[JOINT COMMITTEE PRINT]

TAX RULES RELATING TO PUERTO RICO UNDER PRESENT LAW AND UNDER STATEHOOD, INDEPENDENCE, AND ENHANCED COMMONWEALTH STATUS (S. 712, PUERTO RICO STATUS REFERENDUM ACT)

SCHEDULED FOR HEARINGS

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON NOVEMBER 14-15, 1989

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

NOVEMBER 14, 1989

U.S. GOVERNMENT PRINTING OFFICE
23-769 WASHINGTON : 1989 JCS-19-89

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a discussion of tax rules relating to Puerto Rico under present law and under statehood, independence, and enhanced commonwealth status. S. 712, the Puerto Rico Status Referendum Act, was reported by the Senate Committee on Energy and Natural Resources on September 6, 1989, and has been jointly referred to the Senate Committee on Finance for consideration of matters within its jurisdiction.[2]

Part I of the document provides an overview of United States and Puerto Rican tax rules under present law. Part II provides a description of the provisions of S. 712 as reported by the Senate Committee on Energy and Natural Resources. Part III discusses tax implications of statehood, independence, and enhanced commonwealth status options for Puerto Rico under the bill. Appendix A lists selected Federal excise tax rates, and Appendix B lists selected Puerto Rican excise tax rates.

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[1] This pamphlet may be cited as follows: *Tax Rules Relating to Puerto Rico Under Present Law and Under Statehood, Independence, and Enhanced Commonwealth Status (S. 712, Puerto Rico Status Referendum Act)* (JCS-19-89), November 14, 1989.

[2] S. Rep. No. 101-120, 101st Cong., 1st Session (1989). S. 712 also has been jointly referred to the Senate Committee on Agriculture, Nutrition, and Forestry.

I. PRESENT LAW

A. Overview of United States Tax Rules

1. Taxation of individuals

General rules

The United States generally imposes income tax on the worldwide income of U.S. citizens and residents. The rate structure currently consists of two brackets with rates of 15 and 28 percent.[3] Individuals are eligible for personal exemptions for themselves and for each of their qualified dependents of $2,000 in 1989. In addition, a standard deduction of $3,100 is permitted for single filers and $5,200 for joint filers in 1989. Thus, in general, no Federal income tax is due from a single filer with less than $5,100 of adjusted gross income.[4] The corresponding amount for a married couple with two dependent children would be $13,200.

As a general rule, every U.S. citizen or resident is required to file an annual U.S. individual income tax return. However, an individual whose gross income for a taxable year is less than the sum of the personal exemption amount and the basic standard deduction which is applicable to such individual is excused from this filing requirement.

The U.S. tax system permits numerous deductions, exclusions, and credits in the calculation of taxable income and tax liability. Certain expenses are permitted as itemized deductions that reduce taxable income if the sum of these expenses exceeds the standard deduction. In particular, State and local income and property taxes generally are permitted as itemized deductions.

The earned income tax credit is available to taxpayers who maintain a household for a child. In 1989, the credit equals 14 percent of the first $6,500 of earnings. The credit is reduced by 10 percent of income in excess of $10,240 and is completely phased out at $19,360. The earned income credit is refundable and thus the amount of credit that exceeds the tax otherwise due is paid to the taxpayer. For example, in 1989 a married couple with two children would owe no U.S. income tax and in addition would receive a payment from the U.S. Treasury if their only income were earned income of less than $15,600.

Nonresident alien individuals are subject to U.S. tax, at the above rates, on their net income effectively connected with the conduct of a trade or business in the United States. Such individuals are also subject to a tax (at different rates computed on the basis of

[3] The phaseout of the benefits of the 15-percent bracket and personal exemptions results in a marginal rate of 33 percent for certain income levels.

[4] Other than for certain minor children who are claimed as dependents on their parents' return.

ross income) on certain other types of U.S. source income. Puerto ico generally is not included as part of the United States for this urpose or other purposes of the Internal Revenue Code.[5]

Treatment of foreign source income

In general, U.S. persons (e.g., U.S. residents and U.S. citizens no natter where they reside) are taxed on all their income whether rom U.S. or foreign sources. A credit, with limitations, may be laimed for foreign taxes paid or accrued, or alternatively foreign axes may be treated as an itemized deduction. For this purpose uerto Rico is generally treated as a foreign country.

Code section 911 provides that a U.S. citizen or resident with a ax home abroad may under certain circumstances elect to exclude n amount of his or her foreign earned income from gross income. The maximum exclusion is generally limited to $70,000 per year plus certain housing costs. No deductions, exclusions, or credits are llowed for amounts allocable to this excluded income.

Taxation of U.S. persons residing in Puerto Rico

Under the Jones Act,[6] Puerto Rico is deemed to be a part of the United States for purposes of acquiring citizenship of the United States by place of birth.[7] Thus, a person born in Puerto Rico is typically a U.S. person for U.S. tax purposes. However, section 933 of the Code provides that income derived from sources within Puerto Rico by an individual who is a resident of Puerto Rico generally will be excluded from gross income and exempt from U.S. taxation, even if such resident is a U.S. citizen. Such income will generally be subject to taxation by the Commonwealth of Puerto Rico. Items of income earned from sources outside of Puerto Rico by U.S. persons who reside in Puerto Rico are generally subject to U.S. taxation.

Because Puerto Rico source income earned by U.S. citizens who reside in Puerto Rico is excluded from gross income for U.S. tax purposes, such individuals who earn less than the applicable threshold amount of income from non-Puerto Rico sources generally are not required to file a U.S. income tax return. Presumably, most income of residents of Puerto Rico is derived from sources within Puerto Rico. Thus, it is likely that the majority of Puerto Rican residents do not earn a sufficient amount of non-Puerto Rico source income to require them to file U.S. income tax returns.

Estate and gift tax

For U.S. citizens and residents, the amount subject to estate and gift tax is determined by reference to all property, wherever situated. For nonresident aliens, such amount is determined only by reference to property situated in the United States.

The Federal estate and gift taxes are unified, so that a single progressive rate schedule is applied to an individual's cumulative

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[5] Puerto Rico is generally treated as a "State" and as part of the United States, however, for purposes of the Federal Insurance Contributions and Unemployment Acts (Code secs. 3121(e) and 3306(j)). Thus, under present law, residents of Puerto Rico generally are subject to the Federal employent taxes imposed under these Acts.

