction of dividends and returned annuity considerations. All other kinds of insurance or contracts – 4 percent of premiums after deducting returned premiums, except for certain types of insurers.	On or before March 31 of the subsequent taxable year to the Secretary of Treasury through the Commissioner of Insurance.

Estate and Gift Taxes[120]

Basis - Rates	Due Dates
Tax range from 18 percent of the amount over which the tax is computed to $1,025,800 plus 50 percent of the excess over $2,500,000.	Estate tax payable within 270 days following the date of the decedent. The gift tax is to be paid on or before April 15 of the calendar year following the one in which the gifts are made.

Unemployment Insurance Tax[121]

Basis - Rates	Due Date
Employers covered under the Puerto Rico law, but not under the Federal Unemployment Tax Act pay on the first $7,000 of salary paid at a rate determined by the amount of the Unemployment Fund and the amount of the employer's reserve fund.	Paid through the Secretary of the Treasury for the Unemployment Fund.

[119] *Id.*

[120] *Id.* at 6,366.

[121] *Id.*

C. Overview of U.S. Tax Provisions Relating to Other U.S. Possessions

1. U.S. territories and commonwealths

In general

The United States has 12 unincorporated territories, also known as possessions, and two commonwealths.[122] The major possessions are American Samoa, Guam, and the U.S. Virgin Islands ("USVI"). The major commonwealths are Puerto Rico and the Northern Mariana Islands ("CNMI"). Four of the five major possessions and commonwealths (hereafter referred to as "U.S. possessions") have a non-voting representative in the U.S. Congress.[123] Residents of U.S. possessions are U.S. citizens, with the exception of those individuals in American Samoa who are U.S. nationals, but not U.S. citizens.

In general, all U.S. Federal statutory laws apply throughout the U.S. possessions unless specifically excepted. While U.S. statutory laws apply to the U.S. possessions, and residents of U.S. possessions are full U.S. citizens, for tax purposes, the Code generally treats the U.S. possessions as foreign countries. The hybrid treatment of the U.S. possessions by the U.S. Federal government coupled with the fact that tax systems vary within each U.S. possession, has resulted in a complicated set of rules and regulations governing the major U.S. possessions.

Individuals

Generally, special U.S. income tax rules apply with respect to U.S. persons who are bona fide residents of U.S. possessions and who have possession source income or income effectively connected with the conduct of a trade or business within a possession. The term "bona fide resident" means a person who meets a two-part test with respect to American Samoa, Guam, USVI, Puerto Rico, or CNMI as the case may be, for the taxable year. First, an individual must be present in the U.S. possession for at least 183 days in the taxable year. Second, an individual must (1) not have a tax home outside such possession during the taxable year and (2) not have a closer connection to the United States or a foreign country during such year. There are certain exceptions for persons whose presence outside a U.S. possession for extended periods of time lacks a tax avoidance purpose.[124]

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[122] American Samoa, Baker Island, Guam, Howland Island, Jarvis Island, Johnston Atoll, Kingman Reef, Midway Islands, Navassa Island, Northern Mariana Islands, Palmyra, Puerto Rico, U.S. Virgin Islands (St. Croix, St. John, St. Thomas), Wake Islands.

[123] The Northern Mariana Islands is represented by a resident representative instead of a non-voting delegate in the U.S. House of Representatives. A bill introduced in the 109th Congress, H.R. 873, would give the Northern Mariana Islands a non-voting delegate equivalent to American Samoa, Guam, Puerto Rico, and the U.S. Virgin Islands.

[124] Sec. 937(a).

Individual residents living in U.S. possessions generally are subject to either a single- or double-filing system with respect to their income. Individual residents subject to section 931 or 933 (e.g., bona-fide residents of Puerto Rico and American Samoa) operate under a double-filing system. Under a double-filing system, income that is not exempt from U.S. tax under section 931 or 933, and meets certain filing thresholds, must be reported to the United States on a U.S. return. Thus, individuals operating under a double-filing system that have income from sources outside the U.S. possession where they are resident (e.g., a Puerto Rico individual with non-Puerto Rico-source income) must file a tax return in the United States and in the U.S. possession where they are a bona-fide resident if such income is subject to reporting. Income reported on a U.S. return by a bona-fide resident of a U.S. possession is generally subject to the same U.S. tax treatment that applies to individuals resident in the United States; low-tax income will be subject to U.S. residual tax and high-tax income will be eligible for a foreign tax credit. In contrast, individual residents subject to section 932(c) or 935 (e.g., bona-fide residents of USVI, CNMI and Guam) generally operate under a single-filing system. Under a single-filing system, income is only reported in one jurisdiction, based on bona-fide residency. Thus, individuals operating under a single-filing system generally do not have to file a tax return with the United States. In a single-filing system, income is often allocated between the U.S. possession and the United States through a cover over mechanism.

As a general rule, the principles for determining whether income is U.S. source are applicable for purposes of determining whether income is possession source. In addition, the principles for determining whether income is effectively connected with the conduct of a U.S. trade or business are applicable for purposes of determining whether income is effectively connected to the conduct of a possession trade or business. However, except as provided in regulations, any income treated as U.S. source income or as effectively connected with the conduct of a U.S. trade or business is not treated as income from within any possession or as effectively connected with a trade or business within any such possession.[125]

For purposes of the foreign earned income exclusion, the U.S. possessions are not treated as a foreign country. Thus, residents of U.S. possessions do not qualify for the foreign earned income or housing exclusion under section 911 of the Code because they are not considered resident abroad.[126]

Section 877 of the Code provides that U.S. citizens who relinquish their citizenship and U.S. residents who terminate their long-term residency are subject to an alternative tax regime for a period of 10 years if they meet certain income and net-worth thresholds or they fail to comply with certain U.S. Federal tax obligations. U.S. citizens and residents that leave the United States and establish residency in Puerto Rico or USVI are not considered to have relinquished their U.S. citizenship or terminated their U.S. residency; however, U.S. citizens and

[125] Sec. 937(b).

[126] For a description of certain changes to the section 911 exclusion included in the recently enacted TIPRA, see H.R. Conf. Rep. No. 109-455, at 307-10 (2006).

residents that leave the United States and establish residency in American Samoa, CNMI, or Guam could be subject to the rules governing the alternative tax regime.[127]

Corporations

Corporations formed in the U.S. possessions are generally treated as foreign corporations for U.S. tax purposes. Income earned by a foreign corporation from its foreign operations generally is subject to U.S. tax only when such income is distributed to any U.S. persons that hold stock in such corporation. However, several sets of anti-deferral rules impose current U.S. tax on certain income earned by a U.S. person through a foreign corporation. Thus, the foreign status of entities formed in a U.S. possession means that such entities may be subject to U.S. anti deferral regimes, such as the controlled foreign corporation regime (subpart F), and such entities may have to pay current U.S. tax on their foreign source income.

Foreign corporations with U.S. source income are generally subject to U.S. tax on a net basis at graduated rates on income effectively connected to a U.S. trade or business. U.S.-source passive income paid to a foreign corporation is generally taxed on a gross basis at a withholding rate of 30 percent. However, notwithstanding the general rule that companies organized in a U.S. possession are treated as foreign corporations, certain qualifying corporations are deemed not to be foreign corporations for purposes of withholding taxes on passive income. Corporations organized in American Samoa, Guam, USVI, or CNMI are not subject to withholding tax on payments from corporations organized in the United States, provided that certain local ownership and activity requirements are met. In turn, each of those possessions have adopted local internal revenue codes that provide a zero rate of withholding tax on payments made by corporations organized in such possession to corporations organized in the United States. Thus, certain corporations organized in American Samoa, Guam, USVI, or CNMI can receive dividend payments from a U.S. subsidiary at a zero rate of withholding.

2. U.S. Virgin Islands

In general

USVI has an income tax system that "mirrors" the U.S. Code. In 1921, Congress enacted a statute that made the Code part of the internal law of USVI. Thus, the income tax laws of the United States are generally adopted by USVI, incorporated into the USVI tax code, and where appropriate, the term "Virgin Islands" is substituted for "United States." This is commonly referred to as a "mirror system" of taxation.

In general, persons incurring income tax liability in both the United States and USVI are required to file tax returns and pay income tax to both jurisdictions. USVI may also impose certain local income taxes in addition to taxes imposed by the mirror Code.

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[127] See section 1277(e) of Pub. Law. No. 99-514. Under this special source rule, gains from dispositions of certain property held by a U.S. person prior to becoming a resident in American Samoa, CNMI or Guam is treated as income from sources within the United States for all purposes of the Code.

Individuals

Under the mirror Code, USVI individuals are taxable on their worldwide income. A USVI resident must pay tax on his or her worldwide income and file a tax return with the USVI government as a bona fide USVI resident for the entire taxable year. A foreign tax credit is allowed for income taxes paid to the United States, foreign countries, and other possessions of the United States.

Prior to 1986, U.S. citizens and resident aliens were treated as nonresident aliens for USVI purposes. Similarly, a citizen or resident of USVI who was not otherwise a U.S. citizen or resident alien was taxed as a nonresident alien for U.S. federal tax purposes. The Tax Reform Act of 1986 (the "1986 Act") made significant modifications to the mirror system for individuals and provided that if an individual is a U.S. citizen or alien residing in the United States or USVI, only one tax is computed under the Code. If an individual is a bona fide resident of USVI, such tax is payable to USVI and no U.S. tax is imposed. If a citizen or resident of the United States has income from sources within USVI but does not reside there, such tax is apportioned and the pro-rata portion attributable to USVI is payable to USVI. The remaining portion is payable to the United States.[128]

Corporations

If a corporation is formed in USVI, it is classified as a domestic corporation for USVI purposes and a foreign corporation for U.S. tax purposes. Such a corporation is only subject to U.S. tax if it has U.S. source income or income effectively connected with the conduct of a trade or business in the United States. USVI taxes a domestic corporation on its worldwide income, but the company is allowed a foreign tax credit against USVI tax for taxes imposed by the United States, foreign countries and other possessions. A corporation that is not formed in USVI is treated as a foreign corporation under the USVI mirror Code. A company not formed in USVI is only subject to USVI tax if it has USVI source income or income effectively connected with the conduct of a trade or business in USVI. The United States taxes its domestic corporations on their worldwide income, but allows a foreign tax credit for taxes imposed by foreign jurisdictions, including USVI.

Economic development initiatives

The USVI has enacted development incentives for certain types of businesses operating within its borders. Under section 934 of the Code, USVI is allowed to reduce or remit tax liability incurred to USVI and attributable to USVI source income or income effectively connected to the conduct of a trade or business in USVI. Under such initiatives, companies can receive a 90 percent reduction in their tax liability on certain income.

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[128] Sec. 932.

3. Guam

In general

Under the Organic Act of 1950, Guam employs a mirror system of taxation. The rules for coordination of U.S. and Guam income taxes are found in section 935. This section was repealed by the 1986 Act, however, the 1986 Act changes apply only if there is an implementation agreement in effect between Guam and the United States. The United States and Guam executed a tax implementation agreement in 1989 that was supposed to enter into force on January, 1 1991. However, such agreement was amended in December of 1990 and the effective date was postponed indefinitely. Thus, without an implementation agreement, pre-1986 law is still in effect and section 935 is still applicable to Guamanian residents.

Individuals

Under section 935, an individual resident of the United States or Guam is required to file only one tax return with respect to their income tax liability. In general, U.S. residents file only with the United States, Guamamian residents file only with Guam, and those individuals subject to Guamanian or U.S. income tax who are not residents of either Guam or the United States generally file with the United States. Bona fide residence is determined based on the entire taxable year, as opposed to the close of the taxable year, and joint filers file based on the spouse who has the greater adjusted gross income for the taxable year. In addition, with respect to taxation of U.S. and Guamanian citizens and resident individuals, the United States is treated as part of Guam for purposes of Guamanian taxation and Guam is treated as part of the United States for purposes of U.S. taxation. The United States generally covers over to the Guamanian Treasury certain taxes collected from individuals on Guamanian source income and withholding tax on U.S. Federal personnel employed or stationed in Guam. Similarly, Guam covers over to the U.S. Treasury certain taxes collected from individuals on U.S. source income.

Corporations

In general, a corporation chartered in Guam is treated as a domestic corporation for Guamanian tax purposes and a foreign corporation for U.S. tax purposes. A Guamanian corporation that receives U.S. source income (other than certain passive income) or income effectively connected to a trade or business in the United States has to file a U.S. return and pay U.S. tax on that income. Guamanian taxpayers are generally entitled to a foreign tax credit for taxes paid to the United States, a foreign country, or another U.S. possession. Other tax credits are also allowed, as mirrored by Guam.

Mirroring the U.S. Code, Guam imposes a 30 percent withholding tax on dividends and other payments made to corporations who are foreign for Guamanian tax purposes. However, the Guam Foreign Investment Equity Act (the "GFIE Act") reduced withholding rates on both individuals and corporations with respect to Guam-source income by deeming Guam to be part of the United States for purposes of U.S. income tax treaties and thus the same rates agreed to in

U.S. income tax treaties shall apply to Guam.[129] For example, under the GFIE Act, the reduced withholding rates under the U.S.-Japan treaty apply to dividend payments from a Guamanian corporation to a Japanese shareholder. According to legislative history, the high statutory withholding rates were considered an impediment to foreign investment in Guam, which accounts for approximately 75 percent of all investment in that territory.[130]

4. Commonwealth of the Northern Mariana Islands

In general

CNMI employs a mirror system of taxation, similar to USVI and Guam, but with a few significant differences. First, references in the U.S. Code to Guam are deemed to also refer to CNMI. Thus, CNMI's mirror Code is linked to Guam's mirror Code. Second, CNMI has the authority to rebate the tax imposed by the CNMI Code with respect to CNMI-source income. CNMI rebates a significant amount of this tax, but imposes three separate taxes that cover most of the same types of income at lower rates.

The 1986 Act authorized CNMI to continue with its mirror system of taxation without regard to whether Guam enacts its own tax laws. The 1986 Act also authorized CNMI to impose its own additional taxes contingent on a tax implementation agreement between the IRS and CNMI. The application of new Code provisions (section 931) and the repeal of section 935, set forth in the 1986 Act, are contingent on a tax implementation agreement being in effect. At this time, no tax agreement has been reached between CNMI and the United States.

Individuals

As mentioned above, CNMI's tax system consists of the same tax laws that apply to Guam. Thus, the filing rules for CNMI are the same as for Guam, including the single filing rule under section 935. Like other U.S. possessions, bona fide residency is determined based on a two-part test that requires an individual to be present in the U.S. possession for at least 183 days in the taxable year, while precluding such individual from having a tax home outside CNMI or having a closer connection to the United States or a foreign country. The major difference between the tax structure of CNMI and Guam is that CNMI taxpayers may claim a nonrefundable credit against their CNMI tax liability with respect to CNMI source income. Rebate rates can range from 50 to 90 percent.

Corporations

For CNMI tax purposes, domestic corporations are those formed in CNMI. Foreign corporations are all corporations formed elsewhere, including the 50 United States and the District of Columbia. CNMI corporations are subject to tax on their worldwide income and a

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[129] Pub. L. No. 107-211, 116 Stat. 1051, August 6, 2002, amending 48 USC sec. 1421(i).

[130] Hon. Robert A. Underwood, 147 Cong. Rec. E40, Jan. 30, 2001.

foreign tax credit is allowed for income taxes paid to the United States, a foreign country, or another U.S. possession. As with other U.S. possessions, CNMI corporations that meet certain income and ownership requirements may be subject to a zero withholding tax rate on passive income from sources within the United States. Other U.S. source income will generally be taxed on a net basis at U.S. graduated rates.

The full amount of corporate income tax liability must be paid to the CNMI government, but as with individuals, a certain percentage is generally rebated to the taxpayer. The rebate rates are the same for corporations as individuals. Corporations with a tax liability of $20,000 or less are entitled to a 90 percent rebate, a tax liability of $100,000 receives a 70 percent rebate, and for tax liabilities over $100,000 a 50 percent rebate is granted.

5. American Samoa

In general

Unlike the other U.S. possessions, individuals born in American Samoa are U.S. nationals, not U.S. citizens.[131] However, all residents of American Samoa are subject to tax as U.S. citizens. Samoans are also subject to local income tax in American Samoa. Also, unlike USVI, Guam, and CNMI, the Code does not include a provision similar to section 932 or 935 that provides for relief from a double filing requirement. Thus, residents of American Samoa potentially have to file with both the U.S. and the American Samoa government.

The Code was not imposed on American Samoa as it was with the other mirror Code possessions. American Samoa adopted its own income tax system and chose the Code as its local income tax in 1963. The 1986 Act allowed American Samoa to continue with its own local income tax system, but conditioned such authority on the existence of a tax implementation agreement between American Samoa and the United States. Such agreement was signed in 1988, but declared effective January 1, 1987 to prevent a gap in American Samoa's authority to impose its income tax. The American Samoa tax system is similar to a mirror system in that the words "American Samoa" are substituted for "United States," where appropriate. However, the American Samoa income tax does not replace U.S. Federal tax, it creates instead a territorial income tax modeled after the federal tax. And instead of provisions like section 932 or 935 that create a single filing requirement, bona fide residents of American Samoa are granted an exclusion from U.S. gross income on all American Samoa-source income and income effectively connected to an American Samoa trade or business (similar to the operation of section 933 for Puerto Rico residents).[132]

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[131] U.S. nationals may live in the United States without restriction and naturalize as U.S. citizens under the same rules as other resident aliens. The distinction between a U.S. national and a U.S. citizen is that a U.S. national cannot vote or hold elected office.

[132] Sec. 931.

Individuals

Individual residents of American Samoa are taxed on their worldwide income pursuant to the local tax imposed by American Samoa. A foreign tax credit is allowed for taxes paid to the United States, a foreign country, or another U.S. possession. Nonresident aliens are only subject to tax on their American-Samoa source income.

Under section 931, U.S. citizens or aliens who are bona fide residents of American Samoa for the entire tax year are allowed an exclusion from U.S. gross income for income derived from sources within American Samoa and income effectively connected with the conduct of a trade or business by such individual within American Samoa. As mentioned above, the foreign earned income exclusion under section 911 is not available to individuals residing in a U.S. possession; however in comparing the foreign earned income exclusion to the exclusion under section 931, the section 931 exclusion is more generous because it is unlimited in its amount. The exclusion for possession source income, however, does not apply to compensation paid to employees of the United States and its agencies. An individual with compensation from a U.S. government employer must file a U.S. return.

Corporations

For American Samoa tax purposes, corporations chartered in American Samoa are domestic corporations. Corporations formed outside American Samoa are regarded as foreign corporations. For American Samoa tax purposes, the taxable income of a corporation is calculated the same as for U.S. corporations under the U.S. Code. Foreign taxes paid by American Samoa corporate taxpayers are creditable towards their American Samoa income tax.

III. MECHANICS OF THE POSSESSION TAX CREDIT

A. The Possession Tax Credit in General

Under prior U.S. law, certain domestic corporations with business operations in U.S. possessions could elect under Code section 936 to generally eliminate the U.S. tax (including the alternative minimum tax) on certain foreign source income which was related to their operations in the possessions.[133] The benefit conferred to companies under section 936 is commonly referred to as the possession tax credit. A majority of the corporations that benefited from the possession tax credit established operations in Puerto Rico. Companies with significant operations in Puerto Rico operated through a Puerto Rico branch of a domestic U.S. corporation. Such corporations were commonly referred to as "section 936 companies." Income that was not subject to U.S. tax under this provision included income that was derived either from the active conduct of a trade or business within a U.S. possession or from certain investments in the possessions or in certain Caribbean Basin countries which generated qualified possession source investment income ("QPSII"). The benefit of the possession tax credit was that it spared the electing corporation U.S. tax whether or not it paid income tax to the possession.

The Small Business Act[134] repealed the possession tax credit for tax years beginning after December 31, 1995. In doing so, the Small Business Act provided grandfather rules that allowed for a 10-year transition period. However, for tax years beginning after December 31, 1995, the Small Business Act stated that QPSII earned after July 1, 1996 no longer qualified for the possession tax credit. The Small Business Act also added an additional income limitation to the calculation of the possession tax credit. [135]

The Small Business Act added a new section 30A to the Code with respect to qualified income earned in Puerto Rico. This section allowed an economic activity credit that was applicable for tax years beginning after December 31, 1995 and before January 1, 2006. While in a separate section of the Code, the economic activity credit (section 30A) was calculated under the rules set forth for the possession tax credit (section 936). The possession tax credit applied generally to taxpayers operating in any U.S. possession. The economic activity credit was a special case of the possession tax credit, applicable only to taxpayers in Puerto Rico.

The possession tax credit and the economic activity credit were subject to either an economic activity limitation or an income limitation. A corporation subject to the economic

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[133] Some companies may still qualify for tax benefits under section 936 or section 30A for some period of time after December 31, 2005, if their current taxable year began sometime before December 31, 2005.

[134] The Small Business Job Protection Act of 1996, Pub. L. No. 104-188, August 20, 1988.

[135] A special rule applied to Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands. This rule allowed such applicable possessions to continue to get the full benefit of the possession tax credit, as in effect prior to repeal, until December 31, 2005. See sec. 936(j)(8).

activity limitation with respect to income earned in Puerto Rico claimed a credit under section 30A rather than under section 936. All other corporations claimed a possession tax credit under section 936.

For the past ten years, domestic corporations with business operations in the U.S. possessions could claim the possession tax credit or the economic activity credit to reduce their U.S. tax on certain income related to operations in the possessions.[136] Both credits expired for taxable years beginning after December 31, 2005 (hereafter, the possession tax credit and economic activity credit are collectively referred to as the "possession tax credit," unless otherwise noted.).

[136] Dividends paid by a section 936 corporation to its U.S. shareholder could qualify for a dividends received deduction. In cases where at least 80 percent of the stock of the electing corporation was owned by a single domestic corporation, the electing corporation's possession source income generally could be distributed without incurring any regular U.S. income tax. However, such a dividend constituted adjusted current earnings of the shareholder for purposes of computing the alternative minimum tax.

B. Qualification for the Credit

Income requirements

In order to qualify for the possession tax credit for a taxable year, a domestic corporation had to satisfy two conditions with respect to its gross income. First, the corporation had to derive at least 80 percent of its gross income for the three-year period immediately preceding the close of the taxable year from sources within a possession. Second, the corporation had to derive at least 75 percent of its gross income for that same period from the active conduct of a possession business. A domestic corporation that had elected the possession tax credit and that satisfied the two conditions (80 percent gross income within a possession and 75 percent active business possession income) for a taxable year generally was entitled to a credit based on the U.S. tax attributable to the taxpayer's possession business income.

