Proposed Tax Reform Options for Puerto Rico

This paper is submitted by the Government of the Commonwealth of Puerto Rico (the "Government") to the staffs of the Senate Finance Committee and the House Ways and Means Committee in order to update and elaborate on the Government's position on tax reform. The Government appreciates this opportunity to submit its views and hopes that this submission will lead to a productive dialogue with the members and staffs of the tax-writing committees on the tax reform issues most relevant to Puerto Rico's future.

I. Basic Approach

The paper's focus is on the need for a new tax proposal to encourage increased U.S. economic investment in Puerto Rico and thereby revive the Commonwealth's weakened economy. While the Government has given considerable thought to the development of such a proposal, it has not settled on a particular recommendation to the Congress. That is by design. The Government believes that the best process for developing a viable proposal is to interact with the tax-writing committees and their staffs on the merits of competing proposals.

The Government's discussions of this subject with government decision-makers to date indicate that there is developing agreement that Puerto Rico, in light of its distinguishing circumstances, should receive U.S. tax treatment different from the tax code's treatment of both foreign countries and the 50 U.S. states. There has been no agreement, however, on the appropriate configuration of that treatment. The Government intends in this paper, therefore, to develop general principles that should govern any new proposals regarding the Commonwealth and then to discuss options, or "models," available to respond to and implement those principles. In brief, the Government proposes four alternative models: (i) a degree of exemption relief for Puerto Rico from the new base erosion and minimum tax provisions that have been proposed by Chairman Baucus and Chairman Camp in their respective international discussion drafts; (ii) a bill introduced in the last Congress that would permit U.S.-owned businesses in Puerto Rico to elect to be treated as U.S. domestic corporations and thereby trigger dividend received deductions under current provisions of the tax code; (iii) an economic activity tax credit for U.S. investment in Puerto Rico designed as a revised and improved version of former section 30A of the Internal Revenue Code; and (iv) legislation patterned on the current U.S.-Puerto Rico rum tax regime under which the U.S. would pay over to Puerto Rico tax revenues it receives from the proposed new base erosion and minimum tax provisions. The Government recognizes that these four options do not cover the universe of the proposals that could be considered. We therefore would welcome suggestions of proposals we have not presented.

The Government believes that the current congressional tax reform deliberations constitute the best opportunity available for devising an appropriate approach to the economic issues facing Puerto Rico. It is grateful for the developing agreement referred to that Puerto Rico should be treated differently under the tax code from other major domestic and international government entities. The Government now hopes to assist in furthering agreement on the actual treatment that should be provided.

II. General Principles

The principles that are most relevant to the choice of a new proposal relate to Puerto Rico's unique circumstances from a tax policy standpoint, Puerto Rico's current economic condition, and the historical treatment of Puerto Rico under the tax code. These factors are discussed below in turn.

Puerto Rico's Unique Circumstances and its Resulting Need for Different Treatment Under the Internal Revenue Code

Puerto Rico's circumstances differentiate it from foreign governments and the U.S. states in three major respects that are significant from a tax policy perspective. The Government believes that these differences warrant different treatment in the tax code for Puerto Rico, including adoption of one or more of the proposals presented in this paper.

First, the U.S. government takes responsibility for the well-being of residents of Puerto Rico – who are citizens of the United States and are therefore covered by many U.S. governmental programs. The U.S. therefore has good reason to provide different tax treatment to Puerto Rico than the treatment it provides to foreign jurisdictions, where no such U.S. responsibilities exist. The new proposals, if enacted, will produce jobs and economic growth in the Commonwealth, which will have the desired effect of reducing federal payments and other governmental benefit obligations to U.S. citizens in Puerto Rico. The proposals also will increase federal payroll taxes related to the employment of such citizens. Moreover, well-paying jobs in Puerto Rico equate to jobs on the U.S. mainland, since the two economies are inextricably linked through trade and common citizenship. The fortunes of the U.S. are thus tied to the health of the economy in Puerto Rico in a way that has no parallel when it comes to the economy of a foreign nation.

Second, companies doing business in Puerto Rico, unlike companies doing business in foreign countries, are subject to U.S. regulatory requirements. Stringent U.S. regulations with respect to environmental, worker and consumer protection, among other requirements, while beneficial in and of themselves, often make operating in Puerto Rico more expensive than operating in competing jurisdictions with weaker regulatory regimes. The proposals presented would help to level the playing field by compensating to one degree or another for this competitive disadvantage.

Third, Puerto Rico's circumstances differ significantly from those of the 50 states in that the Government of Puerto Rico has responsibilities that are substantially greater than those of a typical state. The Commonwealth's government programs cover areas where private parties are the principal providers of corresponding goods and services in most states, such as the areas of housing and the production and delivery of energy. Moreover, the level of federal assistance is typically lower in Puerto Rico than in the states. While federal grants and payments to the Government and state governments have been in the same range per capita over the years, direct federal payments to individuals in Puerto Rico have been well below the per capita payments to

individuals in the states.[1] Again, tax preferences for Puerto Rico can help to compensate for this comparative disadvantage.