[6] Ch. 145, 39 Stat. 951 (1917), 48 U.S.C. secs. 731 et seq. (1982).

[7] 48 U.S.C. sec. 733 (1982).

gifts and bequests. The gift and estate tax rates begin at 18 percent on the first $10,000 of taxable transfers and reach 55 percent on taxable transfers over $3 million (50 percent on taxable transfers over $2.5 million in the case of decedents dying and gifts made after 1992). The estate and gift tax rate for transfers in excess of $10 million is increased by five percent until the benefit of the unified credit and graduated brackets is recaptured.

U.S. citizens and residents are allowed a unified credit of $192,800 in determining estate and gift tax. This is equivalent to an exemption for otherwise taxable transfers totaling $600,000. In place of the unified credit, nonresident aliens are allowed a credit of $13,000 in determining estate tax.

Under a special rule, a U.S. citizen residing in a possession is treated as a nonresident alien for estate and gift tax purposes only if citizenship was acquired solely by reason of citizenship of, or birth or residence within, the possession (secs. 2209 and 2501(c); *cf.* secs. 2208 and 2501(b)). Transfers of property by residents of Puerto Rico that are exempt from Federal estate and gift taxation in the United States under these provisions are generally subject to estate and gift taxation in Puerto Rico, the limited extent of which is discussed below in Part I.B.1. Estates of decedents qualifying under this rule are allowed a credit against the estate tax equal to the greater of $13,000 or that proportion of $46,800 which the value of that part of the decedent's gross estate which at the time of death was situated in the United States bears to the value of the entire gross estate wherever situated (sec. 2102(c)(2)).

2. Taxation of corporations

U.S. corporations, in general, are subject to U.S. income tax on their worldwide income. Corporations are taxed at a 34-percent rate on income in excess of $75,000. The benefit of lower marginal tax rates on income less than $75,000 is phased out above $100,000 of income.

Foreign taxes paid or accrued are creditable, with limitations, against U.S. tax liability, or alternatively may be deducted in calculating taxable income. Special rules, described in detail below in Part I.C., apply to income derived in U.S. possessions by certain domestic corporations.

3. U.S. taxation of Puerto Rico obligations

The interest on a bond issued by the Commonwealth of Puerto Rico or its municipalities is generally exempt from tax (sec. 103). The exemption does not apply to any bond that is a non-qualified private activity bond (within the meaning of sec. 141), an arbitrage bond (within the meaning of sec. 148), or a bond issued in unregistered form.

B. Overview of Tax Rules of Puerto Rico

The Constitution of the Commonwealth of Puerto Rico provides that the power of the Commonwealth to impose and collect taxes and to authorize their imposition and collection by municipalities shall be exercised as determined by the Legislative Assembly and shall never be surrendered or suspended. Under its Income Tax

Act, Excise Tax Act, and Estate and Gift Tax Act, Puerto Rico has imposed such taxes in ways that are in some ways similar to, and in other ways different from, U.S. Federal taxes. In particular, the Puerto Rico Income Tax Act was extensively reformed in 1987, in some instances closely following the Federal income tax changes of the Tax Reform Act of 1986.[8]

1. Taxation of individuals

Income tax

Individuals who are resident in Puerto Rico (regardless of citizenship) are subject to tax by the Commonwealth of Puerto Rico on their worldwide income. Generally, a person is considered a resident of Puerto Rico for Puerto Rican income tax purposes if that person is actually present in Puerto Rico and is more than a mere transient or sojourner. Resident individuals are entitled to deduct from gross income[9] those expenses which are connected with the conduct of a trade or business or with the production of income. Additionally, they can claim either certain itemized deductions or a standard deduction, whichever is greater. Itemized deductions include certain mortgage interest, residential property tax, auto license fees, certain casualty losses, and subject to limitations, medical expenses, charitable contributions, personal interest,[10] rent paid on the taxpayer's principal residence, and certain education costs. For 1989, the standard deduction is $3,000 for married persons filing joint returns, $2,000 for single individuals, $2,600 for heads of households, and $1,500 for married persons who file separate returns. Resident individuals are also permitted to claim personal exemptions in the amount of $1,300 for single persons, or $3,000 for married persons filing jointly or heads of households. Additionally, a personal exemption is allowed in the amount of $1,300 for each dependent of the taxpayer ($1,600 in the case of certain dependents who are full time university students). A married couple with two dependent children, for example, has no income tax liability if their income is less than $8,600.

Pursuant to the 1987 tax reform, marginal individual tax rates are reduced from a pre-reform high of 50 percent to 33 percent. This reduction is phased in over a three-year period commencing in 1988.[11] Similar to the U.S. tax system, the Puerto Rican tax system phases out the benefits of the graduated tax rates and personal and dependent exemptions at a 5-percent rate beginning at $75,000 of taxable income.

At the election of the taxpayer, interest income in excess of $2,000 earned by Puerto Rican resident individuals from deposits with Puerto Rican financial institutions may be taxed at a flat rate

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[8] Although the Puerto Rican tax reform changes generally became effective soon after enactment, individuals may elect to delay the effective date of such changes for five years.

[9] Generally, gross income includes all income derived from whatever source, less certain exclusions. Items of exclusion include among others, gifts, inheritances, amounts received under a life insurance contract, interest on government obligations, and interest on individuals' savings accounts up to $2,000 annually.

[10] Similar to U.S. tax law, the deduction for personal interest is currently being phased out and will no longer be deductible following 1989.

[11] The top marginal rate for 1988 is 45 percent, for 1989 is 38 percent, and for 1990 and beyond is 33 percent.

of 17 percent withheld at source. The first $2,000 of such income is excluded from taxable income. Additionally, a maximum tax rate of 20 percent applies to Puerto Rico source dividends, which tax is also withheld at source.

Individuals with taxable income in excess of $75,000 are subject to an alternative basic tax, if the amount of such tax is higher than the taxpayer's regular tax. The rate of the tax varies from 10 to 20 percent as taxable income increases.