Existing credit claimant

In addition to certain income requirements, the possession tax credit applied only to a corporation that qualified as an existing credit claimant. A corporation was an existing credit claimant with respect to a possession if (1) the corporation was engaged in the active conduct of a trade or business within the possession on October 13, 1995, and (2) the corporation elected the benefits of the possession tax credit pursuant to an election which is in effect for its taxable year that includes October 13, 1995. A corporation that added a substantial new line of business (other than a qualifying acquisition of all the assets of a trade or business of an existing credit claimant) ceased to be an existing credit claimant as of the beginning of the taxable year during which such new line of business was added.

C. Computation of the Credit

In general

The possession tax credit generally equaled the electing corporation's pre-credit tax on two types of income: (1) income from sources without the United States that was earned in the active conduct of a trade or business in a possession and (2) foreign source income on a sale or exchange of substantially all assets of an active business in a possession. For years beginning after 1993, the credit was usually limited by a ceiling computed with reference to the payroll and depreciation expenses of the corporation's activities in a possession (economic activity limitation), but the corporation could instead elect to take a fixed percentage of the credit otherwise allowable (income credit limitation.)

Economic activity limitation

Under the economic activity limitation, the possession tax credit was limited to the sum of: (1) 60 percent of the taxpayer's qualifying wage and fringe benefit expense; (2) specified percentages of its depreciation allowances with respect to qualifying intangible property; and (3) in certain cases, the taxpayer's qualifying income taxes in the possession. The credit calculated under the economic activity limitation was referred to as the "economic activity credit." As mentioned above, in the case of a qualifying corporation with qualifying income in Puerto Rico, the limitation on the amount of credit that could be claimed under section 936 by reason of the economic activity limit was the basis of the credit that the taxpayer could claim under section 30A.

Income credit limitation

In lieu of applying the economic activity ceiling, the taxpayer had the option to make a one-time election to take a certain percentage of the credit that otherwise would be allowed. The applicable percentage was initially 60 percent, but was phased down to 40 percent for 1998 and subsequent years. The credit calculated under the percentage limit was referred to as the "income credit." A corporation electing the percentage limitation was allowed a deduction for income taxes paid or incurred to a possession on the portion of the corporation's income that was not sheltered from tax by such credit.

Additional limitations

For corporations that elected to use the income credit method, the possession tax credit attributable to business income from the possession was subject to a cap for taxable years beginning before January 1, 2006. For corporations that used the economic activity credit method, the possession tax credit attributable to business income from the possession was only subject to the income cap for taxable years beginning after December 31, 2001 and before January 1, 2006.

The cap on a corporation's possession business income that was eligible for the possession tax credit was computed based on the corporation's "average adjusted base period possession business income." Average adjusted base period possession business income was the average of the adjusted possession business income for each of the corporation's base period years. The corporation's base period years generally were three of the corporation's five most recent years ending before October 14, 1995, determined by disregarding the taxable years in which the adjusted possession business incomes were highest and lowest. For purposes of this computation, only years in which the corporation had significant possession business income were taken into account.

For purposes of this computation, the corporation's possession business income for a base period year was adjusted by an inflation factor that reflected inflation from such year to 1995. In addition, as a proxy for real growth in income throughout the base period, the inflation factor was increased by five percentage points compounded for each year from such year to the corporation's first taxable year beginning on or after October 14, 1995.

If a corporation's possession business income exceeded the income cap, the corporation's possession business income for the year was an amount equal to the cap for purposes of calculating the possession tax credit. The corporation's credit continued to be subject to either the economic activity limit or the applicable percentage limit, with such limit applied to the corporation's possession business income as reduced to reflect the application of the cap.

IV. LEGISLATIVE HISTORY OF THE POSSESSION TAX CREDIT AND GOVERNMENT REPORTS

For many years, the United States provided a special tax incentive for domestic corporations deriving most of their income from a U.S. possession. As part of the Revenue Act of 1921, Congress enacted the statutory predecessor of section 936. Its purpose was "primarily to help U.S. corporations compete with foreign firms in the Philippines (then a U.S. possession)."[137] Under the 1921 Act, a qualified corporation deriving at least 80 percent of its income from sources within a possession and at least 50 percent of its income from the active conduct of a business within a possession was exempt from U.S. income tax on its foreign source income. The special tax treatment of possessions corporations began to have a significant impact on the economy of Puerto Rico in the late 1940s and although the Philippines ceased to be a U.S. possession in 1946, the provision essentially remained unchanged until 1976.

In 1976, Congress indicated that the special tax treatment for possessions corporations had played an important role in Puerto Rico economic development. The Senate Finance Committee noted that the special tax treatment was said "to assist the U.S. possessions in obtaining employment producing investments by U.S. corporations."[138] The need for special tax incentives was attributed, in part, to the additional costs imposed by possessions status, such as the U.S. minimum wage standards and the requirement to use U.S. flag ships.

As part of the Tax Reform Act of 1976, the United States adopted a credit mechanism by enacting section 936 to replace the existing exemption system. In analyzing section 936 it is helpful to understand that, as a general rule, a domestic corporation may receive no tax benefit from foreign tax incentives because reductions in foreign taxes may simply result in equal reductions in foreign tax credits that are used to offset U.S. taxes. Therefore, the total taxes (U.S. and foreign) paid by the domestic corporation may be unchanged even with the foreign tax incentives. To allow domestic corporations to reap the benefits of tax incentives granted by U.S. possessions, however, section 936 (as originally enacted in 1976) permitted a domestic corporation to elect a credit that effectively exempted the corporation from U.S. tax on its possessions income.[139] As a result, the domestic corporation was effectively taxed on its possessions income only by the possession at the possession's tax rates. The Joint Committee on Taxation has described the section 936 credit as follows:

> In lieu of the ordinary foreign tax credit (for income taxes paid to foreign governments) a tax credit was enacted (the possession tax credit) for the full

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[137] Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 at 999 (1987).

[138] S. Rep. No. 94-938, 94th Cong., 2d Sess. 279 (1976).

[139] The section 936 credit with respect to possessions income was subject to a percentage limitation beginning in 1994 at 60 percent culminating at 40 percent for 1998 and subsequent years.

amount of U.S. tax liability on possessions source income. This is referred to as "tax sparing" since a credit is granted whether or not foreign taxes are paid.[140]

Legislative history accompanying the Tax Reform Act of 1976 stated that it was the understanding of Congress that the Treasury Department would submit to Congress annual reports analyzing the operation and effect of the new section 936 rules. The Treasury Department issued its first report in 1978.[141] In that report, Treasury found that the U.S. Federal tax expenditure per Puerto Rico employee averaged $7,428 in 1975 (under the predecessor rules to section 936). This amount exceeded the average compensation (wages or salary plus other benefits) of a possessions corporation employee, $7,300 in 1975. This U.S. Federal tax expenditure varied substantially among different industries: for pharmaceutical companies, the U.S. Federal tax expenditure averaged almost $35,000 per employee, while in labor-intensive industries, the U.S. Federal tax expenditure typically was less than $3,000 per employee. The Treasury report also concluded that the possessions tax rules had indirect effects on the Puerto Rico economy as a result of increased investment by firms and increased spending by workers, though statistical analysis, according to Treasury, probably overstated these indirect effects because of the opportunity costs of diverting to possessions corporations activity certain resources that would have had other uses.

The Treasury Department study submitted to Congress in 1979 found that the replacement of the pre-1976 rules with section 936 probably did not alter the cost effectiveness of special Federal tax rules for Puerto Rico.[142] The study's findings about the average tax expenditure per employee were similar to the findings of the 1978 study. The 1979 study also found that the Federal tax revenue forgone as a result of the possession corporation rules had increased from $255 million in 1973 to $662 million in 1977 and that forgone revenues were highly concentrated by industry: about 45 percent of tax benefits went to pharmaceutical corporations.

The 1980 and 1983 Treasury reports[143] included findings similar to the earlier reports' conclusions about the average Federal tax expenditure per employee resulting from the possessions corporation rules. The 1980 and 1983 reports also analyzed the effects of changes

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[140] Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* at 1000 (1987).

[141] Department of the Treasury, *The Operation and Effect of the Possessions Corporation System of Taxation* (June 1978).

[142] Department of the Treasury, *The Operation and Effect of the Possessions Corporation System of Taxation* (June 1979).

[143] Department of the Treasury, *The Operation and Effect of the Possessions Corporation System of Taxation* (June 1980); Department of the Treasury, *The Operation and Effect of the Possessions Corporation System of Taxation* (February 1983). The 1983 report did not analyze the effect of legislative changes enacted in 1982.

enacted in 1976 intended to encourage the migration of financial assets to, and physical investment in, Puerto Rico (and the other possessions). In general, these 1976 rules limited a possessions corporation's U.S. tax exemption to (1) income from the active conduct of a trade or business in a possession, and (2) non-business income derived from the possession in which the corporation had its trade or business and which is attributable to the investment of funds derived from that trade or business. The 1980 Treasury report concluded that as a result of these limitations, possessions corporations sent to Puerto Rico a large amount of funds that previously had been invested in the Eurodollar market.[144] This capital inflow, however, had, according to the 1980 report, a "virtually imperceptible" impact on net capital flows into Puerto Rico because of offsetting flows out of Puerto Rico, mainly through the banking system. The 1983 Treasury report found only a modest increase in net capital inflows in 1981.

Congress made some major changes in 1982 to the section 936 credit primarily addressing transfer pricing concerns with respect to intangible assets. For example, prior to the 1982 changes to section 936, a U.S. pharmaceutical company could develop a patentable drug in the United States, deducting costs associated with the research and development of the drug. The U.S. pharmaceutical company could then transfer the patent to a possessions corporation that would produce the drug with the income being possessions income. As a result, it was possible in such a case that very little tax would be paid in either the United States or Puerto Rico. The 1983 Treasury report found that before the 1982 legislative changes, it was common for U.S. parent corporations to allocate to possessions corporations income from U.S. patents, trademarks, and other intangibles. The report estimated that approximately 50 percent of the income of section 936 manufacturing corporations may have been a return on intangibles developed by affiliated corporations.

In 1986, further changes were made to section 936, generally coordinating the 1982 changes with the transfer pricing rules of section 482.

The Treasury Department issued additional reports on section 936 in 1985 and 1989.[145] The 1985 report found that in 1982 possessions corporations in the manufacturing sector realized an average U.S. tax benefit per employee of $20,656, approximately 147 percent of average employee compensation. In the pharmaceutical industry, the average U.S. tax benefit per employee in 1982 was $69,200, or 333 percent of average compensation. The 1989 report, the first report that analyzed the effect of the 1982 changes to the rules regarding intangibles, tentatively concluded that those changes had a noticeable effect: Income, aggregate tax benefits, and benefits as a percentage of compensation fell for possessions corporations in 1983. The report, though, noted several caveats to its conclusion that the 1982 legislation had an effect, including that the 1982 recession might have contributed to a downturn in income.

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[144] The Eurodollar market includes dollar-denominated deposits with non-U.S. banks or non-U.S. branches of U.S. banks.

[145] Department of the Treasury, *The Operation and Effect of the Possessions Corporation System of Taxation* (July 1985); Department of the Treasury, *The Operation and Effect of the Possessions Corporation System of Taxation* (March 1989).

In May 1992, the GAO issued a briefing report to the Chairman of the Senate Special Committee on Aging detailing the pharmaceutical industry's tax benefits obtained from operating in Puerto Rico during the 1980s.[146] The report showed that in the year 1987, the pharmaceutical industry received 56 percent of all section 936 benefits yet provided only 18 percent of the jobs of all section 936 corporations in Puerto Rico. In absolute terms, this meant that the pharmaceutical industry received $1.3 billion of the $2.3 billion in total section 936 tax benefits and employed about 18,000 of 100,916 workers.[147] Tax benefits received per employee by the pharmaceutical industry were three to four times greater than those received by the industry with the next greatest amount of benefits (electrical and electronic equipment). In 1987, tax benefits per employee were $70,788 in the pharmaceutical industry, a figure that was 267 percent of the compensation paid to pharmaceutical employees. In other words, for each dollar of employee compensation, pharmaceutical companies received $2.67 in tax benefits. Representatives of the pharmaceutical industry asserted that other factors needed to be considered such as "the number of (1) high-paying skilled jobs that have been provided to college graduates, (2) Puerto Ricans occupying managerial positions, and (3) indirect jobs created in other companies, such as pill box providers and landscapers, that service pharmaceutical companies."

In 1993, Congress made further changes to section 936 limiting its benefits primarily by imposing a ceiling on the amount of the credit, which is computed with reference to the payroll and depreciation expenses of the corporation's activities in the possession. The Senate Finance Committee wrote:

> Although the section 936 tax credit was enacted to foster economic development in the U.S. possessions, studies have indicated that a disproportionate share of the tax benefits attributable to section 936 is realized by certain industries that create relatively few jobs in the possessions. These industries tend to be those for which a large portion of taxable income is derived from the use of intangible assets (e.g., exploitation of patents, tradenames, or secret formulas). The committee is concerned, moreover, that a disproportionate share of the cost that all U.S. taxpayers bear in order to provide the section 936 credit may have inured to the benefit of the stockholders of the possessions corporations, as compared to the U.S. citizens residing in the possessions.[148]

[146] U.S. General Accounting Office, Briefing Report to the Chairman, Special Committee on Aging, U.S. Senate, *Pharmaceutical Industry: Tax Benefits of Operating in Puerto Rico* (GAO/GGD-92-72BR), May 1992.

[147] The $1.3 billion and $2.3 billion amounts were primarily derived from financial statement data of 26 pharmaceutical corporations that GAO used to estimate tax-savings and tax-exempt income.

[148] S. Prt. No. 103-37, 103d Cong., 1st Sess. 148 (1993).

The 1993 changes to section 936 were enacted shortly after the publication of a GAO report on the section 936 credit.[149] This report was prepared in response to a request by the then chairman of the Senate Finance Committee for assistance to Congress in its consideration of modifications to or replacements of section 936. The report included several conclusions. The GAO concluded that it was difficult to predict the effects on the Puerto Rico economy of changes to the section 936 credit. Making predictions was difficult in part because doing so would require a detailed understanding of the basis of firms' location decisions. The GAO report noted that because the section 936 credit was not based on use of Puerto Rico resources, the impact on Puerto Rico's economy of a reduction in the credit might not be proportional to the amount of tax benefits lost.

The GAO also found, as it had in the 1992 report described above, that in the pharmaceutical industry average tax benefits received greatly exceeded average Puerto Rico wages paid. Tax benefits exceeded wages paid in certain other industries such as manufacturing, though to a lesser extent than they did in the pharmaceutical sector. The GAO found that the President's proposal to limit the section 936 credit to 60 percent of Puerto Rico wages paid − a proposal that, according to the GAO, was based on concerns about the amount of tax benefits under section 936 in relation to employment − could have a great effect on a relatively small number of capital-intensive firms and a small effect or no effect on labor-intensive firms.

In 1996, Congress repealed section 936 for taxable years beginning after December 31, 1995. It provided transition rules under which a corporation that is an existing credit claimant would be eligible to claim credits for a transition period (generally ten years). However, for tax years beginning after December 31, 1995, QPSII earned after July 1, 1996 no longer qualified for the possession tax credit.[150] The Ways and Means Committee wrote:

> The Committee understands that the tax benefits provided by the Puerto Rico and possession tax credit are enjoyed by only the relatively small number of U.S. corporations that operate in the possessions. Moreover, the Committee is concerned about the tax cost of the benefits provided to these possessions corporations that is borne by all U.S. taxpayers. In light of current budget constraints, the Committee believes that the continuation of the tax exemption provided to corporations pursuant to the Puerto Rico and possession tax credit is no longer appropriate.[151]

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[149] General Accounting Office, Report to the Chairman, Committee on Finance, U.S. Senate, *Puerto Rico and the Section 936 Tax Credit* (GAO/GGD-93-109), June 1993.

[150] A special rule applied to Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands. This rule allowed such applicable possessions to continue to get the full benefit of the possession tax credit, as in effect prior to repeal, until December 31, 2005. See sec. 936(j)(8).

[151] H.R. Rep. No. 104-586, 104th Cong., 2d Sess. 131 (1996).

The 1996 changes also added a new section 30A to the Code with respect to qualified income earned in Puerto Rico. This section allowed an economic activity credit that was applicable for tax years beginning after December 31, 1995 and before January 1, 2006. While in a separate section of the Code, the economic activity credit (section 30A) was calculated under the rules set forth for the possession tax credit (section 936).

At around the same time the repeal provision was enacted, the GAO issued a report describing certain possible consequences of extending the U.S. Federal income tax rules to residents of Puerto Rico.[152] Among other findings, the GAO estimated that under certain simplifying assumptions the net aggregate Federal tax liability of Puerto Rico taxpayers in 1992 would have been about $49 million. This $49 million amount was net of $574 million in earned income tax credits for which Puerto Rico taxpayers would have qualified: the GAO estimated that about 59 percent of taxpayers who filed individual income tax returns would have been eligible for the earned income tax credit. The average amount of the earned income tax credit would have been about $1,494, and the median amount would have been $1,623.

In its 1996 report, the GAO did not estimate the revenue effects of the repeal of section 936, but it did note that the Joint Committee on Taxation's most recent tax expenditure estimate of the Federal revenues forgone as a result of section 936 was $3.4 billion for 1996. In part because tax expenditure estimates do not reflect behavioral changes, this $3.4 billion amount could not be viewed as an estimate of the Federal revenue increase that would result from the repeal of section 936.

About nine months after it published its 1996 report, the GAO, in response to a request by the then chairman of the Senate Finance Committee, published a report on the Puerto Rico economy before and after the 1993 legislation.[153] In this report the GAO noted that the Puerto Rico economy generally had been growing in income, employment, and investment and that this growth persisted after the 1993 limitations on the section 936 credit. The GAO stated that it could not conclude that the 1993 changes had no effect on the Puerto Rico economy because any effect might become evident only after several years had passed and because any effect might have been offset by the influence of a strong U.S. economic recovery from the 1990-91 recession.

Specific observations in the 1997 GAO report about the Puerto Rico economy included data showing that between 1982 and 1996 gross domestic product (GDP), which measures total income produced in an area, grew at a faster rate than gross national product (GNP), which measures the total income received by residents of a given area. This faster rate of GDP growth relative to GNP growth meant that an increasing percentage of income produced in Puerto Rico

[152] General Accounting Office, Report to Congressional Requesters, *Analysis of Certain Potential Effects of Extending Federal Income Taxation to Puerto Rico* (GAO/GGD-96-127), August 1996.

[153] General Accounting Office, Report to the Chairman, Committee on Finance, U.S. Senate, *Puerto Rican Economic Trends* (GAO/GGD-97-101), May 1997.

went to non-Puerto Rico residents. This result, according to the GAO, was consistent with an economic program intended to attract external capital. The GAO report noted that although the share of Puerto Rico income received by Puerto Rico residents decreased from 69.3 percent in 1982 to 59.8 percent in 1996, in absolute terms the income of these residents increased over the same period from $16.3 billion to $23.8 billion.

Many commentators would agree that the section 936 credit (and its statutory predecessor) was helpful in promoting Puerto Rico economic growth, particularly during the 1950s and 1960s. However, as shown by GAO reports, the section 936 credit appeared to favor certain types of business. For example, U.S. companies with intangible assets were able to reap the benefits of the section 936 credit without having to make the investments necessary to sustain economic growth in Puerto Rico. As a result, during the 1980s (and probably earlier), the section 936 credit was arguably inefficient and probably ineffective for sustaining Puerto Rico economic growth. As a result of its inefficiency and high cost, it was repealed in 1996 with a ten year transition rule. The ten year transition rule allows domestic companies to continue to receive possession tax credit benefits for taxable years beginning before January 1, 2006.

Anticipating the termination of section 936 benefits, the chairman and the ranking member of the Senate Finance Committee requested that the GAO prepare a study that would, among other things, compare trends in Puerto Rico's principal economic indicators with those for the United States; report on changes in the activities and tax status of corporations that have clamed the section 936 credit; and compare the taxes paid to all levels of government by residents of Puerto Rico and the U.S. states. The GAO published its report in May 2006 (the "2006 GAO study").[154]

The 2006 GAO study found a large gap in the economic well-being of Puerto Rico residents compared with residents of U.S. States. The median household income in Puerto Rico in 2005 was $14,412. The figure for the United States was $41,994. Per capita GNP shows a similar gap: In 2005, per capita GNP in Puerto Rico was about $14,000 and in the United States was $41,000. Because of possible inaccuracies in the Puerto Rico government's inflation statistics, the GAO concluded that it was difficult to measure the real growth in per capita GNP. If the U.S. inflation statistic is applied to Puerto Rico, annual real per capita GNP growth in Puerto Rico from 1980 through 2005 was 2.5 percent. This figure is greater than the 1.9 percent annual real per capita GNP growth in the United States over the same period.

The 2006 GAO study found a significant decline from 1997 through 2002 in the share of employment and income in the manufacturing sector attributable to section 936 companies. It also found, however, that in general the decline in income and value added of section 936 companies has been largely offset by increased income and value added of affiliated corporations operating in Puerto Rico. As a result of repeal of section 936 in 1996, the GAO concluded that

[154] Government Accountability Office, Report to the Chairman and Ranking Minority Member, Committee on Finance, U.S. Senate, *Puerto Rico: Fiscal Relations with the Federal Government and Economic Trends During the Phaseout of the Possessions Tax Credit* (GAO-06-541), May 2006.

many large corporate groups that owned section 936 companies in Puerto Rico shifted their operations to other business entities including controlled foreign corporations and limited liability companies. The GAO found that the Puerto Rico chemical industry, which is dominated by pharmaceutical companies, experienced growth in value added from 1997 through 2002. Value added in the rest of the manufacturing sector has declined over the same period.

The 2006 GAO study shows that U.S.-owned businesses accounted for about 71 percent of the value added and 54 percent of employment in the Puerto Rico manufacturing sector in 2002. U.S.-owned corporations are dominant in the pharmaceutical sector but account for less than 25 percent of employment in Puerto Rico's wholesale and retail trade sectors and are not the majority employers in any significant service industry.

