Puerto Rico and the US Federal Tax System – Lessons from the Past and a Proposal for Economic Growth through Reduced Tax Burdens

A Report Prepared by
Mary Schmitt
And
Judy Xanthopoulos

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Optimal Benefit Strategies, LLC

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INTRODUCTION AND EXECUTIVE SUMMARY

In October 2003, Chairman Charles Grassley and Vice Chairman Max Baucus of the Senate Committee on Finance requested that the Government Accountability Office (GAO) and the Congressional Joint Committee on Taxation (JCT) prepare reports for the Senate Finance Committee relating to the Puerto Rican economy, the impact of US Federal tax policy on Puerto Rico and analysis of potential legislative options concerning the US Federal tax treatment of Puerto Rico. This paper considers one important part of that request, specifically the impact of US Federal tax policy on Puerto Rico – both the effects of past policies on Puerto Rican residents and corporations and the effects of a possible change in such policy.

The recent issuance of the report of the President's Advisory Panel on Federal Tax Reform suggests that the time is right to consider a coherent and rational policy toward the US Federal tax treatment of Puerto Rico. In its report, the President's Commission stated "tax provisions favoring one activity over another or providing targeted tax benefits to a limited number of taxpayers create complexity and instability, impose large compliance costs, and can lead to an inefficient use of resources."[1] Historic US Federal tax policy toward Puerto Rico provides an example of how targeted tax benefits create complexity and instability and lead to an inefficient use of resources. While US corporations received billions of dollars of US Federal tax subsidies for their Puerto Rican operations, low-income Puerto Rican residents have faced significantly higher marginal tax rates on their wages than their counterparts residing on the mainland. As the Congress and the President consider a broad restructuring of the US Federal tax system, appropriate consideration must be given to addressing this inequity.

In considering the impact of US Federal tax policy on Puerto Rico, two important conclusions become clear. The first point to emerge from the analysis is that despite a long history of special tax treatment for US corporations doing business in Puerto Rico (in the form of the possessions tax credits), these tax benefits have had a limited effect on the Puerto Rican economy. US Federal tax policy primarily provided relief from US Federal tax liability to a limited number of large US corporations. The tax benefits were justified to (1) reduce the burden of US regulatory provisions, such as minimum wage laws, and (2) stimulate the Puerto Rican economy. The evidence suggests that, over the long term, the policies ultimately offered piecemeal incentives that benefited a limited number of US firms and did little to stimulate investment by Puerto Ricans themselves. As a result, the past incentives did little to expand employment or increase the standard of living for residents of Puerto Rico.

With the scheduled expiration of the possessions tax credits at the end of 2005, there has been considerable discussion of alternative approaches to the US Federal tax policy toward Puerto Rico. Some have proposed new piecemeal approaches that would introduce different tax incentives (under sections 956 and 243) for US corporations doing business in Puerto Rico.

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[1] *Simple, Fair, & Pro-Growth: Proposals to Fix America's Tax System*. Report of the President's Advisory Panel on Federal Tax Reform. November 2005, xi.

None of the proposals that have been advanced have suggested a cohesive, forward-thinking approach to Puerto Rico.

The second conclusion is that current US Federal tax policy discriminates against and imposes undue tax burdens on lower income Puerto Rican residents. 44.6 percent of Puerto Rican residents live below the poverty level. While Puerto Rican residents currently are not subject to US Federal income taxes on their Puerto Rican source income, their wages are subject to Social Security and Medicare payroll taxes. These Social Security and Medicare payroll taxes impose significant marginal tax rates on the wages of lower income Puerto Rican residents, yet they are not entitled to claim the earned income credit, which is intended to offset partially the employment tax liability of low income taxpayers. In effect, current law requires lower income Puerto Ricans to subsidize the Social Security and Medicare benefits provided to US residents. For example, currently a Puerto Rican on the island who files as a head of household with two children and $20,000 of income has a total Federal tax liability of $792. Yet a person living in New York – perhaps the brother of the Puerto Rican on the island – with the same income and family circumstances would receive on net a tax refund of $3,708. The difference is accounted for by the fact that the New Yorker, unlike the Puerto Rican, is eligible for the earned income and child tax credits.

This paper focuses primarily on the effects of fully extending the US Federal income tax system to Puerto Rico. Our findings include the following:

- Puerto Rican residents would, for the most part, benefit from the extension of the US Federal tax system. We estimate that 92 percent of Puerto Ricans would either receive a tax refund or incur no US Federal tax liability. Thus, this approach would generally reduce the overall tax burdens borne by Puerto Rican residents and would increase after-tax income, thereby increasing the spending power of these individuals and likely improving Puerto Rican economic conditions.
- We estimate that 950,000 Puerto Rican returns would benefit from the earned income credit receiving, on average, $1,155 of credit. More than 94 percent (99 percent in the case of single taxpayers and heads of households) of the credits would be delivered to taxpayers with incomes below $25,000.
- There are more than 1.1 million children under the age of 18 in Puerto Rican households. While some Puerto Rican residents are permitted, under current law, to claim the child tax credit for 3 or more dependents, there are more than 500,000 dependents in families with less than 3 dependents. A large majority of these families would become eligible for the child tax credit.
- Extending the US Federal income tax to Puerto Rican individuals may also improve compliance levels in Puerto Rico, where compliance has historically been low.
- Including Puerto Ricans on the island in the US Federal tax system would place them in a similar position to their counterparts on the mainland. The majority of Puerto Rican taxpayers would be affected positively in this way, bringing about a reduction in poverty on the island at minimal cost to the US treasury and in a manner that treated Puerto Ricans the same as other US citizens.
- With the expiration of the possessions tax credits, there is evidence that US corporations doing business in Puerto Rico are converting to controlled foreign

corporation (CFC) status to minimize current US Federal income tax liability. If Puerto Rico is fully incorporated into the US Federal tax system, corporations and other businesses operating in Puerto Rico could face an increase in US Federal taxes as CFC status no longer is available. On the other hand, certain US Federal tax benefits that are not currently available, such as the deduction for domestic production activities, would become available to offset partially these tax increases.

- The extension of the US Federal tax system to Puerto Rico may result in some corporations moving their operations out of Puerto Rico to avoid or minimize US Federal taxes. However, favorable local tax conditions and low wage rates could mitigate this effect. Whether such companies would move their business operations from Puerto Rico to another country is unclear given the substantial costs involved with such relocation and the availability of certain domestic provisions, such as the deduction for domestic production activities, which might reduce the actual US Federal tax liability. It is important to note that the response to the phase out and repeal of section 936 of US corporations was not to leave the island, contrary to the dire predictions of a mass exodus.
- Transition rules could be provided for US corporations currently operating in Puerto Rico to ease the transition, such as rules relating to the treatment of previously unrepatriated earnings of US corporations doing business in Puerto Rico.
- Overall, it is unlikely that incorporating Puerto Rico into the US Federal tax system would have a significant impact on US Federal tax receipts.

After careful analysis of the US Federal tax policy and the economic evidence, it becomes clear that a unified US Federal tax policy is appropriate for Puerto Rico. If policymakers were to extend fully the US Federal tax system to Puerto Rico rather than continue piecemeal incentives, the goal of the previous policies – economic stimulation – has a greater possibility of being realized. This approach would make all corporations (whether U.S. or Puerto Rican) operating in Puerto Rico domestic corporations for US Federal tax purposes.[2] In addition, Puerto Rican residents would report all Puerto Rican-sourced income for US Federal tax purposes.

However, even if this broad and rational approach is not followed, it can be argued that, at a minimum, Puerto Ricans should be entitled to benefits equivalent to those provided by the earned income credit to reduce the burdens of US Federal Social Security and Medicare taxes.

In order to demonstrate the validity of these two important conclusions, this paper examines the history of the Federal tax treatment of Puerto Rico and provides an overview of the current-law tax treatment of Puerto Rican individuals and businesses. The following sections present empirical evidence of both the economic performance and effect of the past policies on individuals and businesses in Puerto Rico. Finally, the analysis addresses the consequences of fully incorporating Puerto Rico into the US Federal tax system.

[2] The analysis considers only the impact of applying Federal income tax laws to US corporations operating in Puerto Rico and to Puerto Rico residents with only Puerto Rican source income. A likely consequence of extending the US Federal tax treatment to Puerto Rico is that: (1) the Puerto Rican government would likely respond with changes in their own tax policies and (2) many US corporations operating in Puerto Rico may change their country of domicile or may move their operations from Puerto Rico.

I. HISTORICAL PERSPECTIVE – ANALYZING THE EFFECTS OF PAST TAX POLICIES ON PUERTO RICO

A. Brief Overview of Puerto Rico Vis-à-Vis the US Federal Tax System

Puerto Rico was a Spanish colony from 1493 until the end of the Spanish-American War in 1898, at which time it became a US territory. In 1917, Puerto Ricans were granted status as US citizens. Since 1952, Puerto Ricans have had their own Constitution, operating in Commonwealth form. Puerto Rico's relationship with the US Federal government is, in many respects, similar to that of a state. Puerto Rico operates under the tenets of the US Constitution. Matters of currency, defense, international relations, and interstate commerce are governed by the US Federal government. All US labor and safety laws apply, as well as minimum wage laws and standards. Exports of Puerto Rican products to the United States mainland are duty free, leading to consistent treatment with the transfer of goods within the United States.

However, from a US Federal tax perspective, the treatment of Puerto Rican residents and businesses is quite different. Since 1921, there has been special treatment for Puerto Rican residents and businesses for purposes of the US Federal tax system. Some might view these special rules as a perquisite that is not afforded to US citizens and businesses that reside or operate in one of the 50 states. A closer look at Puerto Rico's economic performance raises the question whether the Federal government should adopt a new set of policies that may contribute more to Puerto Rico's economic development.

This section reviews briefly the history of special tax treatment of Puerto Rican residents and businesses.

US Federal Tax Law and Puerto Rico

It is a fundamental principle of US Federal tax law that US citizens and corporations are subject to Federal taxes on their worldwide income. However, in the case of US citizens and corporations who are residents of Puerto Rico, the application of the US Federal tax system becomes much murkier. For US Federal tax purposes, the status of Puerto Rico individuals, corporations, and income has developed into a muddled jumble of rules. While Puerto Ricans have had the status of US citizens since the enactment of the Jones Act of 1917, special rules apply to them for Federal tax purposes.

Puerto Ricans pay employment taxes on their wages (and are entitled to receive social security benefits), but they do not pay Federal income tax on their earnings if they are residents of the island. This tax treatment disadvantages low-income Puerto Ricans because they are not eligible for certain Federal refundable tax credits (the Earned Income Credit and the Child Tax Credit) that would help reduce their employment tax burden.

Puerto Rican corporations are treated as foreign corporations under the Internal Revenue Code and, therefore, their Puerto Rican income is treated as foreign-source income of a foreign corporation not subject to US taxes.

US corporations doing business in Puerto Rico have historically been entitled to special tax incentives. As these tax breaks are set to expire, there will be renewed debate about the appropriateness of continuing to provide special tax incentives for US corporations to maintain businesses in Puerto Rico. The following section provides a brief history of these tax breaks.

Overview of the History of Special Tax Incentives for US Corporations with Puerto Rican Business Operations

US Federal tax policy has long provided special tax breaks to US corporations that maintain business operations in Puerto Rico. Historically, these tax breaks have been justified to help boost employment and investment in Puerto Rico and to help offset what are viewed as burdensome regulatory requirements applying to Puerto Rico, such as the Federal minimum wage laws. Yet, each time the Congress considered these tax breaks, there is evidence of repeated concerns about whether the tax breaks were yielding the intended results and whether the costs to the Federal treasury far exceeded the benefits extended to US corporations and to the Puerto Rico economy.

Beginning in the Revenue Act of 1921, special tax benefits were enacted to help US corporations compete with foreign corporations in the Philippines, which was then a possession of the United States. Under the original tax legislation, US corporations were provided an exclusion from income for US Federal tax purposes for income from US possessions (including Puerto Rico).[3] Dividends paid to a US corporation by a possession subsidiary were taxable, but distributions made to the parent upon liquidation were excluded from the parent's income. In addition to this exclusion from US Federal income tax, most Puerto Rican subsidiaries of US corporations operated under a complete or partial exemption from Puerto Rican taxes.

In 1976, the income exclusion was converted to a possessions tax credit (sec. 936 credit).[4] At the time, the legislative history for the change indicated that the purpose of the special tax benefit was "to assist the US possessions in obtaining employment producing investments by US corporations."[5] It was argued that special tax benefits were necessary due to additional costs attributable to possessions status, such as US minimum wage laws and a requirement to use US flag ships to carry products. However, there also were concerns expressed about the revenue cost of the possessions system of taxation relative to the benefit to the possessions in either employment or investment.[6] The 1976 Act also provided that dividends repatriated from a possessions corporation were eligible for a 100-percent dividends-received deduction so that no US Federal tax would be due when the corporation's earnings were repatriated to the United States in the form of dividends.

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[3] Revenue Act of 1921, sec. 262. Pub. L. No. 67-98 (1921).
[4] Tax Reform Act of 1976, sec. 1051, Pub. L. No. 94-455 (1976).
[5] Report of the Committee on Finance, United States Senate. Sen. Rept. 94-938 (June 10, 1976), p. 279.
[6] *General Explanation of the Tax Reform Act of 1976*. Joint Committee on Taxation. JCS 33-76 (December 29, 1976).

The Joint Committee on Taxation General Explanation of the 1976 Act indicated that the Congress intended the Treasury Department to review the operations of section 936 and submit an annual report to the Congress with an analysis of the operation and effect of the possessions corporation system of taxation, including a review of the revenue loss from the provisions and the effects of the provisions on employment and investment.[7] This provision reflected Congressional concern about the benefits of the credit.

In 1982, in adding restrictions on the definition of a possessions corporation, the Congress expressed continuing concerns about the cost and efficiency of the possessions credit. The legislative history for changes made in 1982 stated: "Treasury's three reports to date have confirmed the existence of two problems in that system: (1) unduly high revenue loss attributable to certain industries due to positions taken by certain taxpayers with respect to the allocations of intangible income among related parties, and (2) continued tax exemption of increased possession source investment income."[8]

In 1985, President Reagan's tax reform proposals included a recommendation to replace the possessions tax credit with a permanent wage credit.[9] The President's proposal stated that "...despite the fact that inflation-adjusted tax-exempt income of corporations which have elected the benefits of section 936 has more than doubled since 1972; employment levels (both overall and in the manufacturing sector) have been flat."[10] The proposal indicated that "the average tax benefit per employee for all section 936 corporations was more than $22,000 in 1982, more than 50 percent more than the average wage of possessions corporations' employees of $14,210."[11]

The Tax Reform Act of 1986 failed to follow the President's tax reform proposal and instead adopted additional reforms of the existing possessions tax credit. These restrictions were designed to reduce the amount of passive investments qualifying for the credit and to encourage more employer-producing investment per dollar of revenue loss to the Treasury.[12] The legislative history indicates that the Congress anticipated that continuation of the possessions tax credit would promote economic development in the possessions.

In 1996, Congress adopted legislation repealing the possessions tax credit (with a 10-year phase down) and adding a new credit (the "Puerto Rico economic activity credit") that is available only for a 10-year period. Both these credits are set to expire at the end of 2005. Under the 1996 legislation, the possessions tax credit is available only to existing credit claimants. The legislative history in 1996 indicated that the Congress was concerned that the tax benefits of the

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[7] Joint Committee on Taxation. *General Explanation of the Tax Reform Act of 1976.* JCS-33-76 (December 29, 1976).

[8] Report of the Committee on Finance, United States Senate. Sen. Rept. 97-494 (July 12, 1982), pp. 81-82.

[9] It should be noted that, in 1984, the Treasury Department's tax reform report to the President included a proposal to repeal the possessions tax credit and replace it with a wage credit that would be available for six years and then phased out over another six years. The permanent wage credit proposed in 1985 reflected the substantial influence of the US businesses doing business in Puerto Rico.

[10] *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity*. May 1985, p. 308.

[11] Id.

[12] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, JCS-10-87 (May 10, 1987).

possessions tax credit was enjoyed by a relatively small number of US corporations, while the high costs of the tax benefits were borne by all US taxpayers.[13]

Throughout the history of the special tax incentives for US corporations doing business in Puerto Rico, there is evidence of concern by the Congress and the Administration about the size of the foregone revenue attributable to these tax incentives. In addition, there has been ongoing concern that the tax incentives have not translated into adequate growth for the Puerto Rican economy. The following section looks at the performance of the Puerto Rican economy in an effort to explore the possible effects of prior US Federal tax policies.

B. Trends in the Puerto Rican Economy

Beginning in 1945, Puerto Rico started to the transformation to an industrialized economy from an agrarian economy. Many believe the dramatic transformation represents the model for other developing economies and some even liken the economic development to that experienced in Asian countries.[14] However, Puerto Rico's transformation was aided, in large part, by the substantial Federal transfer payments that built infrastructure, modernized facilities, and provided public education as well as training for workers.

One of the factors that may also have influenced Puerto Rico's economic development is the presence of Federal and Puerto Rican tax preferences for fixed investment. The coordination of such tax preferences with certain non-tax benefits provided a welcoming environment for US corporations.

As mentioned, in 1921, the Federal government enacted a tax exemption for qualifying income of US corporations operating in US territorial possessions – possessions corporations. In 1948, Puerto Rico enacted complementary legislation, the 'Industrial Incentives Act,' that for the most part, exempted manufacturing profits from taxation.[15]

As a result of the generous Federal transfer payments that promoted economic development (e.g. infrastructure, facilities, and education and skill training of the workforce) the Puerto Rican Gross Domestic Product (GDP) has increased steadily, with periods of significant increases. (See graph 1.) The ten-year period from 1960 to 1970 showed the greatest average annual increase per capita and the rate of increase in GDP since that time has been declining. It is important to note that, while still demonstrating significant growth, the growth rates for periods after 1975 are increasing at a decreasing rate. Further, growth rates since 1990 to the present have been moderate at best.[16]

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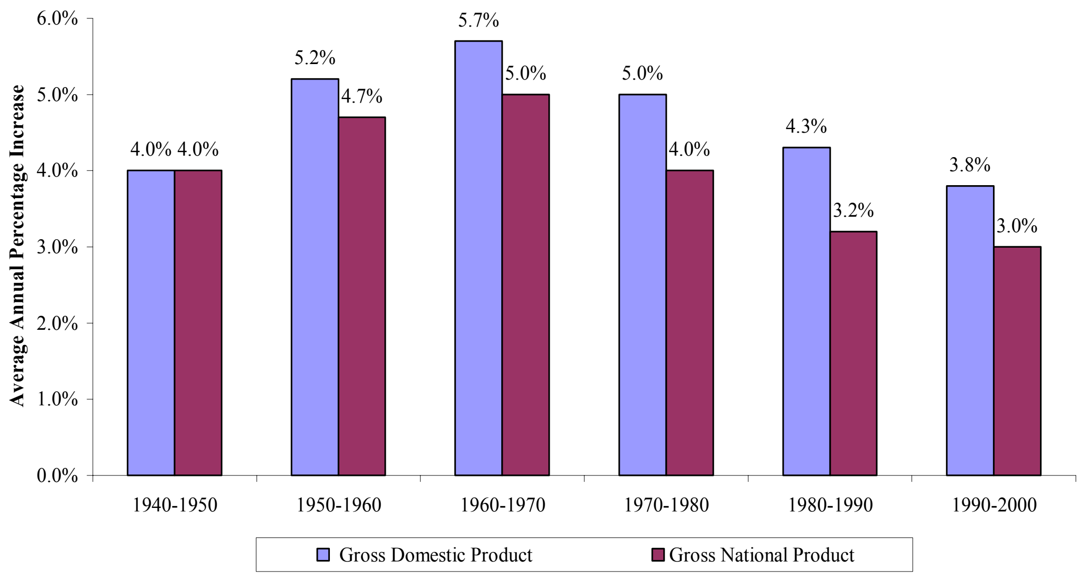
[13] Report of the Committee on Finance, United States Senate. Sen. Rept. 104-281, June 18, 1996.