Nonresident individuals are taxed the same as residents with respect to income which is effectively connected with a trade or business conducted in Puerto Rico. Generally, nonresidents are subject to a withholding tax of 29 percent on non-effectively connected fixed and determinable annual or periodical income and capital gains.[12]

Estate and gift tax

For residents of Puerto Rico, the amount subject to estate and gift tax is determined nominally by reference to all property, wherever situated. However, property located in Puerto Rico is generally deductible from any gift and from the gross estate (except in the case of a U.S. citizen decedent whose worldwide gross estate is subject to U.S. estate taxation, as discussed below). Nonresidents of Puerto Rico are subject to estate and gift tax only on property located in Puerto Rico.

Puerto Rico's estate and gift taxes are unified, so that a single progressive rate schedule is applied to an individual's cumulative gifts and bequests. The estate and gift tax rates begin at 18 percent on the first $10,000 of taxable transfers and reach 50 percent on taxable transfers over $2.5 million. Nonresidents whose estates are subject to tax in their countries of origin are taxed in the amount of the maximum tax credit allowed by the estate tax rules of such country on property located in Puerto Rico, rather than by application of the progressive rates to property located in Puerto Rico. In the case of U.S. citizen decedents (1) who were resident in Puerto Rico and whose worldwide gross estate is subject to U.S. estate taxation, or (2) who were not resident in Puerto Rico and whose gross estate located in Puerto Rico is subject to U.S. estate taxation, the estate tax law provides that a tax equal to the maximum credit computed under section 2014(b)(2) of the Code shall be imposed on that part of the gross estate located in Puerto Rico.

Residents of Puerto Rico are allowed a fixed exemption (in lieu of a unified credit) in the amount of $400,000 in determining the taxable estate, reduced by the deduction taken for property located in Puerto Rico. The estates of nonresidents of Puerto Rico who were citizens of the United States generally are eligible for a fixed exemption in the amount of $10,000. However, in the case of a U.S. citizen not resident in Puerto Rico whose property in Perto Rico is not subject to estate taxation in the United States, the law provides that the allowable exemption is the greater of (a) the proportion between the value of all the gross estate of the decedent subject to

[12] If the individual is a U.S. citizen, the withholding rate is generally 20 percent.

taxation and the estate in both jurisdictions, multiplied by $60,000 or (b) $30,000.

2. Taxation of corporations and partnerships

In general

Under current Puerto Rican tax law, corporations and partnerships are generally both taxed on an entity basis.[13] Such entities which are organized or created under the laws of Puerto Rico are subject to tax on their worldwide income, determined on a net profits basis.

Corporations and partnerships which are organized or created under the laws of a country other than Puerto Rico are taxed on income earned from sources within Puerto Rico and on income that is effectively connected with the conduct of a trade or business in Puerto Rico.

Puerto Rican corporations and partnerships and the effectively connected income of non-Puerto Rican corporations and partnerships are generally subject to three separate income taxes in Puerto Rico: a "normal tax" which is imposed on all taxable income at a flat rate of 22 percent, a "surtax" which is levied at graduated rates on a progressive basis, and an "additional tax" of 5 percent on certain corporations and partnerships. The benefits of the graduated rates are phased out by the additional tax beginning at $500,000 of taxable income. For taxable years beginning prior to January 1, 1989, the combined effect of the applicable taxes provided marginal tax rates that ranged from 22 to 45 percent. For taxable years beginning after December 31, 1988, the 22 percent minimum rate remains unchanged, but the maximum rate will be gradually reduced over a four-year period to 35 percent.[14]

Gains from the disposition of capital assets held for more than six months are subject to a maximum tax of 25 percent.

Affiliated Puerto Rican corporations and partnerships are not permitted to consolidate their operations for purposes of determining their Puerto Rican income tax liability. Thus, each member of an affiliated group must file a separate Puerto Rican income tax return and generally pay tax on its separate taxable income.

Non-effectively connected fixed or determinable annual or periodical income (e.g., interest, dividends, royalties, rents, wages, and annuities) that is earned from sources within Puerto Rico by non-Puerto Rican corporations and partnerships is generally subject to a gross basis withholding tax of 29 percent, except that certain specified items of such income are subject to withholding tax at reduced rates.[15]

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[13] However, certain partnerships referred to as "special partnerships" are allowed flow through treatment similar to the treatment afforded to partnerships under U.S. tax law. To qualify as a special partnership, at least 70 percent of the partnership's income must be from Puerto Rico sources and at least 70 percent of its gross income must be derived from certain specified activities.

[14] The highest marginal rate for 1989 is 42 percent, for 1990 is 39 percent, for 1991 is 37 percent, and for 1992 and beyond is 35 percent.

[15] For example, dividends are subject to withholding tax at a rate of either 10 percent (if derived from manufacturing or other specified activities) or 25 percent.

Alternative minimum tax

As part of the 1987 tax reform, a corporate alternative minimum tax was enacted that is similar, in some respects, to the U.S. corporate alternative minimum tax. The Puerto Rican corporate alternative minimum tax will apply if it results in a tax liability greater than the corporation's regular tax liability.

The corporate alternative minimum tax rate is a flat 22 percent, levied on "alternative minimum net income." Generally, alternative minimum net income is computed by adding back to taxable income certain items which receive preferential treatment in computing the regular tax. Items of tax preference include flexible depreciation (discussed in Part I.B.4.), income deferred under the installment method, and net operating losses, among others. Additionally, alternative minimum net income is increased by an amount equal to 50 percent of the excess of the corporation's net income per its audited financial statements over alternative minimum net income before this adjustment.

Branch profits tax

Puerto Rico also imposes a tax on certain profits of a Puerto Rican branch of a non-Puerto Rican corporation or partnership. The purpose of the branch profits tax is to provide similar tax treatment to Puerto Rican branches and Puerto Rican subsidiaries of non-Puerto Rican corporations and partnerships. The branch profits tax rate is generally equal to 25 percent of the branch's "dividend equivalent amount." This amount represents profits of the branch that are effectively connected with a trade or business in Puerto Rico, and that are not reinvested in such a trade or business.

The branch profits tax rate is only 10 percent for manufacturing, hotel, and shipping operations; and the tax is inapplicable to non-Puerto Rican corporations and partnerships that derive at least 80 percent of their gross income from Puerto Rico sources.[16]

In addition to the branch profits tax, a special 29 percent branch-level interest tax is levied on the excess of the amount of interest deducted by a Puerto Rican branch over the amount of interest it actually paid during the taxable year.