According to the 2006 GAO study, the per capita amount of taxes imposed by all levels of government was noticeably lower in 2002 in absolute terms in Puerto Rico than in the U.S. states. Tax burden as a percentage of personal income, by contrast, was similar in Puerto Rico (28 percent) and in the U.S. states (30 percent) in 2002.

V. OVERVIEW OF FEDERAL TAX POLICY ISSUES RELATING TO ECONOMIC DEVELOPMENT IN PUERTO RICO

A. Overview of Economic Well Being in Puerto Rico in Comparison to the 50 States

When the possession tax credit was repealed in 1996, the Congress expressed its concern that the tax benefits provided by the credit were enjoyed by only the relatively small number of large U.S. corporations that operate in the possessions and that the tax cost of the benefits provided to these possessions corporations was borne by all U.S. taxpayers. In light of the then current budget constraints, the Congress believed that the continuation of the tax exemption provided to corporations pursuant to the Puerto Rico and possession tax credit was no longer appropriate. However, a number of policy makers are concerned that while living standards in Puerto Rico as traditionally measured are high in comparison to other Caribbean economies, they are low in comparison to the 50 States.

The 2006 GAO study finds that Puerto Rico's per capita GNP was approximately $14,000 in 2005 in comparison to approximately $41,000 for the 50 States. Similarly, Puerto Rico's median household income was less than 40 percent that of the United States. The 2006 GAO study notes that when measured in real dollars, this gap has existed without measurable narrowing since 1980. As a consequence, the GAO reports that in 1999, 48.2 percent of Puerto Rico residents had incomes (measured without the value of any government-provided assistance) below the U.S. poverty line, while for the United States the comparable figure was 12.4 percent. Table 1 below, reproduces the GAO's calculation of the income distribution of households in the United States and Puerto Rico in 1999.

Table 1.−Income Distribution of Households in the United States and Puerto Rico, 1999 (Percentage Distribution)

Household Income	United States (percent)	Puerto Rico (percent)
Less than $10,000	9.5	37.1
$10,000 − $24,999	19.2	32.9
$25,000 − $49,000	29.4	19.9
$50,000 − $74,999	19.4	5.7
$75,000 − $99,999	10.2	2.0
$100,000 − $149,999	7.7	1.4
$150,000 − $199,999	2.2	0.4
$200,000 or more	2.4	0.6

Source: GAO from Bureau of Census data.

The 2006 GAO study also finds that the unemployment rate has been higher in Puerto Rico than in the United States, and that the labor force participation rate has been lower in Puerto Rico than in the United States. In addition, the GAO finds that while gross investment in the United States has recently averaged 19 percent of GDP, in Puerto Rico the comparable figure is approximately 15 percent. The labor force and investment figures suggest that the Puerto Rico economy will not close the reported income gap in the near term. However, the GAO notes that it may be difficult to make sound policy decisions based on the reported income and labor force data because the "casual" or "underground" economy appears stronger in Puerto Rico than in the 50 States. The economic activity of the "casual" or "underground" economy generally would not be measured in statistics on income, poverty, and labor force participation and employment.

The 2006 GAO study reports that, as a positive precursor to economic growth, Puerto Rico has markedly closed the gap in educational attainment between the United States and Puerto Rico. The percentage of the population in Puerto Rico over age 24 with a high school degree increased from 49.7 percent in 1990 to 60.0 percent in 2000. The comparable percentages in the United States were 75.2 percent in 1990 and 80.4 percent in 2000. The potential Puerto Rico labor force also made gains in post-secondary educational attainment.

B. Federal Tax Policy and Economic Development in Puerto Rico

In general

Economists assess policy proposals in terms of the proposal's effect on efficiency, equity, and growth. Analysis of efficiency typically involves assessing the extent to which the proposal leads to distortion in investment or consumption choices, as such distortion usually leads to wasted economic resources. Analysis of equity typically involves judgments as to what constitutes a "fair" outcome. Analysis of growth typically involves assessment of a policy's potential to increase the future well being of the residents of the economy. Often policies that promote one of the three goals involve a tradeoff with the other two goals. For example, a policy promoting growth may distort market choices and may produce outcomes that many see as inequitable. A policy that promotes one standard of fairness may involve slower prospects for growth.

The findings of the 2006 GAO study suggest that there are underutilized labor resources in Puerto Rico and an inadequate rate of investment necessary to reduce the gap in income between the United States and Puerto Rico. In the past the Congress has made efforts to reduce the income gap through increasing investment and employment in Puerto Rico by enacting targeted tax benefits and through other measures. Proposals to provide tax benefits to foster Puerto Rico development typically have a goal of attempting to "distort" taxpayer's behavior. For example, prior law section 936 effectively increased the after-tax return to investments in Puerto Rico. In response, some taxpayers located production facilities in Puerto Rico that they may have chosen to locate in another jurisdiction (domestic or foreign) in the absence of the tax benefit. The policy challenge is to promote faster growth in Puerto Rico without materially harming growth in the States or other territories and without creating too much market distortion. An additional policy challenge is discerning when increased growth in Puerto Rico is self sustaining so that the distortions or unequal treatment created by a pro-development tax benefit does not become a permanent feature of the Code.

Federal tax policy as a development tool

Federal taxpayers in the Puerto Rico economy

U.S. Federal tax incentives may be a limited tool in the promotion of economic development in Puerto Rico. A tax incentive operates by providing the taxpayer with tax benefits, a reduction in total tax burden, in return for certain behavior. U.S. Federal tax benefits can be delivered only to U.S. taxpayers. U.S. taxpayers are not the sole source of potential investment or employment opportunities in Puerto Rico. Local Puerto Rico investors and foreign investors can be important sources. The GAO estimates that in 2002, possessions corporations accounted for approximately one-third of the manufacturing payroll in Puerto Rico[155] and less in

[155] *Id.* at 158 and 164. CFCs of U.S. parent corporations account for another one sixth to one fifth of manufacturing payroll. In other industries, U.S. taxpayers account for smaller shares of employment than in manufacturing. The GAO estimates that in 2002 U.S. taxpayers, through possessions corporations, CFC, or other U.S. corporations, accounted for 28 percent of employment in the

all other industries. Even significant change in U.S. taxpayer activity in Puerto Rico may have only modest effects on the overall Puerto Rico economy. However, a U.S. Federal tax incentive would be expected to increase the presence of U.S. taxpayers in the Puerto Rico economy. The GAO documents that possessions corporations accounted for more than 38 percent of manufacturing payroll in Puerto Rico in 1987 and the GAO suggests that the lower reported percentage in 2002 may reflect the reduction in U.S. Federal tax benefits since 1995.[156] Moreover, while employment by U.S. Federal taxpayers accounts for a minority of direct employment opportunities in Puerto Rico, employment by these taxpayers can increase the demand for local consumer services provided by local employers and be the source of employment through subcontracting. The importance of the investment and employment opportunities resulting from U.S. tax incentives with respect to activities in Puerto Rico is not measured solely by the direct investment and direct employment by Federal taxpayers.

From the perspective of Puerto Rico, a tax benefit that is limited to only U.S. taxpayers may diminish the efficiency of the development outcome by excluding other potential business owners who may be able to achieve the same outcome as the U.S. taxpayer at a lower level of subsidy.[157] Theoretically, if the Puerto Rico government were given the estimated dollar value of a proposed tax benefit as a grant, and if the Puerto Rico government chose wisely, a larger growth effect would result from being able to allocate the value of the tax expenditure across potential investors and employers other than solely those who are U.S. taxpayers. Alternatively, if a particular tax incentive were determined to be an efficacious development tool, Puerto Rico could provide comparable non-U.S. owned businesses with comparable incentives.

<u>Some problems constraining development may not be tax problems</u>

The GAO reports that labor force participation is lower in Puerto Rico than in the 50 States. The 2006 GAO study notes that labor supply may be discouraged because of the magnitude of government benefits available to those outside of the labor force. Alternatively, a low demand for labor could lead some individuals to stop seeking employment (i.e., "discouraged workers"). Some have suggested that the fact that the U.S. minimum wage applies in Puerto Rico may discourage hiring of lower skilled workers who become discouraged. Neither of these possible causes for low labor force participation is a result of Federal tax policy. A potential tax solution, to be effective in changing these employment-related problems, would

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accommodation and food services industry, 26 percent of employment in retail trade, 23 percent of employment in wholesale trade, 15 percent of employment in health care and social assistance, and 21 percent of employment in the administrative support and waste management sector, the next five largest employment sectors after manufacturing.

[156] *Id*. at 81. Possessions corporations accounted for 61.6 percent of value added in Puerto Rico manufacturing in 1987 and 26.7 percent in 2002.

[157] If it were advantageous, potential local or foreign investors could reincorporate as U.S. taxpayers to avail themselves of a U.S. Federal tax subsidy, but such reincorporation suggests a distortion of choice of business structure and an inefficiency created by the tax subsidy.

need to be generous enough to offset non-tax effects. A direct approach could involve changing existing government benefit programs or the minimum wage, if those were thought to be the primary cause of low labor force participation. A potential tax solution may not be able to be targeted at the appropriate group of affected individuals and would create inefficiencies.

A lack of infrastructure (such as roads or waste water treatment facilities) may forestall certain business investments. It is difficult for tax benefits to address those sorts of business development initiatives. Use of a tightly defined tax benefit as a business development tool may constrain the availability of Federal Government funds for other development initiatives that might foster business development in Puerto Rico. More generally, one might question the efficacy of using tax benefits in lieu of direct spending to foster economic development. Direct subsidies could be made to certain businesses to encourage location in Puerto Rico, and the subsidies could be tailored to the specific circumstance of the business, whereas a tax benefit operates as an open-ended entitlement to any business that is eligible to claim the benefit. On the other hand, unlike direct subsidies, under a tax benefit, the marginal investment decisions are left to the private sector rather than being made by government officials. Economists generally argue that private market outcomes promote a more efficient use of limited resources.

Identification of problems limiting economic development in Puerto Rico

The 2006 GAO study notes, and the Office of the Governor of Puerto Rico highlights, that manufacturing employment has fallen in Puerto Rico. However, the loss of manufacturing jobs is not a phenomenon unique to Puerto Rico. The 50 States also have experienced a loss of manufacturing jobs, though, as the GAO documents, the rate of loss of manufacturing jobs has been greater in Puerto Rico than in the 50 States. Nevertheless, the reason for some of the job loss is the same in Puerto Rico as in the 50 States. Increased internationalization of product markets and reduced transportation costs (in relation to final goods' prices) have made outsourcing of many lower-skilled manufacturing operations profitable. Puerto Rico, like the United States in general, has a more educated, higher-wage labor force than much of the rest of the world and analysts would expect some of the same pressures on business to relocate to lower labor cost locations to work to the detriment of Puerto Rico as they do to the 50 States. Some observers blame institutional factors such as labor laws and environmental regulations for the loss of manufacturing jobs in certain industries. Generally Puerto Rico shares these institutional factors with the United States. A policy designed for Puerto Rico to counteract a problem that is common to the United States is likely to induce businesses to relocate from the United States to Puerto Rico. This may result in gains to the Puerto Rico economy largely at the expense of the rest of the United States. A policy to foster economic development in Puerto Rico is likely to be more efficient if it can target problems that are unique to Puerto Rico.

Coordination of U.S Federal tax policy with local policy

The Puerto Rico corporate income tax rate generally applicable to the larger incomes that would be earned on larger investments is 39 percent, substantially above corporate income tax rates in the 50 States, and higher than the highest Federal tax rate applicable to corporate income.[158] In addition to taxation at the corporate level, dividends received from Puerto Rico corporations are generally subject to a flat 10-percent tax in Puerto Rico.[159] In the potential investor's calculation, a Federal tax reduction related to investments in Puerto Rico would reduce the combined U.S. and Puerto Rico tax liabilities. If tax reductions for U.S. taxpayers locating in Puerto Rico to encourage relocation of potential investments to Puerto Rico were enacted and Puerto Rico raises its local taxes, the incentive effect of the Federal tax reduction would be diminished. Such an outcome would also have the, perhaps unintended, effect of converting the U.S. Federal tax reduction into a revenue sharing program with Puerto Rico.[160] More generally, policy makers may want to consider coordination between local development initiatives and any possible U.S. Federal tax benefit. For example, tax benefits targeted at one industry or one type of industry may work at cross purposes to initiatives in Puerto Rico if Puerto Rico's plans for development do not include such investments. With respect to U.S. Federal tax benefits, as noted above, absent changes in business structures, some potential investors are neither U.S. taxpayers nor subsidiaries of U.S. taxpayers. Puerto Rico may target local tax benefits to such taxpayers to encourage investment while leaving U.S. Federal tax policy to provide benefits encouraging investment for U.S. taxpayers.

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[158] As noted above, there are many special exceptions such that many taxpayers may not be subject to the 39-percent tax rate. Special tax incentives are offered by Puerto Rico under the Puerto Rico Tax Incentives Act of 1998. Certain U.S. Federal taxpayers may qualify under this law and, thereby, not be subject to the local tax at a rate of 39 percent. Although the tax incentive law is public information, the identity of those companies receiving these tax benefits, and the value of such benefits, is not public information. It is widely believed that currently U.S. companies or subsidiaries of U.S. companies receive the majority of these incentives.

U.S. Federal taxpayers not organized as C corporations are subject to different tax rules in Puerto Rico which may impact the decision of these taxpayers to avail themselves of a U.S. Federal tax benefit designed to foster economic development in Puerto Rico. In Puerto Rico a special set of tax laws permits certain closely held corporations known as a "corporation of individuals," similar to the U.S.-law Subchapter S provisions, to elect Puerto Rico income taxation solely at the individual shareholder level, which has a top marginal income tax rate of 33 percent. (See, ERNST & YOUNG, supra note 46, at 50 (2004). P.R. Code sec. 1390 (c); 13 L.P.R.A. sec. 8680 (c).) Although pass-through treatment similar to that offered under U.S. partnership tax law is not generally available to partnerships or limited liability corporations in Puerto Rico, a partnership may qualify as a corporation of individuals if it otherwise meets the requirements. It appears that only corporations may qualify for tax incentives under the Puerto Rico Tax Incentives Act of 1998.

[159] ERNST & YOUNG, supra note 46, at 47 (2004). P.R. Code sec. 1012; 13 L.P.RA. sec. 8412.

[160] The calculation of the total size of the Federal tax benefit and the total combined Federal and Puerto Rico tax would depend upon the structure of the proposed tax benefit. For example, would a U.S. taxpayer be allowed to claim the foreign tax credit for taxes paid to Puerto Rico in addition to any reduction in U.S. income taxes that may be permitted as part of the tax benefit?

Issues in the design of a new tax policy instrument to enhance development

In the design of a tax incentive for development, a permanent provision, as opposed to a temporarily effective provision, tends to carry out the policy more effectively. Because many large investment plans implemented take many months to plan and execute, a policy of tax benefits enacted with a requirement that taxpayers make necessary investments within a short period of time is more likely to see the tax benefits claimed by taxpayers who already were planning such investment in the absence of the policy – a windfall to such taxpayers. Completely new investments are unlikely to be induced, because taxpayers need adequate time to learn of the incentive and make plans. In some cases, learning by doing may enhance the efficacy of a tax incentive as the same taxpayer makes multiple investments based on his or her earlier experience. Successful development might result in self-sustaining future growth in Puerto Rico. If such a result occurs, a policy initiated to spur investment may, at some point, no longer be necessary, so a sunset date may be appropriate.

If a proposed policy initiative differs from tax incentives previously enacted to foster development, some consideration should be given to whether transition should be provided to taxpayers claiming the old benefits to enable them, without penalty, to claim the new tax benefits. To the extent that taxpayers already located in Puerto Rico become eligible for a new tax benefit, the new tax benefit may provide a windfall reduction in Federal tax liability to the taxpayer, yet provide no additional benefits to growth of the Puerto Rico economy. For other taxpayers, however, the new tax benefits may remain necessary to help maintain existing business operations that may otherwise have ceased operation. In this case, if such businesses are part of the development plan, transition relief may be necessary. It may be difficult to distinguish for which businesses transition relief results in a windfall benefit and those businesses that require further implicit subsidy from the new tax benefit in order to maintain their operations. If one goal of development is to create a local economy that has self-sustaining growth and if a tax benefit is provided to entice a taxpayer to retain his or her operation in Puerto Rico rather than relocating outside Puerto Rico, one may ask whether the tax benefit has become a permanent subsidy to the taxpayer and inconsistent with self-sustaining growth.

VI. SUMMARY OF STATEHOOD, COMMONWEALTH, AND INDEPENDENCE STATUS[161]

A. Description of Statehood Agenda

In general

Proponents of Puerto Rico statehood advocate obtaining the full rights and benefits of U.S. citizenship for Puerto Rico persons, including full voting representation in Congress for Puerto Rico and its citizens. Statehood advocates argue that Commonwealth status was meant to be a transitional stage, not a permanent status, on the road to statehood. Proponents of statehood argue that statehood would increase economic growth in Puerto Rico, and point to the substantial growth of the economies of Hawaii and Alaska after becoming States. Politically, the statehood advocates are represented in Puerto Rico by the New Progressive Party ("PNP").[162]

Tax effects

Corporate taxes

If Puerto Rico became a State of the United States, the Federal tax laws would apply uniformly to Puerto Rico and the current 50 States (and the District of Columbia).[163] Although the Code imposes lower statutory rates of corporate income tax than does the Puerto Rico tax system, the widespread availability of tax incentives under the Puerto Rico tax system implies that many business enterprises may have greater tax liability under the Code than under the Puerto Rico system. Corporations organized in Puerto Rico and foreign corporations engaged in a trade or business in Puerto Rico would become fully subject to U.S. Federal income tax regardless of their ownership.[164] Puerto Rico CFCs and other CFCs with branches in Puerto

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[161] The discussion in this section is summary and general in nature and is not based upon the provisions of a particular bill or proposal. For illustrative purposes, however, portions of the discussion reference the Puerto Rico Status Referendum Act, S. 712, 101st Cong., 1st Sess. (1989) and the analysis of that bill in Joint Committee on Taxation, *Tax Rules Relating to Puerto Rico Under Present Law and Under Statehood, Independence and Enhanced Commonwealth Status (S. 712, Puerto Rico Status Referendum Act)* (JCS-19-89), November 14, 1989.

[162] The New Progressive Party primarily favors the proposal described in section VII defining the United States as including Puerto Rico for purposes of the deduction for domestic production activities.

[163] While some believe that, even under statehood, the special circumstances of Puerto Rico may require special assistance over some term, such special assistance (to the extent offered through the tax Code) would likely be confined to a relatively small number of tax Code provisions. It is probable that the bulk of the permanent Federal tax laws would apply in Puerto Rico in the same manner as in the rest of the United States. In addition, there would likely be certain transition rules applicable to Puerto Rico statehood.

[164] Foreign corporations (as well as nonresident aliens) would also become subject to U.S. net basis taxation of their gains on dispositions of real property located in Puerto Rico.

Rico would lose their U.S.-tax deferral.[165] Foreign-controlled corporations operating in Puerto Rico and receiving Puerto Rico income tax incentives would suffer a significant detriment, as their profile changed from one without any U.S. Federal income taxation (including on repatriation of income) to one with full current Federal taxation of all income. Certain payments of dividends, interest, rents, royalties and other fixed or determinable periodical income by a Puerto Rico payor to a foreign payee would be considered to be U.S.-source income subject to Federal withholding.

In addition, under statehood, the possibility of special section 936-type or section 30A-type benefits in the future would likely disappear. Instead, benefits applicable to all the States (and the District of Columbia) would apply, such as the deduction for domestic production activities (i.e., manufacturing and certain other activities), benefits for empowerment and enterprise zones, renewal communities, and other general business credits. Corporate groups headquartered in the United States would receive the benefit of the dividends-received deduction and the tax consolidation rules with respect to their Puerto Rico subsidiaries. Moreover, the imposition of the U.S. tax system could significantly influence the choice of business entity utilized in Puerto Rico. For example, because Puerto Rico does not treat most partnerships as nontaxable pass-through entities under present law, the use of partnership entities in Puerto Rico might increase.

Individual taxes

The primary U.S. Federal income tax change for individuals would be that U.S. Federal income taxes would fully apply to Puerto Rico-source income of Puerto Rico residents. Consequently, there would be a large increase in the number of Puerto Rico residents filing U.S. income tax returns. The addition of U.S. Federal income tax to current Puerto Rico tax could increase the individual income tax burden in Puerto Rico (at least before considering the effects of the earned income credit and the child tax credit). It is reasonable to expect, however, that Puerto Rico would adjust its tax system to reflect the changed fiscal responsibilities of statehood.

Due to their relatively lower income levels, many residents of Puerto Rico would be eligible for the earned income credit or the child tax credit, as well as other present or future tax benefit programs based on income.

Under statehood, Federal estate and gift taxes would fully apply to the worldwide property of all citizens of Puerto Rico. Currently, certain Puerto Rico residents are treated as nonresident aliens for Federal estate and gift tax purposes, and therefore are subject to such taxes only with respect to property situated in the United States.[166] Under statehood, U.S. Federal estate and gift taxes would also apply with respect to the Puerto Rico-situated property of

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[165] Foreign subsidiaries of Puerto Rico corporations would become CFCs (i.e., subject to subpart F).

[166] These Puerto Rico residents are those whose U.S. citizenship was acquired solely by reason of Puerto Rico citizenship, or birth or residence within Puerto Rico.

nonresident aliens. It is possible that Puerto Rico would adjust its estate and gift tax laws to adapt to the application of Federal estate and gift taxes under statehood.

Excise taxes

Under statehood, Puerto Rico persons and persons importing property into Puerto Rico would be subject to Federal excise taxes to the same extent as persons in other States and the District of Columbia and importers into those jurisdictions. In general, Puerto Rico could, and (based on experience with the current 50 States) probably would, continue to impose its own excise taxes, although it might adjust some rates in recognition of the increased overall tax burden.

Puerto Rico taxes

Puerto Rico tax law (as well as other Puerto Rico laws) would assume the status of State law. It can be argued that Puerto Rico taxes are likely to be reduced after statehood to the extent that prior governmental functions of the Commonwealth are assumed by the Federal government, and thus are financed by Federal taxes rather than Puerto Rico taxes. The validity of this argument turns on larger budgetary issues concerning the relative levels of Federal and State spending in Puerto Rico after statehood.