[14] See Baumol, W., and Wolff, E., "Catching up in the Postwar Period: Puerto Rico as the fifth 'Tiger'?" World Development, 24(5), 869 – 885.

[15] Puerto Rico's Industrial Incentives Act provided a flexible depreciation provision that effectively reduces the tax burden in qualifying industries. In addition, certain manufacturing and export service firms may qualify for tax exemption of up to 90 percent of their income for up to 10 to 25 years. Further, the act exempted from taxation all interest income associated with financial assets held in Puerto Rico.

[16] The slowing of the economic growth of the 1970s and early 1980s was a result of a variety of factors. One important factor was the increase in the wage rate, which was increasing relative to the wage rate in the United States. Another possible factor was the reduction in the value of the section 936 provisions during this period.

Graph 1
Average Annual Growth Rate of Real GDP and GNP, Per Capita
(Source: MacEwan, "Puerto Rico's Dependent Development: A Comment," July 2003)



However, closer examination of GDP statistics reveals a different picture. Most of the early studies that examined the Puerto Rican economy relied on GDP statistics which include income generated by non-nationals doing business on the island.[17]

Arguably, the best indicator of growth in a country is Gross National Product (GNP) rather than GDP.[18] GNP provides the economic performance attributable to the nationals of a country. For most countries, the difference between GDP and GNP is small. According to the Penn World Tables, of the 128 countries and the Puerto Rican territory, 115 countries have ratios of GNP to GDP between 90 and 110 percent. There are four outliers with ratios in excess of 110 percent, but the remaining 10 countries (including the Commonwealth of Puerto Rico) are at rates less than 90 percent. With the largest difference between GNP and GDP, Puerto Rico's ratio was approximately 65 percent.

The relationship between GDP and GNP is particularly important when considering the Puerto Rico economy since a significant portion of the manufacturing firms doing business in Puerto Rico are US businesses. For Puerto Rico, the gap between GNP and GDP began to increase in 1970, during the periods of robust growth in Puerto Rico, concurrent with the expansion in Federal tax preferences for US corporations locating in Puerto Rico. More recent data indicate that the gap continues to widen.

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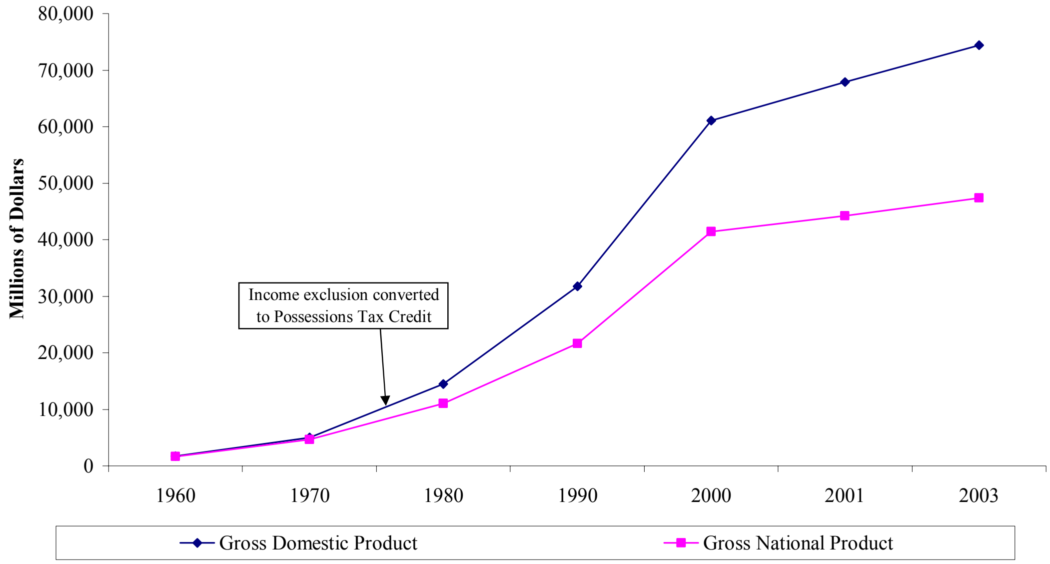
[17] Baumol and Wolfe relied exclusively on GDP statistics, which overstate the economic performance attributable to Puerto Rico.
[18] See MacEwan, Arthur, "Measuring the Puerto Rican Economy: Things may not be as they seem," 2004. It is important to note that Baumol and Wolfe used GDP in their study, rather than GNP.

Graph 2
Puerto Rico Gross Domestic Product and Gross National Product
(Source: MacEwan, "Measuring the Puerto Rican Economy: Things May Not Be As They Seem," 2004)



This increasing gap between GNP and GDP for the Puerto Rican economy suggests that a large proportion of GDP does not accrue to Puerto Ricans or to Puerto Rican firms. Ruiz and Menendez report that in 1987 possessions corporation profits within the manufacturing sector accounted for 77 percent of the value added, while other manufacturing profits were only 16 percent.[19]

In fact, manufacturing firms in Puerto Rico, particularly the possessions corporations, are the primary contributors to this growth. Table 1 decomposes the shares of GDP showing the growth in manufacturing and the government sectors as a share of GDP. In addition, it is noteworthy to observe the relative decline in the agricultural sector. These trends demonstrate the move from an agrarian economy to an industrial economy was largely complete by 1970.

[19] Ruiz, Angel and Edwin Melendez, "The Economic Impact of Repealing Section 936 on Puerto Rico's Economy," in Edwin Melendez and Angel L. Ruiz, Eds, Economic Effects of the Political Options for Puerto Rico, Centro de Publicaciones, Universidad Interamericana de Puerto Rico, 1998.

Table 1 – Share of Gross Domestic Product for Selected Sectors of the Puerto Rican Economy

Year	Manufacturing	Agriculture	Government
1950	16.5 %	18.2 %	10.4 %
1960	21.7 %	9.7 %	11.1 %
1970	23.6 %	3.2 %	12.1 %
1980	36.8 %	2.6 %	13.1 %
1990	39.2 %	1.5 %	11.1 %
2004*	43.7%*	0.9%*	14.5%*

*Based on Economic Report of the Governor, 2005. All other figures are from CBO, "Potential Effects of Removing Section 936 Tax Benefits."

One explanation of manufacturing's growing share of GDP as well as the divergence of GNP and GDP was the transfer of certain intangible assets from the US (manufacturing) domestic corporation to their possessions corporation located in Puerto Rico. The domestic parent corporation reported the cost of the intangible asset (such intangible assets may be intangibles from patents and trademarks) and the possession corporation reports the income. With the ability to shield from tax most income generated in the possession corporation, these firms were able to take advantage of the differences in tax treatment between the US and Puerto Rico.

Closer examination of the growth within the manufacturing sector reveals another trend. The manufacturing sector, which initially was dominated by such labor-intensive sectors as apparel and shoe manufacturing, ultimately was dominated by such non-labor intensive sectors as pharmaceuticals, electrical and electronic equipment, and scientific equipment. Many attribute this trend to the characteristics of those manufacturing firms more likely to benefit from the preferential tax treatment and the transfer of intangible assets.[20] Such characteristics as firms with high marketing costs (which generate marketing intangibles) and high research and development costs (which generate manufacturing intangibles) are most likely to benefit. The pharmaceutical and electronic manufacturing firms generally exhibit these characteristics. Further, they both tend to produce products that require capital-intensive mass-production processes.[21]

While the Puerto Rican economy as a whole continued to grow and transform into an industrial economy, the benefits of this growth and transformation were not uniformly received. Specifically, the economic growth stimulated by the tax benefits for the manufacturing sector did not accrue directly to the Puerto Rican workers. (We discuss the tax treatment of Puerto Rican residents in more detail in a following section.)

Despite the economic growth, per capita incomes and labor force participation remained low and rates of unemployment remained high. The combination of these important economic

[20] Congressional Budget Office, "Potential Economic Impacts of Changes in Puerto Rico's Status under S.712," April 1990.

[21] While many refer to these manufacturing industries as hi-tech industries, because the underlying technology may represent technological innovation, the production process relies on unskilled workers, not technically trained workers.

indicators results in a large number of Puerto Ricans living below the poverty level. Nearly half of all Puerto Ricans live below the poverty level. Estimates indicate that 44.6 percent of all Puerto Ricans are living in poverty.[22]

As the manufacturing firms benefited from the Federal and Puerto Rican tax preferences, per capita incomes still remain low and lag behind the poorest US states.[23] Table 2 shows that in constant dollars, per capita net incomes, while growing, still remain quite low. While the economy demonstrates positive growth rates, this level is not enough to bring significant changes or improvement to the Puerto Rico economy. This low rate of growth precludes the Puerto Rican economy from convergence with the US economy and prevents Puerto Ricans from moving out of poverty.

Table 2 – Per Capita Net Income, Constant Dollars and Labor Force Participation Rates

Year	Per Capita Net Income	Growth Rate	Labor Force Participation
1995	$1,786		45.9
1996	$1,910	7.0%	47.2
1997	$2,025	6.0%	48.0
1998	$2,071	2.2%	48.1
1999	$2,176	5.1%	47.2
2000	$2,230	2.5%	46.2
2001	$2,277	2.1%	45.4
2002	$2,300	1.0%	45.8
2003	$2,396	4.2%	46.6
2004	$2,461	2.7%	46.4

Another important factor that attributes to the low per capita income is the extraordinarily low labor force participation rates. Possible explanations of these low rates include the limited employment opportunities, the under-reported underground economy, and the disincentives of the high marginal tax rates paid by many low income workers on the island (addressed in more detail in subsequent sections).

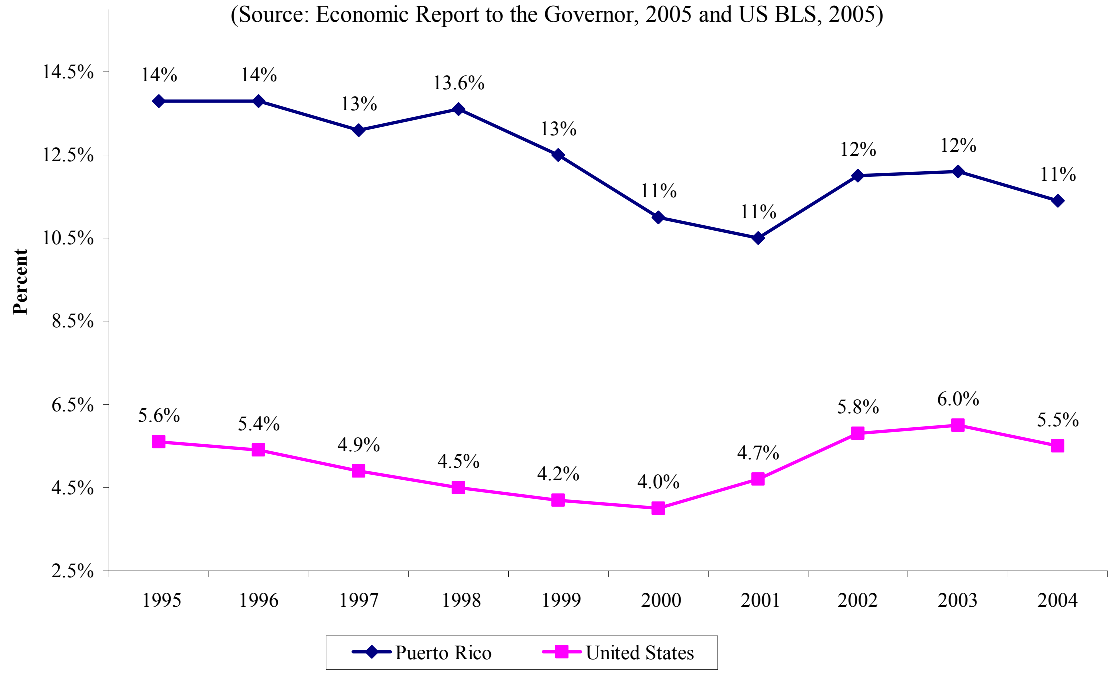
[22] Estimates are from Federal poverty level guidelines from the US Department of Health and Human Services, 2004.
[23] Comparisons to US states are handled in more detail in a later section of this paper.

Puerto Rican unemployment rates remain twice the rate of those in the US, despite an overall downward trend. In 2004, the unemployment rate was approximately 11 percent compared to 5 percent in the US. (See Graph 3)

Graph 3

Puerto Rico and US Unemployment Rates, 1995 to 2004

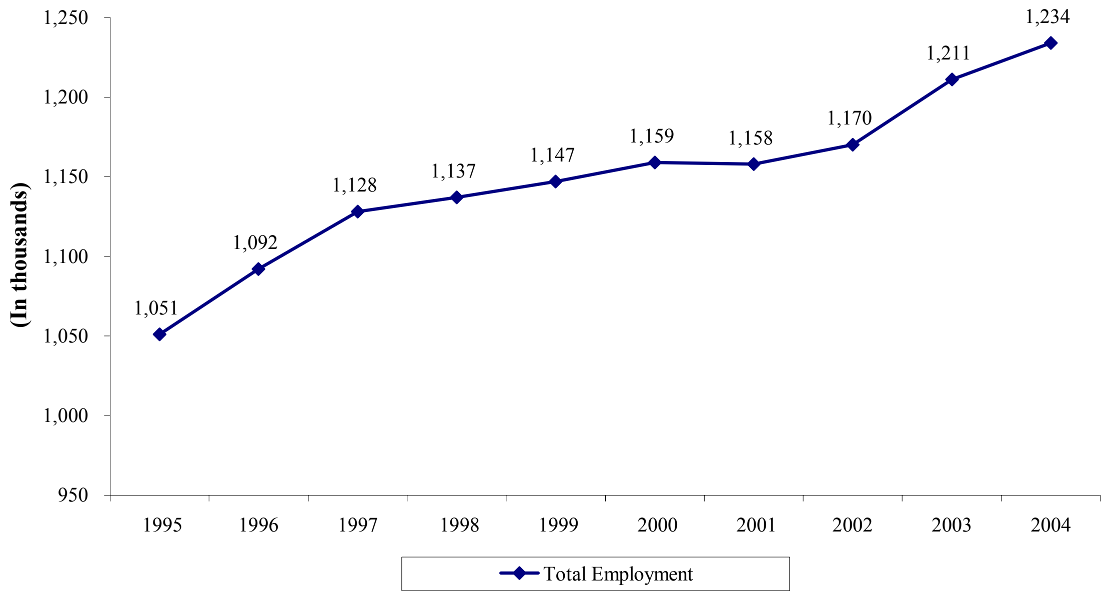
(Source: Economic Report to the Governor, 2005 and US BLS, 2005)



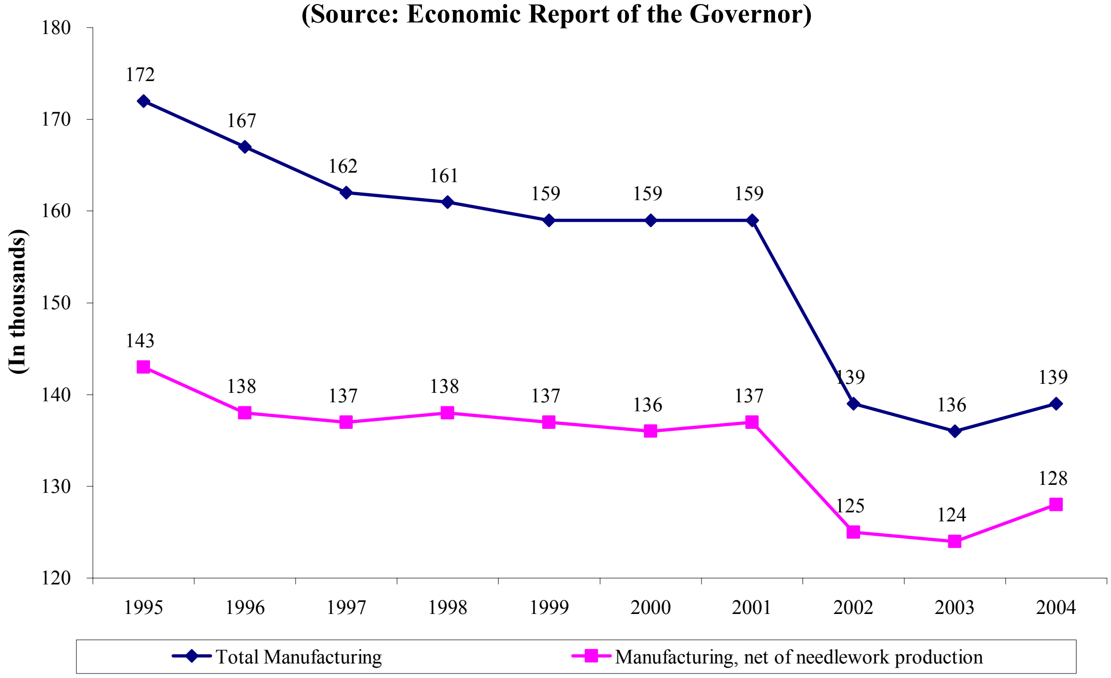
Overall employment continues to increase in Puerto Rico (See Graph 4). However, much of the growth is attributable to the continued expansion of the public, construction, and services sectors and not the heavily tax subsidized manufacturing sector.[24] As overall employment increases, it is worthwhile to examine the trends within the manufacturing sector.

[24] During the past ten years, the annual rate of growth in these sectors ranged from 2 to 8 percent.

Graph 4
Total Puerto Rican Employment, 1995 to 2004
(Source: Economic Report of the Governor, 2005)



Graph 5
Manufacturing Employment, 1995 to 2004
(Source: Economic Report of the Governor)



Graph 5 highlights the period during which the section 936 began to phase out. While the gradual phase out of benefits commenced, most firms received substantial benefits until 2001. The graph attempts to isolate the employment levels in those manufacturing industries that continued to receive tax benefits. The first line in graph 5 depicts employment for the entire manufacturing sector. The trend demonstrates a slow decline with a significant decrease between 2001 and 2002. The second line in graph 5 shows the manufacturing industry after eliminating needlework manufacturing production – the only other significant contributor to Puerto Rican manufacturing employment. The remaining manufacturing firms shown in the second line comprise the largest share of GDP and are the largest contributor to the increasing gap between GDP and GNP. Despite the tax benefits provided to these firms, their contribution to Puerto Rican employment continued to decline.

C. Activities of US Corporations Doing Business in Puerto Rico

US corporations operating in Puerto Rico have several options when considering their legal form of organization. The primary forms of organization include possessions corporation, foreign branch, or controlled foreign corporation status.[25] Currently, the special Federal tax benefits associated with possessions corporation status expire in 2005, and it is anticipated that most existing possessions corporations will convert to either a branch operation or a controlled foreign corporation.