3. Foreign tax credit

Non-Puerto Rican taxes paid by a Puerto Rican corporation, Puerto Rican partnership, or individual resident in Puerto Rico on non-Puerto Rico source income can be claimed as a credit against Puerto Rican tax on such income. This credit, however, is subject to a per-country limitation and an overall limitation. Alternatively, non-Puerto Rican taxes may be claimed as a deduction against gross income in arriving at taxable income.

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[16] This exemption from the branch profits tax generally covers U.S. corporations that claim benefits under Code section 936.

Tax incentives

In general

The Puerto Rican tax law provides numerous tax incentives intended to encourage capital formation and attract foreign investment. Many of these incentives are available to sole proprietorships, as well as to corporations and partnerships.

Industrial tax incentives

The Puerto Rico Tax Incentives Act of 1987 provides for a partial tax exemption for corporate income and property taxes. Generally, taxpayers engaged in manufacturing or that provide export services are allowed 90-percent tax exemptions on their industrial development income. The length of time for which a taxpayer may qualify for this incentive depends on the location of the taxpayer's qualified operation, as set forth in the following table.

Investment in:	*[Exemption is applicable for]* *Years*
High Industrial Zones	10
Intermediate Industrial Zones	15
Low Industrial Zones	20
Vieques and Culebra [17]	25

An eligible taxpayer is permitted to elect specific taxable years to which the exemption would apply. For example, if an eligible taxpayer incurs a net operating loss during the first taxable year in which it qualifies for the exemption, it could elect not to apply the exemption for that year and still have the full exemption period remaining. Following the expiration of the applicable exemption period, manufacturing firms may apply for an additional ten years of exemption at a 75-percent exemption rate.

A manufacturing operation that qualifies under the tax incentive system and that has income of less than $500,000 and employs more than 15 persons generally is granted a 100-percent tax exemption on the first $100,000 of such income. In lieu of this exemption, certain manufacturing companies are allowed a deduction equal to 15 percent of their production worker payroll, not to exceed 50 percent of industrial development income.

Other tax incentives which are made available to manufacturing firms include a reduced tax of 5 percent on the repatriation of one-half of current earnings by a Puerto Rican corporation to a non-Puerto Rican shareholder if the other half is invested for at least five years in designated Puerto Rican assets.[18]

Puerto Rico also provides incentives to certain financial institutions referred to as "International Banking Entities" (IBEs). Generally, income earned by an IBE from authorized activities is completely exempt from income and branch profits tax. Also, distributions of such earnings to owners of the IBE are exempt from all withholding tax.

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[17] Offshore islands.

[18] After the expiration of the five-year period, the reinvested earnings may also be repatriated, subject to a 5-percent tax.

Taxpayers in other specified industries also are eligible for various tax incentives. The favored industries include shipping, agriculture, tourism, art and literature. Generally, the incentives are provided by means of special tax exemptions or deductions that vary by industry.

Flexible depreciation

As a general rule, a taxpayer is permitted to claim depreciation deductions for the cost of a capital asset over the asset's estimated useful life. Depreciation is usually claimed either on a straight-line basis or on any other basis in accordance with a recognized trade practice.

However, in certain circumstances, taxpayers are entitled to claim depreciation deductions on an accelerated system known as "flexible depreciation." Flexible depreciation may be claimed by taxpayers with income from construction, agriculture, land development, real estate rehabilitation, real estate development, manufacturing, hotel, tourism, shipping, and certain export operations. Under the flexible depreciation system, a taxpayer may elect to depreciate all, part, or none of the undepreciated cost of the qualifying asset during the taxable year. The deduction is limited, however, to an amount not to exceed 100 percent of the pre-depreciation net income of the qualified activity for the taxable year.

For example, assume a taxpayer engaged in manufacturing has pre-depreciation net income for the taxable year of $100,000, and has manufacturing equipment with an undepreciated basis of $200,000. Further assume that under the general depreciation system, the taxpayer would receive a depreciation deduction in the amount of $20,000. Under the flexible depreciation system, the taxpayer is permitted to claim up to $100,000 of depreciation, thereby reducing its taxable income to zero.

C. U.S. Internal Revenue Code Section 936

As described above, a U.S. domestic corporation is subject to U.S. Federal income tax on its worldwide income. Generally, a foreign corporation is subject to U.S. income tax only with respect to its income derived from sources within the United States or income which is effectively connected with the conduct of a trade or business in the United States. For this purpose, a domestic corporation is one created or organized under U.S. or State law, and the term "United States" generally includes only the 50 States and the District of Columbia. Any other corporation is a foreign corporation. For example, a corporation organized under Delaware corporate law and doing business solely in Puerto Rico is a domestic corporation and is therefore generally subject to U.S. tax on its Puerto Rican income; by contrast, a corporation organized under the laws of Puerto Rico, and engaged in the same business as the Delaware corporation in Puerto Rico, is a foreign corporation and is subject to no U.S. tax.

A domestic corporation in certain circumstances may eliminate its U.S. tax on certain income associated with certain possessions (including Puerto Rico) and certain foreign countries by means of the possessions tax credit under section 936 of the Internal Revenue Code. In effect, this credit may eliminate all income tax on a domestic corporation doing business in Puerto Rico where the corporation is also excused from Puerto Rican income tax pursuant to a tax incentive provided under Puerto Rican law as described above.

1. Qualification requirements

In order to qualify for the possessions tax credit, a domestic corporation must satisfy the following two requirements. First, the corporation must derive at least 75 percent of its gross income from the active conduct of a trade or business within a U.S. possession (which can include the Commonwealth of Puerto Rico) during the preceding three years.[19] Second, at least 80 percent of the gross income of the corporation must be derived from sources within a U.S. possession during that same three-year period. A domestic corporation which satisfies these requirements and elects the benefits of section 936 is generally referred to as a "qualified possessions corporation" or a "section 936 corporation."

2. Operation of the credit

General rule

As described above, a qualified possessions corporation, like any other domestic corporation, is generally subject to U.S. taxation on its worldwide income. However, section 936 allows such a corporation a credit equal to the portion of its U.S. tax liability that is attributable to (1) foreign source taxable income from the conduct of an active trade or business within a U.S. possession or the sale or exchange of substantially all of the corporation's assets which were used in such a trade or business, and (2) certain income earned from investments in U.S. possessions or certain foreign countries, generally referred to as qualified possession source investment income ("QPSII").