Although Puerto Rico might continue to offer tax incentives to corporations, such incentives would likely be less attractive than those offered under present law because Puerto Rico income tax rates would likely be lower. In addition, it is possible that Puerto Rico would impose some consumption taxes, such as a retail sales tax in a manner similar to that of most of the other States.

Under statehood, Puerto Rico income taxes could no longer be taken as a foreign tax credit against U.S. Federal income taxes. Instead, for U.S. Federal income tax purposes, Puerto Rico income and property taxes would generally be deductible, subject to restrictions on itemized deductions for individuals.

Tax compliance

Under statehood, the Internal Revenue Service ("IRS") would directly collect income taxes from a larger number of Puerto Rico taxpayers than under present law. This is likely to result in an increase in the Puerto Rico income tax compliance level due to the greater amount of resources and economies of scale available to the IRS. Assuming that Puerto Rico imposes a State income tax with rules that generally follow those of the United States, the compliance benefits would inure to Puerto Rico as well. In addition, both Puerto Rico corporations and individual residents would be able to claim benefits under all U.S. tax treaties.

U.S. spending programs

Federal benefit spending programs that presently do not apply (or only partly apply) to Puerto Rico persons would fully apply under statehood. Examples of these programs are Food Stamps, Supplemental Security Income,[167] Medicaid, Temporary Assistance for Needy Families, and certain education programs. On the other hand, it is likely that the cover over of customs duties and Federal excise taxes to Puerto Rico, including the rum excise tax, would cease. Grants to Puerto Rico from Congress would generally be made by direct spending appropriation. Puerto Rico persons and the government of Puerto Rico would benefit by access to the full range of Federal government services and support available to individual citizens and States generally.

Transition issues

It is likely that there would be significant issues raised by the transition to full Puerto Rico statehood. For example, the Treasury Department might require some lead time in order to properly administer and enforce the U.S. tax laws in Puerto Rico. Similarly, the Puerto Rico government might also require some lead time to adopt legislation conforming to the new status and to implement the new rules administratively. It is possible that Congress could choose to fund the government of Puerto Rico by enhanced grants or cover over of various taxes while these transition processes are continuing.[168] In particular, issues would arise concerning the continuation and/or the timing of phasing out of the cover over of excise taxes and customs duties.[169]

[167] Supplemental Security Income ("SSI") is a Federal income supplement program funded by general tax revenues (not Social Security taxes). It is designed to help aged, blind, and disabled people who have little or no income, by providing cash to meet basic needs for food, clothing, and shelter.

[168] See the description of the Puerto Rico Status Referendum Act in Joint Committee on Taxation, *Tax Rules Relating to Puerto Rico Under Present Law and Under Statehood, Independence and Enhanced Commonwealth Status (S. 712, Puerto Rico Status Referendum Act)* (JCS-19-89), November 14, 1989, at 27-28 (bill provided for "two-year period during which all revenues derived from the application of Federal internal revenue laws within the State of Puerto Rico will be deposited into the Treasury of Puerto Rico").

[169] The "uniformity clause" of the U.S. Constitution provides that "…all Duties, Imposts and Excises shall be uniform through out the United States." U.S. Const., art I, sec. 8, cl. 1. The continuation of special treatment of Puerto Rico with respect to any "duties, imposts [or] excises" once it becomes a State raises issues under the uniformity clause. See Joint Committee on Taxation, *Tax Rules Relating to Puerto Rico Under Present Law and Under Statehood, Independence and Enhanced Commonwealth Status (S. 712, Puerto Rico Status Referendum Act)* (JCS-19-89), November 14, 1989, at 35-40.

B. Description of Commonwealth Agenda

In general

Proponents of Commonwealth status favor the continuation of the Commonwealth relationship with the United States. Proponents of Commonwealth status argue that the Commonwealth relationship has fostered growth in Puerto Rico over a long period of years. They argue that the optimal course for Puerto Rico is one of economic development based on the existing U.S.-Puerto Rico relationship, with the implementation of special U.S. and Puerto Rico incentives and programs to benefit Puerto Rico, particularly in the areas of life sciences and computing and information technology. Proponents of Commonwealth status argue that their primary global competitors are Singapore, India, Ireland, and China, and that Commonwealth status will better enable Puerto Rico to compete with these countries, in part by offering multinational corporations both Puerto Rico and U.S. tax benefits. Politically, Commonwealth status advocates are represented in Puerto Rico by the Popular Democratic Party ("PDP").[170]

Tax effects

The U.S. and Puerto Rico tax laws would generally not change under continued Commonwealth status.[171]

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[170] The Popular Democratic Party primarily favors the proposal described in Part VII for an expanded dividends-received deduction for dividends paid out of business income from the possessions.

[171] The description of present tax law may be found in Part II of this report.

C. Description of Independence Agenda

In general

Proponents of Puerto Rico independence argue generally that Puerto Rico should be a separate country politically independent of the United States. Because political independence may be somewhat incompatible with U.S. citizenship of Puerto Rico persons, however, it would be necessary for the United States and Puerto Rico to address a range of issues arising from the dual citizenship of Puerto Rico persons under present law. Like proponents of Commonwealth status, advocates of independence see their primary global competitors as countries such as Singapore and Ireland, and are primarily interested in implementing economic development strategies that will promote jobs and create business activity. Politically, independence is promoted in Puerto Rico by the Puerto Rico Independence Party ("PIP").

Tax and spending effects

In general

Many proponents of independence advocate for the negotiation of tax treaties with the United States and other countries containing tax sparing provisions, and, more generally, for the establishment of new economic arrangements with the United States that address two-way capital flows.

Effects on taxpayers

Under independence, the U.S. tax status of Puerto Rico persons would likely be addressed in enabling legislation, or would be the subject of negotiations between the United States and Puerto Rico. For example, under the Puerto Rico Status Referendum Act,[172] if independence status had been chosen by the Puerto Rico voters, after the date of certification of the referendum Puerto Rico would no longer have been deemed to be part of the United States for the purpose of acquiring U.S. citizenship by reason of place of birth.[173] That Act, however, would not have affected the citizenship of any person born before the date of the certification of the referendum.[174] Under independence, unless the United States or Puerto Rico changes its internal tax law or the two countries negotiate a tax treaty that addresses the citizenship issue, dual citizens could be subject to taxation in both jurisdictions, although such double taxation might be largely eliminated by foreign tax credits.

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[172] S. 712, 101st Cong., 1st Sess. (1989).

[173] See Joint Committee on Taxation, *Tax Rules Relating to Puerto Rico Under Present Law and Under Statehood, Independence and Enhanced Commonwealth Status (S. 712, Puerto Rico Status Referendum Act)* (JCS-19-89), November 14, 1989, at 40 (publication describes in detail the potential tax effects of that particular legislation).

[174] *Id*. at 24.

In general, corporations doing business in Puerto Rico would continue to be taxed under Puerto Rico law. Under U.S. tax law, Puerto Rico CFCs would continue to be treated as foreign corporations subject to the subpart F and foreign tax credit rules.

U.S. spending programs

In general, U.S. spending, transfer, and entitlement programs, including Social Security and Medicare, would terminate with respect to Puerto Rico and its citizens. Presumably some transitional arrangements would be made for those persons who had paid into the Social Security and Medicare systems or who receive benefits under those systems. In addition, excise taxes would no longer be covered over to the Puerto Rico Treasury.

VII. RECENT PROPOSALS REGARDING THE U.S. TAX TREATMENT OF PUERTO RICO

The legislative options included in this pamphlet represent specific proposals that have been advocated by various interested parties, including some members of Congress, with respect to stimulating economic growth in Puerto Rico. The Joint Committee staff has provided a summary of the tax and economic policy implications of these legislative options in response to the Finance Committee's request. Such options do not represent recommendations of the Joint Committee staff.

The legislative options reviewed by the Joint Committee staff can be divided into three categories: individual proposals; corporate proposals; and a proposal related to revenue transfers.

A. Proposals Related to Individuals

1. Extend earned income tax credit to residents of Puerto Rico

Present Law

Overview

Low and moderate-income workers residing in the United States may be eligible for the refundable earned income credit ("EIC"). Eligibility for the EIC is based on earned income, adjusted gross income ("AGI"), investment income, filing status, and immigration and work status in the United States. The amount of the EIC is based on the presence and number of qualifying children in the worker's family, as well as on AGI and earned income.

The EIC generally equals a specified percentage of wages up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phaseout range. For taxpayers with earned income (or AGI, if greater) in the phaseout range, the maximum EIC amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the lower limit of the phaseout range. For taxpayers with earned income (or AGI, if greater) greater than the upper limit of the phaseout range, no credit is allowed.

An individual is not eligible for the EIC if the aggregate amount of disqualified income of the taxpayer for the taxable year exceeds $2,800 (for 2006). This threshold is indexed annually for inflation. Disqualified income is the sum of: (1) interest (taxable and tax exempt); (2) dividends; (3) net rent and royalty income (if greater than zero); (4) capital gains net income; and (5) net passive income (if greater than zero) that is not self-employment income.

The EIC is a refundable credit, meaning that if the amount of the credit exceeds the taxpayer's U.S. Federal income tax liability, the excess is payable directly to the taxpayer. Under an advance payment system, eligible taxpayers may elect to receive the credit in their paychecks, rather than waiting to claim a refund on their tax return filed by April 15 of the following year.

Filing status

An unmarried individual may claim the EIC if he or she files as a single filer or as a head of household. Married individuals generally may not claim the EIC unless they file jointly. An exception to the joint return filing requirement applies to certain spouses who are separated. Under this exception, a married taxpayer who is separated from his or her spouse for the last six months of the taxable year is not considered married (and, accordingly, may file a return as head of household and claim the EIC), provided that the taxpayer maintains a household that constitutes the principal place of abode for a dependent child (including a son, stepson, daughter, stepdaughter, adopted child, or a foster child) for over half the taxable year,[175] and pays over half the cost of maintaining the household in which he or she resides with the child during the year.

Presence of qualifying children and amount of the EIC

The EIC is available to low and moderate-income working taxpayers. Three separate schedules apply: one schedule for taxpayers with no qualifying children; one schedule for taxpayers with one qualifying child; and one schedule for taxpayers with more than one qualifying child.[176]

Taxpayers with one qualifying child may claim a credit in 2006 of 34 percent of their earnings up to $8,080, resulting in a maximum credit of $2,747. The maximum credit is available for those with earnings between $8,080 and $14,810 ($16,810 if married filing jointly). The credit begins to phase down at a rate of 15.98 percent of earnings above $14,810 ($16,810 if married filing jointly). The credit is phased down to zero at $32,001 of earnings ($34,001 if married filing jointly).

Taxpayers with more than one qualifying child may claim a credit in 2006 of 40 percent of earnings up to $11,340, resulting in a maximum credit of $4,536. The maximum credit is available for those with earnings between $11,340 and $14,810 ($16,810 if married filing jointly). The credit begins to phase down at a rate of 21.06 percent of earnings above $14,810 ($16,810 if married filing jointly). The credit is phased down to zero at $36,348 of earnings ($38,458 if married filing jointly).

Taxpayers with no qualifying children may claim a credit if they are over age 24 and below age 65. The credit is 7.65 percent of earnings up to $5,380, resulting in a maximum credit of $412, for 2006. The maximum credit is available for those with incomes between $5,380 and $6,740 ($8,740 if married filing jointly). The credit begins to phase down at a rate of 7.65 percent of earnings above $6,740 ($8,740 if married filing jointly). The credit is phased down to zero at $12,120 of earnings ($14,120 if married filing jointly).

[175] A foster child must reside with the taxpayer for the entire taxable year.

[176] All income thresholds are indexed for inflation annually.

If more than one taxpayer lives with a qualifying child, only one of these taxpayers may claim the child for purposes of the EIC. If multiple eligible taxpayers actually claim the same qualifying child, then a tiebreaker rule determines which taxpayer is entitled to the EIC with respect to the qualifying child. The eligible taxpayer who is not entitled to claim the EIC with respect to the qualifying child may not claim the EIC for taxpayers without qualifying children.

Definition of qualifying child

Present law provides a uniform definition of qualifying child (the "uniform definition") for purposes of the dependency exemption, the child credit, the EIC, the dependent care credit, and head of household filing status. The uniform definition generally does not modify other parameters of each tax benefit (e.g., the earned income requirements of the EIC) or the rules for determining whether individuals other than children of the taxpayer qualify for each tax benefit. Under the uniform definition, in general, a child is a qualifying child of a taxpayer if the child satisfies each of three tests: (1) the child has the same principal place of abode as the taxpayer for more than one half the taxable year; (2) the child has a specified relationship to the taxpayer; and (3) the child has not yet attained a specified age. A tie-breaking rule applies if more than one eligible taxpayer claims a child as a qualifying child.

Taxpayer identification number requirements

Individuals are ineligible for the credit if they do not include their taxpayer identification number ("TIN") and their qualifying child's TIN (and, if married, their spouse's TIN) on their tax return. Solely for these purposes and for purposes of the present-law identification test for a qualifying child, a TIN is defined as a Social Security number issued to an individual by the Social Security Administration other than a number issued under section 205(c)(2)(B)(i)(II) (or that portion of sec. 205(c)(2)(B)(i)(III) relating to it) of the Social Security Act regarding the issuance of a number to an individual applying for or receiving federally funded benefits. If an individual fails to provide a correct taxpayer identification number, such omission will be treated as a mathematical or clerical error by the IRS.

A taxpayer who resides with a qualifying child may not claim the EIC with respect to the qualifying child if such child does not have a valid TIN. The taxpayer also is ineligible for the EIC for workers without children, because he or she resides with a qualifying child. However, if a taxpayer has two or more qualifying children, some of whom do not have a valid TIN, the taxpayer may claim the EIC based on the number of qualifying children for whom there are valid TINs.

Principal place of abode

A child is a qualifying child only if the child shares the same principal place of abode as the taxpayer for more than one-half of the taxable year and such principal place of abode is in the United States. Similarly, an individual without children is eligible for the EIC only if such individual's principal place of abode is in the United States for more than one-half of the taxable year.[177] For purposes of both of these requirements, the United States is considered not to include Puerto Rico.[178] Generally, these requirements exclude full-time residents of Puerto Rico from eligibility for the EIC.

Description of Proposal

The earned income tax proposal is based on a bill introduced in the 108th Congress.[179]

The proposal extends the EIC to Puerto Rico residents whose principal place of abode is in Puerto Rico and who satisfy the otherwise applicable eligibility requirements to claim the EIC.

Under the proposal, low and moderate-income workers with a permanent place of abode in Puerto Rico are permitted to file a U.S. Federal income tax return and claim the EIC. While these residents of Puerto Rico are still not subject to U.S. Federal income taxation on their Puerto Rico-source income, under the proposal such income is taken into account (along with the individual's U.S.- and other foreign-source income, if any) for purposes of determining eligibility for the EIC.

Discussion

Proponents argue that the EIC, unlike many traditional government aid programs for low-income individuals, provides significant work incentives for low-income workers. It is contended that extension of the EIC to residents of Puerto Rico will increase both employment and labor force participation rates in Puerto Rico.[180] Others argue that the EIC, which generally

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[177] There is no definition of "principal place of abode" in either the Code or the Treasury Regulations relating to the EIC. However, the legislative history to the Omnibus Budget Reconciliation Act of 1990 indicates Congress's intention "that the determination of whether the residency requirement is met is made under rules similar to those applicable with respect to whether an individual meets the requirements for head-of-household filing status." Thus, for example, the fact that an individual is born or dies during the taxable year does not prevent the individual's residence from being his or her principal place of abode for that year. Similarly, "certain temporary absences due to education or illness are disregarded for purposes of determining whether the child had the same principal place of abode as the taxpayer for over half the year." H.R. Conf. Rep. No. 101-964, at 1037.

[178] Sec. 7701(a)(9); Rev. Rul. 78-400, 1978-2 C.B. 7 ("the term 'United States' as used in [the EIC provisions] of the Code includes only the States and the District of Columbia and does not include Puerto Rico").

[179] The proposal was included in S. 1658 (108th Cong.) (the "Puerto Rico Economic Stimulus Act of 2003"), introduced on September 25, 2003, by Sen. Daschle for Sen. Graham (of Florida). S. 1658 (108th Cong.) would phase in the proposal over the period 2004 through 2013.

[180] For an analysis of Puerto Rico's labor force participation rate (generally defined as the portion of the working age population that participates in the labor force (i.e., those actively employed or seeking employment)) and unemployment rate (generally, the portion of the labor force unable to find employment) in comparison to the United States, see 2006 GAO study, pp. 69-76 ("Official Statistics

encourages the supply of labor, may work less well in Puerto Rico than in the United States because of low demand for labor in Puerto Rico.

In addition, proponents argue that the present-law requirement that an individual maintain a principal place of abode within the United States creates an incentive for low and moderate-income workers to relocate from Puerto Rico to the United States, and likewise creates a disincentive for such workers to return to Puerto Rico. Proponents argue that, by eliminating these effects, the proposal will help Puerto Rico attract and retain the skilled labor force necessary for economic development.

Finally, proponents argue that Puerto Rico residents are U.S. citizens who share in the obligations and duties of all U.S. citizens. Thus, proponents argue that residents of Puerto Rico should be eligible for the EIC on the same terms and to the same extent as their fellow citizens residing in the United States.

Opponents argue that, as residents of Puerto Rico are generally not subject to U.S. Federal income tax on their Puerto Rico-source income, neither should they be entitled to the EIC.[181] Additionally, opponents dispute the argument that because the EIC provides incentives to seek employment it would therefore increase employment in Puerto Rico. It is suggested that Puerto Rico's high unemployment rate (which measures those actively seeking work but unable to find work) shows that many are currently willing to work and thus it is not unwillingness to supply labor, but rather inadequate demand for labor, that is the source of Puerto Rico's low employment levels.

In the United States, the EIC effectively operates as a mechanism for wealth transfer from higher-income individuals (who pay income taxes) to lower-income workers (who receive payments in the form of a refundable credit). Under the proposal, however, high-income Puerto Rico residents generally will remain exempt from U.S. Federal income tax, while low- to moderate-income Puerto Rico residents will receive the EIC. Opponents argue that extension of the EIC therefore creates an undesirable policy result unless it is coupled with the repeal of

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Indicate That Unemployment Has Been Much Higher in Puerto Rico Than in the United States and Labor Force Participation Has Been Lower").

[181] Opinions differ as to the merit of this argument. Proponents of the proposal point out that, although Puerto Rico residents generally do not pay U.S. Federal income tax on their Puerto Rico-source income, they are generally subject to payroll tax on those earnings. Indeed, the premise that workers who pay little or no Federal income tax but who are subject to payroll tax should be entitled to a full or partial refund of such payroll taxes (just as those with income tax liability can obtain a full or partial refund of income taxes through the general mechanism of the child credit) is central to the policy underlying the payroll tax formula of the refundable child credit. Opponents contend that payroll taxes serve a fundamentally different purpose from income taxes and should be viewed as analogous to a forced retirement savings mechanism; thus, it is argued, it is inappropriate to refund such taxes to a worker who has already obtained something of concrete value in return, i.e., a right to a future stream of retirement income and other benefits under the Social Security Act.

section 933, the provision of the Code that exempts from U.S. Federal income taxation the Puerto Rico-source income of Puerto Rico residents.[182]

Separately, opponents argue that extending the EIC to Puerto Rico residents imposes a substantial administrative burden both on Puerto Rico residents, who will now be required to file U.S. Federal income tax returns in order to claim the credit, and on the IRS, which will need to process these additional returns. It is likewise argued that the Code is an inefficient mechanism for the delivery of such a benefit when most residents of Puerto Rico are not otherwise subject to U.S. Federal income tax filing requirements. Finally, opponents point out that the EIC has been the subject of controversy as a source of erroneous tax filings. Opponents argue that an extension of the EIC, whether to Puerto Rico or elsewhere, will compound the existing filing problems.

Finally, many observers regard the earned income credit as merely one component of the overall U.S. system of public support for low-income individuals. As the 2006 GAO study notes, Puerto Rico receives Federal funds for a variety of social programs that provide assistance to low-income individuals, and Puerto Rico delivers similar services, although not always through the program as it exists in the United States.[183] A full consideration of the proposal should take into account not only the tax consequences of the proposal, but also the interaction between the proposal and such other programs.

<u>Estimated Revenue Effect</u>

In 2001, there were over one million employed workers in Puerto Rico, with an average wage of almost $16,000. The proposal would allow many of these workers to claim the earned income credit. Assuming the proposal is effective for tax years beginning after December 31, 2006, the projected effect on Federal revenues for fiscal years 2007 through 2011 is -$2.7 billion and for fiscal years 2007 through 2016 is -$5.2 billion.

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[182] While not necessarily illustrative of the typical situation, it is possible to imagine that the effect of the EIC on an individual U.S. resident who climbs the socioeconomic ladder may be neutral over his or her life cycle (and that the EIC thus acts as a mechanism for intergenerational wealth transfer from older to younger): in young adulthood, the individual earns relatively low wages and thus qualifies for the benefit of the EIC. As the individual obtains skills and experience, earnings increase until the individual is phased out of eligibility for the EIC and is instead paying in to the system in the form of Federal individual income tax on his or her (now significantly higher) amount of income. Because a resident of Puerto Rico never "pays in" to the system as the hypothetical U.S. resident does, this balance would not exist if the proposal were implemented (unless section 933 were also repealed).

[183] See 2006 GAO study, pp. 123-25 ("The Extent That Federal Social Programs in Puerto Rico Mirror Those in the States and Other U.S. Insular Areas Varies").

2. Extend refundable child credit to residents of Puerto Rico with fewer than three children

Present Law

Overview

An individual may claim a tax credit for each qualifying child under the age of 17. [184] The amount of the credit per child is $1,000 through 2010.[185] A child must be a citizen, national, or resident of the United States to be a qualifying child.[186]

The credit is phased out for individuals with income over certain threshold amounts. Specifically, the otherwise allowable child tax credit is reduced by $50 for each $1,000 (or fraction thereof) of modified AGI over $75,000 for single individuals or heads of households, $110,000 for married individuals filing joint returns, and $55,000 for married individuals filing separate returns.[187] The credit is allowable against the regular tax and the alternative minimum tax. To the extent the child credit exceeds the taxpayer's U.S. Federal income tax liability, the taxpayer is eligible for a refundable credit (the refundable child credit) calculated using one of two formulas, the "earned income" formula or the "payroll tax" formula.[188]

Earned income formula

A taxpayer is entitled to a credit equal to 15 percent of earned income in excess of $11,300 for 2006 (the earned income formula). The threshold dollar amount is indexed annually for inflation.