The choice between the remaining two primary organizational forms depends upon many factors. Such factors include, in addition to the Federal and foreign tax treatment, a wide array of legal and commercial issues under both the US and host country's law.

There are certain advantages and disadvantages to each organizational form. With respect to business formation and operations, foreign branches are relatively less expensive and they are somewhat less time consuming to establish in a host country. Generally, foreign branches face fewer restrictions on corporate ownership and control and have fewer disclosure requirements. Conversely, foreign subsidiaries (specifically CFCs) are relatively more expensive to establish and maintain. They often face significant restrictions on the control and ownership as well as significant disclosure requirements.

However, despite the higher costs to establish foreign corporate subsidiaries, these firms enjoy greater flexibility in terms of business operations (financing and legal rights in local courts) compared to foreign branches. Further, foreign corporate subsidiaries generally limit liabilities of the parent corporation, while parent corporations of foreign branches may face unlimited liability in the host country.

These non-tax considerations are just a few of the practical issues that US corporations must consider before establishing a foreign presence in Puerto Rico or any other country. However, the considerations will vary with the type of industry and the size of the transactions involved.

[25] Other options for direct foreign presence include joint venture operations and representative offices. However, these forms are used less often.

With respect to Puerto Rico, the tax benefits provided for possessions corporations clearly dominated other legal organizational forms. The following table shows that possessions corporations remained the dominant form in 2001, the most recent tax year available.

Table 3 – Returns Filed by US Corporations, by Organizational Form Selected Years (Number of returns, money amounts in millions)

Organizational Form		1994/1995	1996/1997	1998/1999	2000/2001
Branch Operations	Returns	606	443	398	415
	Gross Income	$2,901	$3,213	$5,170	$11,424
Controlled Foreign Corporation	Returns	30	31	37	42
	Gross Receipts	$3,367	$3,103	$5,276	$8,910
Possessions Corporation	Returns	395	353	310	171
	Gross Receipts	$40,403	$41,869	$34,994	$25,538

* Due to the release schedule of certain IRS-SOI statistics, data for Possession Corporations are available only for odd numbered years. Data for branch operations and controlled foreign corporations are available for even numbered years.

According to the Internal Revenue Service, the number of active returns for US possession corporations peaked at 553 in 1983 (see Graph 6) and the number declined slowly to 395 over the next ten years. However, with the phase out and repeal of the Section 936 tax benefits, the number of possessions corporations started to decline more rapidly as most corporation are likely to reorganize and convert from possessions corporations to controlled foreign corporations.

As shown in Table 3, the number of CFCs in Puerto Rico increased slightly from 30 to 42 between 1994 and 2000. However, more recent data is expected to show a sharp increase in the number, an increase that corresponds approximately with the decrease in possessions corporations.[26] Branch operations dropped sharply between 1994 and 1996, but remain stable with approximately 400 branch operations. It is important to note that the approximately 400 branch operations do not necessarily represent a one-to-one correspondence with US corporations as many US corporations with branch operations have multiple branch locations within Puerto Rico. Since possessions corporations were the most common legal organization

[26] The SOI expects to release updated statistics for both the Possessions Corporations as well as Controlled Foreign Corporations later in 2005. Possessions corporation data for 2001 (in graphs 6 and 7) were made available prior to the formal release date.

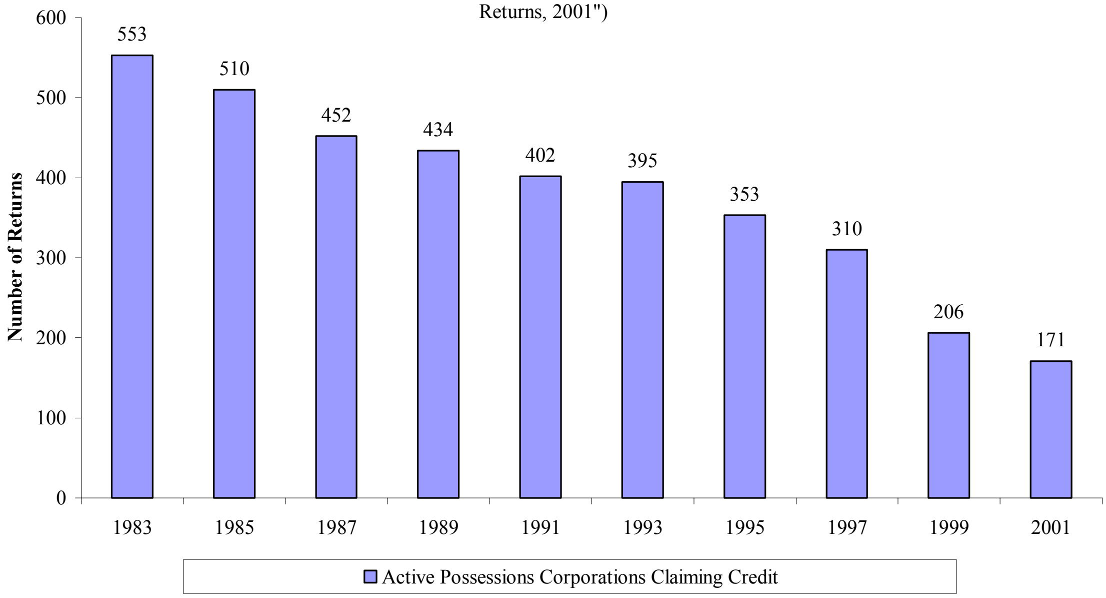
for US corporations doing business in Puerto Rico, we focus closer attention on the numbers of firms and the associated tax benefits.

Clearly, the decline in possessions corporations corresponds with the phase out of section 936 benefits. The sharp decline in the numbers of firms is expected to continue as more recent data become available. However, despite the phase out of section 936 benefits, the possessions tax credit continued to provide generous tax benefits to US corporations.

Graph 6

Active Possessions Corporations Claiming Credit, Selected Years 1983 to 2001

(Source: IRS SOI, "US Possessions Corporation Returns, 1997 and 1999" and "US Possessions Corporation Returns, 2001")

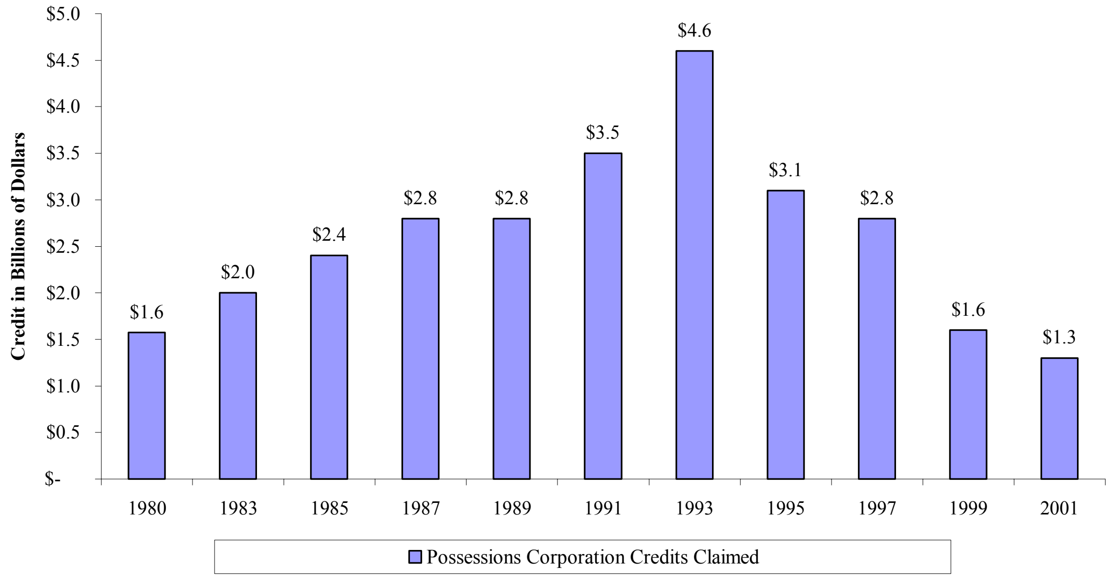


Benefit of Section 936 Credit – The possessions tax credit reduced appreciably the tax liability that possession corporations would otherwise pay. At its highest level, as the following graph displays, the tax credit in 1993 was worth nearly \$4.6 billion to approximately 395 possession corporations. The value of the credit declined (as did the number of firms claiming the credit) to \$1.3 billion for approximately 171 firms. On average, the each firm received approximately \$11.6 million and \$7.9 million in 1993 and 1999 respectively.

Graph 7

Possessions Corporation Credits Claimed by Active Corporations, Selected Years 1980 to 2001

(Source: IRS SOI, "US Possessions Corporation Returns, 1997 and 1999" and "US Possessions Corporation Returns, 2001")



SOI data indicate that the benefits of the possessions tax credit accrued primarily to manufacturing corporations. The following table shows the share of manufacturing corporations receiving the tax benefits as well as the percentage of the possession tax credit received by manufacturing corporations. The manufacturing corporations represented approximately 75 percent of all corporations claiming the possession credit, but they received more than 95 percent of the tax benefits.

Table 4 – Active US Possession Corporation Returns
(Numbers of returns, Dollar amounts in millions)

Manufacturing corporations	Number or Dollars	As a percent of total returns
Returns	333	75.7%
Possession Tax Credit Claimed	$2,939	95.4%
Reduction in US Tax Liability	$2,140	94.9%

Source: IRS, SOI Bulletin, Summer 1999, Publication 1136 (9-99).

Economic Trends **–** Prior to the phase out and repeal of section 936 possession tax credits, a number of economic studies, most notably the Congressional Budget Office, attempted to demonstrate that the benefits of section 936 were vital to the Puerto Rican economy. Many argued that benefits accrued primarily to the local economy and without such benefits, the economy would suffer. However, the available empirical evidence does not support this.[27]

[27] The Congressional Budget Office Report, "Potential Economic Impacts of Changes in Puerto Rico's Status under S.712," April 1990, predicted the dire consequences of phasing out Section 936 incentives. The results and prediction in the CBO report reflected the conventional wisdom of the period and may have influenced the

Since the phase out and repeal of the benefits, total employment in Puerto Rico continued to increase despite the gradual decline in manufacturing employment. Generally, employment trends in Puerto Rico follow US employment trends. The economies move somewhat in tandem, and changes in tax benefits are only one factor influencing those economic trends.

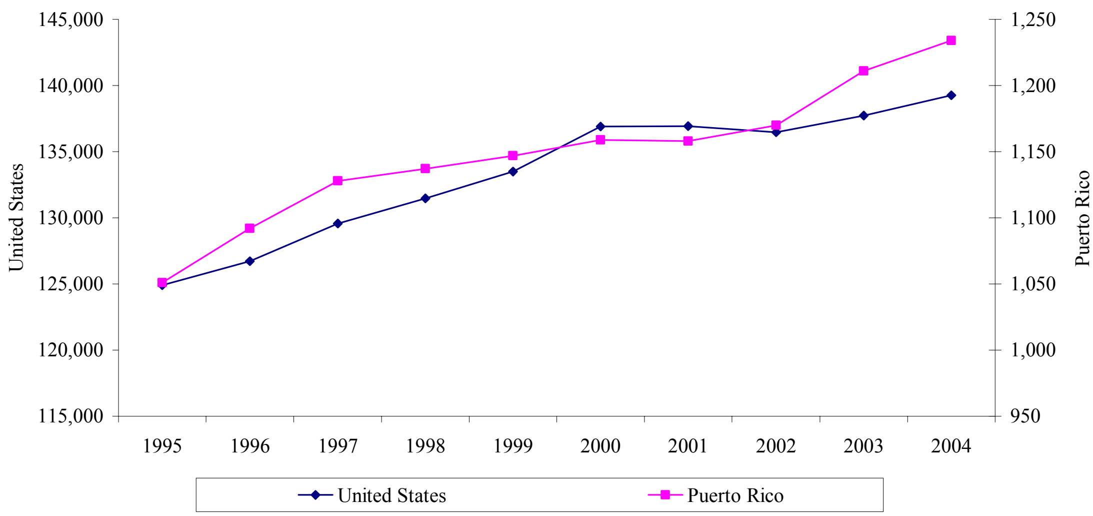
Graph 8 shows the total employment trends for both the US and Puerto Rico. Note that total employment continued to increase after the enactment of the Small Business Job Protect Act of 1996 and as many argued, the phase out and repeal of the generous tax benefits did not affect total employment in Puerto Rico.[28]

For the ten-year period, the trend represents a 17.4 percent increase in employment for Puerto Rico and an 11.5 percent increase for the US.

Graph 8

Total Employment in the United States and Puerto Rico, 1995 to 2005

(Source: US BLS, 2005 and Economic Report of the Governor, 2005)



Closer examination of the role manufacturing plays in the total employment picture shows another striking parallel to the US economy. During the past twenty years, manufacturing employment as a share of total employment experienced a downward trend. Puerto Rico's trend is nearly identical to the US trend. This correspondence suggests that tax benefits directed toward US manufacturing firms in Puerto Rico play little or no part in the role of manufacturing employment.

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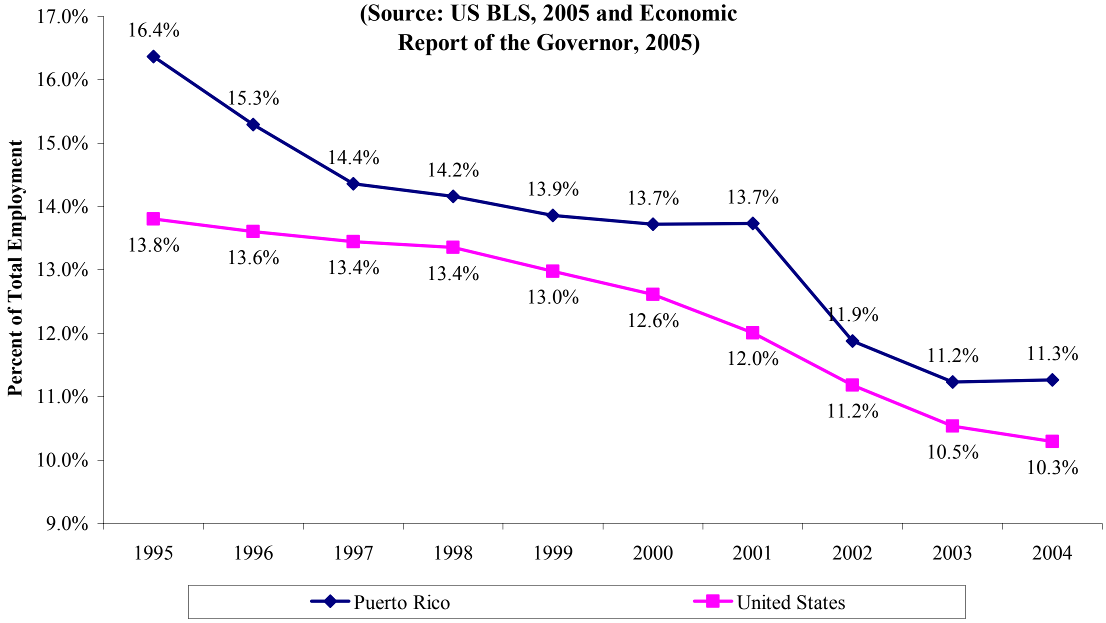
decision to retain the section 936 tax incentives. However, since the phase out began in 1995, there has been no evidence to support the predicted dire consequences.

[28] See US Bureau of Labor Statistics and Economic Report to the Governor, 2005.

The following graph displays the corresponding relationship between manufacturing employment and total employment in the US and Puerto Rico. The trends indicate that overall, manufacturing has played a less significant role in the Puerto Rican economy. Such influences as trade liberalization and global competition from newly industrialized economies decrease the importance of manufacturing employment in Puerto Rico and the US.

Graph 9
Manufacturing Employment as a Percent of Total Employment, 1995 to 2004
(Source: US BLS, 2005 and Economic Report of the Governor, 2005)



Manufacturing employment as a share of total employment began decreasing in the early 1980's. Clearly the trend was well established prior to the legislative changes repealing the possession tax credit.

As previously discussed, one of the issues repeatedly raised by the Congress and the Administration with respect to the section 936 credit was the size of the tax benefit provided to US corporations relative to the benefits that accrued to Puerto Rico and its residents.

One way to look at the section 936 tax benefits is to compare the size of the credit per worker to the average compensation in selected manufacturing companies eligible for the credit in Puerto Rico. Table 5 shows this comparison.

Table 5 – Possession Tax Benefits as a Percentage of Compensation, All Manufacturing Industries and Selected Industries Selected Tax Years

	1993			1995		
Industry	**Total Manufacturing**	**Drug**	**Electronic**	**Total Manufacturing**	**Drug**	**Electronic**
Number of Returns	354	58	45	269	40	40
Number of Workers	109,598	22,026	17,500	100,982	20,064	15,789
Compensation Per Worker	$22,817	$37,224	$21,527	$23,835	$39,404	$21,572
Credit Per Worker	$34,296	$79,274	$49,705	$18,736	$56,040	$10,036
Credit as a Percent of Compensation	150 %	230 %	231 %	79 %	142 %	47 %

Source: IRS Statistics of Income.

Data from the SOI Division of the IRS shows that the section 936 credit provided substantial tax benefits to the eligible corporations. For example, in 1993, for all manufacturing companies, the average section 936 credit per worker equaled 150 percent of the average compensation per worker. By 1995, the average credit per worker was still nearly 80 percent of average compensation. Thus, the amount of the tax benefit exceeded total compensation in 1993. In fact, on a per worker basis, the tax benefit was far greater than compensation. The drug manufacturing companies received the most generous benefits in both 1993 and 1995, receiving credits in excess of their compensation costs.

Another way to evaluate these tax benefits looks at the effect they had on companies' US Federal tax liability, as shown in Table 6, below.

Table 6 – Possessions Corporations' Income Statement Items and Distributions to Shareholders, Selected Tax Years (Dollar amounts are in millions)

	1995		1997		1999	
Industry	All Industries	Total Manufacturing	All Industries	Total Manufacturing	All Industries	Total Manufacturing
Number of Returns	440	333	378	297	300	226
US Income tax before credits	$4,553	$4,401	$5,214	$5,073	$4,110	$4,010
US Income tax after credits	$1,466	$1,457	$2,415	$2,411	$2,433	$2,394
Distributions to Stockholders	$8,512	$7,816	$11,755	$11,466	$7,935	$7,505

Source: IRS Statistics of Income, various years.

Table 6 shows that, in 1995, US income before credits was approximately 3 times the US income after applying the credit. Over time, this relationship diminished somewhat and the US income before credits was about 1.7 times the US income after applying the tax credit.

Graph 10

US Possessions Corporations, Distributions to US Shareholders, Selected Years

(Source: SOI, US Possession Corporation Returns, 1995 and US Possession Corporation Returns,1997 and 1999)

The possessions corporations in the manufacturing concerns comprised between 95 and 98 percent of all distributions to US shareholders, as shown in graph 10.

The relationship between the specific tax benefits provided to possessions corporations under the US Federal tax system and the growth (and health) of the Puerto Rican economy is not convincing. Conventional wisdom suggests that the amount of US Federal tax benefits provided to US corporations doing business in Puerto Rico since 1976 is the key factors driving the Puerto Rican economy. However, other factors have also contributed, including the size of US Federal transfer payments to Puerto Rico and the size of local tax incentives provided to businesses.