To illustrate the operation of the section 936 credit, consider the following examples. Assume that a qualified possessions corporation which has elected the use of the section 936 credit earns $80 of foreign source taxable income from the active conduct of a trade or business in Puerto Rico, and $20 of QPSII (also foreign source) during the taxable year. Further assume that the corporation earns no additional income. Absent the section 936 credit, the corporation would have a U.S. tax liability of $34.[20] However, section 936 allows a tax credit equal to the portion of tentative U.S. tax attributable to Puerto Rico-related income. Since all of the corporation's taxable income for the year was derived from an active business conducted in Puerto Rico or from QPSII, the credit eliminates the corporation's entire U.S. tax liability for the year.

Now assume that the same company earned an additional $20 from U.S. sources during the taxable year. In this case, the corporation's U.S. tax liability prior to application of the credit would be $40.80.[21] Because $100 of the corporation's taxable income was pos-

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[19] The majority of corporations that currently qualify for the section 936 credit have established operations in Puerto Rico.
[20] $100 multiplied by the current corporate tax rate of 34 percent.
[21] $120 x .34 = $40.80.

session source income which qualifies for the credit, the credit would reduce the corporation's U.S. tax liability to only $6.80.[22]

As this description indicates, the section 936 credit, unlike the ordinary foreign tax credit, is a "tax-sparing" credit. That is, the foreign tax credit is applicable only where a U.S. corporation has actually paid or accrued a foreign tax liability with respect to income earned from non-U.S. sources. The foreign tax credit operates as a mechanism to prevent double taxation of the same item of foreign source income. By contrast, the section 936 credit is not contingent on taxation in the possession, but spares the section 936 corporation U.S. tax whether or not it pays income tax to the possession. In fact, qualified possessions corporations are typically granted full or partial exemptions from Puerto Rican income taxes under the tax incentive programs described above. Therefore, the section 936 credit often allows corporations to earn income that is subject to little or no income tax by any jurisdiction.

Taxation of intangible property income

Prior to enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), many U.S. companies took the position that they could utilize qualified possessions corporations to generate tax-free income from any intangible property that had been developed in the United States by such U.S. companies. To achieve this result, a U.S. company would transfer developed intangible property to a wholly owned qualified possessions corporation. That transfer would generally be free of U.S. tax under Code section 351. The qualified possessions corporation would, in turn, use the intangible property in its Puerto Rican manufacturing operations. Profits attributable to the intangible property would be recognized by the qualified possessions corporation upon sale of its manufactured product. Taxpayers argued that because such profits were attributable to an active business conducted in Puerto Rico, they were eligible for the section 936 credit and could escape U.S. taxation. These positions were the subject of considerable disagreement between taxpayers and the U.S. government.

In response to the issues associated with the transfer of intangible property developed in the United States, the Congress in TEFRA added sections 367(d) and 936(h) to the Code. Section 367(d) provides special rules which generally treat the transfer of intangible property by a U.S. person to a foreign person in an otherwise tax-free exchange or reorganization as a taxable sale of such property, the sales price of which is contingent on the future income to be generated by the intangible property. The resulting income is treated as having a U.S. source. Section 936(h) provides rules for allocating income from intangible property between a qualified possessions corporation and its U.S. shareholders. Three alternative methods are provided for allocating intangible property income. These methods include (1) a general rule, (2) a cost sharing method, and (3) a profit split approach. Under the general rule, a qualified possessions corporation is prohibited from earning any return on intangible property. Instead, all such income must be allocated to

[22] $40.80 x ((120-100)/120) = $6.80.

its U.S. shareholders. However, a qualified possessions corporation may elect to use either the cost sharing or profit split method instead of the general rule.

The operation of the cost sharing and profit split methods was revised by the Tax Reform Act of 1986. Relevant 1986 Act revisions included both direct amendments to section 936(h) and also amendments to section 482. Insofar as amounts computed under either method were determined by reference to the meaning of "arms length" as used in section 482, these methods were affected by the requirement, added by the 1986 Act, that the income with respect to any transfer or license of intangible property shall be "commensurate with the income attributable to the intangible."

Currently under the cost sharing method, a qualified possessions corporation must pay to the appropriate members of its affiliated group (which includes foreign affiliates) an amount representing its current share of the costs of the research and development expenses incurred by the affiliated group. A qualified possessions corporation's current share of the affiliated group's research and development expenses is the greater of (1) the total amount of such expenses, multiplied by 110 percent of the proportion of its sales as compared to total sales of the affiliated group, or (2) the amount of the royalty payment or inclusion that would be required under sections 367(d) and 482 with respect to intangibles which the qualified possessions corporation is treated as owning under the cost sharing option, were the latter a foreign corporation (whether or not intangibles actually are transferred to the qualified possessions corporation). By making this cost sharing payment, the qualified possessions corporation becomes entitled to treat its income as including a return from certain intangibles, primarily manufacturing intangibles, associated with the products it manufactures in the possession.

Under the profit split method, the qualified possessions corporation and its U.S. affiliates are permitted to split their combined taxable income derived from sales of products which are manufactured in the possession by the qualified possessions corporation. Generally, 50 percent of this combined taxable income is allocated to the qualified possessions corporation. However, a special allocation of research and development expenses as required by section 936(h)(5)(C)(ii)(II) can cause the proportion of combined taxable income allocated to the qualified possessions corporation to be less than 50 percent. In no event under the profit split approach will the portion of combined taxable income which is allocable to the qualified possessions corporation exceed 50 percent.

As a result of the 1986 Act provision that requires the amount of a cost sharing payment to be determined in accordance with the rules of section 367(d), some taxpayers previously utilizing that method may find that they are no longer able to claim as much section 936 credit against U.S. tax on income attributable to intangible property under that method as they would be able to claim using the profit split method. As a result, some taxpayers may find the cost sharing method less desirable and may switch to the profit split approach, as permitted by I.R.S. Notice 87-27, 1987-1 C.B. 471. Because Treasury has yet to issue certain guidelines applicable to the relevant computations, the time for making such a switch has

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been extended by I.R.S. Notice 88-97, 1988-2 C.B. 421, and I.R.S. Notice 89-82, 1989-32 I.R.B. 54.

Alternative minimum tax

Income earned by a qualified possessions corporation that qualifies for the section 936 credit is excluded from alternative minimum taxable income, and therefore is not subject to the alternative minimum tax.