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[184] Sec. 24(d)

[185] The credit reverts to $500 in taxable years beginning after December 31, 2010, under the sunset provision of EGTRRA.

[186] Sec. 152(b)(3). Residents of Puerto Rico are generally citizens of the United States by operation of Federal law, so this requirement imposes no significant limitation on the eligibility of Puerto Rico residents for the child tax credit.

[187] For purposes of the phase-out, modified AGI includes Puerto Rico-source income even if such income is not subject to U.S. Federal income tax under section 933 (i.e., because the taxpayer is a bona fide resident of Puerto Rico for the taxable year).

[188] The "earned income formula" was added by EGTRRA and is subject to the EGTRRA sunset provision. Thus, for taxable years beginning after December 31, 2010, taxpayers with three or more qualifying children will be eligible to calculate the refundable child credit only under the payroll tax formula, and taxpayers with one or two qualifying children will no longer qualify for the refundable child credit.

Earned income is defined as the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings. Unlike the earned income credit, which also includes the preceding items in its definition of earned income, the refundable child credit (as determined under the earned income formula) is based only upon earned income to the extent it is included in computing taxable income. Because residents of Puerto Rico are not subject to U.S. Federal income tax on income earned in Puerto Rico, a Puerto Rico resident whose sole income consists entirely of Puerto Rico-source wages will have no earned income for purposes of the earned income formula.[189]

Payroll tax formula

Families with three or more children may determine the refundable child credit using the payroll tax formula, if this results in a larger credit than that calculated under the earned income formula. Under the payroll tax formula, the refundable child credit equals the amount by which the taxpayer's "social security taxes" (as defined for purposes of the provision)[190] exceed the taxpayer's earned income credit.

Puerto Rico residents generally are required to pay employment taxes on Puerto Rico-source wages (as well as on U.S.-source wages, if any). Thus, residents of Puerto Rico with three or more children are generally eligible for the refundable child credit to the extent of social security taxes (as defined for purposes of the provision) paid in the taxable year.

Description of Proposal

The refundable child credit proposal is based on two bills introduced during the 109th Congress.[191]

Under the proposal, income is no longer excluded from the definition of earned income for purposes of the refundable child credit merely because it is Puerto Rico-source income of a Puerto Rico resident (and thus otherwise exempt from United States U.S. Federal income

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[189] Likewise, because such an individual is not subject to Federal income tax, he or she receives no benefit from non-refundable credits against such tax.

[190] For purposes of the payroll tax formula, the statutory term "social security taxes" includes the employee's share of FICA taxes (including taxes withheld for old age, survivors and disability insurance (i.e., the employee's contributions to the Social Security trust fund) as well as for hospital insurance (i.e., the employee's Medicare contributions)), plus 50 percent of the tax on self-employment income and 50 percent of railroad retirement tax paid by the employee for such taxable year. Sec. 24(d)(2).

[191] This proposal was included in S. 1757, introduced by Sen. Clinton on September 22, 2005, and H.R. 4451, introduced by Mr. Towns on December 6, 2005. S. 1757 and H.R. 4451 would phase in the proposal ratably over the five-year period from 2006 through 2010. The proposal was also included in S. 1658 (108th Cong.) (the "Puerto Rico Economic Stimulus Act of 2003"), introduced on September 25, 2003, by Sen. Daschle for Sen. Graham (of Florida). S. 1658 (108th Cong.) would phase in the proposal over the period 2004 through 2013.

taxation under section 933). Thus, residents of Puerto Rico with one or two children (who currently are not generally eligible for the credit under either the earned income or the payroll tax formula) are eligible for the refundable child credit to the extent the amount of their total earned income (i.e., Puerto Rico-source as well as U.S.- and foreign-source income) exceeds the relevant threshold. Residents of Puerto Rico with three or more children are able to calculate their refundable child credit either by using the payroll tax formula, as under present law, or (to the extent it results in a larger calculation of the refundable child credit) by using the earned income formula.

Discussion

Because the refundable child credit is conditional upon having significant labor earnings, proponents argue that the refundable child credit, like the earned income credit, provides significant work incentives for low-income workers. For this reason proponents believe that expansion of the refundable child credit to residents of Puerto Rico will increase both employment and labor force participation rates in Puerto Rico.[192]

Proponents argue that the present-law refundable child credit creates an incentive for low and moderate-income families to relocate from Puerto Rico to the United States (where, upon establishing a new principal place of abode, they will be eligible for the refundable child credit (as well as the earned income credit)), and that the present law draws an irrational distinction between Puerto Rico residents with one or two children (who are generally unable to claim the refundable child credit) and those with three or more children (who are eligible to calculate their refundable child credits using the payroll tax formula). Proponents argue that the proposal eliminates these effects by treating residents of Puerto Rico with one or two children in a similar manner to individuals who either relocate with their children to the United States or have three or more children.

Additionally, proponents argue that extending the scope of the earned income formula to residents of Puerto Rico may facilitate eliminating the payroll tax formula altogether in the interest of simplification.[193] Finally, proponents argue that Puerto Rico residents are U.S.

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[192] For an analysis of Puerto Rico's labor force participation rate (generally defined as the portion of the working age population that participates in the labor force (i.e., those actively employed or seeking employment)) and unemployment rate (generally, the portion of the labor force unable to find employment) in comparison to the United States, see 2006 GAO study, pp. 69-76 ("Official Statistics Indicate That Unemployment Has Been Much Higher in Puerto Rico Than in the United States and Labor Force Participation Has Been Lower").

[193] The President's budget proposals for both fiscal year 2007 and fiscal year 2005 proposed eliminating the payroll tax formula, but separately proposed restricting the refundable child credit to residents of the United States, thereby making all Puerto Rico residents ineligible for the credit regardless of the number of children. Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2007 Budget Proposal* (JCS-1-06), March, 2006; Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2005 Budget Proposal* (JCS-3-04), February, 2004.

citizens, who share in the obligations and duties of all U.S. citizens. Thus, proponents argue that residents of Puerto Rico should be eligible to receive the refundable child credit on the same terms and to the same extent as their fellow citizens living in the United States.

Opponents argue, as in the case of the earned income credit, that as residents of Puerto Rico are generally not subject to U.S. Federal income tax on their Puerto Rico-source income, neither should they be entitled to the refundable child credit.[194] Additionally, opponents dispute the argument that because the refundable child credit provides incentives to seek employment it would therefore increase employment in Puerto Rico. It is contended that Puerto Rico's high unemployment rate (which measures those actively seeking work but unable to find work) shows that many are currently willing to work and thus it is not unwillingness to supply labor, but rather inadequate demand for labor, that is the source of Puerto Rico's low employment levels.

In the United States, the present-law refundable child credit operates as a mechanism for wealth transfer from higher-income taxpayers (who pay income taxes) to low to moderate-income families (who receive payments in the form of a refundable credit). Under the proposal, however, Puerto Rico residents generally will remain exempt from U.S. Federal income taxation while being enabled to claim the refundable child credit, even for upper-income Puerto Rico residents. Because the general child credit does not begin to phaseout until a taxpayer's modified AGI (which includes the Puerto Rico income excluded under section 933) exceeds $110,000 ($75,000 for taxpayers not filing a joint return),[195] a taxpayer earning up to $110,000 would receive a refundable child credit of $1,000 for each eligible child. Subject to the operation of the phaseout and the number of eligible children, taxpayers with significantly more income than $110,000 would remain eligible for refundable child credits. Opponents of the proposal consider such an outcome to be an inappropriate result that stems from applying only portions of the tax system to residents of Puerto Rico.

Opponents argue that extension of the refundable child credit therefore creates an undesirable policy result unless it is coupled with the repeal of section 933, the provision of the

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[194] Opinions differ as to the merit of this argument. Proponents of the proposal point out that, although Puerto Rico residents generally do not pay U.S. Federal income tax on their Puerto Rico-source income, they are generally subject to payroll tax on those earnings. Indeed, the premise that workers who pay little or no Federal income tax but who are subject to payroll tax should be entitled to a full or partial refund of such payroll taxes (just as those with income tax liability can obtain a full or partial refund of income taxes through the general mechanism of the child credit) is central to the policy underlying the payroll tax formula. Opponents contend that payroll taxes serve a fundamentally different purpose from income taxes and should be viewed as analogous to a forced retirement savings mechanism; thus, it is argued, it is inappropriate to refund such taxes to a worker who has already obtained something of concrete value in return, i.e., a right to a future stream of retirement income and other benefits under the Social Security Act.

[195] Sec. 24(b)(2)(A).

Code that exempts from U.S. Federal income taxation the Puerto Rico-source income of Puerto Rico residents.[196]

Finally, many observers regard the refundable child credit as merely one component of the overall U.S. system of public support for low-income individuals. As the 2006 GAO study notes, Puerto Rico receives Federal funds for a variety of social programs that provide assistance to low-income individuals, and Puerto Rico delivers similar services, although not always through the program as it exists in the United States.[197] A full consideration of the proposal should take into account not only the tax consequences of the proposal, but also the interaction between the proposal and such other programs.

Estimated Revenue Effect

In 2001, there were over one million employed workers in Puerto Rico, with an average wage of almost $16,000, and there were more than one million children in Puerto Rico younger than 17 years of age. Although certain Puerto Rico workers (i.e., those with three or more qualifying children) are currently eligible to claim the refundable child credit, the proposal would allow many more workers to claim a refundable child tax credit. Because the earned income formula of the refundable child credit sunsets under EGTRRA for taxable years beginning after December 31, 2010, the proposal (which modifies the earned income formula) likewise only affects taxpayers for taxable years beginning before December 31, 2010.[198] Assuming the proposal is effective for tax years beginning after December 31, 2006, the projected effect on Federal revenues for fiscal years 2007 through 2011 is -$0.9 billion and for fiscal years 2007 through 2016 is -$0.9 billion.

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[196] Taken to its logical conclusion, this argument would urge not only that the refundable child credit not be extended as proposed, but that the existing payroll tax formula should either be eliminated or otherwise modified to exclude residents of Puerto Rico from eligibility.

[197] See 2006 GAO study, pp. 123-25 ("The Extent That Federal Social Programs in Puerto Rico Mirror Those in the States and Other U.S. Insular Areas Varies").

[198] In taxable years beginning after December 31, 2010, only those residents of Puerto Rico with three or more qualifying children will be eligible to claim the refundable child tax credit (and only as determined under the payroll tax formula), as under present law.

B. Proposals Related to Corporations

As mentioned above, most U.S. companies with significant operations in Puerto Rico historically operated through a Puerto Rico branch of a domestic corporation to take advantage of the special tax benefits provided under section 936. Following the expiration of section 936, it may now be more advantageous for such companies to operate in Puerto Rico through a CFC structure, which allows the company to defer U.S. Federal income taxation on the CFC's earnings until those earnings are repatriated to the United States. However, some companies, especially those with valuable intangible assets, argue that the current tax cost associated with converting from a domestic entity to a foreign entity under section 367 is too large and would overwhelm the present value of the current and future tax benefit associated with deferral.

The Joint Committee staff reviewed four legislative proposals designed to provide tax benefits to corporations. Two of these proposals would provide benefits to companies that remained in a section 936 structure with regard to their Puerto Rico operations (extension of section 30A proposal and section 199 proposal) and two of these proposals would benefit companies that converted their Puerto Rico activities into a CFC structure pursuant to the expiration of the section 936 credit (section 956 proposal and section 245 proposal).

1. Extension of section 30A

Present and Prior Law

The Small Business Act[199] generally repealed the possession tax credit. However, certain domestic corporations that had active business operations in Puerto Rico or another U.S. possession on October 13, 1995, could continue to claim credits under section 936 or section 30A (both amended versions of the possession tax credit) for a 10-year transition period. Such credits applied to possession business income, which is derived from the active conduct of a trade or business within a U.S. possession or from the sale or exchange of substantially all of the assets that were used in such a trade or business. In contrast to the foreign tax credit, the possession tax credit was granted whether or not the corporation pays income tax to the possession.

One of two alternative limitations was applicable to the amount of the credit attributable to possession business income. Under the economic activity limit, the amount of the credit with respect to such income could not exceed the sum of a portion of the taxpayer's wage and fringe benefit expenses and depreciation allowances (plus, in certain cases, possession income taxes); beginning in 2002, the income eligible for the credit computed under this limit generally is subject to a cap based on the corporation's pre-1996 possession business income. Under the alternative limitation, the amount of the credit was limited to the applicable percentage (40 percent for 1998 and thereafter) of the credit that would otherwise have been allowable with respect to possession business income; beginning in 1998, the income eligible for the credit

[199] The Small Business Jobs Protection Act, Pub L. No. 104-88, August 20, 1988.

computed under this limit generally was subject to a cap based on the corporation's pre-1996 possession business income. Special rules applied in computing the credit with respect to operations in Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands. The credit was eliminated for taxable years beginning after December 31, 2005.

Some companies may still qualify for tax benefits for some period of time under section 936 or section 30A after December 31, 2005 if their taxable year began sometime before December 31, 2005.

Description of Proposal

The President's Fiscal Year 2001 budget proposal included long-term extensions of section 30A.[200]

The proposal would modify the credit computed under the economic activity limit with respect to operations in Puerto Rico only. First, the proposal would permanently extend the economic activity credit. Second, the proposal would eliminate the limitation that applies the credit only to certain corporations with pre-existing operations in Puerto Rico. Accordingly, under the proposal, the credit computed under the economic activity limit would be available with respect to corporations with new operations in Puerto Rico.[201] The proposal would not modify the credit computed under the economic activity limit with respect to operations in possessions other than Puerto Rico. The proposal also would not modify the credit computed under the alternative limit with respect to operations in Puerto Rico or other possessions.

Discussion

In general

The proposal to extend and modify the credit computed under the economic activity limit is intended to provide an incentive for job creation and economic activity in Puerto Rico. The credit computed under the economic activity limit as provided in section 30A reduces the U.S. Federal income tax burden on economic activity located in Puerto Rico. By reducing the U.S. Federal income tax burden, the credit may make it attractive for a business to locate in Puerto Rico, even if the costs of operation or transportation to or from the United States would otherwise make such an undertaking unprofitable. Thus, the credit is a deliberate attempt to distort taxpayer behavior. Generally, distortions of taxpayer behavior, such as those that distort decisions regarding investment, labor choice, or choice of business location reduce overall well-being by diverting labor and capital resources from their highest and best uses. However,

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[200] Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal* (JCS-2-00), March 6, 2000. Similar proposals were included in the President's Fiscal Year 1998, 1999, and 2000 Budget Proposals.

[201] An operation would be defined as "new" if established after October 13, 1995, the end of the base period established by the Small Business Job Protection Act of 1996.

proponents of the credit argue that such a distortion of choice may increase aggregate economic welfare because Puerto Rico has so many underutilized resources, as evidenced by its chronic high unemployment rate.

Some also have suggested that the credit may partially offset certain other distortions that exist in the Puerto Rico economy. For example, some have suggested that the application to Puerto Rico of the Federal minimum wage, which generally has been chosen based on the circumstances of the States, may contribute to Puerto Rico's relatively high unemployment rate. Others have suggested that the cost of investment funds to Puerto Rico businesses may be higher than is dictated by the actual risk of those investments. If this is the case, there may be an imperfect capital market. The credit, as it applies to wages and capital, may partially offset a distortion created by the minimum wage or a capital market imperfection.

Economic activity credit and economic neutrality

The credit computed under the economic activity limit is based loosely on the value added by a business that occurs within a qualifying Puerto Rico facility. In general, the economic concept of value added is the sum of the value of labor and the return to capital (profit, interest, or rent). The economic activity credit of section 30A is based upon compensation paid to employees in Puerto Rico and upon tangible personal property located in Puerto Rico. Proponents of the credit note that this design does not bias a business's choice of production between more labor-intensive or more capital-intensive methods, and thus should not promote an inefficient use of resources in production. In concept, the economic activity credit does not create a bias between businesses that provide services and businesses that manufacture goods. The economic activity credit does not create a bias between the choice of lower-skill, low-wage labor and higher-skill, high-wage labor. Similarly, the credit generally does not create bias in the choice of short-lived versus longer-lived tangible property. Proponents further observe that the economic activity credit under section 30A is based upon the labor employed in Puerto Rico and the equipment located within Puerto Rico which add value to the good or service produced, not the cost of raw materials, land, intangibles, interest, or other expenses. Thus, advocates of the section 30A credit argue that the credit directly targets underemployed resources within Puerto Rico.

While designed on the concept of economic value added, critics of the economic activity credit observe that the economic activity credit may not accurately measure value added and, as a consequence, creates certain inefficiencies and other distortions in taxpayer choice. For example, as noted above the concept of economic value added includes rent earned from investments in real property. Thus, a bias may exist against certain businesses in which real property is an important element of value added. For example, Puerto Rico real property may be an important component of valued added in the hospitality industry. However, the hospitality industry generally tends to employ significant amounts of labor, so that industry would not be without benefit under the economic activity credit. More generally, the application of the economic activity credit to capital investment depends upon the depreciation deductions allowed under the Code. To the extent that capital cost recovery under the Code does not reflect economic depreciation (and it is generally conceded that the Code does not accurately reflect economic depreciation), then a credit based on depreciation allowed under the Code does not accurately measure the value added from invested capital, and the economic activity credit may distort taxpayer choice of investment leading to inefficiencies in the credit.

More generally, if the intent were to promote complete neutrality between sources of value added, it may be more appropriate to measure value added more directly, such as by subtracting the costs of purchased materials and capital goods from the gross receipts received from the sale of a good or service. However, such a base for computation of the credit amount would allow credit for the value added by intangible assets sourced to Puerto Rico. The income based credit of prior law was criticized for encouraging intangible capital intensive business development rather than general business development regardless of type.[202] If the intangible assets were developed in Puerto Rico, including the return on intangible assets in the credit base arguably would help foster economic development in Puerto Rico. However, critics of section 30A argue that given the somewhat ephemeral nature of the development of intangible assets and the ability of investors to move the ownership of intangible assets across borders, in practice it would be too difficult to distinguish that portion of intangible assets developed in Puerto Rico from that portion developed outside Puerto Rico.

Other issues related to the economic activity credit

Some criticize section 30A for the magnitude of the credit allowed. They observe that the credit rate on compensation is 60 percent and that, unlike most credits permitted under the Code, the taxpayer is not required to reduce the amount of compensation that may be deducted by the amount of credit claimed. Thus, a U.S. corporate taxpayer in the 35-percent marginal tax bracket would be able to recover 95 percent of compensation paid (the deduction for compensation valued at the 35-percent tax rate plus the 60-percent credit) in the form of a reduced income tax liability. In this situation the cost of hiring an additional employee is borne almost entirely by revenue forgone to the U.S. Treasury and, thereby, by U.S. taxpayers generally, with little cost borne by the employer.

The economic activity credit has only been available to taxpayers since 1994. There have been no studies of its efficacy to date. However, the tax credit can never be fully efficient. The credit would be available to any business locating in Puerto Rico, regardless of whether the business would have chosen to locate in Puerto Rico in the absence of the credit for other business reasons. Thus, as with most tax benefits designed to change economic decisions, in some cases, the Federal Government will lose revenue even when there has been no change in taxpayer behavior. Also, like any tax credit, the value of the credit is limited by a taxpayer's other tax attributes. Thus, if a taxpayer has losses in any given year or is limited by application of the alternative minimum tax, the taxpayer would have to defer claiming the economic activity credit, thereby diminishing the value of the credit.

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[202] See the discussion in Department of the Treasury, *The Operation and Effect of the Possessions Corporation System of Taxation, Sixth Report*, March 1989.

Data related to the economic activity credit

Taxpayers have claimed substantial amounts of credit under the economic activity credit since its inception in 1993. Table 2, below, reports the amount of taxable income earned and the economic activity credit claimed by possessions corporations in Puerto Rico for 1995 through 2003. Both the income earned and the credit amount are declining because, as explained above in Part III, both the income credit and economic activity credit have been phasing out since 1995, with limits on the amount of credit that can be claimed. Also, as the 2006 GAO study documents, the number of possessions corporations has declined during this period. More than 70 percent of possessions corporations claiming credit for activities in Puerto Rico claimed the economic activity credit in each year. These corporations accounted for between 18 and 23 percent of total taxable income reported by possessions corporations. The economic activity credit accounted for between 30 and 40 percent of total (income or economic activity) credits claimed between 1995 and 2003.

Table 2.−Economic Activity Credit Claimed by Possessions Corporations, 1995-2003 (millions of dollars)

Year	Number of Possessions Corporations Claiming Credit	Taxable Income Subject to Tax ($ millions)	Credit Claimed ($ millions)
1995	264	2,974	932
1997	236	2,830	841
1999	165	2,147	650
2001	118	1,630	493
2003	114	1,331	384

Source: Daniel S. Holik, "U.S. Possessions Corporation Returns, 2001, *SOI Bulletin*, 25, Fall 2005, pp.248-262 and special tabulations from Internal Revenue Service data.

Estimated Revenue Effect

Assuming the proposal to extend section 30A would apply to taxable years beginning after December 31, 2006, the projected effect on Federal revenues for fiscal years 2007 through 2011 is -$2.7 billion and for fiscal years 2007 through 2016 is -$8.6 billion. The proposal is estimated to generate some modest expansion of the Puerto Rico operations coming into, or staying in, the U.S. tax base. There would be some new employment and investment under the proposed extension of section 30A, but to some extent the credit is likely to inure to the benefit of corporate shareholders with respect to current operations.

2. Section 199 proposal

Present Law

In general

Present law provides a deduction from taxable income (or, in the case of an individual, adjusted gross income) that is equal to a portion of the taxpayer's qualified production activities income. For taxable years beginning after 2009, the deduction is nine percent of such income. For taxable years beginning in 2005 and 2006, the deduction is three percent of income and, for taxable years beginning in 2007, 2008 and 2009, the deduction is six percent of income. For taxpayers subject to the 35-percent corporate income tax rate, the 9-percent deduction effectively reduces the corporate income tax rate to just under 32 percent on qualified production activities income.

Qualified production activities income

In general, "qualified production activities income" is equal to domestic production gross receipts (defined by section 199(c)(4)), reduced by the sum of: (1) the costs of goods sold that are allocable to such receipts; and (2) other expenses, losses, or deductions which are properly allocable to such receipts.