In the next section, we take a closer look at the tax systems of both Puerto Rico and the United States and examine more closely how individuals and businesses are treated under these systems.

II. COMMONWEALTH OF PUERTO RICO – OVERVIEW OF TAXES APPLICABLE TO BUSINESSES AND INDIVIDUALS LOCATED IN PUERTO RICO

A. Taxation of Puerto Rican Individuals

1. Puerto Rican Individual Income Tax System

Puerto Rico has its own tax system that is separate and independent from the US Federal tax system, much in the same way that the individual States have separate tax systems. Like many of the State income tax systems, the Puerto Rican tax system is broadly modeled after the US tax system, but has different tax rates and different provisions.

US citizens who are residents of Puerto Rico are subject to Puerto Rican tax on their income from sources within Puerto Rico.

The individual tax rate schedule for Puerto Rico for 2004 is shown below:

Table 7 – Puerto Rican Individual Income Tax Rates, 2004*

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

*A separate tax rate schedule applies to married persons living with their spouses and filing separate returns.

The 2004 standard deduction, personal exemptions, and dependent exemptions by filing status for Puerto Rican taxes purposes are as follows:

Table 8 – 2004 Standard Deductions and Personal Exemptions for Puerto Rican Tax Purposes by Filing Status

Filing Status	Standard Deduction	Personal Exemption	Dependent Exemption
Married couple filing a joint return	$3,150	$3,000	$1,600
Single individual	$2,100	$1,300	$1,600
Head of household	$2,730	$3,000	$1,600
Married couple not living together	$2,100	$1,300	$1,600
Married couple living separately	$1,575, if spouse does not itemize	$1,500	$1,600

A family of four with $20,000 of Puerto Rican income (all from wages) would pay $885 of Puerto Rican income tax in 2004 (taking into account a special salaried taxpayer credit), which is an effective tax rate of 4.43%.[29]

2. Current law US Federal Income Tax Treatment of Puerto Rican Residents

Puerto Rican residents are US citizens, however for individual income tax purposes are not treated in the same manner as mainland citizens. US citizens and residents are subject to the US Federal income tax on their worldwide income. However, in the case of Puerto Rican residents, a special provision permits them to exclude their Puerto Rican source income from US Federal tax.[30] Thus, most Puerto Ricans who reside in Puerto Rico generally don't have to pay US Federal taxes unless they have income from sources outside Puerto Rico.[31]

Furthermore, Puerto Ricans whose income is not exempt from US tax can claim a foreign tax credit for Puerto Rican taxes paid on the same income. At first glance, these provisions would appear to reduce the overall tax liability of Puerto Rican residents compared to the tax liability of an individual who is a resident of a State of the United States. But a closer look at how the tax treatment of Puerto Ricans who reside in Puerto Rico compares to the tax treatment of a US citizen residing in one of the 50 States reveals a different story. Indeed, a large percentage of Puerto Ricans would benefit if Puerto Rico were fully incorporated into the US Federal tax system.

The following section outlines some of the individual provisions of the US Federal tax system and compares how these provisions apply to Puerto Rican residents and to individuals who reside in a State.

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[29] In addition, Puerto Rican residents are also subject to US Federal Social Security and Medicare taxes, which significantly increase the overall effective tax rate borne by Puerto Ricans. See the discussion in Part 3, below.

[30] Sec. 933 of the Internal Revenue Code of 1986.

[31] It should be noted that individuals who have income from sources outside Puerto Rico and income from Puerto Rican sources are required to reduce the standard deduction that they can claim on their US Federal income tax return.

3. Discussion of Selected US Federal Income Tax Provisions Vis-à-Vis Puerto Rican Residents

Employment Taxes

Because they are treated as US citizens, Puerto Ricans pay employment taxes for Social Security and Medicare insurance coverage. By paying these taxes for a sufficient period of time, Puerto Ricans become entitled to receive benefits under the US Social Security and Medicare systems. Both the employer and the employee are required to pay equal shares of these employment taxes.[32] The employee share equals 6.2% of wages up to $90,000 (for 2005) for Social Security coverage and 1.45% of all wages for Medicare coverage (i.e., there is no cap on wages subject to tax for Medicare purposes).[33] The wage threshold for 2004 was $87,900.

The following table shows examples of the amount of the employee share of Social Security and Medicare taxes at various wage levels.

Table 9 – Employee Share of Social Security and Medicare Taxes at Various Wage Levels (2005)

Wages	Social Security tax (6.2%)	Medicare tax (1.45%)	Total employee share of taxes
$10,000	$620	$145	$765
$20,000	$1,240	$290	$1,530
$40,000	$2,480	$580	$3,060
$90,000	$5,580	$1,305	$6,885

Thus, a Puerto Rican worker who has $40,000 of wage income will pay $3,060 of the employee share of taxes for Social Security and Medicare coverage (the worker's employer will also pay $3,060 for the employer's share of taxes).

In 2002, an estimated 1.16 million Puerto Rican residents worked in jobs covered under the Social Security program.[34] Their wages equaled $19.27 billion in taxable earnings for Social Security purposes; employers and employees paid a combined $2.39 billion in Social Security taxes on this income.[35] An estimated 1.2 million Puerto Rican residents worked in employment covered by the Medicare program earning $21.5 billion in covered earnings and paying a total (combined employer and employee) of $616 million in Medicare taxes.[36] At the same time, in Puerto Rico, Social Security benefits were paid to 317,870 retired workers, 81,220 widows and widowers, 134,990 disabled workers, 63,420 wives and husbands, and 100,510 children.[37]

[32] Economists generally believe that employees bear both the employer and employee share of employment taxes.

[33] As noted, the employer share is equal to the employee share of taxes for Social Security and Medicare care coverage. Thus, the employer pays 6.2% of wages (up to $87,900 for 2004) for Social Security coverage and 1.45% of all wages for Medicare coverage).

[34] *State Statistics for December 2003, Puerto Rico.* Social Security Administration. www.socialsecurity.gov/policy.

[35] Id.

[36] Id.

[37] Id.

A separate Federal program – Supplemental Security Income (SSI) – is a means-tested Federal income assistance program designed to provide monthly cash payments to certain low-income elderly, blind, or disabled persons. The SSI program is considered a supplement to the Social Security program and acts to supplement income for those who were not covered or were minimally covered under Social Security and for those who had earned only a minimal entitlement under the program. Thus, the SSI program is intended to provide a positive assurance that the aged, blind, and disabled "would no longer have to subsist below poverty-level incomes."[38] Residents of Puerto Rico are not eligible to participate in the SSI program.[39]

Earned Income Tax Credit

The Federal earned income tax credit (EIC) provides a refundable tax credit to low-income working taxpayers. The credit was enacted in 1975; the legislative history of the credit indicates that it was made refundable to help offset the employment tax liabilities of low-income taxpayers.[40] Puerto Rican residents are not eligible for the EIC because of the exclusion from gross income for their Puerto Rican source income.

Advocates of the refundable EIC made two principal arguments when it was enacted. First, low-income workers were paying more in employment taxes than they paid in income taxes. But the idea of a graduated or reduced rate of employment taxes for low-income workers was not politically feasible. Second, supporters believed that the earned income credit reinforces work incentives and help get people off welfare. The refundable earned income credit helped offset the disincentive effects of higher payroll tax rates, which had risen from 4.8 percent on workers and employers in 1970 to 5.85 percent in 1975. The legislative history made clear that the Congress viewed the refundable earned income credit as a de facto payroll tax cut.

For 2004, the earned income credit is available to taxpayers who have earned income and adjusted gross income for US Federal tax purposes less than certain amounts (see Table 10, below).[41] Earned income means wages, salaries, tips, and other taxable employee compensation. The amount of the earned income credit that may be claimed depends upon whether the taxpayer has no qualifying child, one qualifying child, or more than one qualifying child. A qualifying child is related to the taxpayer, resides with the taxpayer for more than half the year, and generally is under age 19.

The following table (Table 10) shows the specific parameters for the earned income credit for 2004:

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[38] Social Security Amendments of 1972, S. Rpt. 92-1230, Committee on Finance, U.S. Senate, September 26, 1972, p. 384, cited in the 2004 Green Book, page 3-2, Committee on Ways and Means, U.S. House of Representatives.

[39] US citizens who are Puerto Rican residents are entitled to participate in the predecessor to the SSI program – the Federal-State Programs of Old-Age Assistance and Aid to the Blind.

[40] S. Rept. No. 94-36 (1975), at 11, 33. If the credit were nonrefundable, it would only offset an individual's income tax liability.

[41] Married taxpayers filing separate returns are not eligible for the earned income credit.

Table 10 – 2005 Earned Income Credit Parameters
(Married taxpayers filing joint returns)

	Two or more qualifying children	One qualifying child	No qualifying children
Credit rate (percent)…………………………	40%	34%	7.64%
Earned income limit	$11,000	$7,830	$5,220
Maximum credit……………………………..	$4,400	$2,662	$399
Phase-out begins (adjusted gross income)......	$16,370	$16,370	$8,530
Phase-out rate (percent)……………………..	21.06%	15.98%	7.64%
Phase-out ends (adjusted gross income).........	$37,263	$33,030	$13,750

Viewed in light of its original intent, the fact that Puerto Rican taxpayers are not subject to US Federal income tax on their Puerto Rican income means that they are unable to utilize the Federal earned income tax credit to offset the employment taxes that they pay for Social Security and Medicare coverage. As a result, US citizens residing in Puerto Rico are at a disadvantage relative to US citizens residing in one of the 50 States. Because low-income Puerto Rican taxpayers cannot utilize the Federal earned income credit, they pay more (i.e., a higher percentage of their wages) for Social Security and Medicare coverage than other workers of comparable income levels.[42] The example below illustrates this problem.

Suppose an individual began working at age 20 and earned $20,000 per year throughout the individual's working career. (Annual wages are held fixed to simplify the example.) The individual pays $1,530 per year for his or her employment taxes (Social Security and Medicare combined). Assuming the individual works until age 67 (47 years) and then retires, the individual would pay $71,910 in Social Security and Medicare taxes over his or her working career.[43] For these payments, the individual at retirement would be entitled to $10,750 in annual benefits from Social Security plus coverage under the Medicare system. The US citizen residing in Puerto Rico would pay the full amount of these taxes over his or her working career. A US citizen who resides in one of the 50 States would be entitled to a refundable tax credit each year that would offset these taxes. Consider the 2004 tax year. For this tax year, a married taxpayer with two children received a credit under the earned income tax credit of $3,250. A family of four had an income tax threshold for 2004 of $22,100; in other words, no Federal income tax liability would be imposed for taxable income below this threshold.[44] Thus, in this example, the earned income tax credit fully offsets the employee share of the employment taxes.

[42] See Table 11, below, for further analysis of the effects of current law for various types of taxpayers residing in the United States and in Puerto Rico.
[43] The individual's employer(s) would also pay an equal amount of these taxes (the employer's share).
[44] The standard deduction for married taxpayers filing a joint return was $9,700 for 2004. In addition, a family of four had personal exemptions totaling $12,400 for 2004.

Child Tax Credit

US Federal taxpayers are entitled to claim a $1,000 per child tax credit for certain qualifying children. The credit is partially refundable. Qualifying children are certain dependents of the taxpayer who are under age 17. The child tax credit is phased out for taxpayers with adjusted gross income above certain levels ($110,000 for married couples filing joint returns).[45]

The child credit is refundable to the extent of 15 percent of the family's earned income. In addition, if a family has three or more children, the child tax credit generally is refundable to the extent that the taxpayer's social security taxes exceed the taxpayer's earned income tax credit (this is referred to as the additional child credit). Thus, for families with three or more children, the refundable portion of the child tax credit is intended to offset more of the social security taxes paid by the family.

The child credit was originally intended to make it easier for mothers to stay at home and raise their children, rather than work outside the home. Although not refundable at first, the credit had the effect of increasing the earned income tax credit that taxpayers could claim. In 2001, the child credit was made explicitly refundable and the extent to which the credit is refundable has been subsequently increased.

As a result of the earned income credit, the child tax credit and other US Federal tax cuts (including rate reductions), the percentage of US taxpayers with no income tax liability has grown to 30 percent of all tax filers.

Puerto Ricans with only Puerto Rican source income generally cannot claim the child tax credit because they do not file a US Federal tax return. However, a Puerto Rican who is not required to file a US Federal income tax return can file a return to claim the additional child tax credit (the refundable credit for individuals with 3 or more children) if: (1) the individual is a bona fide resident of Puerto Rico, (2) the individual paid Social Security or Medicare taxes on wages (or paid self-employment taxes), and (3) the individual has 3 or more qualifying children.

Deduction for State and Local Taxes

Individuals who file US Federal tax returns are entitled to either a standard deduction ($4,850 for single filers and $9,700 for married couples filing jointly in 2004) or they may itemize their deductions (e.g., if the itemized deductions exceed the standard deduction). Included in the allowable itemized deductions are a variety of taxes, including State and local income taxes, foreign income taxes, State and local real estate taxes, foreign real estate taxes, personal property taxes, and certain other taxes and fees.

The itemized deduction for State and local taxes reduces income subject to Federal tax by the amount of State and local taxes paid. By contrast, Puerto Rican residents who have US source and Puerto Rican source income are permitted to claim a foreign tax credit for Puerto Rican taxes paid. While a 100% tax credit confers a greater tax benefit than the itemized deduction

[45] In calculating adjusted gross income, taxpayers are required to include Puerto Rican income that is excluded for US Federal tax purposes under section 933.

for state and local taxes, in essence, the provisions both operate to offset US Federal income tax liability to the extent of other taxes paid (state and local or Puerto Rican). Since the vast majority of Puerto Rican taxpayers do not have non-Puerto Rican source income under current law and, therefore, do not file US Federal income tax returns, most do not utilize the available tax credit.

Federal Tax Benefits for the Elderly

In addition to specific provisions designed to reduce the tax liability of low-income US taxpayers, the US Federal tax system provides certain specific benefits for the elderly, blind, and disabled to further reduce the burden of the Federal income tax system.

An additional standard deduction can be claimed by individuals who are elderly or blind. For 2004, the additional standard deduction for the elderly or blind equals $1,200 for single individuals and heads of household and $950 for married taxpayers and surviving spouses. An individual who is elderly and blind is entitled to two additional deductions ($1,900). In 2000, about 11.3 million taxpayers (76 percent of which had income below $40,000) claimed these additional standard deductions.[46]

In addition, a separate tax credit is available for certain low-income individuals who are at least age 65 or who have retired with a permanent and total disability. The maximum credit is $750 for a single individual, $1,125 for married couples filing joint returns, and $562.50 for married couples filing separate returns. The credit begins to phase out for taxpayers with income in excess of $7,500 (single individuals), $10,000 (married couples filing joint returns), and $5,000 (married couples filing separate returns).

Table 11 below shows the Federal income tax thresholds for elderly individuals for 2004.

Table 11 – US Federal Income Tax Thresholds
Elderly Individuals, 2004

Filing Status	Amount of Social Security Income			
	None	**$2,500**	**$5,000**	**$7,500**
Single	$12,729	$13,800	$14,150	$16,650
Joint	$20,886	$21,957	$22,800	$25,300

Source: Congressional Budget Office. Reported in 2004 Green Book, Committee on Ways and Means, US House of Representatives.

Effect of US Federal Tax System on Low-Income People

Under the US Federal income tax system, a variety of tax provisions, including the standard deduction, personal exemptions, the earned income tax credit and the child tax credit, operate to eliminate or substantially reduce the Federal tax burden for low-income individuals. Indeed, under the 2004 Federal tax rate schedules, a family of four with income up to $40,000 (all from

[46] *2004 Green Book. Background Material and Data on the Programs Within the Jurisdiction of the Committee on Ways and Means.* Committee on Ways and Means, US House of Representatives. March 2004, p. 13-52.

wages) and two children under age 18 would pay no Federal income tax.[47] The combination of the EIC and the child tax credit offsets 100 percent of the income tax liability for almost all families with incomes below $30,000. And refundability of the earned income tax credit and child tax credit offsets 100 percent of the payroll tax liability for those with incomes below $20,000. Those with earnings below $10,000 pay no income taxes and get a check from the government for 2.6 times their payroll tax liability.

Table 12, below, shows the combined income and payroll tax for hypothetical US taxpayers for 2004. The payroll tax liability is 7.65% of compensation (i.e., the employee share of payroll taxes). The examples show how the variety of tax benefits available (earned income credit, child tax credit, and the additional standard deduction for the elderly) can reduce (or eliminate) the US Federal tax liability for lower and middle income taxpayers.

For example, a US couple filing a joint return with $22,100 of gross income (all from wages of one spouse) with two dependent children and claiming the standard deduction would have $1,690 of employment tax liability (7.65% of $22,100) and a tax refund of $2,821 on their US Federal income tax return for a net Federal tax liability of -$1,131. This results in an effective US Federal tax rate of -14.11%. However, the same taxpayer who is a Puerto Rican resident has an effective US Federal tax rate of 7.65% because this taxpayer must pay US Federal employment taxes on his or her wages, but is not eligible for refundable credits that offset this liability on a US Federal income tax return.

Closer inspection of Table 12 shows that the current situation benefits some Puerto Rican residents and hurts other. In particular, it is clear that lower income families actually pay a higher effective US Federal tax rate than their mainland counterparts when Social Security and Medicare taxes are taken into account. This occurs because individuals who are filing US Federal income tax returns are eligible for refundable tax credits (earned income tax credit and the child tax credit) that are intended to offset some of the burden of these employment taxes.

[47] Taxpayers may claim as dependents those children older than age 18, if the child is still in school. However for purposes of the child credit the dependent child must be under the age of 18.

Table 12 – Examples of Federal Income and Payroll Tax Liabilities of Hypothetical US Taxpayers, 2004

	Combined Federal income and payroll tax liability, U.S. taxpayer					Effective Federal tax rate (Puerto Rican resident) (percent)
Parameters	**Income tax liability (before credits)**	**Payroll tax liability (Social Security & Medicare)**	**Total income and payroll taxes paid (after credits)**	**Tax credits (earned income credit and child tax credit)**	**Effective Federal tax rate (percent)**	
Single taxpayer, age 30, $15,000 gross income, standard deduction, no dependent children[1]	$708	$1,148	$1,856	$0	12.4%	7.65%
Single taxpayer, age 30, $30,000 gross income, standard deduction, 1 dependent child[1]	$1,991	$2,295	$3,236	$1,050	10.8%	7.65%
Joint return, $22,100 gross income, standard deduction, 2 dependent children	$0	$1,690	($2,821)	$4,511	-14.11%	7.65%
Joint return, $30,000 gross income, standard deduction, 2 dependent children	$793	$2,295	($56)	$3,144	-0.19%	7.65%
Joint return, $40,000 gross income, standard deduction, 2 dependent children	$1,974	$3,060	$3,034	$2,000	7.6%	7.65%
Joint return, $40,000 gross income, standard deduction, 3 dependent children	$1,509	$3,060	$1,569	$3,000	3.92%	-7.50[4]
Joint return, $60,000 gross income, $15,000 itemized deductions, 2 dependent children	$4,179	$4,590	$6,769	$2,000	11.28%	7.65%
Elderly couple filing joint return, $25,000 gross income[2]	$0	$0	$0	$0	0%	0%
Elderly couple filing joint return, $50,000 gross income[3]	$1,283	$0	$1,283	$0	2.6%	0%

[1] All income is wage income. Dependent children are assumed to be eligible for the child tax credit.
[2] $12,000 is Social Security income, $12,000 of income is taxable pension benefits, and $1,000 of income is interest income. Standard deduction is claimed.
[3] $20,000 is Social Security income, $20,000 of income is taxable pension benefits, and $10,000 of income is interest income. Taxpayer has $15,000 of itemized deductions.
[4] This family can, under current law, file a US Federal tax return to utilize the additional child tax credit, which will equal $3,000.

