PUERTO RICO, USA – A "FOREIGN" TAX HAVEN IN THE US BACKYARD

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This is a historic opportunity to redress an injustice that was made against the US Citizens of Puerto Rico in 1921, when Congress decided to treat Puerto Rico as a "foreign country" for tax purposes. While Congress approved the 1921 exclusion in order to promote economic development, this commendable objective has not been achieved in almost a century. Puerto Rico continues to fall behind all the states in the Nation, mired in economic, social and demographic stagnation for more than a decade.

Unfortunately, the 1921 tax exclusion that Congress established to help Puerto Rico has been transformed into a significant drain to the US Treasury, victim of well-documented transfer pricing abuses by the "Controlled-Foreign Corporations" (CFCs) in the Island. There is no economic or moral justification to allow a U.S. corporation to have tax savings of $22 million per employee in Puerto Rico.

This is the right moment to draft legislation to finally include Puerto Rico in the U.S. tax code, with all the responsibilities and privileges of US citizens. This historic change can be achieved by **deleting** Section 933 of the Internal Revenue Code, and **defining** corporations incorporated in Puerto Rico as U.S. Corporations, for tax and other purposes.

With Puerto Rico´s full inclusion in the tax code, Congress can stop transfer pricing abuses and create effective tax benefits that generate real jobs and promotes tangible investments in Puerto Rico through specific legislation that treat US citizens in the Island in a manner similar to other communities in the 50 states. There is a real opportunity to draft effective legislation for Puerto Rico that creates a direct link between each dollar of federal tax benefits to a job, similar to the Earned Income Tax Credit that have benefitted residents in the 50 states since 1975. In addition, Federal tax benefits to generate real investments in Puerto Rico can be designed similar to the provisions in Enterprise Zone acts and the Promise Zones legislative proposals of President Obama.

Bringing back Puerto Rico as a full partner into the federal tax system would carry significant benefits to the People of Puerto Rico and the US Treasury, but are not possible without your strong commitment to carry them through to the final budget agreement. As you know, there are formidable moneyed interests that benefit from using Puerto Rico as a tax heaven, and they would not give up the hugely inefficient tax deferral benefits without a fight. The almost 4 million disenfranchised US citizens in Puerto Rico count on your support to secure our equal rights and responsibilities.

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This brief describes the unexpected results of two Federal tax acts which have defined Puerto Rico´s tax identity since it became a U.S. territory in 1898. The first law – the Revenue Act of 1921 – classified Puerto Rico as a "foreign country" for tax purposes. The second piece – the Small Business Job Protection Act of 1996 Act – eliminated the main Federal tax incentive, known as Section 936, that the U.S. Congress used to promote new manufacturing jobs and investments in Puerto Rico until 1996.

What remained untouched after 1996 was Puerto Rico´s "foreign" tax label, which was embraced by former Section 936 firms in order to obtain the benefits of tax deferral, converting to Controlled Foreign Corporations (CFCs). Unlike the former Section 936 program, however, the CFCs in Puerto Rico do not have to create jobs and generate real investments to benefit from tax deferral, and the U.S. Treasury does not have formal indicators to measure their cost effectiveness. This brief takes a first step to restore

accountability and transparency for the CFCs in Puerto Rico, providing the evidence to assess growing CFC Federal tax benefits at a time of decreasing jobs and investments in Puerto Rico.

Section 1 – Controlled Foreign Corporations (CFCs) in Puerto Rico

Puerto Rico has been an unincorporated territory of the United States under the jurisdiction of the U.S. Congress since the Spanish-American War of 1898.[1] Although major U.S. taxes apply in Puerto Rico as in the 50 states, e.g. Social Security taxes, for income tax purposes the U.S. Congress has excluded Puerto Rico since 1921 from the definition of "United States".[2] As a result, although Puerto Rico belongs to the United States and most of its residents are U.S. citizens, the income earned in Puerto Rico is considered "foreign-source income" and Puerto Rico corporations are considered "foreign". This category includes the CFCs with a US parent entity, which are analyzed in this brief.

The 1921 Revenue Act also created the predecessor of the IRC Section 936, which became the preferred alternative to operate a US subsidiary in the Island because it possessed two ideal features of a tax haven: Puerto Rico-source income was spared 100% of the U.S. federal tax and it was subject to a minuscule P.R. tax, right inside the U.S. borders.[3]

U.S. electronic and pharmaceutical firms with significant intangible assets tried to maximize their tax benefits in Puerto Rico, engaging in transfer pricing practices which spawned important court cases and scathing U.S. Treasury reports. In order to curtail the abuses of Section 936 firms, Congress in 1993 tied tax benefits to payroll and depreciation expenses, in an effort to channel more of the Section 936 benefits to the U.S. citizens residing in Puerto Rico.