Domestic production gross receipts

"Domestic production gross receipts" generally are gross receipts of a taxpayer that are derived from: (1) any sale, exchange or other disposition, or any lease, rental or license, of qualifying production property[203] that was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the United States; (2) any sale, exchange or other disposition, or any lease, rental or license, of qualified film[204] produced by the taxpayer; (3) any sale, exchange or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the United States; (4) construction activities performed in the United States; or (5) engineering or architectural services performed in the United States for construction projects located in the United States.

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[203] "Qualifying production property" generally includes any tangible personal property, computer software, or sound recordings.

[204] "Qualified film" includes any motion picture film or videotape (including live or delayed television programming, but not including certain sexually explicit productions) if 50 percent or more of the total compensation relating to the production of such film (including compensation in the form of residuals and participations) constitutes compensation for services performed in the United States by actors, production personnel, directors, and producers.

For purposes of section 199, the United States does not include Puerto Rico or other U.S. possessions.[205]

Wage limitation

For taxable years beginning after May 17, 2006, the amount of the deduction for a taxable year is limited to 50 percent of the wages paid by the taxpayer, and properly allocable to domestic production gross receipts, during the calendar year that ends in such taxable year.[206] Wages paid to bona fide residents of Puerto Rico generally are not included in the wage limitation amount.[207]

Description of Proposal

In December 2005, the House of Representative passed H.R. 4388, the Tax Revision Act of 2005, which includes the section 199 proposal with the same wage limitation. There were also several prior initiatives related to the proposal in the 108th and 109th Congress.[208]

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[205] Sec. 7701(a)(9) ("the term 'United States' when used in a geographical sense includes only the States and the District of Columbia").

[206] For purposes of the provision, "wages" include the sum of the amounts of wages as defined in section 3401(a) and elective deferrals that the taxpayer properly reports to the Social Security Administration with respect to the employment of employees of the taxpayer during the calendar year ending during the taxpayer's taxable year. For taxable years beginning before May 18, 2006, the limitation is based upon all wages paid by the taxpayer, rather than only wages properly allocable to domestic production gross receipts.

[207] Sec. 3401(a)(8)(C).

[208] Including the U.S. possessions as part of the United States for purposes of the section 199 manufacturing deduction has received previous consideration. The manufacturing deduction was added to the Code by section 102 of AJCA. The bill as passed by the House and Senate provided differing treatment of U.S. possessions for purposes of the deduction; the House bill did not treat possessions as part of the United States, whereas the bill as passed by the Senate did treat possessions as part of the United States for purposes of section 199. The final version of the bill followed the House approach. Following the enactment of AJCA, on December 7, 2005, the House passed H.R. 4388, the "Tax Revision Act of 2005," which includes the proposal described herein. The proposal as set forth in H.R. 4388 applies only to tax years beginning in 2006. Similar proposals have been included in other bills introduced in the House and the Senate. The same proposal (applying for all tax years beginning after December 31, 2005, with no sunset) is included in S. 1816, introduced by Senator Santorum on October 4, 2005. A similar proposal, which (unlike H.R. 4388 and S. 1816) contains no requirement that the gross receipts giving rise to the section 199 deduction be currently taxable for U.S. Federal income tax purposes, is included in H.R. 2181, introduced on May 5, 2005, by Mr. Fortuño.

The proposal amends section 199 of the Code to include Puerto Rico within the definition of the United States for purposes of determining the domestic production gross receipts of eligible taxpayers. Under the proposal, a taxpayer is allowed to treat Puerto Rico as part of the United States for purposes of section 199 (thus allowing the taxpayer to take into account its Puerto Rico business activity for purposes of calculating its domestic production gross receipts and qualified production activities income), but only if all of the taxpayer's gross receipts from sources within Puerto Rico are currently taxable for U.S. Federal income tax purposes.

Discussion

Under the proposal, a domestic company is eligible for the benefit of the section 199 deduction relating to activity in Puerto Rico only if its gross receipts from Puerto Rico are currently taxable.[209] Generally, a taxpayer will satisfy this condition by operating in flow-through form such as through a Puerto Rico branch or partnership.[210]

Given the tax benefits afforded by section 936, most U.S. companies with significant operations in Puerto Rico historically operated through a Puerto Rico branch of a domestic U.S. corporation. Therefore, many companies are structured in a manner that would allow them to benefit from the section 199 deduction if it were extended to Puerto Rico. Following the expiration of section 936, it may now be more advantageous for such companies to operate through a Puerto Rico CFC structure, which allows the company to defer U.S. Federal income tax on the CFC's Puerto Rico-source active income until those earnings are repatriated to the

[209] The proposal, like section 199 itself, also applies to an individual operating a business as a sole proprietorship or through a flow-through entity such as a partnership or subchapter S corporation. However, because Puerto Rico residents are generally not subject to U.S. Federal income tax on their Puerto Rico-source income, the proposal will generally be of limited benefit to an individual Puerto Rico-resident owner of a local small business with little or no activity outside of Puerto Rico. The proposal could, however, be of significant benefit to an individual who is otherwise subject to U.S. Federal income taxation (either because the individual is a U.S. citizen or permanent resident and is not a resident of Puerto Rico, or because the individual is a Puerto Rico resident who has significant non-Puerto Rico-source income), and who owns a business (either a sole proprietorship or a pass-through entity) that pays substantial amounts of qualifying wages and that has significant amounts of manufacturing activity in Puerto Rico. As the number of such individuals, as well as their potential aggregate benefit under the proposal, is likely to be small, the scope of the discussion that follows is limited to corporate taxpayers.

[210] In general, a CFC is not subject to U.S. tax on its active foreign-source income, and therefore any manufacturing income earned by a CFC will not generate a section 199 deduction under the proposal. A CFC that manufactures in Puerto Rico and sells directly to consumers in the United States might have a U.S. trade or business, in which case it could take advantage of the deduction with respect to its effectively connected income; however, this is likely to be a rare structure. To the extent that a Puerto Rico CFC's production is ultimately being sold in the United States, the U.S. parent will likely attempt to maximize the benefit of deferral either by structuring the CFC's U.S. sales in a manner that avoids creating a U.S. trade or business, or by causing the CFC to sell to a (related or unrelated) U.S. distributor.

United States.[211] Even if the proposal were adopted, the potential present value benefit of such deferral (for a U.S. corporation operating in Puerto Rico through a CFC) might significantly exceed the approximately three-percentage-point rate cut (once section 199 is fully phased in) that is otherwise available to a U.S. corporation operating in Puerto Rico through a flow-through entity once section 199 is fully phased in (for a U.S. corporation operating in Puerto Rico through a flow-through entity).[212] However, some U.S. companies, particularly those with valuable intangible assets, contend that the current tax cost associated with converting from a

[211] As discussed in Part V, above, the 2006 GAO study found a significant decline from 1997 through 2002 in the share of employment and income in the manufacturing sector attributable to possessions corporations. It also found that the decline in income and value added of possessions corporations has been largely offset by increased income and value added of affiliated corporations operating in Puerto Rico. The GAO concluded that many large corporate groups that owned section 936 companies in Puerto Rico shifted their operations to other business entities, including controlled foreign corporations. See Chapter 4 of the GAO study, pp. 80-100 ("Much Possessions Corporation Activity Has Shifted to Affiliated Corporations"). These results are consistent with the expectation that U.S. companies doing business in Puerto Rico, faced with the expiration of section 936, will restructure their operations with a view to maximizing the benefit of tax deferral; indeed, the GAO data suggest that U.S. companies doing business in Puerto Rico have already undertaken this restructuring process.

[212] To illustrate this point, suppose a U.S. corporation has a Puerto Rico manufacturing operation that is expected to generate $1,000 in pretax profit in 2010 (assume also that the entire $1,000 amount is qualified production activities income and that the U.S. corporation has otherwise paid sufficient wages to satisfy the section 199 wage limitation), and the company is considering whether to operate the business through a flow-through structure or through a CFC structure. Flow-through structure: Under present law, if the operation is structured as a Puerto Rico branch of the U.S. parent, the taxpayer includes the $1,000 profit in its current year taxable income and incurs a tax liability of $350 (i.e., 35 percent of $1,000; for the sake of simplicity, this analysis ignores the effect of both state and local income taxes and Puerto Rico income tax). If the proposal is enacted, the U.S. taxpayer will be able to claim a section 199 deduction of $90 (9 percent of $1,000), thus reducing its taxable income from the operation to $910. The taxpayer will now pay tax of $319 (35 percent of $910), resulting in a tax savings of $31 when compared to present law. CFC structure: If the taxpayer instead operates through a Puerto Rico CFC, it loses any benefit from section 199 under the proposal, but gains the benefit of possible tax deferral. In 2010, the CFC earns the same $1,000 of income in the first example. (For the sake of simplicity, as noted, these examples assume there is no Puerto Rico corporate income tax; in reality, although any Puerto Rico corporate income taxes paid by the CFC will generally be creditable against U.S. income tax when the earnings are repatriated, because Puerto Rico taxes are paid currently and are not subject to deferral the Puerto Rico corporate tax rate will significantly affect the present value benefit of the CFC structure.) Suppose the CFC retains the $1,000 within Puerto Rico for ten years, finally paying a dividend to the U.S. taxpayer in 2020. The U.S. taxpayer will then be subject to $350 of tax on the earnings (i.e., the same nominal amount as in the flow-through example under present law). However, the U.S. taxpayer has deferred the payment of this $350 tax liability during the intervening ten years. Even assuming a conservative discount rate of five percent, the present value of a $350 obligation paid ten years in the future is approximately $215. In this very simplified example, therefore, the taxpayer is significantly better off operating through a CFC structure, which results in a present-value tax cost of $215, than it is operating through a flow-through structure, which results in a current tax cost of $319 even if the section 199 proposal is enacted.

domestic entity to a foreign entity under section 367 is so large as to overwhelm the present value of the current and future benefit of tax deferral.[213]

Proponents of the proposal contend that a U.S. taxpayer operating a manufacturing facility in Puerto Rico through a flow-through entity (such as a Puerto Rico branch or partnership) will experience a higher level of U.S. Federal income taxation on its operating profit than will an otherwise identical manufacturing operation located in the United States. These proponents argue that Puerto Rico should be included within the scope of section 199 in order to provide the same tax treatment for manufacturing operations in Puerto Rico as in the United States. However, opponents point to several key differences between Puerto Rico and the United States which they argue justify excluding Puerto Rico from the scope of section 199. First, businesses operating entirely within the United States lack the option to organize in CFC form and thereby benefit from the deferral of U.S. tax on active income. While the economic viability of converting to a CFC structure may be adversely affected by tax costs associated with section 367, taxpayers nevertheless retain the option to convert to CFC status, as well as to structure new or expanded Puerto Rico operations using a CFC. Opponents argue that the proposal encourages large U.S. companies operating in Puerto Rico to bifurcate their activities into a partially "foreign" (i.e., CFC) and partially "domestic" (i.e., flow-through) structure. Under such a strategy, a U.S. corporate group would move certain Puerto Rico assets and activities into a CFC structure, while retaining other Puerto Rico assets and activities (e.g., certain intangibles and related activities, which would generally be expected to trigger significant amounts of taxable gain under section 367 gain if transferred to a CFC) within its domestic structure. This ability to maximize tax benefits through a bifurcated part-foreign, part-domestic structure would be unique to Puerto Rico, and is unavailable to businesses operating exclusively in the United States (or in any other foreign jurisdiction).[214]

Opponents of the proposal point out that State income taxes are deductible from U.S. Federal taxes, while foreign taxes (including those imposed by Puerto Rico) are generally creditable against foreign-source income, potentially allowing a corporate taxpayer to fully recover income taxes imposed by Puerto Rico in the form of reduced U.S. Federal income tax liability. Opponents of the proposal argue that this treatment results from a fundamental policy decision to treat Puerto Rico as a foreign country for U.S. Federal income tax purposes, and that

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[213] Section 367 generally requires a U.S. taxpayer to recognize taxable gain on the transfer of property to a foreign corporation (such as a Puerto Rico CFC). In particular, special rules under section 367(d) apply to the transfer of intangible assets, and much of the gain from such a cross-border transfer of the assets of a Puerto Rico branch to a newly-established Puerto Rico CFC could be expected to relate to intangible assets.

[214] It should be noted that this ability is a function of present law, and that U.S. corporations that have historically operated in Puerto Rico through a branch (rather than a CFC) may be motivated to establish a bifurcated structure regardless of whether the proposal is enacted, in an attempt to maximize the benefit of the deferral available under a CFC structure while minimizing the current tax cost of such a restructuring.

it is therefore inappropriate to apply to Puerto Rico discrete provisions in the Code that are otherwise limited to domestic U.S. businesses.

Finally, under the proposal, gross receipts from Puerto Rico will be included in domestic production gross receipts; however, because section 3401(a)(8)(C) generally excludes wages paid to bona fide residents of Puerto Rico from the definition of "wages," taxpayers would not be permitted to include such wages in calculating the 50-percent wage limitation. If this result is unintended, the proposal can be modified to allow eligible taxpayers to take such wages into account for purposes of calculating the 50-percent wage limitation.

Estimated Revenue Effect

Assuming the proposal is effective for tax years beginning after December 31, 2006, the projected effect on Federal revenues for fiscal years 2007 through 2011 is -\$0.7 billion and for fiscal years 2007 through 2016 is -\$1.9 billion. This estimate assumes that the proposal as enacted would not only expand the scope of section 199 for purposes of calculating domestic production gross receipts, but would also include wages paid to Puerto Rico residents within the definition of "W-2 wages" for purposes of the wage limitation. It is anticipated that the size and scope of the proposal's incentive effect − particularly in light of the availability of alternative tax-favored structures for U.S. taxpayers operating in Puerto Rico (i.e., through a CFC) − is such that enactment of the proposal will induce only a limited change in taxpayer behavior; most of the estimated revenue impact is thus anticipated to relate to U.S. taxpayers who would already be operating in Puerto Rico in the absence of the provision.

3. Section 956 proposal

Present Law

The United States employs a "worldwide" tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred, and U.S. tax is imposed on such income when repatriated.

When a U.S. corporation receives dividends from a foreign corporation, the dividend income generally is subject to full U.S. taxation, though a foreign tax credit may be available for foreign taxes associated with the dividend payment. Section 245 mitigates this full taxation by allowing a deduction for certain dividends attributable to U.S.-source earnings that already have been subject to U.S. tax. Under section 245, a corporation that receives a dividend from a qualified 10-percent owned foreign corporation generally is allowed a deduction for the percentage of the U.S.-source portion of the dividend equal to the applicable percentage described above for dividends received from domestic corporations. A qualified 10-percent owned foreign corporation is a foreign corporation that is owned at least 10 percent (by vote and value) by the corporation receiving the dividend. The U.S.-source portion of a dividend is defined in section 245(a)(3) and generally represents the portion of a dividend attributable to income of the paying corporation that is effectively connected with the conduct of a trade or business in the United States and that is subject to U.S. income tax.

Under U.S. anti-deferral rules, the domestic parent corporation may be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. One of the main anti-deferral regimes in this context is the subpart F regime.[215] The subpart F regime denies deferral of certain income earned by CFCs, including income that is invested in U.S. property (section 956 income). Investments in U.S. property include investments in, and loans to, the CFC's U.S. shareholders.[216] A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether earned directly by the domestic corporation, repatriated as a dividend from a foreign subsidiary, or included in income under the anti-deferral rules.[217]

AJCA offers a temporary election to reduce U.S. taxes on repatriated dividends from CFCs provided that certain conditions are met. In general, this reduction consists of an 85 percent deduction of cash dividends received during a taxable year by a U.S. corporation from a CFC (a Puerto Rico corporation can qualify as a CFC). If a U.S. corporation is in the 35 percent income tax bracket, the 85 percent deduction would yield an effective tax rate of 5.25 percent.

Description of Proposal

The section 956 proposal is generally based on two bills introduced during the 107th Congress.[218]

The proposal modifies the definition of section 956 (relating to certain investments in U.S. property) to permit deferral of U.S. tax on 90 percent of qualified income earned by a qualified corporation (defined below). As an alternative to the new section 956 rule, the

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[215] Secs. 951-964.

[216] Sec. 956.

[217] Secs. 901, 902, 960, 1291(g).

[218] The first bill, H.R. 2550, known as the "Economic Revitalization Tax Act of 2001," was introduced in the House of Representatives by Representative Philip Crane, the Ways and Means Trade Subcommittee chairman, on July 18, 2001. The second bill, S. 1475, also known as the "Economic Revitalization Tax Act of 2001," was introduced in the Senate by Sen. Breaux (and Sen. Hatch) on September 26, 2001. Some modifications have been made to the description of these two bills to account for more updated provisions suggested by various interested parties after the introduction of such bills. In particular, the description of the proposal omits the safe harbor rules for certain transfers or licenses of intangible property included in the original bills. The description includes a new requirement by defining a qualified trade or business.

proposal also provides for an 85 percent deduction for dividends actually paid by a qualified corporation out of its qualified income (defined below).

90-percent section 956 exception

In general

Under the proposal, section 956 would be amended to allow a qualified corporation to invest 90 percent of qualified income in the United States without triggering current U.S. tax. Tax would be deferred until this income is distributed to U.S. shareholders. The proposal would not change the taxation of income (including passive income) that is currently subject to the other anti-deferral provisions of subpart F.

Qualified corporation

A qualified corporation includes any CFC (as defined in section 957(a) of the Code), but only if the CFC is created or organized under the laws of Puerto Rico, the Virgin Islands, Guam, American Samoa and the Northern Mariana Islands (hereafter collectively referred to as "qualified jurisdictions").

Qualified income

Qualified income is limited to foreign-source income earned by a qualified corporation in taxable years beginning after December 31, 2006 (the expiration date of sections 936 and 30A) from the active conduct of a qualified trade or business within a qualified jurisdiction.

Qualified trade or business

Under the proposal, qualified income is limited to income from the active conduct of a qualified trade or business. The term qualified trade or business includes any trade or business with three exceptions. First, the proposal excludes from the definition of qualified business the holding of intangible property for sale or license unless (1) the intangible is developed in the qualified jurisdiction by a qualified corporation, and (2) substantially all the developmental activities occur in the qualified jurisdiction. The proposal also excludes from the definition of qualified business the holding for investment purposes of stock, securities, land or other property, and the ownership and operation (including leasing) of real or personal property unless the owner provides significant services with respect to the operation and management of the property.

Calculation of exception

Under the proposal, U.S. tax would be deferred on 90 percent of investments in U.S. property by a qualified corporation out of its qualified income from active business operations in a qualified jurisdiction.

Imputed interest and constructive dividends

The proposal would provide that no interest is imputed and no original discount is accrued with respect to any obligation issued to a qualified corporation. The proposal would also provide that no amount of U.S. property held by a qualified corporation should be treated as a dividend for any purpose under the Code.

Regulations

The proposal would grant Treasury and the IRS the authority to issue regulations to "carry out the purposes of" the proposal.

85-percent dividends received deduction

In general

In general, section 245 of the Code would be amended to provide a dividends received deduction equal to 85 percent of the eligible dividends received by a U.S. corporation from an electing qualified corporation (defined above) out of its qualified income (defined above). For this purpose, dividends would be treated as coming first out of qualified income, but eligible dividends are limited to the amount of qualified income that has not benefited from the 90 percent exclusion from current taxation of investment in U.S. property (even if the investment in U.S. property is subsequently reduced.)

Election

Under the proposal, the dividends received deduction would be elective. Treasury and the IRS would have the authority to issue regulations to prevent duplication of tax benefits where a qualified corporation making such election has taken advantage of the new 90 percent exception for investments in U.S. property in a prior taxable year.

Coordination with foreign tax credit

Under the proposal, Treasury and the IRS would have the authority to issue regulations applying the principles of sections 245(a)(8) and (9) to dividends with respect to which the 85-percent dividends received deduction is allowable. The taxes attributable to income eligible for the special dividends received deduction would not be creditable and this income would not increase the taxpayer's foreign tax credit limitation.

Discussion

In general

As explained above, income earned by a domestic parent corporation from the foreign operations of its foreign subsidiaries generally is subject to U.S. tax only when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred, subject to certain anti-deferral regimes. These regimes --

most significantly the subpart F regime -- may cause the domestic parent to be taxed on a current basis with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries. A foreign tax credit is available to offset, in whole or in part, the U.S. tax owed on the domestic corporation's foreign-source income, whether earned directly by the domestic corporation, repatriated as a dividend, or included under one of the anti-deferral regimes.

The amount of U.S. tax owed as a result of a dividend repatriation thus depends on the U.S. parent's ability to use foreign tax credits to offset some or all of the U.S. tax on the dividend. The ability to use foreign tax credits depends on a number of different factors. As a general matter, however, earnings that are subject to higher rates of foreign tax often carry with them sufficient usable foreign tax credits to eliminate or substantially offset the U.S. tax on the repatriation, while earnings that are subject to lower rates of foreign tax are more likely to trigger substantial levels of residual U.S. tax at the time of repatriation.[219]

It has long been recognized that this deferral system creates incentives in some cases for companies not to repatriate certain of their foreign earnings, and instead to accumulate and reinvest these earnings abroad, in order to maintain deferral of U.S. taxes. This distortion is, of course, more prevalent with respect to earnings generated in lower-tax jurisdictions, since, as explained above, it is often possible under present law to repatriate earnings generated in higher-tax jurisdictions with little or no residual U.S. tax.

The section 956 proposal would reduce the disincentive for repatriating foreign earnings from Puerto Rico (or other qualified jurisdictions) by allowing: (1) the deferral of foreign earnings invested in U.S. property (90 percent section 956 exception); or (2) a reduced rate of tax for repatriated foreign earnings (85 percent dividends received deduction). As described in Part II.B., above, the rate of Puerto Rico income tax generally applicable to large enterprises is 39 percent. Under present law, Puerto Rico tax paid by a U.S. subsidiary would give rise to a foreign tax credit in the United States and because the general Puerto Rico tax rate exceeds the U.S. corporate tax rate, income paid from the Puerto Rico subsidiary to a U.S. parent corporation generally would not be subject to any U.S. residual tax. However, as also described in Part II.B., Puerto Rico grants exemptions from the Puerto Rico corporate income tax under the 1998 Act. As a result, some Puerto Rico subsidiaries of U.S. corporations may face residual U.S. tax on income distributed to the U.S. parent. If the exemption granted under the 1998 Act is complete, the residual tax could be at a rate as high as 35 percent. In this circumstance, the U.S. parent would benefit under the proposal. More generally, the magnitude of the tax benefit under this proposal would depend on the extent to which the Puerto Rico subsidiary is subject to Puerto Rico income tax under the generally applicable law and the 1998 Act.