B. US Corporations Organized or Operated in Puerto Rico

1. In General

Companies doing business in Puerto Rico are subject to the Puerto Rican tax system and, in theory, the US Federal tax system. However, the reality is that very few corporations pay any US Federal income tax on their earnings from Puerto Rico.

Corporations that are organized and operate only in Puerto Rico do not pay any US Federal income tax because corporations that are chartered in the territories are treated as foreign corporations under the Internal Revenue Code and their income is treated as foreign source income.[48] Thus, a Puerto Rican corporation operating only in Puerto Rico has an advantage over a corporation organized under the laws of one of the 50 United States.[49] The primary tax advantage of foreign corporations over domestic corporations is the ability to defer income tax liabilities on earnings until such earnings are repatriated to the US.

The Puerto Rico business tax structure is similar in many ways to the US Federal tax system. Two significant differences are that partnerships, other than special partnerships, are taxed as corporations in Puerto Rico and Puerto Rico corporations are not allowed to file consolidated tax returns, so the income of one corporation cannot be used to offset the losses of an affiliated corporation.

2. Puerto Rican Corporate Tax Rates and Provisions

In General

Puerto Rican corporations are subject to corporate income tax on their worldwide income at a flat rate of 20 percent. In addition, a surtax applies to certain corporate income, which may increase the rate of tax to 39 percent.[50] These base corporate tax rates can be reduced substantially due to a variety of tax incentive provisions that are designed to encourage the development of new business in Puerto Rico.

The Puerto Rico Tax Incentives Act of 1998 provides special corporate tax incentives for companies establishing new companies in Puerto Rico. These special tax incentives are generally available to companies manufacturing or producing goods in Puerto Rico, companies performing services destined for foreign markets, companies involved with ports and transshipment facilities. The tax incentives are available to new businesses and existing businesses that expand their operations by at least 25%. These tax incentives can substantially reduce the tax burden for companies doing business in Puerto Rico.

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[48] Internal Revenue Code section 854.

[49] In deciding where to locate a business, a variety of factors must be considered, including, for example, the availability of inexpensive goods and labor. Tax can play a significant role in this decision – for example, the decision to invest in a Puerto Rican business may be compared, from a tax perspective, to the option of investing in a country such as Ireland or Malaysia.

[50] *Doing Business in Puerto Rico.* Ernst & Young LLP, 2004.

Among the many special tax incentives available are the following:

> *Reduction in corporate tax rates*: A reduction in corporate income tax rates to a flat tax between 2 and 7%. The maximum tax rate is 7% for industrial development income. The apparel, textile, shoe, leather products and fish canning industries are eligible for a special rate of 4%. In particular cases, the rate could be lowered to 2% depending upon the importance of the investment project.
>
> *Reduced rates for innovative* technologies.--Further, companies that are deemed to have a novel or innovative technology (so-called Pioneer Industries) not utilized in Puerto Rico before January 1, 2000, and that will have a significant impact on the economic and industrial development of Puerto Rico may be subject to income tax rates between 2% and 0%. Factors that enter into the determination of whether these reduced rates apply include: development of high levels of technical, scientific, and managerial expertise in the employees; the extent of the investment to be made in plant, machinery, and equipment; a substantial concentration of production for global markets to be located in Puerto Rico; integration of research, development and technological improvements as part of the industrial operation; and additional tax impact including such factors as payment of withholding tax on royalty payments for technologies transferred.[51]
>
> *Special deductions*: Special deductions may apply, such as a deduction for 15% of annual production payroll or $100,000, 100% expensing for investments in property, plant, and equipment, a 200% deduction for research and development costs, special deductions for production payroll expenses, and a 200% super deduction for training costs aimed at increasing employee productivity.
>
> *Special tax credits*: A variety of special tax credits are available, including the following: 25% tax credit for the purchase of locally manufactured goods from unrelated parties within Puerto Rico; a 35% credit for the purchase of locally recycled products or products manufactured with locally recycled products; a tax credit for withheld royalty payments; and a 30% credit for residents of Puerto Rico owning stock in an exempt business.
>
> *Capital gains and dividends*: Exempt businesses are subject to a 4% tax rate on capital gains obtained from the sale of shares of stock in the business, compared to the normal corporate tax rate of 12.5% for capital gains. In addition, shareholders of an exempt corporation are not subject to income tax on dividends distributed from industrial development income.
>
> *Repatriation tax*: The elimination of the tollgate tax on repatriation of Puerto Rican earnings to a parent company.

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[51] *Corporate Income Tax Incentives,* Puerto Rico Industrial Development Company of the Commonwealth of Puerto Rico (PRIDCO). <http://www.pridco.com/english/overview/2.2pr_overview_commonwealth.html>

Property tax incentives: Exemption from personal and real property taxes through the first year of operation plus a 90% property tax exemption in subsequent years and an exemption from personal property tax for intangible assets (patents, production licenses, or trademarks) and personal property used by a service unit like stocks, bonds, or other securities.

Excise tax exemptions: Manufacturers are allowed a 100% exemption from excise taxes on raw materials, machinery, and equipment needed to fulfill environmental, safety, sanitary or health regulations. In addition, a 100% exemption applies to the raw material, machinery, and equipment used in the manufacturing process.

Municipal license taxes: A 100% exemption from municipal license taxes applies during the construction period and period of initial operation. Additional exemptions from municipal license taxes of 60%, 75%, or 80% apply, depending upon the industrial classification of the eligible company. Apparel, textile, shoe, leather products and fish canning companies are entitled to a 75% exemption, trading companies are entitled to an 80% exemption, and other companies are entitled to a 60% exemption.

Companies operating in certain areas: Special incentives are provided to companies that operate in non-urban areas with high unemployment and a small number of industries.

Special tax credit for acquiring closing business: A 50% tax credit (up to $15 million) for the acquisition of certain businesses in the process of closing operations in Puerto Rico.

Foreign Trade Zones

Puerto Rico has a system of foreign trade zones (indeed, the largest, noncontiguous foreign trade zone system in the United States), which provide significant financial incentives to companies doing business in these zones.[52] In essence, raw materials, components, finished goods, and packaging stored in, and transported through, these foreign trade zones are exempt from certain duties and taxes.

The benefits of operating a business in the Puerto Rican foreign trade zone include the following:

- Deferral of US customs duties;
- Deferral of Puerto Rican excise taxes (detailed in a subsequent section);
- Exemption from municipal license taxes on exports outside the United States;
- Exemption from duties on damaged, scraped and obsolete merchandise; and
- Exemption from US customs duties on labor, overhead, and profit attributed to production operations in a foreign trade zone.

[52] Import Administration; Foreign Trade Zone Board. http://ia.ita.doc.gov/ftzpage/info/ftzstart.html

3. US Federal Tax Treatment of US Corporations Doing Business in Puerto Rico

In general, a US corporation doing business in Puerto Rico can operate the business in branch form or in controlled foreign corporation (CFC) form. The tax consequences of these operations will vary depending on the form of doing business that is chosen.

Corporations that operate a CFC in Puerto Rico will pay US tax on income earned only when the income is distributed to any US corporations or individuals that hold stock in the CFC. The US corporation includes the income in the year the distribution is received; however, the foreign tax credit may reduce the US tax imposed on the income.

A corporation operating a branch in Puerto Rico will, in theory, pay tax currently on the income earned in the branch. However, under current law, the possessions credit operated to reduce significantly the taxes imposed. In addition, the availability of the research and development credit in Puerto Rico may also reduce current tax liability.

Possessions Credit

US corporations with business operations in Puerto Rico have been eligible for a special credit since 1976.[53] Under section 936, this Puerto Rico and possession tax credit was an extension of a US tax principle in effect since 1921 that provided special tax treatment to US corporations operating in Puerto Rico. The intent of the special tax treatment was to encourage US corporations to invest in active business operations in Puerto Rico.

In 1996, a separate credit (the Puerto Rico economic activity credit (sec. 30A credit)) was enacted. The section 30A credit is a special case of the section 936 credit, applicable only to US corporations operating in Puerto Rico; the section 936 credit applies to taxpayers operating in any US possession. The section 30A is calculated under rules set forth in section 936 (the Puerto Rico and possession tax credit). Under current law, the credits are only available to corporations that were engaged in active business in Puerto Rico (or a possession in the case of the section 936 credit) and elected the benefits of the section 936 credit on October 13, 1995. Both credits are scheduled to expire for taxable years beginning after December 31, 2005.

In order to qualify for the section 936 and the section 30A credits, a US corporation must satisfy two conditions. First, the US corporation must derive 80 percent of its gross income for the 3 preceding years from sources within the possession or Puerto Rico. Second, the US corporation must derive at least 75 percent of its gross income for the same 3 preceding years from the active conduct of a possession business.

US corporations are permitted to repatriate the earnings of a Puerto Rican subsidiary free of US income tax if a section 936 election is in effect for the year that the dividend is paid.[54] Thus, under current law, in addition to the benefits of the section 936 and section 30A credits, US

[53] Sec. 936 and sec. 30A of the Internal Revenue Code of 1986. Prior to 1976, US corporations were entitled to an income exclusion with respect to income from possessions subsidiaries.
[54] Section 243(b)(1)(B)(ii) of the Internal Revenue Code of 1986.

corporations doing business through Puerto Rican subsidiaries can bring the earnings of the subsidiary back to the United States without incurring additional US Federal corporate income tax.

Controlled Foreign Corporations

With the expiration of the section 936 and section 30A credits after 2005, US corporations have been reevaluating the status of their Puerto Rican operations. According to information provided by PRIDCO, over 50 section 936 corporations have reorganized their Puerto Rican operations into controlled foreign corporations (CFCs) for US Federal tax purposes.[55]

Income earned by a foreign corporation from its foreign operations generally is subject to US tax only when the income is distributed to any US corporations or individuals who own stock in the foreign corporation. Thus, income from foreign operations generally is subject to US tax only when the income is repatriated to the United States through a dividend distribution to a US shareholder. The income is reported on the US shareholder's income tax return for the year the income is received, but the amount of US tax paid on the income may be reduced by the foreign tax credit.

There are a number of specific anti-deferral provisions that operate to require the current payment of US Federal taxes on income from foreign operations. These provisions include the controlled foreign corporation rule (Subpart F rules)[56], the passive foreign investment company rules[57], the foreign personal holding company rules[58], the personal holding company rules[59], the accumulated earnings tax rules[60], and the foreign investment company rules[61].

Using a CFC structure enables a US corporation to avoid current US Federal income tax on certain earnings from Puerto Rican business operations. The income, when earned, will be subject to a maximum tax rate of 7% in Puerto Rico. The income can then be used to fund foreign operations (including Puerto Rican operations) through investment in or loans to the corporations other non-US subsidiaries. When the earnings are repatriated to the United States, the amounts will be included in income for US Federal tax purposes, but will be eligible for a foreign tax credit for the taxes paid to Puerto Rico on such income. This structure is not as favorable from a tax perspective as the expiring possessions corporation provisions because the US corporation cannot repatriate its earnings on a tax-free basis. However, the corporation can time the repatriation of earnings so as to defer inclusion of this income until such time as the corporation has excess foreign tax credits available to offset the income.

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[55] Rivera, Frank. *Federal Tax Benefits for Puerto Rico Operations After Termination of Sections 936/30A Tax Credits.* Mr. Rivera is a special tax advisor with Martinez Odell & Calabria. This report can be located at www.PRIDCO.com.

[56] Sections 951-964 of the Internal Revenue Code of 1986.

[57] Sections 1291-1298 of the Internal Revenue Code of 1986.

[58] Sections 551-558 of the Internal Revenue Code of 1986.

[59] Sections 541-547 of the Internal Revenue Code of 1986.

[60] Sections 531-537 of the Internal Revenue Code of 1986.

[61] Sections 1246-1247 of the Internal Revenue Code of 1986.

Detailed Example

Income from outbound business investment earned by a CFC generally is not subject to tax until that income is repatriated. However, income from foreign branches of a US corporate taxpayer must be included in current taxable income.[62]

The majority of foreign business activity controlled by US corporations is conducted by separate foreign corporations as opposed to branches. In 2000, the largest 7,500 CFCs of US multinationals had $207.6 billion in earnings compared to $94.4 billion in earnings of foreign branches.

The following section examines quantitatively the differences between applying corporate tax laws to a US branch operating abroad and a US controlled foreign corporation. The analysis relies on publicly available financial statement information of a large pharmaceutical corporation operating in Puerto Rico.

Background – In general, the benefit of CFC status is the ability to defer income tax on earnings until those earnings are repatriated to the US shareholder. If the effective tax rate of the foreign country is lower than the effective rate in the US, then US corporations may enjoy two benefits of the deferral. First, the deferral will delay payment of US taxes on foreign source income until earnings are actually paid. Second, because excess foreign tax credits cannot be carried forward indefinitely, deferral expands the opportunity to apply credits (cross-crediting) when amounts are actually repatriated.[63]

CFC Status – Income earned by a foreign corporation is subject to US tax only when that income is distributed to the US shareholder. However, a variety of anti-deferral regimes do impose current tax liability on certain income earned through the foreign corporation. A US shareholder of a foreign corporation must include in income its proportionate share of their subpart F income, whether distributed or not. The shareholder must report the income as a dividend.

In general, subpart F income is passive income or income that is easily movable from one taxing jurisdiction to another. Subpart F income includes the sum of the corporation's insurance income, foreign base company income, as well as boycott income, illegal payments and income from countries not diplomatically recognized by the US government. Subpart F income does not include income of the CFC that is effectively connected with the trade or business operations within the US.

A CFC's subpart F income is limited to its total earnings and profit for that year. Under this limitation, current deficits in earnings and profits may reduce the CFC's subpart F income. Also, prior year accumulated deficits in earnings and profits may reduce the CFCs subpart F income in the current year.

[62] This tax may be reduced by any applicable foreign tax credit.
[63] There are limits on the amount of the foreign tax credit that may be claimed in any given year, but the corporate taxpayer has ability to alter the timing of foreign tax payments to coincide with the repatriation of earnings.

Present law provides a de minimis rule. Under the rule, generally none of the CFC's income (insurance income or gross foreign base company income) is subject to tax if the income is less than the lesser of $1 million or 5 percent of the gross income. However, if more than 70 percent of the CFC's income is attributable to foreign base company income and/or subpart F insurance income, then all of the income is treated as foreign base company income and subpart F insurance income.

Foreign base company income includes five categories of income: foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil related income. However, for purposes of determining the income, each item is reduced by its associated allowable deductions.

The major category of foreign base company income is personal holding company income which includes dividends, interest, royalties, rents and annuities (among other items).[64] The purpose of subpart F is to tax passive income or such income generated from activities outside the normal course of business operations (refer to Appendix B for a detailed example of the subpart F income calculation.)

Branch Status **–** When a US corporation operates as a branch in a foreign country, the branch net taxable income is subject to tax when earned. Determining taxable income is the same as if the branch operated in a US state (refer to Appendix C for a detailed example of the branch income calculation.).

The following table (Table 23) compares the tax differences for a foreign branch operation and a CFC operation. In general, if the CFC does not meet the de minimis rule, it is not subject to US corporate income taxes on its subpart F income.

[64] Certain exceptions may apply if the CFC is engaged in business that gives rise to these income items as part of the primary business activity.

Table 13 – Example of Potential Difference in Federal Income Tax Branch Operations and CFC Operations

	Branch Operations	**CFC Operations**
Inter-company Sales[65] (Assumes transfer price)	**$41,250**	**$55,000**
Cost of Sales	30,500	30,500
General & Administrative Costs	2,000	2,000
Other costs	500	500
Total Costs	**33,000**	**33,000**
Net Operating Income	$8,250	$22,000
Federal Tax (at 35 percent)	$2,888	$7,700
Subpart F Income	– 0 –	**$5,500**
Subpart F Deductions	– 0 –	**$3,300**
Subpart F Net Taxable Income	– 0 –	$2,200
Federal Tax (at 35 percent)	$2,888	$8,470
Federal tax due currently[66]	**$2,888**	**$770**
Federal tax deferred	– 0 –	$7,700

In general, at some point, most CFCs repatriate some portions of their earnings to provide access to as at some point, US corporations may want access to those earnings. At the time of repatriation, those amounts are includible in income and subject to income tax. While the earnings enjoy deferral, the deferral merely postpones, not eliminates the tax liability.

Consequently, the decision to repatriate depends heavily on the timing of other factors. One such factor may include the timing of payments of foreign taxes. If the CFC makes large payments for its foreign taxes, those payments may offset tax liabilities (as a foreign tax credit) when the CFC repatriate its CFC earnings.

Aside from the advantage that CFCs have with respect to the differences in the timing of Federal corporation taxes, there are other advantages to establishing a branch rather than a CFC. In general, it is usually less expensive and easier to establish a branch as opposed to a separate foreign corporation. The branch operations are not subject to the host country restrictions on ownership and control and branch operations typically face fewer requirements for information disclosure.

Alternatively, there are some non-tax benefits of establishing a CFC as opposed to establishing a branch operation. As a CFC, the parent corporation faces limited liability as well as often

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[65] For purposes of this example, it is assumed that the inter-company sales from the branch are priced in such a way to minimize the Federal income tax. However, they may adjust inter-company sales prices as long as they do not violate transfer pricing rules in Code Section 482.
[66] Only subpart F income is due currently for the CFC operations.

limits liability from other world-wide operations. In most countries, forming a CFC provides greater flexibility in conducting business. Such flexibility may include ease in obtaining financing or enhanced legal rights in the host country court systems.

Research and Development Tax Credit

Under current law (beginning after June 30, 1999), the research and development tax credit (R&D credit) is available with respect to research and development conducted in Puerto Rico by corporations subject to the US Federal income tax system.[67] The credit equals 20% of the excess of qualified research expenditures over the base amount for a year. The credit expires after December 31, 2005.

Manufacturing Deduction

Beginning in 2005, US corporations are entitled to claim a special deduction for income attributable to domestic production activities. This deduction is intended to replace the tax benefits previously applied through the extraterritorial income regime. The deduction equals 9% of the lesser of (1) the qualified domestic production activities income of a US corporation or (2) the US corporation's taxable income. The deduction is phased in at a rate of 3% for 2005 and 2006 and 6% for 2007 through 2009. The full deduction applies after 2009.

The special deduction is available only for activities of US corporations conducted in the United States, which for this purpose, means only the states and the District of Columbia. Thus, activities of US corporations in Puerto Rico and activities of Puerto Rican corporations do not qualify for this deduction.

C. Miscellaneous Taxes

1. Personal and Real Property Taxes

In general, like most states, personal and real property in Puerto Rico is subject to an annual property tax.