Finally, the U.S. Congress replaced Section 936 with a temporary Section 30A credit, and initiated a 10-year phaseout of existing 936 subsidiaries. This momentous decision created a massive conversion of Section 936 US corporations to CFC status, and left U.S. Treasury without a congressional reporting mandate and performance indicators to assess the tax effectiveness and efficiency of CFCs in Puerto Rico.

The CFC conversions have triggered a significant increase in CFC activity in PR, shown in tables 1 to 5:

- There was a **122 percent increase in the reported Earnings and Profits (E&P) of CFCs in Puerto Rico**, to $6.6 billion in 2008, which is the most recent year of available CFC data (table 1).
- The average tax rate of CFCs in Puerto Rico was 3.9% in 2008, **which was 10.2% lower than the average tax rate by CFCs operating in the world** in 2008 (table 2).
- The U.S. corporations with CFCs in Puerto Rico received in just three years **$3.5 billion of tax benefits,** relative to the 35% tax rate of U.S. domestic firms (table 3).
- There was a wide variation in tax rates across industries. **Manufacturing CFCs in PR had a 2.3% tax rate, compared to the 14.9% tax rate of CFCs in finance** (table 4).
- The distribution of the tax benefits of CFCs is most likely highly concentrated in a few specific firms with significant intangible patents, trademarks and copyrights. Congressional investigators found that one CFC reported $4 billion in profits, and provided 177 direct jobs, or $22.5 million per job.

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[1] The website www.puertoricoreport.com provides summaries of federal commissions that examined Puerto Rico´s territorial status subject to Congressional powers.

[2] IRC Sec 7701(a)(9) defines the term "United States" in a geographical sense to include "only the States and the District of Columbia." In contrast, *The Revenue Act of 1916* (Part III, Sec. 15), defines the word "State" or "United States" to include any Territory, the District of Columbia, Porto Rico, and the Phillippine Islands. *The Revenue Act of 1921* (Title I, Sec. 1), excludes Porto Rico and the Philippines from the definition of the "United States".

[3] See Joint Committee on Taxation, *An Overview of Special Tax Rules Related to Puerto Rico and an Analysis of the Tax and Economic Policy Implications of Recent Legislative Opinions*, (JCX-24-06), June 23, 2006.

IRS and Congressional investigations have started to uncover significant transfer pricing abuses that lie behind the growing trend in earnings of US CFCs in Puerto Rico. As early as 1997, the IRS designated Section 936 conversions to CFCs as a Tier I issue, with high potential compliance risks.[4] In 2011 IRS sent notices of deficiency to Medtronic for $958 million and to Boston Scientific for $452 million over their Section 936 conversions to CFC status.[5]

In 2012 the staff of the U.S. Senate Permanent Subcommittee on Investigations analyzed the complex layers of tax haven subsidiaries created by Microsoft to minimize its tax on sales of products manufactured in Puerto Rico and sold in the United States. According to the congressional report, in 2011 the CFC of Microsoft in Puerto Rico reported $4 billion in profits, and provided 177 direct jobs earning an average salary of $44,000 a year, or $22.5 million per person. This example shows the low ineffectiveness of a specific CFC in Puerto Rico. Ideally, the U.S. Treasury should conduct an in-depth examination of the whole program of CFC tax incentives in Puerto Rico, as was done of the Section 936 tax program.

Table 1: Assets, Receipts, Earnings & Profits, and Taxes of CFCs in Puerto Rico

Indicators	Years			% Change´04 -´08
$ in billion	´04	´06	´08	
Number of CFCs in PR	395	401	423	7%
Total assets	$25.9	$26.7	$31.4	21%
Total receipts	$17.2	$26.7	$27.7	61%
Earnings and profits (E&P) before income taxes	**$2.996**	**$2.756**	**$6.639**	**122%**
Income taxes	$0.265	$0.275	$0.262	0%
Average tax rate	**8.9%**	**10.0%**	**3.9%**	

Source: IRS Statistics of Income (SOI) Bulletin, "Controlled Foreign Corporations", Table 3, Summer 2008, Winter 2011, Winter 2013.
Note: Data are based on the SOI corporate sample. Since 2004 this sample is far more inclusive than earlier SOI studies of CFCs.

Table 2: Average tax rates of CFCs in PR and in other countries

Average tax rates	´04	´06	´08
CFCs in Puerto Rico	**8.9%**	**10.0%**	**3.9%**
CFCs in other countries	15.7%	16.4%	14.1%
Difference in tax rates	(6.8%)	(6.4%)	(10.2%)

Note: Average tax rate is defined as income tax divided by E&P before income taxes.
Source: IRS Statistics of Income Bulletin, "Controlled Foreign Corporations", Summer 2008, Winter 2011, Winter 2013.