These factors and others, in the Government's view, provide strong policy justification for the specific treatment accorded to Puerto Rico in the proposals presented. The tax code already provides some preferential treatment for Puerto Rico, as can be seen with respect to some of the provisions included in Attachment A to this paper. The Government strongly believes, however, that additional tax-related support for Puerto Rico is both justified and sorely needed.

The Puerto Rican Economy

The need for such support at this particular time is intensified by Puerto Rico's current economic circumstances. While these conditions have been amply covered in the media, two matters regarding those conditions are worth emphasizing. First, we believe that the Commonwealth's economy can be critically influenced by U.S. tax policy. It is hardly coincidental that the last year that Puerto Rico enjoyed a healthy economy was 2006, the last year of effectiveness of section 936. The effects of the repeal of section 936 were felt most severely in the manufacturing sector, where job losses began in 2005 and have continued unabated since. Since 2006, the Puerto Rican economy as a whole has consistently deteriorated, so that today the Commonwealth, notwithstanding considerable fiscal repair activity in the last year, finds itself with significant economic challenges. Those challenges no doubt are largely due to the absence from the tax code – for the first time in many decades – of a major tax incentive for U.S. investment in Puerto Rico. In repealing section 936, Congress essentially experimented with the removal of the most critical feature of the code affecting Puerto Rico. It is now apparent from Puerto Rico's economic conditions that this experiment has been a critical failure – especially since close to 200,000 jobs have been lost to the Commonwealth since the repeal. It is also apparent from this fact pattern, however, just how responsive the economy of Puerto Rico can be to directly applicable changes in U.S. tax law. There is thus every reason to believe that a well-designed tax proposal on the order of those discussed in this paper can restore Puerto Rico's economy to a healthy status.

Second, we believe it is important to point out that if such a proposal is *not* included in major tax reform legislation, Puerto Rico's present circumstances could significantly *worsen*. That is because the base erosion and minimum tax proposals that have been supported by Chairman Camp and Chairman Baucus are likely to have the effect of taxing when earned certain Puerto Rico source income of U.S.-based companies, notwithstanding that under current law any tax on that income may be deferred until the repatriation to the U.S. of the earnings in question. Moreover, these adverse legislative effects on Puerto Rico's economy could be experienced well before the actual enactment of tax reform. The inclusion of the new anti-deferral measures in any bill proposed by either chairman, coupled with the absence of any indication of support for

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[1] GAO, *Puerto Rico: Fiscal Relations with the Federal Government and Economic Trends during the Phaseout of the Possessions Tax Credit* at 12. Updated U.S. Census Bureau statistics confirm that this remains the case. U.S. Census Bureau, *Consolidated Federal Funds Report for Fiscal Year 2010* at 4 (Sept. 2011) and U.S. Census Bureau, *Annual Estimates of the Resident Population for the United States, Regions, States, and Puerto Rico: April 1, 2010 to July 1, 2013, available at* http://www.census.gov/popest/data/puerto_rico/totals/2013/index.html.

an offsetting tax advantage for Puerto Rico, is likely to suggest to current and prospective investors in Puerto Rico that the Congress favors new barriers to investment in the Commonwealth. We are afraid, therefore, that the absence of any such indication of support could result in a serious near-term reduction in investment based on the proposed bill alone. The inclusion of support for a new proposal favorable to Puerto Rico, on the other hand, could avoid such adverse effects – as well as generate a productive dialogue regarding the new proposal.

Historical Tax Treatment of Puerto Rico

As a final matter, we want to underscore that in proposing different tax treatment for Puerto Rico, the Government is not proposing anything unusual as far as the history of the tax code is concerned. As noted, Puerto Rico has enjoyed such different treatment for much of its history. Themes running through the tax code over the years include a significant number of exemptions for Puerto Rico from U.S. taxes; a recognition of the need for Puerto Rico, rather than the U.S., to receive revenue from U.S. taxes on products produced in Puerto Rico; and an acceptance of the appropriateness of taking into account Puerto Rico's economic needs during periods of hard times for the Commonwealth. These traditional themes will be discussed further below. The point to emphasize here is that each of the tax proposals discussed in this paper has significant precedents in U.S. tax law.

III. Options for Tax Reform Proposals

The Government's proposals basically follow four models. As discussed earlier, the Government is not currently endorsing any one of these models over another. Rather, it is presenting all of them with the hope of eliciting reactions from the members and staffs of the tax-writing committees to the various approaches that might be taken to produce additional U.S. investment in Puerto Rico.