By providing companies with a partial reduction of U.S. taxes regardless of the amount of Puerto Rico taxes paid, both of the options under this proposal would operate as "tax-sparing"

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[219] These low-taxed foreign earnings increase a company's foreign tax credit limitation. This income may allow the company to claim foreign tax credits generated by high-tax foreign income.

mechanisms.[220] Furthermore, because both of these options would grant partial relief from U.S. taxes for qualified income derived from a qualified jurisdiction, such options represent a territorial-style approach with respect to certain income generated in Puerto Rico. The effect is to lower the overall rate of tax (U.S. tax and Puerto Rico tax) on income earned in Puerto Rico to a rate close to that imposed in Puerto Rico (both under the general Puerto Rico corporate income tax and the 1998 Act).

The 90-percent section 956 option

Under the 90-percent section 956 exception, companies could invest 90 percent of their qualified income in U.S. property without triggering the U.S. anti-deferral rules that result in current U.S. taxation. The deferral amount is calculated on a pro-rata basis such that 90 percent of a company's investments in U.S. property would be granted the exception and 10 percent of the investment would be subject to current U.S. tax. This means, for example, a CFC incorporated in Puerto Rico could enter into a $100 loan with its U.S. parent and only $10 of the imputed dividend would be subject to current U.S. Federal income tax. The other $90 of the loan amount would escape U.S. Federal income tax until the note is forgiven and such amount is treated as a dividend. In the interim, no interest would be imputed on the note and the note could not be deemed a constructive dividend. Thus, the provision provides the potential for permanent reinvestment in U.S. property with no interest charge. By maintaining deferral indefinitely, a taxpayer may achieve a result that is economically equivalent to 90-percent exemption of income, with no corresponding disallowance of expenses allocable to the exempt income, provided that the taxpayer does not actually repatriate the earnings. This benefit is afforded to taxpayers regardless of the level of tax imposed by Puerto Rico. The result is a tax-sparing proposal that largely resembles a territorial-type exemption.

While the 90-percent section 956 deferral option could yield an extended exemption from U.S. tax, once an actual distribution is made to U.S. shareholders, companies would be subject to full U.S. tax on such amount. No tax benefit is afforded to companies making actual repatriations under the 90-percent section 956 exception. Thus, taxpayers that opt to defer 90 percent of their section 956 income in lieu of taking the 85-percent dividends received deduction risk exposure to future taxation. In comparing the two options, some may argue that the 85-percent dividends received deduction would be viewed as the more attractive option because it eliminates rather than defers U.S. tax on income earned in Puerto Rico by granting companies a lower rate of a tax on actual repatriations.

The 85-percent dividends received deduction option

The 85-percent dividends received deduction would likely induce two main behavioral responses. The first behavioral response focuses on the actual investment in Puerto Rico. Proponents argue that there would be an increase in the amount of investment in Puerto Rico

[220] Tax-sparing occurs when a taxpayer is granted relief from domestic taxation despite whether foreign taxes have actually been paid (the tax has been "spared").

because the proposal would create a higher after-tax rate of return on that investment by, in essence, exempting 85 percent of the dividends paid by the Puerto Rican corporation to its U.S. shareholders. By exempting 85 percent of the dividend from U.S. tax, the proposal eliminates much of the residual U.S. tax that acts as a barrier for repatriating funds from a low-tax jurisdiction. Reducing this barrier would allow capital to flow more freely out of Puerto Rico and generally would increase the after-tax return to investment in Puerto Rico. Investments in Puerto Rico thereby become more attractive to U.S. investors and investment in Puerto Rico may increase.

Some critics of the proposal point to a second possible behavioral response. They suggest the proposal could reduce potential investment in Puerto Rico by discouraging the retention of earnings in Puerto Rico as may occur under present law as investors take advantage of the benefit of deferral. As mentioned above, AJCA provided for a temporary election to reduce U.S. taxes on repatriated dividends from CFCs by allowing an 85-percent deduction of cash dividends received during a taxable year by a U.S. corporation from a CFC. The motivation for the AJCA provision was to stimulate the U.S. domestic economy by triggering the repatriation of foreign earnings that otherwise would have remained abroad. By allowing companies to repatriate funds at a lower rate, the AJCA provision was designed to encourage companies to take income out of low-tax foreign jurisdictions and bring it back to the United States.[221] The 85-percent dividends received deduction contained in the section 956 proposal is structured the same as the temporary dividends received deduction afforded to CFCs under AJCA. Opponents of the section 956 proposal argue that adopting such provision would motivate companies to take money out of Puerto Rico instead of creating an incentive to reinvest corporate earnings in Puerto Rico.

However, if markets are efficient, potential investors should be influenced by the increased after-tax rate of return they receive from making additional investments in Puerto Rico. In fact, any income flowing out of Puerto Rico may not necessarily equate to a reduction of assets in Puerto Rico as dividends paid out of one Puerto Rico enterprise may be reinvested in another Puerto Rico enterprise. In addition, other investors may now find an investment in Puerto Rico more attractive, in part, because current income can be paid back to the investor at a low effective rate of tax.

This argument is similar to the rationale for reducing the U.S. tax rate on dividends paid by a company to its shareholders; the theory behind reducing the U.S. tax rate on dividends paid to shareholders is that by eliminating a portion of the double-tax burden that discourages companies from distributing profits, companies will now be encouraged to pay out dividends and, in turn, shareholders will no longer be precluded from achieving a higher rate-of-return from potential alternative investments than the return that would be achieved if the company had retained the earnings. Investors can use these dividends received to invest in higher rate of return investments in any industry in any jurisdiction, including new investments in Puerto Rico.

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[221] See Jumpstart Our Business Strength (JOBS) Act, S. 1637, S. Rep. No. 108-192, section 231 and the American Jobs Creation Act, H.R. 4520, H.R. Rep. No. 108-548, section 271.

Reducing the U.S. tax on dividends paid out of Puerto Rico thus could lead to a better allocation of capital worldwide and within the Puerto Rico economy as earnings are not "trapped" within particular industries. Proponents note that the greater after-tax rate of return achieved under this proposal could only be realized by making continued investments in Puerto Rico.

Investor choice among alternative jurisdictions

Proponents of the section 956 proposal argue that in evaluating Puerto Rico's viability for sustained economic growth, the United States must consider Puerto Rico's ability to compete with other low-tax countries in the Caribbean and low-tax foreign jurisdictions like Ireland and Singapore. Proponents argue that Puerto Rico is at a distinct disadvantage in relation to other foreign countries because although it is treated as a foreign country for U.S. tax purposes, it is burdened with the additional costs related to its status as a U.S. possession (e.g., being subject to U.S. statutory rules like the minimum wage standard and the requirement to use U.S. flag ships). Proponents of the section 956 proposal argue that the United States has a responsibility to provide special tax incentives to Puerto Rico because its unique hybrid treatment makes it harder for Puerto Rico to compete in the global market.

The proposal can yield significant U.S. tax benefits relative to present law if Puerto Rico offers tax incentives for local operations. Moreover, although companies may weigh investment in Puerto Rico against investment in a low-tax jurisdiction (for example, Ireland or Singapore), they also may be considering investment in a foreign jurisdiction with higher tax rates. Firms' location decisions are based on tax and non-tax considerations. Even if a U.S. parent company with operations in Puerto Rico could achieve a better tax result in a third country, it may choose to continue or to increase operations in Puerto Rico if tax and non-tax considerations combine to make Puerto Rico an attractive location. Opponents, therefore, observe that a Puerto Rico should be able to attract adequate investment without having the lowest tax rate of all possible alternative locations for investment.

Eligible investments

Opponents of the proposal also note that the rules do not distinguish between old and new investment income. In other words, the proposal does not track when the repatriated or reinvested income was earned. The proposal would allow companies to repatriate low-tax income that has been sitting in Puerto Rico at a preferential U.S. tax rate, despite the company's intentions for future investment in Puerto Rico. This could result in windfall profits for many companies currently operating in Puerto Rico with "trapped" earnings. Opponents further argue that a proposal offering a preferential U.S. tax rate on low-tax income generated in Puerto Rico without limitations tied to new investments would merely abet earnings stripping.[222] On the

[222] Earnings stripping generally occurs when a U.S. company reduces the U.S. tax on its U.S.-source income through the payment of deductible amounts such as interest, rents, and royalties to a foreign entity that is not subject to U.S. tax on the receipt of such payments. These transactions are commonly referred to as earnings stripping transactions because they "strip" U.S.-source income out of the United States and stuff it into low-tax foreign jurisdictions, thereby eroding the U.S. tax base. Under this proposal it would possible for the U.S. parent corporation to enter into a loan or financing

other hand, it can be administratively difficult to distinguish old investment from new investment. Also proponents of the proposal observe that extending the benefits of the proposal to so-called old investments may keep the investors from relocating outside of Puerto Rico.

Allocation of income and expense

The behavioral responses described above are not mutually exclusive and there is uncertainty about which behavioral response would dominate. What is evident about this proposal is that both the 90-percent section 956 exception and the 85-percent dividends received deduction would grant partial relief from U.S. taxes for certain income generated in Puerto Rico, despite the level of local tax imposed by Puerto Rico. Thus, the reduction of U.S. tax under these provisions would function similar to a tax-sparing mechanism and adopting these provisions would create a territorial-style approach with respect to business activities in Puerto Rico. As a result, if such approach is adopted, more pressure would be placed on U.S. transfer pricing rules, to determine the allocation of income and expense. A particular concern may arise with respect to intangible property, because there would be an incentive for U.S. companies to allocate income to Puerto Rico where such income could receive an exemption from U.S. tax.

According to the 2006 GAO study and other recent financial data, not all possessions corporations have converted their business operations into a CFC structure. Thus, in order to take advantage of the tax benefits under this proposal, companies that are still operating in domestic form under section 936, or U.S. businesses that have reorganized their operations in Puerto Rico as branches of CFCs, would have to convert their business to CFC status. Generally, as previously discussed, there are U.S. tax consequences associated with converting domestic operations into a foreign entity.[223] If special transition rules are adopted to ease the tax costs associated with transitioning these companies into a CFC structure, these rules may allow for significant income-shifting opportunities, especially in the case of certain transfers or licenses of intangible property.

As mentioned earlier, issues relating to the transfer of intangible property played a large role in the carve-back and ultimate repeal of the possession tax credit under section 936. The tax benefit provided under prior law section 936 was based upon Puerto Rico source income. The present proposal also ties its tax benefit to Puerto Rico source income. This creates incentives to allocate income and shift property to Puerto Rico. The Congress may want to consider issues related to the allocation of income and the transfer of intangible property under the proposal and with respect to certain transition issues before adopting legislative options of this nature.

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arrangement with its Puerto Rico subsidiary and make deductible interest payments to the Puerto Rico subsidiary.

[223] Sec. 367.

Estimated Revenue Effect

Assuming the 90-percent section 956 exclusion and the 85-percent dividends received deduction would be effective for taxable years beginning after December 31, 2006, the projected effect on Federal revenues for fiscal years 2007 through 2011 is -$1.6 billion and for fiscal years 2007 through 2016 is -$5.1 billion. Under the proposal, some business operations currently operating in a section 936 structure are estimated to migrate to a CFC structure in Puerto Rico. In addition, it is assumed that some business operations in CFCs currently operating in other foreign jurisdictions would relocate to Puerto Rico. The estimate also anticipates some relocation of current U.S. activity to Puerto Rico.

4. Section 245 proposal

Present Law

In the absence of special rules, dividend income of individuals and corporations is treated as ordinary income.

Dividends received by individuals from domestic corporations and from qualified foreign corporations generally are treated as net capital gain and thus are subject to tax at preferential rates. A qualified foreign corporation ("QFC") is a corporation that is (1) incorporated in a possession of the United States, or (2) eligible for the benefits of a comprehensive income tax treaty with the United States which the Treasury Secretary determines is satisfactory for purposes of qualification for the reduced tax rate on dividends and which includes an exchange of information program.[224] A corporation that is not otherwise treated as a QFC is treated as a QFC for any dividend paid by the corporation if the stock with respect to which the dividend is paid is readily tradable on an established securities market in the United States. A corporation may not be a QFC with respect to a dividend if the corporation is a passive foreign investment company under section 1297 in the taxable year in which the dividend is paid or in the preceding taxable year.

Corporations generally are allowed a deduction for all or a portion of the amount received as dividends from domestic corporations. In general, the portion of a dividend received from a domestic corporation that is allowed as a deduction is 70 percent. If a corporation receives a dividend from a 20-percent owned (by vote and value) domestic corporation, the portion of the dividend allowed as a deduction is 80 percent. If a corporation receives a dividend from a member of its affiliated group, the corporation generally is allowed a deduction for the entire amount of the dividend. Affiliated group membership requires at least 80 percent common ownership measured by value and voting power and is restricted to domestic corporations.

In general, a domestic U.S. corporation is subject to U.S. tax on its worldwide income, but foreign-source income of a foreign subsidiary of a domestic corporation generally is not subject to U.S. tax until earnings are distributed to the domestic parent corporation in the form of

[224] Sec. 1(h)(11)(C).

a dividend. When a U.S. corporation receives dividends from a foreign corporation, the dividend income generally is subject to full U.S. taxation, though a foreign tax credit may be available for foreign taxes associated with the dividend payment. Section 245 mitigates this full taxation by allowing a deduction for certain dividends attributable to U.S.-source earnings that already have been subject to U.S. tax. Under section 245, a corporation that receives a dividend from a qualified 10-percent owned foreign corporation generally is allowed a deduction for the percentage of the U.S.-source portion of the dividend equal to the applicable percentage described above for dividends received from domestic corporations. A qualified 10-percent owned foreign corporation is a foreign corporation that is owned at least 10 percent (by vote and value) by the corporation receiving the dividend. The U.S.-source portion of a dividend is defined in section 245(a)(3) and generally represents the portion of a dividend attributable to income of the paying corporation that is effectively connected with the conduct of a trade or business in the United States and that is subject to U.S. income tax.

A domestic corporation that receives a dividend from a foreign corporation that it wholly owns (directly or indirectly) is allowed a deduction for the entire amount of the dividend if the dividend is paid out of the earnings and profits of the foreign corporation for a taxable year during which (1) all of the foreign corporation's stock is owned (directly or indirectly) by the domestic corporation and (2) all of the foreign corporation's gross income is effectively connected with the conduct of a trade or business in the United States.

No foreign tax credit is allowed for any taxes paid with respect to the U.S.-source portion of any dividend received by a corporation from a qualified 10-percent owned foreign corporation. Moreover, in computing a corporation's foreign tax credit limitation amount, the U.S.-source portion of any dividend qualifying under section 245 is treated as from U.S. sources. No deduction under section 245 is allowed for a deemed dividend under section 1248.

In general, a corporation organized in a U.S. possession is treated as a foreign corporation for U.S. tax purposes, and, like a foreign corporation organized outside a U.S. possession, it is not subject to net-basis U.S. tax on its possession-source income.

Description of Proposal

Puerto Rico Department of Economic Development and Commerce Secretary Jorge Silva has indicated that the Puerto Rico governor supports a proposal that would allow a deduction for certain dividends received by U.S. corporations and attributable to possession-source income.[225]

The section 245 proposal expands the class of dividends eligible for the deduction under section 245 to include certain dividends attributable to income that is not effectively connected with the conduct of a U.S. trade or business. The proposal allows the section 245 deduction for a dividend received by a corporation from a QFC to the extent the dividend is attributable to possession-source income. Possession-source income for this purpose does not include income

[225] See Marialba Martinez, "Threat of More Than 60 Companies Closing after Sections 936 / 30A phaseout takes Secretary Silva to Washington D.C.," *Puerto Rico Herald,* June 30, 2005.

from (1) the holding for investment of stock, securities, or real property, or (2) the operation (including leasing) of property owned by the taxpayer unless the taxpayer provides significant services with respect to the property. A QFC under the proposal does not include a corporation that would be considered a QFC only by reason of the U.S. securities market trading test described above.

The amount of a QFC's dividends eligible for deduction under the section 245 proposal in a taxable year is limited to the sum of (1) 50 percent of the QFC's earnings and profits from possessions sources in that taxable year (not including earnings and profits attributable to income, as described in the preceding paragraph, that is excluded from the definition of possession-source income) plus (2) 50 percent of the QFC's qualified investment. Qualified investment includes expenditures for (1) property eligible for the section 167 depreciation allowance that is first placed in service in a possession or in a country that is designated as a beneficiary country under the Caribbean Basin Economic Recovery Act of 1983 ("CBERA");[226] (2) research in a possession or in a CBERA beneficiary country that constitutes an in-house research expense under the section 41 research credit; and (3) education assistance furnished through an educational assistance program under section 127 to employees that are residents of a possession or a CBERA beneficiary country.

The amount of qualified investment taken into account in computing the limitation on the amount of a QFC's dividends eligible for deduction under the proposal is limited in any year to the QFC's possession-source earnings and profits for that year. If the amount of qualified investment in a taxable year exceeds 50 percent of the QFC's earnings and profits from possessions sources in that year, the excess can be carried forward to future tax years.

In determining the amount of a QFC's dividends eligible for deduction under the proposal, dividends paid by the QFC are deemed to be paid first out of most recently accumulated earnings and profits. If the QFC has earnings and profits from more than one source, dividends are considered as paid first from U.S. source income, then from possession-source income, and last from other income. If the amount of dividends paid by a QFC in a taxable year is less than 50 percent of the QFC's earnings and profits in that year from possessions sources, the excess amount of earnings and profits can be carried forward to a future taxable year in computing the limitation on deductible dividends in that year.

As under present law section 245, no foreign tax credit is allowed for any taxes paid or accrued with respect to the portion of any dividend for which a deduction under the proposal is allowed. Similarly, for purposes of the foreign tax credit limitation, the portion of a dividend eligible for the deduction under the proposal is considered to be U.S. source. No deduction is allowed under the proposal for an amount treated as a dividend under section 1248.

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[226] Pub. L. No. 98-67 (1983). There are currently 24 beneficiary countries. Those countries are as follows: Antigua and Barbuda, Aruba, Bahamas, Barbados, Belize, British Virgin Islands, Costa Rica, Dominica, Dominican Republic, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Montserrat, Netherlands Antilles, Nicaragua, Panama, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, and Trinidad and Tobago.

Discussion

In general

Under the proposal, income earned in Puerto Rico (or in another U.S. possession) by a foreign subsidiary of a U.S. corporation may, subject to the earnings and income based limitations described above, be distributed to the U.S. parent corporation free of U.S. tax. The income earned in Puerto Rico (or in another U.S. possession) therefore will be subject to tax, if at all, only in Puerto Rico (or the other possession).

The proposal is an extension of the present-law dividends received deduction under section 245, but the theory and effects of the proposal are different from the theory and effects of present-law section 245. The present-law dividends received deduction for dividends from either domestic corporations (under section 243) or foreign corporations (section 245) is intended to mitigate multiple levels of U.S. taxation of inter-corporate dividends. The section 243 deduction reduces or eliminates the U.S. corporate tax on dividends attributable to income that generally will have been subject to U.S. corporate tax when earned by the paying corporation. The section 245 deduction generally is limited to the amount of a dividend attributable to income that is from U.S. sources and that has been subject to U.S. tax. By contrast, the proposal provides a deduction for dividends attributable to income that will not have been subject to U.S. corporate tax (but that may have been subject to tax by a possession).

Effective tax rates on investments in different jurisdictions

Proponents of the proposal argue that by reducing the tax rates on investment in U.S. possessions by U.S.-owned companies, the proposal will increase the attractiveness of this investment relative to investment in foreign countries. Proponents observe that many U.S.-owned companies now are investing in foreign jurisdictions. They argue that the proposal will divert some of this investment to Puerto Rico. The extent to which any decline in tax rates will encourage possessions investment depends in part on the general effect of tax rules on firms' investment location decisions.[227]

More particularly, the effect of lower tax rates depends on a comparison of the overall tax rate on investment by a U.S. company in a U.S. possession with the rate of tax on a similar investment in a third country.

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[227] For analysis of the effect of taxes on investment decisions, see Rosanne Altshuler, Harry Grubert, and T. Scott Newlon, "Has U.S. Investment Abroad Become More Sensitive to Tax Rates?" in James R. Hines Jr., ed., *International Taxation and Multinational Activity* (2001), pp. 9-32; Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr., "Chains of Ownership, Regional Tax Competition and Foreign Direct Investment," NBER Working Paper 9224 (2002); Harry Grubert and John Mutti, "Taxes, Tariffs and Transfer Pricing in Multinational Corporation Decision Making," *Review of Economics and Statistics,* vol. 73(2) (1991), pp. 285-93; James R. Hines Jr. and Eric M. Rice, "Fiscal Paradise: Foreign Tax Havens and American Business," *Quarterly Journal of Economics,* vol. 109(1) (1994), pp. 149-82.

Investment located in Puerto Rico

Assume a subsidiary of a U.S. corporation earns $1,000 of business income and distributes the entire amount of its after-tax earnings to its U.S. parent. Assume the distribution occurs five years after the income is earned. Now suppose the subsidiary is a Puerto Rico corporation, and the income is from Puerto Rico sources. If the subsidiary is subject to Puerto Rico corporate tax at a 39-percent rate,[228] the subsidiary will be left with $610 in after-tax income for distribution to its U.S. parent. If the $610 distribution is subject to 10-percent withholding by Puerto Rico, the U.S. parent will receive $549 net of withholding tax ($610 - $61). Under the proposal, the $549 will not be subject to U.S. tax. Also under the proposal, no foreign tax credit will be available to offset Puerto Rico tax paid. In the aggregate, $451 ($390 + $61) in tax will have been paid on the $1,000 in income. Because $61 of that tax will have been deferred for five years (under the assumed facts), the present value of the total tax liability in the year the income is earned is somewhat less than $451. Assuming a discount rate of five percent, the value in year one of the deferred $61 tax liability is $47.80, and the value in that year of the aggregate $451 tax liability is $437.80.