Table 3: Tax benefits of operating in Puerto Rico as CFC, compared to operating as a US domestic firm, annually and average figures in latest 3 years.

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[4] See *Audit Guidelines Related to Section 936 Conversion Issues* in www.irs.gov.

[5] See *Puerto Rico Tax Break Shifts to Cayman Islands*, in www.bloomberg.com , and docket number 006944-11 in www.taxcourt.gov

	´04	´06	´08	Total, 3 yrs
Top US corporate tax rate	35.0%	35.0%	35.0%	
Minus: PR CFC average tax rate	**8.9%**	**10.0%**	**3.9%**	
Equals: tax rate advantage of PR CFCs over domestic US firms	26.1%	25.0%	31.1%	
Multiplied by: Earnings & profits of PR CFCs before income tax (millions)	$2,996	$2,756	$6,639	**$12,391**
Equals: Federal tax benefit of CFCs in Puerto Rico over domestic US firms (millions)	**$782**	**$689**	**$2,065**	**$3,536**

Note: Author´s calculation, based on data reported in IRS Statistics of Income Bulletin, "Controlled Foreign Corporations", Summer 2008, Winter 2011, Winter 2013.

Table 4: Average tax rates of CFCs in PR in 2008

Industrial sector	# of PR CFCs	Earnings and profits before tax ($million)	Average tax rate in 2008
Goods production (manufacture)	101	1,352	2.3%
Finance, insurance, real estate	69	426	14.9%
Distribution and transportation	108	259	37.6%
Services	105	4,550	1.4%
Other sectors	40	53	14.9%
Total	423	6,640	3.9%

Note: Average tax rate is defined as income tax divided by E&P before income taxes.
Source: IRS Statistics of Income Bulletin, "Controlled Foreign Corporations", Summer 2008, Winter 2011, Winter 2013.

Given the trend in Federal tax benefits received by CFCs operating in Puerto Rico, it is appropriate to assess how this Federal tax program has contributed to the economic well-being of the almost 4 million U.S. citizens in Puerto Rico. Measures of effectiveness and efficiency of the tax benefits of manufacturing CFCs are discussed in the next section of this brief.

Section 2 – Measuring the cost effectiveness of the CFCs in Puerto Rico

CFCs were introduced in 1921 in Puerto Rico "primarily to help U.S. corporations compete with foreign firms in the Philippines".[6] There is no question that for U.S. multinationals the benefits of tax deferral can be significant, since indefinite deferral of U.S. tax liability generates a complete tax exemption on the foreign-source income. As was shown in Section 1 of this brief, tax deferral is a powerful tax tool to enhance the financial capacity of U.S. multinationals to compete against all firms, especially the domestic U.S. firms that pay the 35% maximum federal corporate tax rate.

[6] Joint Committee on Taxation, JCX-24-06, op. cit., page 50.

However, utilizing the 1921 tax law criterion – "help U.S. businesses to compete in foreign countries against foreign firms" – is not appropriate for determining the CFC benefits in Puerto Rico for three reasons: the Island is a territory of the United States, almost all of its 3.7 million residents are U.S. citizens, and the 423 CFCs in Puerto Rico represent less than one percent of the 83,642 CFCs in the World.

Congress did introduced a different objective when it enacted Section 936 tax benefits for Puerto Rico, namely, "**to assist the U.S. possession in obtaining employment producing investments by U.S. corporations**."[7] In order to obtain a precise estimate of tax benefits per employee it is necessary to obtain firm-specific tax and jobs data, which is not available to the public.

An imprecise estimate of tax benefits per employee is obtained with U.S. Bureau of census data of manufacturing establishments in Puerto Rico, which are owned by CFCs and others. For example, in 2008 there were 2,064 manufacturing establishments with 106,132 employees in Puerto Rico, shown in Table 5. Estimates of the average CFC earnings before income taxes of manufacturing establishments range from $12,739 (if all jobs are assigned to the CFCs) to $25,477 per employee (if 50% of the jobs are assigned to CFCs) in 2008. **These averages, in contrast to the $22 million per job earned by Microsoft Puerto Rico in 2011, show that the distribution of the tax benefits of CFCs is most likely highly concentrated in a few specific firms with significant intangible patents, trademarks and copyrights.**

Table 5: Manufacturing Operations in Puerto Rico, Tax Benefits of CFCs and Jobs, 2008

Sources		2008
Census	Number of manufacturing establishments in PR	2,064
	Employees in manufacturing establishments	**106,132**
SOI	Earnings before income taxes of manufacturing CFCs (million)	$1,352
	CFC earnings before income tax per employee in manufacturing establishments in Puerto Rico	
	100% of jobs were in US CFCs	$12,739
	50% of jobs were in US CFCs	$25,477

Sources: (1) U.S. Bureau of Census, *County Business Patterns*, published annually. (2) Federal tax benefits estimated using IRS SOI Bulletin, "Controlled Foreign Corporations", published in even years.