Taxation of distributions to shareholders of qualified possessions corporations

A qualified possessions corporation is not permitted to join in filing a consolidated U.S. tax return. Therefore, dividends paid by the qualified possessions corporation to its U.S. shareholders are not eliminated under the rules applicable to affiliated groups of corporations that file tax returns on a consolidated basis. However, such dividends may qualify for the deduction for dividends received from a domestic corporation (sec. 243). In the case of a corporate shareholder that owns at least 80 percent of a qualified possessions corporation, 100 percent of dividends received from such corporation generally are deductible by the shareholder. For corporate shareholders owning less than 80 percent of a qualified possessions corporation, a 70-percent dividends received deduction is available. Consistent with the benefits provided by the dividends received deduction to corporate shareholders of qualified possessions corporations, non-corporate taxpayers rarely own the stock of qualified possessions corporations. Such corporations are generally owned by U.S. corporations with sufficient stock ownership to qualify for the 100-percent dividends received deduction. Thus, in most cases, income earned in Puerto Rico by a qualified possessions corporation can be distributed to a U.S. corporate shareholder without incurring any regular U.S. income tax, either to the qualified possessions corporation or to the U.S. corporate shareholder. However, the dividend constitutes adjusted current earnings of the U.S. corporate shareholder for purposes of computing the alternative minimum tax.

Earnings on funds invested by a U.S. corporation are generally subject to U.S. tax. On the other hand, undistributed retained earnings of a qualified possessions corporation which are invested in Puerto Rico (or, indirectly, in certain foreign countries) generally produce QPSII, which is not subject to U.S. tax. As a result, there appears to be little incentive for a qualified possessions corporation to repatriate earnings to the United States (except to the extent that the corporation would otherwise fail to meet the 75-percent active business test) when tax-free income can be earned by investing such amounts elsewhere.

D. Excise Taxes

1. U.S. excise taxes

The Internal Revenue Code imposes a variety of excise taxes on the manufacture, sale or use of particular commodities or services. Occupational taxes and penalty taxes imposed on certain other activities (e.g., prohibited transactions of tax-exempt entities) are also provided as excise taxes. Many excise taxes are collected at the manufacturing level or, in the case of commodities produced abroad, upon importation. Other excise taxes are collected at the wholesale or retail level. (Certain Federal excise taxes imposed under the Internal Revenue Code are listed in Appendix A.)

U.S. excise taxes generally do not apply within Puerto Rico.[23] However, a special excise tax is imposed on articles which are manufactured in Puerto Rico and shipped into the United States for sale or consumption. The tax is equal to the Federal excise tax that would be imposed if the articles were manufactured in the United States (sec. 7652).[24]

Revenues collected from the tax on articles coming into the United States from Puerto Rico are generally "covered over" (i.e., paid) to the Puerto Rican Treasury. With respect to excise taxes imposed on articles not containing distilled spirits, revenues are covered over to Puerto Rico only if the cost or value of materials produced in Puerto Rico plus the direct costs of processing operations performed in Puerto Rico equal at least 50 percent of the value of the article at the time it is brought into the United States (sec. 7652(d)(1)). Moreover, no cover over is permitted on such articles if Puerto Rico provides a direct or indirect subsidy with respect to the article that is unlike the subsidies Puerto Rico generally offers to industries producing articles not subject to Federal excise tax (sec. 7652(d)(2)).

With respect to Federal excise taxes imposed on articles containing distilled spirits that are manufactured in Puerto Rico and shipped into the United States, revenues are covered over to the Puerto Rican Treasury only if at least 92 percent of the alcoholic content of such articles is attributable to rum (sec. 7652(c)). The amount of excise taxes covered over to Puerto Rico with respect to such articles cannot exceed $10.50 per proof gallon (sec. 7652(f)).

In addition, a provision of the Code added by the Caribbean Basin Initiative (described in Part I.F., below) provides a special rule for excise taxes collected on rum imported into the United States from any country. Such excise taxes are covered over to the treasuries of Puerto Rico and the U.S. Virgin Islands, under a formula prescribed by the U.S. Treasury Department for the division of such tax collections between Puerto Rico and the Virgin Islands (sec. 7652(e)).[25] This formula currently results in the cover over of approximately 88 percent of revenues from rum excise taxes to Puerto Rico and the remainder of such revenues to the Virgin Islands.

A special excise tax rule also applies when articles manufactured in the United States are shipped to Puerto Rico (sec. 7653). In such cases, the articles are exempt from Federal excise taxes and, upon being entered in Puerto Rico, are subject to a tax equal in rate and amount to the excise tax imposed in Puerto Rico upon similar articles of Puerto Rican manufacture.

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[23] *See* 48 U.S.C. sec. 734 (1982).

[24] No tax is imposed, however, with respect to distilled spirits manufactured in Puerto Rico and brought into the United States for certain nonbeverage purposes, as provided for by section 5314.

[25] The formula for division of rum excise taxes between Puerto Rico and the Virgin Islands is contained in 27 C.F.R. part 250.31 (1988).

2. Puerto Rico excise taxes

Puerto Rico generally imposes a 5-percent excise tax on a broad range of commodities, transactions, and occupations, with special excise tax rates for certain articles such as sugar, cigarettes, and petroleum products.[26] (Selected Puerto Rican excise tax rates are listed in Appendix B.) Articles manufactured in Puerto Rico and exported therefrom are exempt from Puerto Rican excise taxes, as are articles introduced by importers and deposited in bonded warehouses for reexportation. In addition, certain enumerated items (e.g., food, religious items, certain farm equipment, books, magazines, newspapers, children's clothes, and various personal and medical items) are exempt from Puerto Rican excise taxes.

E. Tax Treaties

In addition to the Federal, State, and local tax laws contained in the Internal Revenue Code and other statutes, tax rules governing U.S. persons, or U.S. income, may also be determined by bilateral or other treaty obligations between the United States and foreign countries. Generally, the purposes of such treaties are the avoidance of double taxation and the prevention of fiscal evasion.