Model 1 – Exemption Relief from the Base Erosion or Minimum Tax Measures

The first model would be to provide some measure of exemption relief from the proposed base erosion or minimum tax measures for U.S. companies with substantial operations in Puerto Rico. This would take the form of exempting the Puerto Rico source income of such companies to some degree from the new proposals, while leaving intact the current anti-deferral measures of Subpart F. The rationale for the exemption, as with the other models to be discussed, would be based on Puerto Rico's unique institutional circumstances and its current economic conditions. Without such relief, as noted above, the U.S. companies involved would be subject to immediate taxation on Puerto Rican source income that currently receives the benefit of tax deferral. Further, Puerto Rico's ability under its own laws to provide corporate tax incentives for U.S. investment would be effectively nullified. These developments could cause U.S. companies to leave the Commonwealth or reduce investment at this critical time for the Commonwealth's economy.

As the staffs are aware, exemption proposals of this nature have been submitted to the tax-writing committees previously. To the extent that those proposals are considered to be insufficiently limited, the applicable provisions could be tightened to suit the committees' preferences. For example, the proposals could be adjusted to apply only to the extent that such

companies use their own employees – as opposed to contract employees – in facilities located in Puerto Rico. The exemptions could also be restricted so that they would apply only to a certain percentage, rather than all, of a company's active business income from Puerto Rico. Alternatively, that income could be taxed at a lower rate than other foreign source income, rather than totally exempted from taxation. In short, there are many variants of these exemption proposals that the committees could consider, and the Government would welcome the opportunity to work with the committees to determine the optimal approach.

Some have argued that any such exemption would confer a tax advantage on Puerto Rico that would have the effect of discriminating against foreign countries and the 50 states. The Government strongly rejects that argument. As noted in the general principles discussed earlier in this paper, we believe that the beneficial treatment that would be provided here is fully justified by the corresponding disadvantages associated with Puerto Rico's circumstances, as well as the other related factors discussed. Such treatment, therefore, cannot be considered discriminatory. The Government's position is that the foreign jurisdictions that would not receive an exemption under this approach typically are not subject to regulatory regimes as stringent as those of the U.S. They typically do not create large numbers of jobs for U.S. citizens, do not have the trade relationships with the United States that Puerto Rico enjoys, and do not affect U.S. fiscal well-being through the success or weakness of their economies. Moreover, none of the 50 states has poverty levels approaching those of Puerto Rico; none is experiencing the same economic difficulties overall; none has governmental responsibilities comparable to those of Puerto Rico's government; and none to our knowledge has energy, shipping or other relevant production costs of the magnitude experienced by Puerto Rico's industries. In short, the Government believes that Puerto Rico's unique circumstances justify a unique exemption from the new proposals.

Model 2 – H.R. 3020 as Introduced in 2011

The second model that the Government asks the committees to consider could well produce tax benefits similar to the first but would establish them through a very different tax structure. The model is a bill introduced in the last Congress, H.R. 3020, which is designed as a corporate version of the current treatment of individual residents of Puerto Rico under section 933 of the tax code. Section 933 exempts individuals who are "bona fide residents" of the Commonwealth – i.e., individuals who reside in Puerto Rico more than half the taxable year – from U.S. tax on their Puerto Rico source income.[2] H.R. 3020 would provide parallel treatment for corporations through the mechanism of allowing a U.S-owned subsidiary that has adequate ties to Puerto Rico under the bill's provisions to elect to be treated as a U.S. corporation for purposes of the proposal. If the subsidiary makes that election under the bill, its Puerto Rico source income would be essentially exempt from taxation, since (i) the bill would expressly exempt that income at the subsidiary level, and (ii) the income would be totally or largely exempted when repatriated to the U.S. parent by virtue of the current dividend received deduction provisions of section 243 of the tax code relating to dividends between U.S.

[2] The "bona fide resident" requirement is imposed by statute. I.R.C. § 933(1) (2013). The requirement that a "bona fide resident" must reside in Puerto Rico for at least half the taxable year is imposed by regulation. 26 C.F.R. 1937-1(c)(i).

companies. The ties to Puerto Rico that are required of a subsidiary under the bill – the ties that would allow the subsidiary and its U.S. parent to receive the bill's benefits – are essentially two. The subsidiary must be incorporated in Puerto Rico, and at least half of the subsidiary's income during the taxable year must be Puerto Rico source income. These requirements can be said to provide a corporate parallel to the "bona fide resident" requirement for individuals that is provided by section 933. The bill is included as Attachment B to this paper.

The policy considerations discussed with respect to Model 1 apply to Model 2 as well. Again, the uniqueness of Puerto Rico's circumstances from a tax policy standpoint provides justification for the different treatment accorded Puerto Rico under the model. While there are of course many differences between the two models, the most significant of these are that (i) Model 2 is structured as a system designed specifically for Puerto Rico, rather than as an exemption for Puerto Rico from another system included in the new tax reform regime, and (ii) Model 2 relies for its precedent on a parallel section of the tax code. The Government would be pleased to discuss specific changes it has considered to the bill if the committees wish to pursue the bill's basic approach.