The rates applicable for purposes of the real property tax depend upon the municipality within Puerto Rico where property is located and range from 6.33% to 8.83% of the assessed value of the property.

Personal property is subject to taxes at rates ranging from 4.33% to 6.83% of the assessed value of the property. Stocks, bonds, and other securities issued by foreign corporations or partnerships owned by corporations or partnerships organized under Puerto Rican law are exempt from the personal property tax. This provision is intended to encourage the development of foreign operations of Puerto Rican companies. Certain exemptions from the personal property tax apply to businesses operating in Puerto Rican foreign trade zones.

[67] Section 41(d)(4)(F) of the Internal Revenue Code of 1986.

2. Excise Taxes

Puerto Rican Excise Taxes

In general, there is no sales tax in Puerto Rico. However, specific taxes apply to the purchase of certain items, including a 5% jewelry tax. 11% tax on room charges in hotels with casinos, 9% tax on hotels without casinos, and 7% on small inns. This is referred to as a transaction excise tax.[68]

Certain businesses or occupations may be subject to a municipal license excise tax. Businesses other than a financial business are subject to a tax as high as .5% of the gross receipts for the year. The maximum rate for a financial business is 1.5% on income from interest, rents, fees, profits, etc.

An excise tax is generally imposed on most goods used or consumed in Puerto Rico. The tax applies to the sales of certain specific items, such as motor vehicles, cigarettes, sugar, carbonated beverages, cement, gasoline and other types of fuels and oils. In addition, the excise tax is imposed on any goods first introduced (i.e., imported) into Puerto Rico. Thus, all inbound shipments to Puerto Rico are subject to a local excise tax that increases the cost of items purchased in Puerto Rico. In general the computation of the tax for merchandise and/or articles arriving from the United States that will be sold, consumed, given away, and/or remain in Puerto Rico results in an effective tax rate of 6.6%.[69] This excise tax is a significant element of the tax burden on Puerto Rican individuals and businesses.

On the other hand, there are significant exemptions that apply to the excise tax, which reduces significantly the items subject to tax. The following items are exempt from the tax:[70]

1. Articles used exclusively for religious purposes by non-profit religious institutions or organizations, excepting those articles for personal use.
2. Frames and mountings for eyeglasses.
3. Articles carried on their persons by the deaf, blind or handicapped to supplement their deficiencies.

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68 As noted above, the excise tax generally is not imposed in the Puerto Rico foreign trade zones.

69 The tax is applied at a 5% rate to the taxable price in Puerto Rico, which means the cost in Puerto Rico plus 20% of the cost. In the case of importers, the cost in Puerto Rico means the sum of all costs (other than freight and insurance) plus 10% of the costs that are deemed to be for freight and insurance. The following table shows the calculation for importers:

Total cost (excluding transportation and insurance)	100%
Plus 10% for transportation and insurance	10%
Cost in Puerto Rico	110%
Plus 20% of Puerto Rico cost (110%X20%)	22%
Taxable price in Puerto Rico	132%
Rate of tax	5%
Effective tax rate	6.6%

70 Section 2015(b) of the Puerto Rico Internal Revenue Code.

4. Articles expressly designed to supplement the physical or physiological deficiencies of persons that are invalids, blind, disabled, cardiac, deaf, mute, deaf-mutes and the maimed.
5. Articles expressly designed to expedite the apprenticeship of the mentally retarded.
6. The clothing and shoes of children.
7. Fruit jellies and products, which have more than fifty percent (50%) fruits, vegetables and natural food as of the principal ingredient.
8. Pastry products processed on the basis of wheat or corn flour, or other cereals.
9. Table chocolates.
10. Home-made candies in small quantities.
11. Cotton candy, maize, crisp, and popcorn.
12. Ice cream and sherbets.
13. Foodstuffs
14. Soft drinks, except carbonated or gassy drinks.
15. Medicines
16. Books, magazines, newspapers, and publications for commercial, religious, and political promotion.
17. Combustible fuels.
18. Works of art when acquired by non-profit museums or non-profit galleries for the sole purpose of a permanent exhibit.
19. The following school supplies and materials: crayons, erasers, pencils, notebooks, coloring books, paste, and rulers to be used in the teaching and learning process.
20. Toilet soaps.
21. Toothpaste, including all dentifrices and toothbrushes.
22. Sanitary napkins, toilet paper and diapers for children.
23. Detergents.
24. Brooms and cleaning buckets.
25. Used merchandise that constitutes, in effect, part of change of domicile. "Change of domicile" shall mean all the articles and effects that usually make up part of the furniture of a household, excluding rugs, photographic equipment, electrical or fluid gas, and articles of jewelry.
26. Plaques that are to be placed on the gravestones of soldiers who died in active duty and veterans, which plaques are sent to their relatives by the Government of the United States of America.
27. Working shoes.
28. Pneumatic tools and equipment.
29. Coal used as an energy source.
30. Herbicides, pesticides, insecticides, fumigants and fertilizers.
31. Any machinery and equipment used in the transformation of coal into energy and in addition is used for the control of the environmental pollution.
32. Every article, which is taxed by any other law of the Commonwealth of Puerto Rico.

The Puerto Rican excise tax operates essentially in the same manner as a customs duty. In 2001, $29.1 billion in goods were imported into Puerto Rico and more than half of these goods were imported by the United States.[71] Importers of goods are required to declare and pay the excise time at the time they are introduced into Puerto Rico; thus, the tax is imposed before the imported good is sold. Large importers may elect to participate in a System for Bonded Importers, which is designed to reduce somewhat the burdens of complying with the requirements of the excise tax program.

The Puerto Rico excise tax is a hidden tax. Because it is paid at the time a good is introduced into Puerto Rico, the excise tax has the effect of increasing the cost of certain goods sold by more than 10 percent and this price increase is not transparent to the consumers who purchase the goods. Furthermore, because the excise tax may be difficult to monitor and control and because of the inefficient collection system used, it is difficult to tell whether goods that are sold have, in fact, been subject to the tax.[72]

US Federal Excise Taxes

Federal receipts for excise taxes reached $70 billion in 2004.[73] Currently, the Federal government collects excise taxes on various economic activities and transactions. For instance, the Federal government imposes excise taxes on ozone-depleting chemicals to discourage the use of such chemicals in manufactured goods. In addition, consumption of alcohol and tobacco are subject to excise taxes – so called 'sin taxes.'

The Federal government imposes certain excise taxes to fund specific transportation activities. The two largest Federal excise receipts are from aviation-related excises taxes (for the Airport and Airway Trust Fund) and gasoline excise taxes (for the Highway Trust Fund). These two components comprise nearly half of all excise tax receipts collecting approximately $13 and $20 billion per year, respectively.

Under current law, articles that are manufactured in Puerto Rico that come into the United States for sale are subject to whatever excise taxes apply to like items manufactured within the United States.[74] For example, the excise tax on tires would apply to tires manufactured in Puerto Rico and brought into the United States. All taxes collected on such items (minus an estimated amount for refunds and drawbacks) are deposited into the treasury of Puerto Rico.[75](See Appendix B for a detailed summary of Federal excise taxes and the agency that administers the tax.)

Puerto Ricans are subject to certain Federal excise taxes under current law. For example, for purposes of various environmental taxes (e.g., tax on ozone-depleting chemicals), Puerto Rico is treated as a state.

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71 *Welcome to Puerto Rico.* http://welcome.topuertorico.org/economy.shtml.

72 *Who Will Lower Taxes? Rosello or Acevedo Vila?* Puerto Rico Herald. October 21, 2004. http://www.puertorico-herald.org/issues/2004/vol8n43/CBWhoWillLower.shtml.

73 IRS, Statistics of Income, "Federal Excise Taxes Reported to or Collected by the IRS, ATF, and Customs Service, by type of Excise Tax, Fiscal Years 1997 to 2004."

74 Internal Revenue Code section 7652(a).

75 Internal Revenue Code section 7652(a)(3).

US Federal Distilled Spirits Excise Tax and Rum Cover Over

In general, a $13.50 per proof gallon excise tax is imposed on distilled spirits produced in or imported into the United States. The excise tax does not apply to distilled spirits exported to Puerto Rico.[76]

In addition, a special rule provides for the cover over (payment) to Puerto Rico and the Virgin Islands of $13.25 (through December 31, 2005) per proof gallon of the US Federal excise tax imposed on rum imported into the United States.[77] This cover over applies without regard to the country of origin of the imported rum. Thus, under current law, Puerto Rico receives excise tax payments from the United States for (1) rum produced in Puerto Rico and (2) rum produced in a location other than Puerto Rico or the Virgin Islands.

The rum cover is intended to bolster the treasuries of Puerto Rico and the Virgin Islands through a form of indirect entitlement support from the US Federal government.

D. Comparison of Tax Burdens of Puerto Rican Individuals Relative to US Citizens Residing in One of the Fifty States

It is interesting to examine how Puerto Rico compares to the 50 states in terms of total tax burden, taking into account Federal, State, and local taxes. While most Puerto Rican residents do not pay Federal income taxes, they do face substantial local tax burdens. These local burdens are so significant that, when combined with the Federal tax obligations, Puerto Rico faces one of the highest total tax burdens.

The following tax burdens are consistent with the methodology used by the National Tax Foundation in their analysis of state and Federal tax burdens. In general, tax burdens rely on aggregate data and are simply per capita taxes divided by per capita income. Federal individual taxes include income and employment taxes. State and local taxes include income, sales, and other licensing and excise taxes.

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[76] Section 5001(a)(1) of the Internal Revenue Code of 1986.

[77] Sections 7652(a)(3), (b)(3), and (e)(1) of the Internal Revenue Code of 1986.

Table 14 –Puerto Rico –
Combined Federal, State and Local Tax Burdens,
Estimated 2004

Individual Puerto Rico Tax Burdens	
Local individual income taxes only[78]	9.2 percent
Local individual income, excise, and license taxes	17.8 percent
US Federal and local individual income taxes[79]	21.4 percent
US Federal and all local taxes	30.0 percent

Table 14 shows estimates of taxes that Puerto Rican residents face. Based on data from the Economic Report of the Governor, the average local income taxes were approximately 9.2 percent. Adding excise and license taxes nearly doubles the local tax burden. Puerto Rico's overall local tax burden (combining income, excise, and license taxes) is 17.8 percent, which is considerably higher than the national average for the states of 10.0 percent.

Table 15 – Tax Burdens --
National Averages all Fifty States
Estimated 2004

State and Local Burdens	10.0 percent
Combined Federal, State and Local Burden	27.8 percent

Federal income taxes do not impose a significant burden since Puerto Rico residents are subject to Federal taxes on US source income only. However, the combined average Federal income and payroll taxes as well as local taxes in Puerto Rico exceeds the national average in the US, with Puerto Rico's average total tax rate of 30 percent compared to the US national average of 27.8 percent (See Table 15.)

[78] Tax receipt statistics for Puerto Rico are from the Economic Report to the Governor. The numbers include only individual income tax receipts, excluding all corporation and partnership income tax payments.
[79] Federal taxes include individual income taxes and payroll taxes. Federal income tax statistics are from the IRS, Statistics of Income.

Table 16 – Ranking Puerto Rico Tax Burdens Relative to the Fifty States Estimated 2004

Puerto Rico Ranks (based on the Tax Foundation 2004 Report)[80]	
Local individual income taxes only (Tied with Oklahoma)	39th
Local individual income, excise, and license taxes (Highest local burden, surpassing NY with 12.9 percent)	1st
US Federal and local individual income taxes (Lowest combined burden)	50th
US Federal and all local taxes (Between New York (32.3 percent and New Jersey (29.9 percent))	3rd

Table 16 displays the ranking of Puerto Rico relative to the standing of the fifty states, showing that the Puerto Rican excise tax system imposes substantial tax burdens on individuals. The tax burden pushes Puerto Rico into the top spot in terms of overall tax burden. If only individual income taxes were considered, Puerto Rico would rank 39th overall (tied with Oklahoma). However, total local taxes (including individual income, excise, and license taxes) pushes Puerto Rico's standing to first. With respect to total local tax burdens in the fifty states, New York has the highest local burden, with 12.9 percent. Despite the low Federal burden on Puerto Rican residents, Puerto Rico still maintains a substantial overall tax burdens relative to the fifty states, ranking 3rd overall.

[80] The Tax Foundation methodology compares per capita tax payments to per capital income. Income statistics rely on current Census population and per capita income estimates.

III. FULLY INCORPORATING PUERTO RICO INTO THE US FEDERAL TAX SYSTEM

A. Treatment of Individuals

1. Overview

In this section we discuss the effects on Puerto Rican residents of fully incorporating Puerto Rico into the US Federal tax system. For the majority of Puerto Rican residents, the effect of such a change would be to decrease their overall tax liability because of the availability of the refundable earned income credit and the child tax credit under the US Federal tax system. A limited number of high-income Puerto Rican residents would see a fairly dramatic increase in overall tax liability. For purposes of this analysis, we have assumed that there would be no adjustment to the level of Puerto Rican taxes imposed. Thus, the calculations in this section assume that Puerto Rican taxes remain constant and the US Federal tax system also fully applies to Puerto Rican residents.

As shown previously, current law disadvantages many Puerto Rican residents by subjecting them to US employment taxes but denying them the benefits of provisions designed to reduce the burden of these taxes for low-income taxpayers. Thus, most Puerto Ricans pay a higher marginal tax rate for Social Security and Medicare coverage than similarly situated US residents.

Irrespective of any decision generally made to incorporate Puerto Rico fully into the US Federal tax system, it can be argued that, at a minimum, Puerto Ricans should be entitled to tax benefits that approximate the benefits provided under current law to reduce the burdens of US Federal Social Security and Medicare taxes. This is because current law has the effect of requiring lower income Puerto Ricans to subsidize the Social Security and Medicare benefits provided to US residents.

2. Changes in the Distribution of Overall Tax Liability

The overall effect of fully incorporating Puerto Rico into the US Federal tax system would be to provide additional benefits in the form of refundable credits to the vast majority of Puerto Rican residents.

Table 17 presents estimates based on data from the Census Department's decennial Public Use Microdata Samples (PUMS) and current law tax provisions. (See Appendix A for a detailed description of the methods used to estimate Puerto Rican tax returns.) Based on these estimates, approximately 92.5 percent of all returns of Puerto Rican residents would either receive a tax refund or have no Federal income tax liability if Puerto Rico were fully incorporated into the US Federal tax system. The proportion of single and head of household returns that would either receive a refund or have no income tax liability is approximately 96.1 percent. Likewise, the proportion of married returns filing jointly that would either receive a refund or have no income tax liability is approximately 87.9 percent.

Table 17 – Cumulative Percent of Puerto Rican Returns With Refunds (or No Liability) Under the US Federal Tax System, by Filing Status and Income Class, 2004

	Single and Head of Household		**Married Filing Jointly**		**All Returns**
Adjusted Gross Incomes	**Returns**	**Cumulative Percent (Single and HOH, only)**	**Returns**	**Cumulative Percent (Married Returns, only)**	**Cumulative Percent (All Returns)**
Less than $5,000	**616,904**	63.8%	**323,804**	22.4%	45.5%
$5,000 to $10,000	**108,629**	75.1%	**75,719**	45.9%	62.2%
$10,000 to $15,000	**103,380**	85.8%	**83,064**	56.1%	72.7%
$15,000 to $20,000	**49,716**	90.9%	**55,790**	65.5%	79.7%
$20,000 to $25,000	**34,256**	94.4%	**51,097**	72.6%	84.8%
$25,000 to $30,000	**16,086**	96.1%	**36,908**	78.6%	88.4%
$30,000 to $35,000	**9,282**	-	**28,482**	83.0%	90.3%
$35,000 to $50,000	**16,961**	-	**56,248**	87.9%	92.5%
$50,000 to $100,000	**8,805**	-	**48,926**	-	-
$100,000 or more	**2,580**	-	**11,039**	-	-
Total	**966,599**	**-**	**771,077**	**-**	**-**

Table 18 shows the estimated average refund by income class and filing status. Two refundable credits, the earned income and the child tax credits, would provide a considerable benefit if Puerto Rico residents were required to file Federal returns.[81]

[81] See Appendix A for a description of the methodology used to estimate tax returns for Puerto Rico.

Table 18 – Estimated Average Tax Liability or Refund, Incorporating Puerto Rican Residents Into US Federal Tax System by filing status and income class, 2004

	Single and Head of Household		Married Filing Jointly	
Adjusted Gross Incomes	**Returns**	**Tax or Refund**	**Returns**	**Tax or Refund**
Less than $5,000	616,904	**-2,660**	323,804	**-206**
$5,000 to $10,000	108,629	**-3,720**	75,719	**-2,405**
$10,000 to $15,000	103,380	**-2,970**	83,064	**-3,508**
$15,000 to $20,000	49,716	**-2,230**	55,790	**-2,969**
$20,000 to $25,000	34,256	**-1,490**	51,097	**-2,358**
$25,000 to $30,000	16,086	**-1,040**	36,908	**-1,716**
$30,000 to $35,000	9,282	**-390**	28,482	**-1,427**
$35,000 to $50,000	16,961	**1,180**	56,248	**-837**
$50,000 to $100,000	8,805	**12,450**	48,926	**1,432**
$100,000 or more	2,580	**84,210**	11,039	**28,320**
Total	**966,599**		**771,077**	

For purposes of these estimates, it is assumed that taxes paid to the Puerto Rican government are treated as State taxes paid in the US.[82] In other words, taxes paid to Puerto Rico would be included as an itemized deduction for those taxpayers who choose to itemize. All other taxpayers are assumed to claim the standard deduction amount. The results of this analysis indicate that most Puerto Rican taxpayers would not have sufficient deductions to use the itemized schedule. For those taxpayers who are assumed to itemize deduction, the simulation relies on average itemized deductions from US taxpayer returns; thus, this analysis does not consider the actual effect of certain provisions of the US Federal tax system, such as home mortgage interest deductions and charitable deductions.

It is important to note that the above estimates represent static estimates. In other words, they do not include any assumptions about behavioral responses. The actual revenue effect of this change would differ because taxpayers are assumed to minimize their tax liability and maximize their refund as allowed under current law.

In practice, it is likely that some taxpayers may be reluctant to file US Federal tax returns, even those eligible to claim a substantial refund. Further, to the extent that income is underreported

[82] For purposes of these calculations, it is assumed that Puerto Rican tax liability of individuals is unchanged.

in Puerto Rico, compliance may improve due to the availability of refundable tax credits. Because this analysis does not incorporate any assumed behavioral response, neither of these possible behavioral responses are taken into account.

The following sections discuss in greater detail the effects of making Puerto Rican residents eligible for either the refundable earned income tax credit or the refundable child tax credit.

3. Extending the Earned Income Tax Credit to Puerto Rican Residents

In addition to reducing the income tax burden on taxpayers, the earned income tax credit operates to reduce the overall US Federal tax burden imposed on US taxpayers. If the US Federal tax system is extended to Puerto Rican residents, a substantial number of Puerto Rican taxpayers would benefit from the earned income tax credit.

As previously noted above, under current law, lower income Puerto Rican residents are generally required to pay the full employee share of payroll taxes for Social Security and Medicare coverage. In contrast, the average lower income US taxpayer will receive refundable earned income tax credits to partially offset his or her full share of Social Security and Medicare payroll taxes. While the amounts dedicated to the Social Security and Medicare trust funds are equal, the average lower income US taxpayer has a reduced burden for these taxes by the operation of the earned income tax credit.