Investment located in Ireland

Now assume instead the subsidiary is an Irish resident company operating in Ireland. Assume the subsidiary is subject to tax at the Irish statutory rate of 12.5 percent.[229] The subsidiary thus is liable for $125 in corporate tax and has available for distribution to its U.S. parent $875. When this amount is distributed, assume no withholding tax is imposed under Irish law because the dividend is paid to a resident of a country (the United States) with which Ireland has an income tax treaty.[230] Assuming the U.S. parent corporation is subject to U.S. corporate tax, the U.S. parent will be liable, before any foreign tax credit, for $350 tax (35 percent of the sum of the $825 actually paid plus the $125 deemed to be paid under the section 78 gross-up). The U.S. parent will be eligible for a credit (under section 902) against this tax liability for the $125 in Irish tax paid. The post-credit U.S. tax liability therefore will be $225, and the total Irish and U.S. tax liability will be $350. The value of this $350 tax liability in year one, assuming the same five-percent discount rate, is $301.29 (the undiscounted, year-one $125 Irish tax liability plus a $176.29 present value of the year-five net U.S. tax liability of $225).

In this example, the present value of the aggregate tax liability from operating in Ireland, $301.29, is significantly lower than the present value of the total tax liability from operating in Puerto Rico under the section 245 proposal, $437.80. This result illustrates that the low Irish corporate tax rate and the deferral of residual U.S. tax liability more than offset the benefit of the exemption provided by the proposal. Actual tax outcomes will vary based on, among other

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[228] See Part II.B., above.

[229] See John Ryan, *Foreign Income: Business Operations in the Republic of Ireland,* BNA Tax Management Portfolio 965-3rd, p. A-26 (2006).

[230] *Id.* at A-41.

factors, the applicable tax rules in the comparison country, the duration of deferral, the discount rate, and whether Puerto Rico offers any special domestic tax incentives.[231]

Investment in Puerto Rico under present law and the proposal assuming local tax incentives

An additional question is the extent of tax savings offered by the proposal relative to present law. Under the assumptions of the example above, the proposal may not provide overall tax benefits compared with present law because the benefit of the exemption from U.S. tax offered by the proposal will be offset by the loss of a credit against U.S. tax for Puerto Rico taxes paid. If, by contrast, a U.S. company is operating in Puerto Rico under a special tax incentive, the proposal may offer significant benefits relative to present law. Assume that the subsidiary in the example above pays no Puerto Rico tax other than a 10-percent withholding tax on dividends. Under present law, the subsidiary has the entire $1,000 in earnings available for distribution to its U.S. parent company. The distribution is subject to 10-percent withholding, and the U.S. parent receives $900. The U.S. tentative tax liability on this $900 dividend payment and the $100 section 78 gross-up is $350. A foreign tax credit is available for the $100 withholding tax, and the aggregate tax liability is $350 ($100 withholding plus $250 U.S. tax net of foreign tax credit). At a five-percent discount rate, the year-one value of this year-five liability is $274.23. Under the proposal, by contrast, the $100 withholding tax will be the only tax on the Puerto Rico income; the U.S. parent company will be exempt from tax on the dividend payment (and no foreign tax credit will be available for the withholding tax). The year-one value of the year-five $100 tax liability is $78.35.

Summary of example

The discussion above illustrates that although in absolute terms, an investment in a low-tax country might produce a better aggregate tax result than an investment in Puerto Rico under the proposal, the proposal can yield significant U.S. tax benefits relative to present law if Puerto Rico offers tax incentives for local operations. Moreover, although companies may weigh investment in Puerto Rico against investment in a low-tax jurisdiction, they also may be considering investment in a foreign jurisdiction with significantly higher tax rates than the Irish (or another low-tax) rate. And firms' location decisions are based on non-tax as well as tax considerations. Even if a U.S. parent company with possessions operations could achieve a better tax result in a third country, it may choose to continue or to increase operations in a U.S. possession if tax and non-tax considerations combine to make the possession an attractive location.

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[231] To the extent that Puerto Rico tax incentives are available for a U.S. corporation's operations in Puerto Rico, the proposal may make the tax treatment of those operations more similar to the tax treatment of operations in a low-tax country such as Ireland.

Limitations on the proposed deduction

As previously described, the amount of dividends eligible for deduction is limited in part based on the amount of expenditures on depreciable property, research, and educational assistance and in part based on the amount of possession-source income other than certain kinds of passive income. These deduction limitation rules might have the effect of trapping capital in non-optimal investment in a possession.

The proposal can be analogized to the reduced tax rate generally available for dividends received by individuals. A rationale for that reduced rate was that by subjecting dividends to a full second level of tax, prior law discouraged corporations from distributing earnings even if shareholders might have generated higher pre-tax rates of return with the earnings than corporate management could have been expected to earn on the retained earnings.[232] By eliminating the U.S. tax on certain dividends paid by corporations with possessions operations, the proposal similarly removes the disincentive those corporations otherwise might have to pay dividend distributions even where their parent corporations could be expected to reinvest the distributions at higher pre-tax rates of return.

The proposal's rules limiting deductible dividends based on certain current-year possessions income and investment, however, may have the effect of locking a dividend-paying corporation into inefficient investments. The parent corporation's choice of how to reinvest distributed dividends in future years has no necessary relationship to a subsidiary corporation's investment decision in the current year, especially where the subsidiary can generate earnings eligible for zero-rate dividend distributions only through certain possessions activities. Proponents of the proposal might argue that encouraging short-run inefficiencies through investment that would not be chosen on a pre-tax basis is a way of increasing economic growth in the U.S. possessions. The general logic of lowering dividend tax rates, however − reducing the cost of capital and removing tax distortions to financial decisions − argues for removing rather than placing restrictions on a corporation's investment choices.

The proposal's potential for trapping capital in inefficient possessions investment relates to a broader issue. The proposal allows zero-rate dividends to be paid based on certain current-year possessions income and investment but does not distinguish between old and new investment or income. That is, the dividends received deduction under the proposal is not limited based on incremental activities in excess of a base-period amount. Firms therefore might benefit from the proposal based on activities they have undertaken or would undertake even in the absence of the proposal. Consequently, the proposal could create a windfall for firms with preexisting operations in and income from a possession. This windfall might be accompanied by limited or no gain to the possession.

[232] See H.R. Rep. No. 108-94, at 31 (2003).

Other issues

If firms respond to lower effective tax rates by increasing their possessions investments, a further question will be the extent to which this investment improves the welfare of possessions residents. The proposal attempts, through the deduction limitation rules described previously, to ensure that increased possessions investment has beneficial welfare effects. In practice, it may be difficult to distinguish between qualifying and non-qualifying investment and income. For example, whether property is held for investment (and therefore does not give rise to qualifying income under the proposal) or as part of a business (and thus gives rise to qualifying income) may, in a particular case, not be clear.

Because the proposal eliminates the U.S. tax on certain possessions-source dividends, evaluation of the proposal should be based not just on possible effects in the possessions, but also on considerations of the U.S. tax system. By creating an effective exemption for certain possessions-source dividends, the proposal increases the importance of expense allocation rules. Companies will have an incentive to fund possessions investment with debt-financed capital, to allocate interest expense against U.S. income, and to earn income in the possessions that, relative to present law, is taxed at low overall rates. Companies will have a similar incentive to shift income, including income from intangibles, to possessions. It was partly this shifting of intangible income that led Congress to restrict benefits under prior law section 936.[233] In certain circumstances, however, this shifting may be difficult under the proposal because a transfer of intangible property from a U.S. corporation to a corporation organized in the possessions or in another foreign jurisdiction would have the potential of triggering a current U.S. tax liability under section 367. U.S. corporations could avoid this problem by instead licensing the intangible property to a subsidiary in exchange for royalty payments. Transfer pricing rules then would be important in ensuring a proper allocation of income between the subsidiary and its U.S. parent company.

The deduction limitation rules may create compliance and administrative difficulties for taxpayers and the IRS because the rules require tracking of multiple pools of earnings and require the tracing, through ordering rules, of dividend payments to the different pools. Compliance and administrative concerns may be especially acute in the case of a possessions corporation that is owned by and pays dividends to multiple shareholders.

Estimated Revenue Effect

Assuming the proposal is effective for dividends paid by a QFC that are attributable to earnings and profits accruing, and qualified investment made, in taxable years beginning after December 31, 2006, the projected effect on Federal revenues for fiscal years 2007 through 2011 is -$2.5 billion and for fiscal years 2007 through 2016 is -$8.0 billion. This estimate of the proposal's revenue effect is based partly on the observation that the proposal may modestly encourage investment in the possessions through CFCs incorporated there or through third-

[233] See the discussion of intangibles income in Part IV, above.

country CFCs operating in the possessions through a branch. Possessions investment through possessions CFCs may include diversion of some CFCs from other foreign jurisdictions. Possessions investment also may include shifting into CFCs (possessions or third-country) of activities now conducted by U.S. companies.

C. Proposal Related to Revenue Transfers

1. Repeal limitation on cover over of rum excise tax to Puerto Rico

Present and Prior Law

Present law

Federal excise taxes on Puerto Rico goods imported into the United States

Federal excise taxes generally do not apply within Puerto Rico. However, Federal excise taxes equal to the taxes imposed on domestically produced articles are imposed on articles of Puerto Rico manufacture brought into the United States from Puerto Rico and withdrawn for consumption or sale.[234] For example, distilled spirits produced in Puerto Rico are subject to a $13.50 per proof gallon Federal excise tax when brought into the United States and withdrawn for consumption or sale.[235]

Cover over of excise taxes on Puerto Rico products

Revenues collected by the United States from the Federal excise taxes imposed on certain articles coming into the United States from Puerto Rico generally are "covered over" (i.e., paid) to the Puerto Rico Treasury.[236] With respect to Federal excise taxes imposed on articles containing distilled spirits that are manufactured in Puerto Rico and shipped into the United States, revenues are covered over to the Puerto Rico Treasury only if at least 92 percent of the alcoholic content of such articles is attributable to rum.[237] The amount of excise taxes covered over to Puerto Rico from such articles cannot exceed $10.50 per proof gallon.[238]

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[234] Sec. 7652(a)(1). A parallel rule applies with respect to USVI. Sec. 7652(b)(1).

[235] The excise tax rate is the same that would apply to domestically produced distilled spirits. Sec. 5001(a)(1). A proof gallon is a liquid gallon consisting of 50 percent alcohol. See sec. 5002(a)(10) and (11).

[236] Sec. 7652(a)(3). With respect to otherwise eligible excise taxes imposed on articles not containing distilled spirits, revenues are covered over to Puerto Rico only if the cost or value of materials produced in Puerto Rico plus the direct costs of processing operations performed in Puerto Rico equal at least 50 percent of the value of the article at the time it is brought into the United States. Moreover, no cover over is permitted on such articles if Puerto Rico provides a direct or indirect subsidy with respect to the article which is of a different kind or in an amount greater than the subsidies which Puerto Rico generally offers to industries producing articles not subject to Federal excise tax. Sec. 7652(d).

[237] Sec. 7652(c).

[238] Sec. 7652(f). That limitation has been suspended over most of the past decade.

Cover over of excise taxes on rum imported from other countries

A provision of the Code added by the Caribbean Basin Economic Recovery Act ("Caribbean Basin Initiative" or "CBI")[239] provides a special rule for excise taxes collected on rum imported into the United States from any country. Such excise taxes are covered over to the Treasuries of Puerto Rico and USVI, under a formula prescribed by the Treasury Department for the division of such tax collections between Puerto Rico and USVI.[240] This allocation formula is based upon the relative amounts of excise taxes collected on rum brought into the United States from Puerto Rico and USVI in 1983.[241] These cover over amounts are also subject to the present-law limitation of $10.50 per proof gallon.[242]

Cover over of U.S. customs duties to Puerto Rico

Articles imported into Puerto Rico from ports other than those of the United States are subject to U.S. customs duties.[243] Such duties, as well as duties collected in the United States upon articles of merchandise coming from Puerto Rico, are covered over into the Treasury of Puerto Rico.[244]

Federal excise taxes on articles exported from the United States to Puerto Rico

Federal excise tax does not apply to articles that are exported from the United States, including exports to U.S. possessions.[245] An additional excise tax rule also applies when articles manufactured in the United States are shipped to Puerto Rico. In such cases, the articles are exempt from Federal excise taxes and, upon being entered in Puerto Rico, are subject to a tax equal in rate and amount to the excise tax imposed in Puerto Rico upon similar articles of Puerto Rico manufacture.[246]

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[239] Pub. L. No. 98-67, sec. 221(a) (1983).

[240] Sec. 7652(e).

[241] The precise percentage for Puerto Rico is 87.626889 percent. 27 C.F.R. sec. 26.31.

[242] Sec. 7652(f). For the fiscal year ended September 30, 2005, approximately $437 million of Federal excise taxes on rum was covered over to Puerto Rico, of which approximately $390 million was attributable to rum brought into the United States from Puerto Rico and $47 million was Puerto Rico's share of excise taxes attributable to rum imported into the United States from other countries.

[243] 48 U.S.C. sec. 739.

[244] 48 U.S.C. sec. 740.

[245] Sec. 7653(b).

[246] Sec. 7653(a)(1). A parallel rule applies with respect to USVI. Sec. 7653(a)(2).

Background of Federal excise tax rate on distilled spirits and rum cover over limitation

Federal excise tax on distilled spirits

From 1951 through September 30, 1985, the Federal excise tax on distilled spirits was imposed at the rate of $10.50 per proof gallon. Effective October 1, 1985, the rate was increased to $12.50.[247] Effective January 1, 1991, the rate was increased to $13.50.[248]

Rum cover over limitation

In 1984, Congress limited the cover over payments with respect to articles containing distilled spirits to articles of which at least 92 percent of the alcoholic content was rum.[249] These new restrictions were in response to a "redistillation" program sponsored by the Government of Puerto Rico, under which spirits originally distilled in the United States were transported to Puerto Rico and redistilled there. The spirits were then returned to the United States for processing and marketing. As a result of their redistillation in Puerto Rico and return to the United States, the Puerto Rico Government received a cover over payment because redistillation was considered to be Puerto Rico production. Congress determined that the redistillation program involved a process that likely would not have occurred without the availability of cover over payments and the availability of subsidies by Puerto Rico to participants in the redistillation program.[250]

Prior to 1984, the full amount of Federal excise taxes imposed on articles, including rum, coming into the United States from Puerto Rico and USVI, was covered over to the respective Treasuries of Puerto Rico and USVI. Effective October 1, 1985, when the Federal excise tax rate on distilled spirits was increased to $12.50 per proof gallon, the maximum cover over payment amount with respect to distilled spirits was frozen at $10.50. Congress froze the cover over rate at $10.50 at that time due to its concern about the effect of the cover over to Puerto Rico and USVI when there was no similar revenue transfer to the States.[251]

Effective October 1, 1993, this cover over limitation amount was temporarily increased to $11.30 as five-year transitional relief (through September 30, 1998) accompanying the reduction of section 936 tax benefits. From mid-1999 until December 31, 2005, the limitation was

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[247] Pub. L. No. 98-369, sec. 27 (1984).

[248] Pub. L. No. 101-508, sec. 11201(a)(1) (1990).

[249] Pub. L. No. 98-369, sec. 2681 (1984). With respect to articles not containing distilled spirits, the 1984 law added local content requirements and tax subsidy limitations.

[250] Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, at 1222.

[251] Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, at 1226.

temporarily increased to $13.25, such increase being renewed by a series of temporary measures, some with retroactive effect.[252] In general, Congress found that the fiscal needs of Puerto Rico (and USVI) remained substantial and that the extension of the increased cover over rate would contribute to the economic stability of Puerto Rico (and USVI). On January 1, 2006, the latest cover over amount limitation increase expired and the cover over amount reverted to $10.50 per proof gallon.[253]

Description of Proposal

The cover over proposal is based on two bills introduced during the 109th Congress.[254]

The proposal repeals the $10.50 per proof gallon limitation on the amount of excise taxes on rum covered over to Puerto Rico. Under the proposal, the full amount of excise taxes (currently $13.50 per proof gallon) imposed on rum brought into the United States from Puerto Rico, and the full amount of excise taxes attributable to rum imported into the United States from other countries that is allocated to Puerto Rico, are covered over to the Puerto Rico Treasury.

Discussion

Cover over of rum excise tax in general

Some argue that increased revenue support for Puerto Rico could be better achieved by intergovernmental support through a direct appropriation, rather than relying on U.S. consumption of rum and other articles subject to Federal excise taxes. The advantage of a direct appropriation is that it provides for annual oversight. Others argue that a cover over is akin to an entitlement in terms of the annual budget process and making it permanent ensures a steady flow of revenue. Although the cover over itself generally may provide a more stable revenue stream because it is not subject to repeated government action, it may be more difficult to administer than a direct appropriation, which requires only a transfer of funds.

One way to view the portion of the rum excise tax cover over that relates to rum produced in Puerto Rico is as a collection mechanism that serves both Puerto Rico and U.S.

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[252] For example, section 305 of the Working Families Tax Relief Act of 2004, Pub. L. No. 108-311, was enacted on October 4, 2004 and retroactively extended the $13.25 limitation from January 1, 2004 until December 31, 2005.

[253] The Tax Revision Act of 2005, H.R. 4388, which was passed by the House of Representatives on December 7, 2005, would have extended the $13.25 cover over until December 31, 2006.

[254] The first bill, H.R. 273, introduced in the House of Representatives by Representative Christensen on January 6, 2005, would permanently repeal the cap on the cover over to Puerto Rico and USVI, effective January 1, 2005. The second bill, H.R. 3, known as the "Safe, Accountable, Flexible, and Efficient Transportation Equity Act of 2005," was passed by the Senate on May 17, 2005. Section 5232 of such bill would have increased the cap on the rum cover over to both Puerto Rico and USVI to $13.50 during 2006, but was not included in the H.R. 3 conference agreement.

objectives. The mechanism relieves Puerto Rico of the obligation to collect the taxes. At the same time, the imposition of the same excise rate on Puerto Rico rum as on U.S.-produced rum ensures that U.S. rum producers and foreign rum importers are not disadvantaged relative to Puerto Rico producers. The mechanism provides a measure of consistency in mode of collection and stability in revenue flow while meeting U.S. tax policy goals of consistency and fairness. While the imposition of excise taxes on these Puerto Rico "exports" to the United States is not normative in an excise tax regime that generally does not impose excise taxes on exports, to some extent this special U.S.-Puerto Rico arrangement reflects the Commonwealth relationship.[255]

The cover over to Puerto Rico of a portion of the excise taxes imposed on rum imported into the United States from foreign countries is intended to compensate Puerto Rico for its loss of cover over revenues attributable to the loss of market share to Caribbean countries due to the CBI.[256] Some argue that this arrangement should have been made transitional and not permanent because it is in the nature of assisting Puerto Rico to adjust to the CBI rather than a tax incentive to Puerto Rico to produce more taxable goods, or that it should be replaced with a direct grant to Puerto Rico. Others argue that the CBI created a permanent disadvantage to Puerto Rico in the area of rum cover over by permanently reducing the Puerto Rico market share of rum imported into the United States, and, therefore, such a permanent compensation to Puerto Rico is warranted.

<u>Limitation on rum cover over</u>

If excise tax cover over in general, and rum excise cover over in particular, is a reasonable policy adaptation to the U.S.-Puerto Rico Commonwealth relationship, some argue that it is difficult to ascertain the policy justification for limiting the rum cover over. Others argue that the cover over limitation helps to finance the cost of administering the program, that it is an appropriate adjustment of the cover over amount in light of the issues described above with respect to the CBI, the unusual nature of cover over generally, or simply U.S. revenue concerns.

However, the repeated reenactment of the increase in the rum cover over limitation, sometimes on a retroactive basis, undercuts the reliability of payment to Puerto Rico of that

[255] The same general arguments may be made with respect to cover over of excise taxes on other taxable articles, and cover over of customs duties.

[256] Joint Committee on Taxation, *Tax Rules Relating to Puerto Rico Under Present Law and Under Statehood, Independence and Enhanced Commonwealth Status (S. 712, Puerto Rico Status Referendum Act)* (JCS-19-89), November 14, 1989, at 18. Most of the rum imported into the United States from foreign countries originates in the Caribbean. In 1982, Jamaica accounted for 64 percent of all rum imported for consumption in the United States from foreign countries and Barbados accounted for over 11 percent. No other country accounted for as much as 6 percent of imports. See Joint Committee on Taxation, *Description of Tax Provisions of S.544 (The Caribbean Basin Economic Recovery Act)* (JCS-6-83), April 1983, at 5 and fn 3 (citing U.S Department of Commerce, U.S. General Imports and Imports of Consumption December 1982, 2-26 (issued March 1983)).

portion of the cover over exceeding $10.50 per proof gallon and makes it more difficult for Puerto Rico to budget these revenues or to access the debt market in anticipation of these revenues.

Estimated Revenue Effect

The projected revenue effect is to be provided by the Congressional Budget Office.

APPENDIX

United States Senate
COMMITTEE ON FINANCE
WASHINGTON, DC 20510-6200

OCT 14 2003

October 10, 2003

Mr. George Yin
Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Yin:

We request that the Joint Committee on Taxation prepare a report on legislative options concerning Puerto Rico. Specifically, the Joint Committee on Taxation's report would provide an analysis of the tax and economic policy implications of the legislative options, the revenue costs of such options, and a comparison of the options to current law relative to the states, the District of Columbia, and the other U.S. territories.

We also have requested that the General Accounting Office (GAO) report to the Finance Committee with respect to the Puerto Rican economy, the impact of U.S. federal tax policy on Puerto Rico, and proposed U.S. tax legislation regarding Puerto Rico. A copy of our letter to the GAO is attached.

We expect that more specific report objectives will be developed in consultation with Finance Committee staff as you proceed with your work. We also anticipate that the GAO staff will periodically brief the Finance Committee and Joint Committee on Taxation staff. Thus, the Chairman is authorizing the staff of the Joint Committee on Taxation, pursuant to section 6103(f)(4) of the Internal Revenue code, as agents of the Committee on Finance, to facilitate the sharing of information between the GAO and the Joint Committee on Taxation staff.

We request that completion of the Joint Committee's report coincide with the completion of the GAO report. We have requested completion of the GAO report by June 30, 2004. We request completion of the Joint Committee on Taxation report two weeks following completion of the GAO report. If you have any questions or concerns, please do not hesitate to contact Anita Horn Rizek or Ed McClellan at 224-4515.

Sincerely yours,

Max Baucus
Ranking Member

Charles E. Grassley
Chairman