Treaties accomplish the goal of avoiding double taxation by limiting the amount of tax that may be imposed by one treaty country on the income earned by residents of the other treaty country, by ensuring the creditability of taxes imposed by the treaty country where income was earned (the "source country") in computing the amount of tax owed by a resident of the other treaty country to his or her residence country (or by exempting from residence country tax income derived from sources in the other treaty country), and by providing procedures under which inconsistent positions taken by both treaty countries with respect to a single item of income or deduction may be mutually resolved by the two countries. Treaties prevent fiscal evasion by providing for exchange of taxpayer information between the two taxing authorities, and in some cases by providing that each tax authority will assist the other in revenue collection. In addition, treaties typically provide that nationals of one treaty country may not be subject by the other treaty country to taxes or requirements connected therewith that are other or more burdensome than those applicable to similarly situated nationals of the other treaty country. Generally, treaties may be used by residents or citizens of one country to reduce the taxes that would otherwise be payable to the other country under its internal laws. Treaties generally do not operate to increase the amount of taxes that would otherwise be due under internal law.

The United States is currently a party to over 35 bilateral income tax treaties, over 15 estate and gift tax treaties, approximately five agreements for the exchange of taxpayer information, and certain other treaties (e.g., friendship, commerce, and navigation treaties) that may affect tax relations with residents or nationals of other countries. The preferred tax treaty policies of U.S. Administrations have been expressed from time to time in model treaties and agreements. In addition, the Organization for Economic

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[26] *See* 1987 Commonwealth of Puerto Rico Excise Act.

Cooperation and Development and the United Nations have published model tax treaties.

Other countries' preferred tax treaty policies may differ from those of the United States depending on their internal tax laws and depending upon the balance of investment and trade flows between those countries and their potential treaty partners. For example, the United States has in the past attempted to negotiate treaties that waive all source country tax on interest, royalties, and personal property rents paid to residents of the other treaty country. Certain capital importing countries, on the other hand, may be interested in imposing relatively high source country tax on such income. In cases where a country taxes certain local business operations at a relatively low rate, or a zero rate of income tax (whether to attract manufacturing capital to that country or for other reasons), that country may seek to enter into "tax-sparing" treaties with capital exporting countries. That is, the first country may seek to enter into treaties under which the capital exporting country gives up its tax on the income of its residents derived from sources in the first country, regardless of the extent to which the source country has imposed tax with respect to that income.[27] However, the United States has rejected proposals by certain foreign countries to enter into such tax sparing arrangements.[28]

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

F. Caribbean Basin Initiative

The Caribbean Basin Economic Recovery Act (title II of Pub. L. No. 98-67, 97 Stat. 369 (1983), also known as the Caribbean Basin Initiative, or "CBI") provides for an integrated, mutually reinforcing set of measures in the fields of trade, tax, investment, and financial assistance to address both emergency problems and long-range economic development among the countries of the Caribbean basin. The Act lists 27 countries that each may be treated as a beneficiary country under the CBI if there is in effect a proclamation by the President designating such country as a beneficiary country.[29] The CBI provides that the President may not make such a

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[27] For a statement of some of the policies implicated by tax sparing, see, e.g., *Double Taxation Convention with Pakistan: Hearing before the Senate Comm. on Foreign Relations*, 85th Cong., 1st Sess. 1-34 (1957) (testimony of Professor Stanley Surrey).

[28] By contrast, the United States has provided, through section 936 of the Code, for "tax-sparing" with respect to certain Puerto Rican source (and other possession source) income of U.S. companies.

[29] The countries listed in the CBI are the following:

Anguilla
Antigua and Barbuda
The Bahamas
Barbados
Belize
British Virgin Islands
Cayman Islands
Costa Rica
Dominica
Dominican Republic
El Salvador
Grenada

Continued

designation, or must withdraw the designation, under certain enumerated circumstances inimical to U.S. public policy in the region. Currently, 22 countries have been designated.[30]

The CBI contains provisions to ensure that Puerto Rico and other U.S. possessions not suffer from the benefits conferred on beneficiary countries under the CBI. For example, insofar as favorable duties on rum imported into the United States from beneficiary countries might have reduced the quantity of Puerto Rican rum imported into the United States, and hence reduce the cover over to Puerto Rico of rum duties under Code section 7652(a), the CBI provides (as described above in Part I.D.) for a cover over to Puerto Rico of rum duties collected from other countries as well, under a formula to be prescribed by the Treasury.

Expenses for attending conventions outside the "North American area" are not deductible unless certain conditions are met. The term "North American area" includes the United States, its possessions, and the Trust Territory of the Pacific Islands, and Canada and Mexico. Under the CBI, the term also includes any CBI beneficiary country, or Bermuda, if there is in effect a bilateral or multilateral agreement between such country and the United States providing for the exchange of information between the United States and such country, and there is not in effect a finding by the Treasury that the tax laws of such country discriminate against conventions held in the United States. Currently, the countries that qualify for this treatment include Bermuda, Jamaica, Grenada, Dominica, Barbados, and the Dominican Republic.

Guatemala
Guyana
Haiti
Honduras
Jamaica
Montserrat
Netherlands Antilles
Nicaragua
Panama
Saint Christopher-Nevis
Saint Lucia
Saint Vincent and the Grenadines
Suriname
Trinidad and Tobago
Turks and Caicos Islands

See 19 U.S.C. sec. 2702(b) (1988).

[30] The designated countries are the following:
Antigua and Barbuda
Aruba
The Bahamas
Barbados
Belize
British Virgin Islands
Costa Rica
Dominica
Dominican Republic
El Salvador
Grenada
Guatemala
Guyana
Haiti
Honduras
Jamaica
Montserrat
Netherlands Antilles
Saint Christopher-Nevis
Saint Lucia
Saint Vincent and the Grenadines
Trinidad and Tobago
See Tariff Schedules of the United States, 19 U.S.C.A. sec. 1202 (1988).

Countries that enter into an information exchange agreement under the CBI are eligible to serve as host countries for Foreign Sales Corporations ("FSCs"), which are entitled to special tax benefits under the Code. In addition, certain investments in CBI countries that qualify for convention deductions may generate qualified possessions source investment income for purposes of the possession tax credit of section 936 when investments in a financial institution or the Government Development Bank for Puerto Rico or the Puerto Rico Economic Development Bank are used for investment consistent with the goals and purposes of the CBI in active business assets or development projects in those CBI countries.