Model 3 – An Improved Version of Former Section 30A of the Tax Code

A third model that we believe should be considered is that of a revised and improved version of former section 30A of the Internal Revenue Code. Section 30A – which is attached as Attachment C – was enacted in 1996 as part of the legislation that repealed section 936 of the tax code, which had provided a significant incentive for U.S. investment in Puerto Rico for many years before then. The later-enacted section was an important element of the transition rules Congress provided for investors during the 10-year period following the section 936 repeal. The approach proposed here would be to design a revised section 30A so that it serves as an effective investment incentive in the future, but one that is without the perceived excesses of the section 936 regime.

Some background may be helpful in understanding the role section 30A played with respect to that regime. Section 936, which was effective in one form or another from 1976 through 2006, used a tax credit mechanism to provide its incentive for U.S. domestic corporations to invest in Puerto Rico and the other U.S. possessions. The tax credit provided by the section was allowed to be taken against U.S. taxes that would otherwise have been due on certain income of the corporations that was sourced to the possessions. Starting in 1993, two alternative limitations were placed on the credit. A corporation choosing to claim the credit was required to elect one of those limitations. The first limited the application of the credit generally to the sum of (i) 60 percent of the corporation's wage and fringe benefit expenses in the applicable possession, and (ii) a specified percentage of the corporation's depreciation allowances for certain tangible property in the possession (15, 40 or 65 percent, depending on the life of the property). The credit, so limited, was known as the "economic activity credit." The alternative limitation that the corporation could elect – known as the "income credit" – was not tied to wages and depreciation. Under its provisions, rather, the corporation could elect to limit the amount of the section 936 credit that would otherwise be available to the corporation to a specified percentage of that credit amount (initially 60 percent but phased down to 40 percent for 1998 and subsequent years).

When Congress repealed section 936 in 1996, it provided for transition rules to allow continued use of elements of the credit for 10 additional years. Specifically, Congress added a new section 30A to the tax code that provided for the continuation of the economic activity credit as it applied to Puerto Rico. The income credit for Puerto Rico and the economic activity and income credits for the other possessions continued to be provided under section 936. The legislation called for the expiration of both section 30A and section 936 in 2006.[3]

The proposal that is recommended would be to restore section 30A with certain modifications discussed below. The proposal, then, would essentially provide an economic activity tax credit to a U.S.-controlled corporate group equal to the sum of 60 percent of its wage expenditures and 15-65 percent of its depreciation allowances with respect to the Commonwealth. These percentages could of course be adjusted by the committees if their analysis suggests that they should be.

The proposed modifications to the section would be designed (i) to make the section applicable to current circumstances as a technical matter, and (ii) to ensure that the new credit mechanism is no longer subject to the criticisms that led to the repeal of the section 936 regime. With regard to the first category of modifications just described – those relating to updating the section technically – the most significant of the modifications would be to allow the section's credit to be claimed by both previous and new claimants of the credit (since the original section, as a transition rule, confined its application to previous claimants) and to apply the credit in circumstances where either branches or controlled foreign corporations ("CFCs") of domestic corporations are involved in Puerto Rico business activity (since the original section applied only to domestic corporations with Puerto Rico branches).

As for the second category of modifications – those intended to tighten the application of the section and thereby respond to criticisms of section 936 – the most important modification would apply not to the language of section 30A, but rather to the role played by the section in the incentive regime. In contrast to the approach of section 936, which provided U.S. corporations with a choice between the economic activity credit and the income credit, it would now be proposed to make the economic activity credit the exclusive credit for U.S. corporate activity in Puerto Rico – a result achieved by restoring section 30A without restoring section 936. The principal criticism of the section 936 regime was that it provided a benefit to companies disproportionate to their contribution to jobs and investment in Puerto Rico. The new proposed structure should help to remedy that concern by expressly tying the amount of the credit directly to a corporation's labor and depreciation expenditures in the Commonwealth.

Another major tightening of section 30A could focus on the generous treatment of *deductions* under that section. Unlike the case with most credits, a corporation that received a credit under sections 30A and 936 was not required to reduce its deduction for expenditures associated with the credit by the amount of the credit. Thus a corporation, for example, that paid

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[3] While, as indicated, section 30A was repealed in legislation enacted in 1996, expired in 2006 under the terms of that legislation, and has not been reinstated since, it should be noted that a long-term extension of the section was included in Clinton administration budgets for fiscal years 1998-2001 and that a modified version of the section currently applies to American Samoa.

$1000 in compensation would, with a 60 percent credit, receive $600 in reduced tax liability plus an additional $350 reduction as a result of being able to deduct the full $1000 at a 35 percent corporate rate. The government would therefore wind up "paying" $950 of the corporation's $1000 compensation expenditure. By contrast, the new section could expressly provide that any deduction for U.S. tax purposes would have to be reduced by the amount of the credit. Thus, in the example above, it would be recognized that the corporation, as a result of the credit, would be "out" only $400 for the compensation involved ($1000 minus $600) and therefore would be allowed to deduct only $400. The government accordingly would wind up "paying" $740 ($600 plus 35 percent of $400) of the corporation's $1000 compensation expense – a situation more in accord with most tax credits.