Keeping Puerto Rico as a ¨foreign" country inside the United States undermines the U.S. federal tax base and creates unfair competition against local communities in the 50 states. For example, in 2010 the Puerto Rico government imposed a 4% **excise** tax on CFCs in PR in order to pay for a significant reduction in income taxes at the local level. Normally, excise taxes cannot be used as foreign tax credits that reduce the U.S. tax liability dollar for dollar. However, in the case of the Puerto Rico´s 4% excise tax on the US CFCs, the IRS took the position that it would not challenge if US corporations claim a U.S. foreign tax credit. In contrast, taxes imposed in the 50 states can be deducted when calculating federal income tax, provided they are attributable to the conduct of the corporation's business. **Effectively, the U.S. Treasury subsidized Puerto Rico´s 4% excise tax increase almost dollar for dollar. This tax expenditure is not available in the 50 states.**

How do these estimated federal cost estimates compare to another Federal credit that is directly linked to job creation, namely, the Earned Income Tax Credit (EITC), is discussed in the next section of this brief.

Section 3 – Incorporating Puerto Rico residents into the Federal Income Tax System and I.R.C. Section 933

[7] Joint Committee on Taxation, JCX-24-06, op. cit., page 50.

Congress in 1917 granted U.S. citizenship to individuals born in Puerto Rico. Thus, a person born in Puerto Rico is subject to the U.S. tax laws. However, section 933 of the IRC exempts from U.S. taxation the Puerto Rico-source income obtained by bona fide residents of Puerto Rico. Some observers have expressed the opinion that the residents of Puerto Rico are better off because Federal income tax laws do not apply in the Island. This opinion is not correct for two reasons:

1) The Federal income tax provides job incentives that are lacking in Federal direct spending programs. For example, the exclusion of Puerto Rico residents from the Federal income tax has prevented almost 60 percent of working families from receiving the Federal Earned Income Tax Credit (EITCs). The Federal income tax could be used as an effective tool to increase Puerto Rico´s 40 percent labor force participation rate, which is the lowest in the United States.[8]

2) The introduction of the Federal income tax, with the administrative support of the Internal Revenue Service, would increase the effectiveness of the local tax administration in Puerto Rico. Local tax auditors in the Department of Hacienda have experienced a 50 percent decrease in the last six years, at the time when the underground economy in Puerto Rico has grown to about 25 percent of the market economy.

Previous congressional studies have already shown the benefits of participating in the Federal tax system. For example, GAO in 1996 found that if IRC tax rules are applied to residents of Puerto Rico, the average EITC earned by eligible taxpayers would be $1,494, taxpayers would owe around $623 million in federal income tax before taking into account the earned income tax credit (EITC), and the aggregate amount of EITC would total $574 million. About 59 percent of the population filing individual income tax returns would earn some EITC, and 41 percent of the households filing income tax returns would have positive federal income tax liabilities, greater than the EITC received. Thus, the introduction of the Federal income tax in Puerto Rico for individuals would generate a wealth transfer from higher-income individuals who would pay Federal income taxes, to lower-income earners who would receive a refundable credit.[9]

CONCLUSION

This brief demonstrated the importance of incorporating Puerto Rico back into the United States for income tax purposes. This fundamental change is necessary to protect the U.S. tax base from the abuses in the ill-defined CFC regime in Puerto Rico. Furthermore, the inclusion of individual taxpayers into the Federal income tax regime would allow families in the Island to receive significant incentives that are likely to increase Puerto Rico´s low labor force participation rate., and restore economic growth in the Island.

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[8] See Caribbean Business, "*The real story behind Puerto Rico's low 40.6% labor-participation rate*," May 10, 2011.

[9] Government Accountability Office, Tax Policy *Analysis of Certain Potential Effects of Extending Federal Income Taxation to Puerto Rico*, GGD-96-127.

APPENDIX – Notes to Drafters of Bill to Include Puerto Rico as Part of the United States

26 §7701. Definitions

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

> **...**
>
> **(4) Domestic**
>
> The term "domestic" when applied to a corporation or partnership means created or organized in the United States or under the law of the United States, or of any State, **or Puerto Rico** unless, in the case of a partnership, the Secretary provides otherwise by regulations.
>
> **...**
>
> **(9) United States**
>
> The term "United States" when used in a geographical sense includes only the States, the District of Columbia **and Puerto Rico.**