We estimate that nearly 950,000 Puerto Rican returns would benefit from the earned income tax credit – they would receive, on average, $1,155 of earned income tax credit.[83] Of this total, nearly 496,000 would be single Puerto Rican residents and 451,000 would be married Puerto Rican residents. Thus, Puerto Rican taxpayers with income below $35,000 generally would be entitled to some portion of the refundable earned income tax credit.

Table 19, below, provides our estimates of the total and the average per taxpayer earned income tax credit that would be available if Puerto Rican residents were filing US Federal income tax returns for 2005. We estimate that eligibility for the earned income tax credit would deliver $1.1 billion in refundable tax credits to Puerto Rican residents filing US Federal income tax returns for 2005.

[83] Appendix A contains a description of the methodology used to estimate the earned income tax credit for Puerto Rican residents contained in this section.

Table 19 – Estimated Distributional Impact of Extending the Earned Income Tax Credit to Puerto Rican Residents (2005)

Income Class	Estimated US Returns Filed By Puerto Ricans		Total Earned Income Credits	Average EIC	
	Single and HOH	Married		Single and HOH	Married
Less than $5,000	332,829	202,541	$300,949,449	$503	$670
$5,000 to $10,000	93,201	69,770	$207,774,497	$782	$1,908
$10,000 to $15,000	38,117	59,047	$284,414,579	$2,429	$3,206
$15,000 to $20,000	14,014	38,034	$158,094,617	$2,781	$3,129
$20,000 to $25,000	10,359	34,931	$96,050,713	$1,881	$2,190
$25,000 to $30,000	4,515	26,252	$37,686,333	$1,001	$1,263
$30,000 to $35,000	2,621	20,866	$8,613,040	$363	$576
Total	**495,657**	**451,441**	**$1,093,583,226**	–	–

Table 19 shows that the largest average credit would be available for Puerto Ricans in the $15,000-$20,000 income range (for single and head of household returns) and the $10,000-$15,000 income range (for married taxpayers). The largest total amount of the earned income credit would be paid to Puerto Rican taxpayers with less than $5,000 of income.

Tables 20 and 21 show the distribution of the earned income tax credit (by income class) for Puerto Rican taxpayers with various dependents. Table 20 provides this information for Puerto Rican taxpayers filing single and head of household returns and Table 21 provides this information for married Puerto Rican taxpayers filing joint returns.

Table 20 – Distribution, by Income Class and by Number of Dependents, of Earned Income Tax Credits for Puerto Rico Residents Filing Single and Head of Household Returns (Credit in Millions of Dollars)

	Estimated Single and HOH Returns					
Income Class	**No Dependents**		**One Dependent**		**Two or More Dependents**	
	Returns	Total Credit	Returns	Total Credit	Returns	Total Credit
Less than $5,000	194,605	$37.6	60,479	$51.4	77,745	$77.7
$5,000 to $10,000	70,215	$17.6	13,815	$29.8	9,171	$27.5
$10,000 to $15,000	9,755	$1.2	13,859	$35.1	14,503	$58.9
$15,000 to $20,000	-	-	7,262	$14.9	6,752	$24.1
$20,000 to $25,000	-	-	5,210	$6.5	5,149	$13.0
$25,000 to $30,000	-	-	2,067	$0.9	2,448	$3.6
$30,000 to $35,000	-	-	1,620	$0.1	1,001	$0.5
Total	**274,576**	**$56.3**	**104,312**	**$138.7**	**116,769**	**$205.2**

Table 20 shows that Puerto Rican individual and head of household taxpayers would be eligible to receive an estimated $400.2 million in tax benefits from the earned income credit (at 2004 levels). The largest share ($205 million) of the earned income tax credit would be provided to taxpayers with two or more dependents. An estimated 99% of the credits would be delivered to single and head of household taxpayers with adjusted gross income below $25,000. Furthermore, the distribution of the earned income tax credit is heavily weighted toward the lowest income levels with fully 84% of the credit being provided to single and head of household taxpayers with incomes below $15,000.

Table 21 – Distribution, by Income Class and by Number of Dependents, of Earned Income Tax Credits for Married Puerto Rico Residents Filing Joint Returns (Credit in Millions of Dollars)

	Estimated Married Returns					
Income Class	**No Dependents**		**One Dependent**		**Two or More Dependents**	
	Returns	Total Credit	Returns	Total Credit	Returns	Total Credit
< $5,000	75,953	$14.7	47,083	$40.0	79,505	$79.5
$5,000 to $10,000	22,451	$5.6	17,373	$37.5	29,946	$89.8
$10,000 to $15,000	6,141	$0.7	19,207	$48.6	33,699	$140.0
$15,000 to $20,000	-	-	14,289	$29.3	23,745	$89.8
$20,000 to $25,000	-	-	12,712	$15.9	22,219	$60.6
$25,000 to $30,000	-	-	8,786	$4.0	17,466	$29.2
$30,000 to $35,000	-	-	7,201	$0.2	13,665	$7.8
Total	104,545	$21.0	126,651	$175.5	220,245	$496.8

Table 21 shows that, in the case of married taxpayers filing joint returns, an estimated $693.3 million of credits would be provided. In addition, it is estimated that 68% of the tax benefit ($456.4 million) from the earned income tax credit would be provided to Puerto Rican married taxpayers with incomes less than $15,000 and 94% would be provided to such taxpayers with incomes less than $25,000.

4. Extending the Child Tax Credit to Puerto Rican Individuals

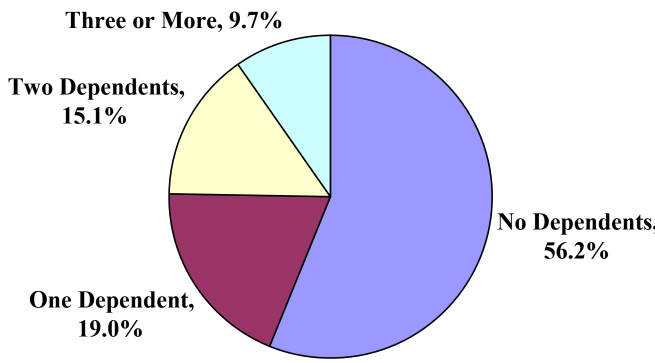
Based on recent Census population statistics, there are approximately 1.1 million children under the age of 18 living in Puerto Rico. These children represent approximately 29 percent of the 3.9 million Puerto Rican residents.

Under current US Federal tax law, Puerto Rican residents with three or more eligible dependents may file a Federal return to claim the child tax credit. This represents approximately 10 percent of the estimated Puerto Rican returns, assuming all residents filed a

Federal return. It is unclear what percentage of eligible Puerto Residents are currently filing Federal returns to claim the child credit.[84]

Extending the child tax credit to taxpayers would affect approximately an additional 32 percent of all returns, if Puerto Rican residents were able to file Federal tax returns. Currently, 42 percent of all Puerto Rican returns have dependent children under the age of 18 years.

Graph 11
Distribution of Estimated Puerto Rican Returns,
By number of dependents, 2004
(Source: Authors estimates based on the PUMS)



The following table (Table 22) shows the distribution of dependent by adjusted gross income. As the data in the table indicated, an estimated 604,000 children live in homes with adjusted gross incomes less than $5,000. Extending the child credit would increase considerably household incomes for those low income families.

[84] Based on available information, the SOI reported about 279,279 Puerto Rican residents filed a Federal return in 2001. According to this information, the IRS issued 226,628 refunds for individual taxpayers. Based on estimates from the PUMS, approximately 163,200 returns have three or more children, so it is unclear what percentage actually filed returns to claim the credit.

Table 22 – Estimated Number of Dependents by Adjusted Gross Income For Puerto Rican Residents, 2004

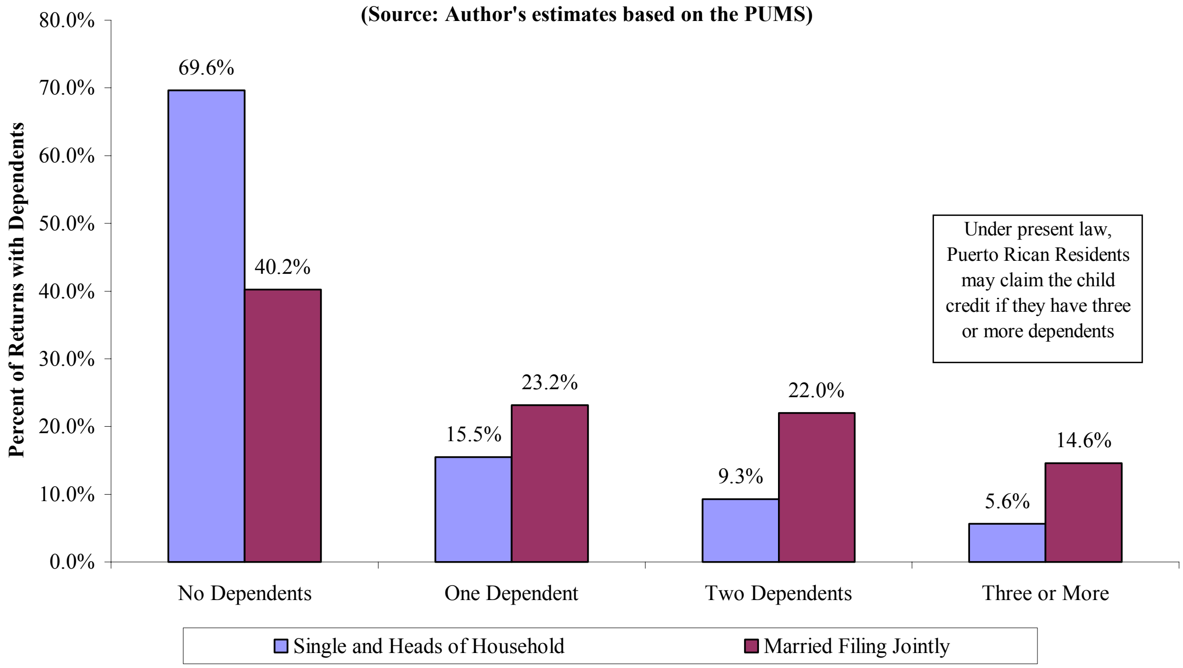
Adjusted Gross Income	No Dependents	One Dependent	Two Dependents	Three or more Dependents
< $5,000	547,890	158,122	97,987	78,375
$5,000 to $10,000	107,441	32,698	28,804	14,443
$10,000 to $15,000	103,315	34,102	29,685	18,912
$15,000 to $20,000	52,786	22,057	18,776	11,862
$20,000 to $25,000	39,696	18,220	17,420	10,001
$25,000 to $30,000	21,995	10,994	13,686	6,319
$30,000 to $35,000	14,148	8,900	9,669	5,047
$35,000 to $50,000	28,767	16,759	18,301	9,382
$50,000 to $100,000	20,612	13,707	16,294	7,118
$100,000 or more	5,724	3,128	2,981	1,783
Total	**942,374**	**318,687**	**253,603**	**163,242**

Graph 12 shows the distribution of dependents according to filing status. Approximately 70 percent of single filers have no dependents. The converse is true for the estimated married filers. Approximately 60 percent of married returns have dependent children.

Graph 12

Estimated Distribution of Puerto Rican Returns, by the Number of Dependents and Filing Status, 2004

(Source: Author's estimates based on the PUMS)



The availability of the child tax credit would have the effect of reducing (or eliminating) potential US Federal tax liability for many Puerto Ricans if Puerto Rico is fully incorporated into the US Federal tax system. Although Puerto Ricans are not permitted to file US Federal tax returns to claim the refundable child tax credit for 3 or more dependents, it is unclear to what extent this credit is being utilized. Thus, the extension of the US Federal tax system to Puerto Rico would likely result in additional Puerto Ricans claiming this refundable credit. In addition, there are more than 500,000 Puerto Ricans with one or two dependents and many of these taxpayers would be permitted to claim the general child tax credit.

5. Comparison of Overall Tax Burden in Puerto Rico Relative to the States

As shown in previous sections, most Puerto Rican residents would benefit greatly from inclusion in the US individual income tax system.

The following analysis (Table 23) compares the tax effects of a hypothetical taxpayer (1) under current law, (2) as a resident of Puerto Rico but fully subject to the US Federal tax system, (3) as a resident of New York State, and (4) as a resident of Mississippi. For purposes of the comparison, we consider a single taxpayer with two dependents filing as a head of household. The second column estimates the tax liability that the taxpayer would face in Puerto Rico under current law. The third column estimates the tax liability for a Puerto Rico resident if Puerto Rico were fully incorporated into the US Federal tax system. The advantage to lower income Puerto Rican taxpayers of filing a US Federal tax return is significant, as the tax liability becomes a tax refund due in large part to the earned income and the child credits.

Table 23 – Total Taxes for Residents of Puerto Rico Under Commonwealth Tax Laws and if Puerto Rico is Fully Incorporated into the US Federal Tax System – Compared to Residents of New York and Mississippi

Assume Taxpayer:	Files as a Head of Household Has two children Has $20,000 of wage income			
Residence	**Puerto Rican Resident Current Law**	**Puerto Rico, Included in US Federal Tax System**	**New York**	**Mississippi**
State Tax Liability[85]	$792	$792	$992	$850
Federal Tax Liability or Credit (Includes both the Child Credit and EIC)	– 0 –	($4,700)	($4,700)	($4,700)
Total State and Federal Tax – (Refund) or Liability	$792	($3,908)	($3,708)	($3,850)

Columns four and five calculate the state tax liability in New York and Mississippi for the same hypothetical taxpayer. Despite higher state taxes in both states, the benefits of the Federal tax credits dominate the overall tax situation, providing a refund in both cases.

The above analysis is significant because it would apply to a majority of taxpayers in Puerto Rico. Based upon the analysis of the decennial (2000) Public Use Microdata Samples (PUMS), approximately 80 percent of all estimated Puerto Rican returns (married filing jointly, head of household and single) have incomes less than $20,000. Therefore, fully incorporating Puerto Rico into the US Federal tax system would extend a significant tax benefit to lower income residents and would have the effect of reducing their overall tax burden (assuming no changes in Puerto Rican tax levels).

6. Compliance levels in Puerto Rico

Compliance levels in Puerto Rico have historically been low. The 1996 GAO report noted that a report in the 1990's prepared by the Puerto Rican Treasury indicated that noncompliance in Puerto Rico was significantly greater than noncompliance with the US Federal tax system.[86] Efforts to improve compliance levels have met with some success, but it is generally accepted that compliance with the Puerto Rican tax laws is still lower than compliance with the US Federal tax laws; some have suggested that the noncompliance rates in Puerto Rico are

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[85] All estimates for State and Federal taxes rely on the current 2004 tax forms. Estimates simulate the tax liability for a taxpayer with only wage and salary income.

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

somewhere in the 10-15 percent range, while others believe that the range may be 13-20 percent.[87] On the other hand, recent studies have reported mixed findings on the size and rate of increase of the underground economy. One study suggested that the so-called "underground economy" in Puerto Rico is not "unusually large" nor has is grown rapidly since 1980.[88] However, more recent work indicates that the underground economy has been increasing its share of GNP and reached 23.9% of GNP in 2003.[89]

If Puerto Rico is fully incorporated in the US Federal tax system, compliance levels of Puerto Rican individuals will likely improve somewhat. First, Puerto Rican individuals may begin to file returns to become eligible for refundable Federal tax credits, such as the earned income tax credit. This is particularly likely to happen if the size of the Federal tax credits offset any Puerto Rican income taxes that would otherwise be payable. In addition, it is likely that there would be efforts made to educate Puerto Rican residents on the benefits of filing their US Federal returns.

Extending the US Federal income tax to Puerto Rican individuals may also make such individuals believe that they are more likely to be caught if they fail to file the appropriate tax returns. This can occur in part because there would be more than one agency with an interest in finding and eliminating tax noncompliance. Furthermore, individuals generally are likely to perceive the US Federal government to be a more efficient tax collector than the Puerto Rican government and individuals may not want to risk the consequences of failing to comply with the US Federal filing requirements. In general, individuals who file Federal returns are more likely to file their Puerto Rican tax returns as well.

B. Treatment of Businesses

1. Domestic Corporation Status and Consequences

Historically, companies doing business in Puerto Rico have had an advantage for US Federal tax purposes relative to companies doing business in one of the 50 States. This advantage led certain US corporations to establish so-called "possessions corporations" that operate businesses that are, in essence, exempt from US Federal taxes.

With the expiration of the section 936 and 30A credits, the evidence suggests that many US corporations doing business in Puerto Rico are shifting to controlled foreign corporation (CFC status). Using a CFC structure generally enables a US corporation to avoid current US Federal income tax on certain earnings from Puerto Rican business operations. It is interesting to note that, with the phase out of these credits, evidence suggests that US corporations are not withdrawing their business operations from Puerto Rico. During the years that the credits were available, some argued that the elimination of the credits would lead to the withdrawal of

87 Compliance problems are particularly acute with the current Puerto Rican excise tax system.

88 Bosworth, Barry and Collins, Susan M. *Economic Growth in Puerto Rico*. August 10, 2005 (Draft version 3). http://www.arts.cornell.edu/econ/seminars/collins.pap.pdf.

89 Valdez, Cynthia, Mariana Caram, and Ricardo Godoy, *The Informal Economy in Puerto Rico*, Center for International Development, Heller School for Social Policy and Management, Brandeis University, Draft Paper, October 2005.

businesses from Puerto Rico. So far, this behavior does not appear to be occurring to any significant extent; this suggests that there may be other reasons why corporations will continue to maintain their Puerto Rican business operations. The deferral of current taxes available in the case of a CFC is likely to be a significant factor in the decision to maintain current business operations in Puerto Rico.

If Puerto Rico were fully incorporated in the US Federal tax system, then the income of a US corporation's Puerto Rican operations would be included in gross income for US tax purposes. Thus, the benefits of tax deferral for US corporations would be lost if Puerto Rico is fully incorporated into the US Federal tax system. On the other hand, losses from Puerto Rican operations could be used to offset income from US operations.

In addition, by fully incorporating Puerto Rico into the US Federal tax system, the deduction for income attributable to domestic production activities would become available with respect to the Puerto Rican operations.[90] The deduction equals 9 percent (3 percent for 2005 and 2006 and 6 percent for 2007 through 2009) of the lesser of the taxable income of the business or the qualified production activities income of the business for the year. The deduction cannot exceed 50 percent of the business's W-2 wages.

For example, assume that a company manufactures widgets in Puerto Rico. In 2006, the company's taxable income is $1.5 million; the qualified production activities income equals $2.0 million; and W-2 wages equal $3.5 million. The domestic production activities deduction would be 6% times $1.5 million ((the lesser of $2.0 million or $2.5 million), but not more than 50% of $3.5 million). Thus, the deduction would equal $90,000.

In addition to the domestic production deduction, other specific tax incentives would become available to companies with Puerto Rican business operations. For example, the Work Opportunity Tax Credit and Welfare-to-Work Credit would become available to provide tax credits to employers who hire individuals in specific targeted groups. The Work Opportunity Tax Credit equals 40 percent of the first $6,000 of qualified first-year wages for the hiring of an individual in a targeted group (e.g., qualified veterans, high risk youth, qualified food stamp recipient, and qualified SSI recipients). The Welfare-to-Work Tax Credit equals 35 percent of first year wages (up to $10,000) and 50 percent of second-year wages (up to $10,000) for the hiring of long-term family assistance recipients.