If the committees favor this model, the Government is convinced that other tightening measures could be developed if necessary. The most significant challenge under the model, however, would be – as in the case of most of the other models – to develop the appropriate level of incentive or subsidy that should be provided under the proposal. In the case of this model, that decision would focus on the specific percentages to be used with respect to the credits relating to wages and depreciation. The Government would be pleased to submit recommendations for such percentages if the committees decide to give serious consideration to a proposal based on this model.

Model 4 – The Rum Tax Cover Over

A final model to consider would be based on the rum tax cover-over provisions of the tax code. Under current law the U.S. initially receives the tax revenue from the existing excise tax on rum imported into the United States but then "covers over" – or pays over – to the treasuries of Puerto Rico and the U.S. Virgin Islands (the "USVI") the amounts obtained from the tax. The Government believes that this approach could appropriately serve as precedent for a provision that covered over to Puerto Rico the incremental revenues obtained by the U.S. from the new base erosion or minimum tax proposals as applied to Puerto Rico.

That is because significant elements of the conceptual rationale for the current rum tax approach can be said also to apply to those new proposals. That rationale is best seen through a historical review of the rum tax. Under the Foraker Act of 1900, Congress essentially exempted Puerto Rico from U.S. internal revenue laws. However, so as not to advantage products produced in Puerto Rico over products produced on the mainland, Congress imposed an "equalization tax" on certain items produced in Puerto Rico and shipped to the mainland.[4] World War I, and its disruption of foreign trade, had a severe detrimental impact on Puerto Rico's primary revenue stream at the time – U.S. customs duties on goods entering the island from foreign states.[5] As part of the Jones Act of 1917, therefore, Congress mandated that equalization tax funds be covered over to Puerto Rico's treasury to ease Puerto Rico's financial

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[4] Karla Hoff, "U.S. Federal Tax Policy Towards the Territories: Past, Present, and Future," 37 *Tax L. Rev.* 51, 56-57 (Fall 1981).

[5] *Id.* at 57.

plight.[6] Both the House and Senate committee reports for the Jones Act stated that "it is believed to be just and fair that [Puerto Rico] should receive the internal-revenue taxes collected upon its products, whether those products are used in Porto Rico [sic] or produced in Porto Rico [sic] and transported to and used in the United States."[7] From this legislative history, it appears that the rum cover-over program was established in recognition of the appropriateness of permitting Puerto Rico to retain the revenue collected from its domestic industries and for the added purpose of addressing Puerto Rico's economic needs.[8] Further, it seems reasonable to assume that some of the factors discussed earlier in this paper relating to Puerto Rico's special circumstances have influenced congressional decisions to retain the cover-over program over the years.

Another element of the history of the program is also relevant here. In recent years, some in the Congress have expressed concern about the use of cover-over amounts by the affected possession governments to subsidize rum producers in their respective jurisdictions. While no limitations on those subsidies have been enacted, Senators Menendez and Bingaman argued for such limitations in connection with the Senate Finance Committee's consideration of the most recently enacted "extender package."[9] The desirability of such limitations has also been supported by others inside and outside the Congress, including the Government.

It can plausibly be argued that all of these policy considerations regarding the structure of the current rum tax regime are relevant to one degree or another to the application of the proposed base erosion or minimum tax proposals to Puerto Rico. As with the rum tax, it can be said that Puerto Rico has a legitimate interest in receiving tax revenues from the new proposals as they relate to products – and, by extension, services – produced or generated in Puerto Rico. Also as with the rum tax, the new tax proposals can be justified in part by the need for "equalization" of treatment of competing goods and services produced in Puerto Rico and on the mainland. As with rum, that equalization of treatment need not be exact. The rum tax regime from the start has allowed Puerto Rico and the USVI to use rum tax revenues in part to subsidize the production of rum in their respective jurisdictions – thus allowing some competitive advantage to products produced in those possessions. It seems reasonable to acknowledge, however, that some limitations on such subsidization, such as those proposed by Senator

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[6] *Id.*

[7] U.S. Congress, Committee on Insular Affairs, Report to Accompany H.R. 9533, *Civil Government for Porto Rico*, Report No. 77 at 2, 64th Congress, 1st sess., Jan. 16, 1916; *see* Congressional Res. Serv., "The Rum Excise Tax Cover-Over: Legislative History and Current Issues" 1 (Jan. 20, 2010) (quoting same).

[8] Additional references to the needs of Puerto Rico (and those of the USVI) as a motivation for the cover-over regime can be found in the legislative history accompanying some of the extensions of recent years of the temporary cover-over amount of $13.25 per proof gallon. *See* U.S. Congress, Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress* 138 (2005); U.S. Congress, Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 112th Congress* 195 (2013).

[9] *See Open Executive Session to Consider the Family and Business Tax Cut Certainty Act of 2012*, U.S. SENATE COMM. ON FIN. (Aug. 2, 2012), available at http://www.finance.senate.gov/hearings/hearing/?id=c36e29ca-5056-a032-5260-7997a539f948.

Menendez, are justified in the case of both rum taxes and the new tax proposals. Finally, and as this paper has argued repeatedly, the factors that justify beneficial tax treatment for Puerto Rico in various portions of the tax code – including the provisions on rum taxes – also apply with respect to the proposed new taxes.

There also are of course identifiable differences between the purposes – and the resulting scope and reach – of the rum tax regime and the new proposals as they affect Puerto Rico. For example, the rum regime affects only such products from Puerto Rico that are exported to the mainland, while the new proposals are not so limited. The new proposals, on the other hand, relate only to Puerto Rico activity conducted or controlled by U.S. companies, while the rum tax regime is not so limited. Yet the regimes are similar enough to allow the rum regime to serve as a legitimate precedent for the treatment of activities under the new proposals. Thus, under an approach based on that precedent, an effort might be made annually to gauge the incremental amount of U.S. tax revenue that would result from the new proposals as they relate to Puerto Rico. That revenue would then be covered over to Puerto Rico, subject to limitations on the amounts that could be used for subsidies for the commercial activities of the affected entities. As with the other models, the Government would be pleased to propose relevant details if the committees should indicate an interest in following this model.

IV. Conclusion

The Government looks forward to interacting further with the tax-writing committees and staffs on the proposals presented, and it wishes to be as responsive as possible to the committees' needs in evaluating these ideas. Again, the Government greatly appreciates the opportunity it has been provided to participate in the committees' processes, and it plans to do all it can to make that participation productive.

Attachments

INTERESTS OF PUERTO RICO REGARDING CURRENT TAX PROVISIONS IN THE CONTEXT OF U.S. TAX REFORM

Because of the interaction between the U.S. Federal income tax system and the economy of Puerto Rico, the Government of Puerto Rico (the "Government") has a significant interest in U.S. tax reform. This paper provides a non-exclusive list of tax provisions in the current tax system that have a positive impact on Puerto Rico and that the Government urges be retained in the tax code.

Deferral of Active Income of Controlled Foreign Corporations

Proposal: The current system of deferral should not be replaced with a worldwide current inclusion system. If a territorial tax system is considered, special consideration should be given to Puerto Rico and the territories in the design of that system.

Explanation: The economy of Puerto Rico depends on investment from U.S.-based multinational companies and the jobs created by such investment. Following the expiration of the Possessions Tax Credit (former section 936) in 2006, most of the largest employers in Puerto Rico reorganized their Puerto Rico operations into controlled foreign corporations (CFCs). The deferral of U.S. tax on the active business income of such CFCs helps to maintain the competitiveness of the Puerto Rican economy and the effectiveness of Puerto Rico's fiscal incentives to businesses to participate in that economy. Therefore, the current system of deferral should not be replaced with a worldwide current inclusion system in which all foreign income of CFCs is taxed when earned. Moreover, if a territorial tax system is considered, special consideration should be given to Puerto Rico and the territories in the design of that system. For example, it may be that additional base erosion rules would not be appropriate as applied to income derived in connection with operations in Puerto Rico.

Exclusion of Puerto Rico Income

Proposal: Retain the current rules exempting from U.S. tax income derived from Puerto Rico by bona fide individual residents of Puerto Rico.

Explanation: Longstanding rules exempt from U.S. tax income earned in Puerto Rico by residents of Puerto Rico, even if those residents are U.S. citizens. Such income generally is subject to tax by Puerto Rico. Similar rules are provided for the territories. These rules are appropriate given the interest of the United States in the welfare of Puerto Rico and its residents, most of whom are U.S. citizens. Eliminating these rules would be unfair and would impose a substantial administrative burden on residents of Puerto Rico.

Domestic Production Deduction and R&E Credit

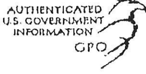
Proposal: Continue equal treatment of production and research and experimentation activities of U.S. taxpayers in Puerto Rico.

Explanation: For purposes of the domestic production deduction and the research and experimentation credit, activities conducted in Puerto Rico by a U.S. taxpayer are treated in the same manner as if those activities had been conducted in a U.S. state. This is appropriate since the U.S. tax law should not create a disincentive to conducting manufacturing and research activities in Puerto Rico. The objectives of these provisions – to support U.S. manufacturing and research jobs – are furthered by including Puerto Rico.

Cover Over of Excise Tax on Rum

Proposal: Provide that the full amount of the $13.50 U.S. excise tax on rum be covered over, or paid, to Puerto Rico and the Virgin Islands, but limit the amount that can be received by spirits producers.