Certain businesses would be eligible under section 179 for expensing for up to $100,000 for certain tangible property or computer software.

The low-income housing credit would become available to the owners of qualified low-income rental housing. The availability of this credit would provide incentives for the development of low-income housing in Puerto Rico. The credit equals the applicable percentage (60 percent present value for new buildings and 30 percent present value for other buildings) of the qualified basis for each eligible low-income housing building.

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[90] Internal Revenue Code, section 199.

The decision of any individual company to continue to do business in Puerto Rico if Puerto Rico is fully incorporated into the US Federal tax system will be influenced by a variety of factors, including tax consequences (both within Puerto Rico and at the US Federal level), the costs of moving business operations out of Puerto Rico, the availability of alternative suitable locations, and the easy availability of labor and goods needed for the business operation. There is evidence with respect to the section 936 credits that the decision to continue or expand operations in Puerto Rico was made primarily because of the availability of the credits and that the earnings did not inure to the Puerto Rican economy or to Puerto Rican residents in the form of higher wages**.** Certain special tax provisions in the current US Federal tax system, such as the empowerment zone and enterprise community provisions might be extended to Puerto Rico (see the discussion below). However, the extension of special tax provisions to Puerto Rico must be carefully considered in light of the costs to the US Federal government and whether such provisions will in fact help to grow the Puerto Rican economy or will, like the section 936 credits, provide tax benefits that do not inure to Puerto Rico or its residents.

Fully incorporating Puerto Rico into the US Federal tax system would eliminate the distortions in economic decision making that results under current law. A US corporation would, from a US Federal tax perspective, be indifferent as to whether a business operation should be located in Puerto Rico or in a State. On the other hand, given that current law creates an incentive for investments in Puerto Rico compared to the States, it is possible that such a change in the law will reduce the likelihood that a business will be located in Puerto Rico. The possible consequences of this effect and the potential effect that such a change might have on the Puerto Rican economy is beyond the scope of this paper and would be influenced, in part, by incentives that the Puerto Rican and US governments might provide to ease the transition and continue to encourage business to locate in Puerto Rico.

2. Possible Transition Relief

Two significant transition issues are presented from a business tax perspective if Puerto Rico is fully incorporated into the US Federal tax system. First, there is an issue as to the appropriate treatment of existing unrepatriated earnings of US parents of Puerto Rican subsidiaries. Several approaches could be taken. For example, the unrepatriated earnings could be deemed to be earned or repatriated in the year for which the US Federal tax system first fully applies. This approach would maximize the income inclusion of either the Puerto Rican subsidiary or the US parent in the first year the Federal tax system applies with respect to the Puerto Rican operations. Alternatively, this previously untaxed income could be deemed to be earned or repatriated ratably over a period of time in order to smooth the income inclusion. Finally, these earnings could be taxed only when they are actually distributed to the US parent, thereby allowing a permanent deferral as long as they are not repatriated. This third approach would also require ordering rules to address the extent to which repatriated earnings are deemed to be attributed to previously untaxed earnings.

The second transition issue relates to the potential disruptions that may occur when Puerto Rico is fully incorporated into the US Federal tax system. Thus, certain transition relief could be provided to ease the effects of potential increases in tax liability for business operations and to give the Puerto Rican government time to assess any specific legislative responses it may wish to enact (e.g., altering the incentives provided to businesses operating in Puerto Rico) by providing some form of transition relief to Puerto Rican businesses that become subject to the US Federal tax system. This transition relief could take the form of special deductions or tax credits that apply for a temporary period to companies that had existing business operations in Puerto Rico. This transition relief would have to be narrowly crafted to ensure that it is not open to abuse and could be constructed so that the transition relief is phased out over a period of time. The down side of such transition relief is that there will be ongoing pressure to extend or increase the amount of relief that is provided, which would undercut the intent of fully including Puerto Rico in the US Federal tax system.

4. Possible Enterprise Zone Status

If Puerto Rico is fully incorporated into the US Federal tax system, consideration could be given to extending certain existing tax benefits to Puerto Rico. For example, US empowerment zone or enterprise community status could be extended to Puerto Rico. Under current law, there are specific tax incentives that are available to 40 designated empowerment zones, 95 enterprise communities (65 in urban areas and 30 in rural areas), and 40 renewal communities (at least 12 of which are in rural areas). Each of these tax incentive regimes has different rules and different tax incentives. The empowerment zone provisions generally provide the most significant tax incentives, including (1) a 20 percent wage credit for the first $15,000 of wages paid to a zone resident who works in the empowerment zone;[91] (2) additional section 179 expensing ($35,000) for qualifying zone property;[92] (3) expanded tax-exempt private activity bond rules to finance qualifying facilities in empowerment zones; (4) ability to roll over capital gain from the sale or exchange of any qualified empowerment zone asset held for more than one year;[93] and (5) an increased exclusion (60 percent) of gain from the sale of qualified small business empowerment zone stock held for more than five years).[94]

5. Rum Cover Over

If Puerto Rico is fully incorporated in the US Federal tax system, the current-law rum cover over could be eliminated and Puerto Rico could be treated in the same manner as the states for purposes of the Federal tax on alcohol. Some have argued that the current- law rum cover over has the effect of a direct appropriation to Puerto Rico that is not earmarked for any specific purpose. By including Puerto Rico in the US Federal tax system, this benefit would be eliminated. The US Federal government could return an equivalent amount of money to the Puerto Rican government through a direct appropriation, which would not be determined by reference to an artificial calculation that bears no relation to the needs of the Puerto Rican government.

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[91] Internal Revenue Code section 1396(b).
[92] Internal Revenue Code section 1397A(a).
[93] Internal Revenue Code section 1397B.
[94] Internal Revenue Code section 1202(a)(2).

C. Overview of Potential Static Revenue Effects

1. In General

This section presents a brief analysis of the potential revenue effects of the extension of the US Federal income tax system to Puerto Rico. This analysis is generally limited to a qualitative discussion of how extending the US Federal tax system to Puerto Rico would affect US Federal tax receipts. Thus, it does not take into account any potential changes in Federal payments to Puerto Rico that might occur as a result of the change in tax treatment of Puerto Rican individuals and businesses. Furthermore, it generally does not consider the potential effects on Puerto Rican tax receipts or on the Puerto Rican economy.

For purposes of this analysis, it is assumed that the Puerto Rican government does not respond to equalize the overall Federal/Puerto Rican tax burden of individuals and does not respond with tax or other incentives to reduce potential increases in tax liability of corporations doing business in Puerto Rico.[95]

While these assumptions are helpful to isolate the potential static revenue effects that might occur if Puerto Rico were fully incorporated in the US Federal tax system, it is likely that individual taxpayers, affected companies, and the Puerto Rican government would indeed respond to such a change, particularly with respect to businesses that might consider moving operations outside of Puerto Rico in response to the change.

2. Potential Effects on Individuals

Approximately 90 percent of Puerto Rican tax returns would be eligible for refundable Federal tax credits (e.g., EITC) that would reduce or eliminate any potential Federal tax liability that would be due if Puerto Ricans are required to file Federal tax returns. As a result of these Federal tax credits, the vast majority of Puerto Ricans would actually have a reduced overall tax liability if they are subject to US Federal income tax. Thus, Federal tax revenues would be reduced to the extent of these refundable tax credits.

For middle or upper income taxpayers, extending the US Federal income tax system to Puerto Rico will result in an increase in Federal tax revenues because the individuals will not be entitled to any refundable Federal tax credits. These taxpayers would likely be able to claim itemized deductions for their Puerto Rican taxes, which will mitigate somewhat the added burden of the US Federal tax system. However, this component will result in a net revenue income in Federal tax revenues.

Some US persons who currently pay Puerto Rican income taxes and Federal income taxes (such as those US persons who are working in Puerto Rico) can claim a foreign tax credit for their Puerto Rican taxes paid. If Puerto Rico is fully incorporated in the US Federal tax system, these individuals would no longer be entitled to claim the foreign tax credit and would instead be eligible for the itemized deduction for state and local taxes. This may result in an increase in Federal tax liabilities.

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[95] However, see the discussion below of the possible effects of such a proposal on the Puerto Rican economy.

Overall, it is unlikely that incorporating Puerto Rico into the US Federal tax system would have a significant impact on US Federal tax receipts. There will be revenue effects that are, to a degree, offsetting, suggesting that the overall effect will not be large. Indeed, even if the only assumed effect were the extension of the refundable earned income credit to Puerto Rican residents, the overall revenue loss would be miniscule relative to total US Federal tax receipts.

Puerto Rican tax receipts may increase if Puerto Rico is fully incorporated in the US Federal tax system. It is anticipated that more individuals will become tax filers because they may be eligible for Federal refundable tax credits. This will have the effect of increasing the number of tax filers for Puerto Rico tax purposes, with a net increase in Puerto Rican government receipts.

3. Potential Effects on Businesses

If Puerto Rico is fully incorporated in the US Federal tax system, US-owned corporations and other businesses would face increases in current US Federal taxes. Puerto Rican operations would be treated as domestic business operations for Federal tax purposes, which would result in a net increase in Federal tax revenues.

The potential increase in Federal tax liabilities would be offset to the extent that corporations respond to the tax change by moving their business operations out of Puerto Rico to other countries, particularly low-tax countries. Such a move would not affect Federal tax revenues because these businesses are not subject to Federal tax under current law. Even after expiration of the section 936/30A credits, it is assumed that most US corporations will operate their Puerto Rican business operations through controlled foreign corporations. Thus, such a shift in business operations out of Puerto Rico would merely have the effect of reducing the Federal taxes that are presumed to be raised. On the other hand, if taxpayers shift their business operations out of Puerto Rico, there will be a reduction in Puerto Rican income taxes paid.

It is difficult to assess the extent to which companies would shift their business operations given the substantial costs involved in moving operations out of Puerto Rico. It is likely that a shift in operations would take place over a period of time, rather than in the short term. Furthermore, it is unclear whether any migration out of Puerto Rico that might occur would be offset by new investment both from the United States, from other countries, and within Puerto Rico. For example, the increased spending power of Puerto Rican residents that will occur if Puerto Rico is fully incorporated into the US Federal tax system might be one factor attracting new business to Puerto Rico.

IV. CONCLUSION

Despite a long history of special tax treatment for US corporations doing business in Puerto Rico, US Federal tax policy has had a limited effect on the Puerto Rican economy. These policies primarily provided relief from US Federal tax liability to a limited number of large US corporations. The evidence suggests that, over the long term, the policies ultimately offered piecemeal incentives that benefited a limited number of US firms and did little to stimulate investment by Puerto Ricans themselves. As a result, the past incentives did little to expand employment or increase the standard of living for residents of Puerto Rico.

After careful analysis of the economic evidence, it becomes clear that a unified tax policy is appropriate for Puerto Rico. If policymakers were to extend fully the US Federal tax system to Puerto Rico rather than continue piecemeal incentives, the goal of the previous policies – economic stimulation – has a greater possibility of being realized. This approach would make all US corporations operating in Puerto Rico domestic corporations, as well as Puerto Rican corporations.[96] In addition, Puerto Rican residents would report all Puerto Rican-sourced income for US Federal tax purposes.

This approach would address the regressive nature of the present system, specifically that residents with income derived from Puerto Rican sources are not subject to Federal income taxes, but their income is subject to Social Security and Medicare payroll taxes. Irrespective of any decision generally made to incorporate Puerto Rico fully into the US Federal tax system, it can be argued that, at a minimum, Puerto Ricans should be entitled to tax benefits that approximate the benefits provided under current law to reduce the burdens of US Federal Social Security and Medicare taxes. This is because current law has the effect of requiring lower income Puerto Ricans to subsidize the Social Security and Medicare benefits provided to US residents. Including Puerto Ricans in the US Federal individual income tax system means that the majority of people living and working on the island would benefit from the earned income and child tax credits and these refundable credits would reduce the number of Puerto Rican residents living in poverty (at minimal cost to the US Treasury) and generate considerable economic stimulus.

US corporations doing business in Puerto Rico would, in theory, face an increase in tax liability if the US Federal tax system were to apply fully to Puerto Rico. Whether such companies would move their business operations from Puerto Rico to another country is unclear given the substantial costs involved with such relocation and the fact that there would remain certain US Federal tax benefits, such as the deduction for domestic production activities that might reduce the actual US Federal tax liability.

[96] The analysis considers only the impact of applying Federal income tax laws to US corporations operating in Puerto Rico and to Puerto Rico residents with only Puerto Rican source income. A likely consequence of extending the US Federal tax treatment to Puerto Rico is that: (1) the Puerto Rican government would likely respond with changes in their own tax policies and (2) many US corporations operating in Puerto Rico may change their country of domicile or may move their operations from Puerto Rico.

While it is difficult to predict the precise behavioral response to extending the Federal tax system to US corporations operating in Puerto Rico, such a proposal would clearly shift the burden of US Federal taxes from individuals to businesses. Such an approach will increase the after-tax income of Puerto Rican residents (assuming no adjustment in Puerto Rican taxes by the Puerto Rican government). This approach would also reduce the distortions in corporate decision-making that have occurred in the past with the possessions tax credits.

Further a comprehensive approach to would eliminate the regressive nature of the present Federal tax treatment and would likely stimulate reforms in the Puerto Rican tax system.

As major tax reform proposals begin to emerge in the Congressional policy debate, it is important to recognize that past legislative action often addressed Puerto Rico as an afterthought. The time is right for the United States to address comprehensively the appropriate tax treatment of Puerto Rico. At a minimum, this appropriate tax treatment should not ask low-income Puerto Ricans to bear a disproportionate share of the tax burden for US employment taxes and should refrain from reinstating the past policies that contributed to distortions in economic decision making for businesses operating in Puerto Rico. Such an approach will increase the standard of living for Puerto Rican residents, which could lead to a path of growth and prosperity for the Puerto Rican economy.

Appendix A – Estimating the Impact of Fully Incorporating Puerto Rico into the US Federal Tax System for Individual Income Tax Purposes

The decennial (2000) Public Use Microdata Samples (PUMS) for Puerto Rico were used as the basis for estimating tax return units based on current US Federal income tax law.

There are three types of filing units, married filing jointly, single, and heads of household. For earned income tax credit purposes, the filings units collapse to two categories – singles (with and without dependents) and married couples (with and without dependents). In other words, the amount of the credit varies for non-married persons with/without dependents and married persons with/without dependents. For purposes of calculating the income tax liability, all three categories were used as separate tax rate schedules apply to each.

With respect to marital status for tax purposes, most married couples – independent of living arrangements – file jointly. The tax benefits evaporate for married couples filing separately, so for modeling purposes, we assume that the couple will minimize their tax burden.

Construction of the tax units relied on a detailed algorithm that uses both the household ID and the sequence number for that ID. Additional information was retained from the census record for each individual, so that dependency, age, and relationship status could enter into the filing status decision. The general steps used to create the tax units are as follows:

- The first program creates a composite, person-level extract that combines household and individual data into one record. There should be one record for each person in the PUMS file and that record contains all the household information.
- The second program produces a stand-alone household extract that is the main input to the program that generates returns. Tax units are created one household at a time. After reading in one household record, the program goes to the person-level file and loads into an array selected information for every person in the household.

Once every person in the household has been assigned to a tax unit (every household has at least one tax unit, by definition), the programs checks to see if they are required to file a Federal income tax return or not.

After creating the tax units, returns were tabulated according to earned income, filing status (dependent or non-dependent filer), age status, marital status, and for the presence of dependents (classes of 0, 1, or 2 or more dependents).

The corresponding earned income credits were applied to each class, based on their eligibility status.

Appendix B – Federal Excise Taxes

Excise Tax	Includes:	Administered by:
Retail Excise Tax	Luxury passenger vehicles (expired 1/1/2003) Dyed diesel fuels Special motor fuels Compressed natural gas Alcohol fuels Truck, trailer and certain tractors	IRS
Manufacturers Excise Tax	Gas guzzlers Tires Aviation gasoline Gasoline, gasoline used in gasohol, gasohol Diesel fuel, except for use in trains Aviation fuel other than gasoline Coal Vaccine taxes Sport fishing equipment Electric outboard motors, sonar devices Bows and arrows	IRS
Taxes on Facilities and Services	Telephone and teletypewriter services Air transportation Use of international travel facilities Transportation of property by air Taxes of policies issued by foreign insurers	IRS Customs
Taxes related to wagering	Certain wagering Occupational taxes	IRS
Environmental Taxes	Ozone-depleting chemicals Imported taxable products containing ozone-depleting chemicals	IRS
Taxes related to Private Foundations	Net investment income Other private foundation excise taxes Black Lung Benefit Trust	IRS
Taxes on Qualified Pension Plans	Failure to meet minimum funding standards Nondeductible contributions Excess contributions Prohibited transactions Failure to distribute minimum amount Reversion of qualified plan assets to employers Other transactions and other penalties	IRS
Taxes on Undistributed Income of Qualified	Real Estate Investment Trusts Regulated Investment Companies	IRS

Excise Tax	Includes:	Administered by:
Investment Entities		
Alcoholic Beverages	Distilled spirits Wine Beer	ATF
Tobacco Products	Cigarettes Cigars Chewing tobacco and snuff Cigarette paper and tubes Pipe tobacco	ATF
Firearms and Ammunitions	Pistols and revolvers Other firearms Ammunition	ATF
Other	Special Occupations Passenger transportation by water Use tax on heavy vehicles by use and weight	ATF IRS IRS

Appendix C – Subpart F Income and Branch Operations

Subpart F Income Calculation

Simplified Subpart F Income Calculation Worksheet A for inclusion on Information Return Form 5471
Gross foreign personal holding company income
Interest
Dividends
Royalties
Rents
Annuities
If gross foreign base company income and gross insurance income is less than 5% of total gross income and less than $1m, enter -0-
If gross foreign base company income is greater than 70% of total gross income, enter total gross income
Total adjusted gross foreign base company income (greater of gross foreign base company income plus gross insurance income and gross income for tax purposes)
Adjusted net foreign base income
Adjusted net foreign personal holding company income
Adjusted net foreign base company sales income
Adjusted net foreign base company service income
Adjusted net foreign base company shipping income
Adjusted net foreign base company oil-related income
Adjusted net full inclusion foreign base company income
Subpart F Income before adjustments
Adjusted net foreign base income
Adjusted net related persons insurance income
Adjusted net insurance income
International boycott income
Illegal bribes, kickbacks and other payments
Total subpart F Income
Pro rata share of income

Income Tax Calculation

Simplified Schedule 1120 Corporation **Income Tax Calculation**
Gross Sales
Cost of goods sold
Gross Profit (Gross Sales minus cost of goods sold)
Income Items (plus)
Domestic corporation dividends (subject to 70% deduction)
Interest
Gross Rents
Gross Royalties
Capital gains or net gains and losses
Other income
Deductions (minus)
Compensation of Officers
Salaries and Wages
Repairs and Maintenance
Bad debts
Rents
Taxes and Licenses
Interest expense
Charitable contributions
Depreciation
Other Deductions
Operating Loss Deductions (minus)
Taxable Income (Gross Profit + Income Items - Total Deductions – NOL)
Tax on Taxable Income reduced by:
Foreign Tax Credit
Possessions Tax Credit
Fuels Credit
General Business Credits
Tax Liability