Explanation: The U.S. imposes an excise tax of $13.50 per proof gallon on rum imported into the U.S. Revenues from that tax are then covered over to the treasuries of Puerto Rico and the Virgin Islands. The tax code provides that the cover over amount is limited to $10.50 per proof gallon, the amount of an earlier excise tax, with a relaxation of that limit to $13.25 with respect to rum imported between June 30, 1999, and January 1, 2014. (The end date for the higher amount has been routinely extended in various extender packages.) The Government believes that the full amount of the excise tax should be covered over to the two jurisdictions on a permanent basis. During the period of the earlier $10.50 excise tax, the full amount was covered over, and the Government believes there is no reason to depart from that precedent. There has been concern, however, that cover over payments have been used to an excessive degree for the benefit of the spirits industry, rather than for essential government operations and public services in the affected jurisdictions. Legislation has been proposed in the Congress to remedy those circumstances and limit the amounts that can be received by spirits producers. The Government supports such legislation and believes that it also should be made a permanent part of the tax code.



Attachment B

112TH CONGRESS
1ST SESSION

H. R. 3020

To amend the Internal Revenue Code of 1986 to allow certain Puerto Rico corporations to elect to be treated as domestic corporations.

IN THE HOUSE OF REPRESENTATIVES

SEPTEMBER 22, 2011

Mr. PIERLUISI (for himself, Mr. YOUNG of Alaska, and Mr. SERRANO) introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1986 to allow certain Puerto Rico corporations to elect to be treated as domestic corporations.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. SHORT TITLE.**
4 This Act may be cited as the "Puerto Rico Invest-
5 ment Promotion Act of 2011".

1 **SEC. 2. CERTAIN PUERTO RICO CORPORATIONS MAY**
2 **ELECT TO BE TREATED AS DOMESTIC COR-**
3 **PORATIONS.**

4 (a) IN GENERAL.—Subpart D of part III of sub-
5 chapter N of chapter 1 of the Internal Revenue Code of
6 1986 (relating to possessions of the United States) is
7 amended by inserting after section 933 the following new
8 section:

9 **"SEC. 933A. ELECTION BY PUERTO RICO CORPORATIONS**
10 **TO BE TREATED AS DOMESTIC CORPORA-**
11 **TIONS.**

12 "(a) IN GENERAL.—A qualified Puerto Rico corpora-
13 tion for which an election under this section is in effect
14 for any taxable year shall be treated for such year as a
15 domestic corporation for purposes of this title.

16 "(b) QUALIFIED PUERTO RICO CORPORATION.—For
17 purposes of this section, the term 'qualified Puerto Rico
18 corporation' means any corporation if—

19 "(1) the corporation is incorporated under the
20 laws of Puerto Rico, and

21 "(2) at least 50 percent of its gross income (de-
22 termined without regard to subsection (c)) for the
23 taxable year is derived from sources within Puerto
24 Rico.

25 "(c) EXCLUSION OF PUERTO RICO SOURCE IN-
26 COME.—

1 "(1) IN GENERAL.—In the case of a qualified
2 Puerto Rico corporation for which an election under
3 this section is in effect for any taxable year, gross
4 income for such year shall not include income de-
5 rived from sources within Puerto Rico.
6 "(2) DENIAL OF CERTAIN FOREIGN TAX CRED-
7 ITS.—No credit shall be allowed for the amount of
8 taxes paid or accrued to a foreign country or posses-
9 sion of the United States to the extent such taxes
10 are properly allocable to amounts excluded from
11 gross income under paragraph (1).
12 "(d) RULES RELATING TO ELECTION.—
13 "(1) PERIOD ELECTION IN EFFECT.—
14 "(A) IN GENERAL.—Except as otherwise
15 provided in this paragraph, an election under
16 this section shall apply to the taxable year for
17 which made and all subsequent taxable years.
18 "(B) REVOCATION.—
19 "(i) REVOCATION BY CORPORATION.—
20 A corporation may revoke an election
21 under this section for any taxable year
22 only if the election has been in effect for
23 at least the 3 most recent preceding tax-
24 able years.

1 "(ii) CEASING TO BE QUALIFIED.—An
2 election under this section shall be revoked
3 by the Secretary for any taxable year for
4 which the corporation fails to meet the re-
5 quirements of subsection (b).

6 "(iii) EFFECT OF REVOCATION.—Ex-
7 cept as provided in subparagraph (C), a
8 revocation under this subparagraph shall
9 apply to the taxable year for which revoked
10 and all subsequent taxable years.

11 "(C) ELECTION AFTER REVOCATION.—An
12 election under this section may be made after
13 a revocation under subparagraph (B), but the
14 election may not apply to any taxable year be-
15 fore the 4th taxable year following the most re-
16 cent preceding taxable year for which the elec-
17 tion was in effect.

18 "(2) EFFECT OF MAKING AND TERMINATING
19 ELECTION.—

20 "(A) MAKING ELECTION.—For purposes of
21 section 367, any qualified Puerto Rico corpora-
22 tion making an election under this section shall
23 be treated as transferring (as of the 1st day of
24 the 1st taxable year to which such election ap-
25 plies) all of its assets to a domestic corporation

1 in connection with an exchange to which section
2 354 applies.
3 "(B) EFFECT OF TERMINATION.—For pur-
4 poses of section 367, if an election is made by
5 a corporation under this section for any taxable
6 year and such election ceases to apply for any
7 subsequent taxable year, such corporation shall
8 be treated as a domestic corporation transfer-
9 ring (as of the 1st day of such subsequent tax-
10 able year) all of its property to a foreign cor-
11 poration in connection with an exchange to
12 which section 354 applies.
13 "(C) INTANGIBLES.—For purposes of sec-
14 tion 367(d) and the second sentence of section
15 482, any election made under this section shall
16 be disregarded.
17 "(e) DENIAL OF INCLUSION IN CONSOLIDATED RE-
18 TURN.—A qualified Puerto Rico corporation for which an
19 election under this section is in effect for any taxable year
20 may not be included in any consolidated return under
21 chapter 6.".
22 (b) CLERICAL AMENDMENT.—The table of sections
23 for such subpart D is amended by inserting after the item
24 relating to section 933 the following new item:

"Sec. 933A. Election by Puerto Rico corporations to be treated as domestic corporations."

1 (c) EFFECTIVE DATE.—The amendments made by
2 this section shall apply to taxable years beginning after
3 September 30, 2011.

○

Internal Revenue Code

§ 30A Puerto Rico economic activity credit.

(a) Allowance of credit.

(1) In general.
Except as otherwise provided in this section, if the conditions of both paragraph (1) and paragraph (2) of subsection (b) are satisfied with respect to a qualified domestic corporation, there shall be allowed as a credit against the tax imposed by this chapter an amount equal to the portion of the tax which is attributable to the taxable income, from sources without the United States, from—

(A) the active conduct of a trade or business within Puerto Rico, or

(B) the sale or exchange of substantially all of the assets used by the taxpayer in the active conduct of such trade or business.

In the case of any taxable year beginning after December 31, 2001, the aggregate amount of taxable income taken into account under the preceding sentence (and in applying subsection (d)) shall not exceed the adjusted base period income of such corporation, as determined in the same manner as under section 936(j)

(2) Qualified domestic corporation.
For purposes of paragraph (1), the term "qualified domestic corporation" means a domestic corporation--

(A) which is an existing credit claimant with respect to Puerto Rico, and

(B) with respect to which section 936(a)(4)(B) does not apply for the taxable year.

(3) Separate application.
For purposes of determining—

(A) whether a taxpayer is an existing credit claimant with respect to Puerto Rico, and

(B) the amount of the credit allowed under this section,

this section (and so much of section 936 as relates to this section) shall be applied separately with respect to Puerto Rico.

(b) Conditions which must be satisfied.
The conditions referred to in subsection (a) are—

(1) 3-year period.
If 80 percent or more of the gross income of the qualified domestic corporation for the 3-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession (determined without regard to section 904(f))

(2) Trade or business.
If 75 percent or more of the gross income of the qualified domestic corporation for such period or such part thereof was derived from the active conduct of a trade or business within a possession.

(c) Credit not allowed against certain taxes.
The credit provided by subsection (a) shall not be allowed against the tax imposed by—

(1) section 59A (relating to environmental tax)

(2) section 531 (relating to the tax on accumulated earnings),

(3) section 541 (relating to personal holding company tax), or

(4) section 1351 (relating to recoveries of foreign expropriation losses).

(d) Limitations on credit for active business income.
The amount of the credit determined under subsection (a) for any taxable year shall not exceed the sum of the following amounts:

(1) 60 percent of the sum of

(A) the aggregate amount of the qualified domestic corporation's qualified possession wages for such taxable year, plus

(B) the allocable employee fringe benefit expenses of the qualified domestic corporation for such taxable year.

(2) The sum of—

(A) 15 percent of the depreciation allowances for the taxable year with respect to short-life qualified tangible property,

(B) 40 percent of the depreciation allowances for the taxable year with respect to medium-life qualified tangible property, and

(C) 65 percent of the depreciation allowances for the taxable year with respect to long-life qualified tangible property.

(3) If the qualified domestic corporation does not have an election to use the method described in section 936(h)(5)(C)(ii) (relating to profit split) in effect for the taxable year, the amount of the qualified possession income taxes for the taxable year allocable to nonsheltered income.

(e) Administrative provisions.

For purposes of this title—

(1) the provisions of section 936 (including any applicable election thereunder) shall apply in the same manner as if the credit under this section were a credit under section 936(a)(1)(A) for a domestic corporation to which section 936(a)(4)(A) applies,

(2) the credit under this section shall be treated in the same manner as the credit under section 936, and

(3) a corporation to which this section applies shall be treated in the same manner as if it were a corporation electing the application of section 936 .

(f) Denial of double benefit.

Any wages or other expenses taken into account in determining the credit under this section may not be taken into account in determining the credit under section 41.

(g) Definitions.

For purposes of this section, any term used in this section which is also used in section 936 shall have the same meaning given such term by section 936.

(h) Application of section.

This section shall apply to taxable years beginning after December 31, 1995, and before January 1, 2006