II. DESCRIPTION OF THE BILL (S. 712)

A. Overview

The bill (S. 712) as reported by the Senate Committee on Energy and Natural Resources,[31] provides for a referendum to be held on June 4, 1991 (and if necessary for a runoff referendum to be held on August 6, 1991), or on a date (or dates) during the summer of 1991 as may be mutually agreed by the three principal political parties of Puerto Rico. The purpose of the referendum will be to determine whether Puerto Rico is to become a U.S. State, become an independent country, or remain in a Commonwealth relationship with the United States.[32] The procedures for implementing whichever status option receives a majority (as certified to the President and the Congress of the United States by the Governor of Puerto Rico) are detailed in titles II (which applies if statehood is chosen), III (independence), and IV (commonwealth) of the bill. The bill provides that the set of procedures appropriate to implement the status chosen generally shall go into effect on October 1, 1991. Moreover, in the event of a delay due to a legal challenge, implementation of the status option receiving a majority is intended to go into effect as soon as is practicable after October 1, 1991 (S. Rep. No. 101-120, at 31).

As discussed below, titles II and III of the bill contain provisions regarding tax and other economic issues that arise under the options providing for a change from Puerto Rico's current status. The report of the Committee on Energy and Natural Resources states that the committee intended to establish three principles to guide future consideration of the bill:

> These principles include: first, that there ought to be an even playing field, politically, between the three political parties with regard to the status options; second, that there ought to be a smooth transition so that any change in political status, to statehood or independence, ought to work economically; and third, economic adjustment should be revenue-neutral to the extent possible, in that it does not cost the Treasury additional dollars over a period of time.[33]

As the report also states, specific concerns were expressed as to whether the committee had in fact achieved an even playing field. The one specific concern identified in the report is not a tax issue, however, but rather that there is a tilt toward statehood because

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[31] S. Rep. No. 101-120, 101st Cong., 1st Sess., September 26, 1989.

[32] The bill describes Puerto Rico, under the Commonwealth relationship, as a self-governing body politic joined in political relationship with the United States and under the sovereignty of the United States (bill sec. 402).

[33] S. Rep. No. 101-120, at 26.

there are a number of Federal benefit programs on which, effective January 1, 1992, the existing Federal "caps" on benefits would be eliminated and recipients of these program benefits might thus be encouraged to vote for statehood (*id.*).

B. Statehood

Should statehood be certified as having obtained a majority of the votes cast in the referendum, and upon the certification of the election of officers (U.S. Senators and Representatives) required under the bill, then the President is to issue a proclamation announcing the result of the election, and admitting the Commonwealth of Puerto Rico as a State on an equal footing with the other States (bill sec. 201). Upon admission of Puerto Rico into the Union, all of the local laws then in force in Puerto Rico continue in force and effect (except as modified or changed by the bill) subject to repeal or amendment by the Puerto Rico legislature (bill sec. 208(a)).

As a general rule, all of the laws of the United States will have the same force and effect within the State as they had on the date immediately prior to the date of admission of the State of Puerto Rico, subject to certain important exceptions (*id.*). For example, the continuation of laws in effect does not apply to existing laws providing for grants or other assistance to State or local governments or to individuals, under which Puerto Rico or its residents are either excluded or whose eligibility is less than that provided on a uniform basis to other States.

Under section 213 of the bill, entitled "Economic adjustment," the bill contains a set of transitional provisions which, according to the language of the bill, are intended to be

> Pursuant to Congress's power to admit new States, in recognition of the unique Federal tax provisions and programs affecting the Commonwealth of Puerto Rico which differ from those which applied to any other newly admitted State, and solely for the purposes of effecting a smooth and fair transition for the new State with a minimum of economic dislocation and to permit Federal agencies to assume or expand responsibilities for the administration and enforcement of Federal taxes and programs affecting the citizens residing in the new State.

The transitional provisions relate specifically to excise taxes, to income taxes, to the payment of Federal tax receipts and customs duties and equivalency payments on alcohol to Puerto Rico after statehood, and to the application in Puerto Rico of Federal entitlement programs (such as Aid to Families with Dependent Children (AFDC), Medicaid, Medicare, and the Food Stamp Program, among others). This pamphlet addresses the first three topics.

With respect to excise taxes, all Federal excise taxes which are not applicable to Puerto Rico as a possession are extended to Puerto Rico, effective on the date of admission of Puerto Rico to statehood, in the same manner as otherwise applicable in the several States (bill sec. 213(a)). It is apparently intended that with respect to other taxes, the current tax treatment applicable to Puerto

Rico is continued until January 1, 1994 (bill sec. 213(d)).[34] Effective on that date, the Federal internal revenue laws would apply generally within the State of Puerto Rico as within the several States, subject to such transitional rules or other provisions as Congress may have enacted prior to that date. However, the bill provides that the tax credit previously allowed under section 936 of the Code with respect to income or investments from activity in Puerto Rico would be reduced to 80 percent for taxable years beginning in 1994, 60 percent for taxable years beginning in 1995, 40 percent for taxable years beginning in 1996, 20 percent for taxable years beginning in 1997, and would not be available with respect to such income or investments thereafter. The bill expressly reserves to Congress authority to enact appropriate transitional rules regarding the implementation of the above credit reductions and the tax treatment of corporations with respect to which a section 936 election is in effect during the transition period. The bill would also authorize the Treasury Department to promulgate and implement such regulations as are necessary.

Further, the bill would provide certain grants and other payments to Puerto Rico based on tax revenues. The current payment provided by permanent indefinite appropriations of customs duties and equivalency payments on alcohol would be continued as a statehood grant (bill sec. 213(e)(1)). Unless otherwise provided by law, all revenues derived from Federal excise taxes which became applicable in the State of Puerto Rico pursuant to the bill, or any new Federal excise taxes which become applicable thereafter, would be deposited into the Treasury of Puerto Rico (bill sec. 213(e)(2)). The bill provides that, "[a]s a compact with the State of Puerto Rico," no alteration in the transfer of funds under this provision or the above provision on customs duties and equivalency payments on alcohol may be made until after October 1, 1998. The bill would not change the rule that prevents the cover over to Puerto Rico of amounts in respect of taxes imposed on any article (other than an article containing distilled spirits) if the U.S. Treasury determines that a Federal excise tax subsidy was provided by Puerto Rico with respect to such article. That is, as under current law, cover over will be prevented if Puerto Rico provides any subsidy of a kind different from, or in an amount per value or volume of production greater than, the subsidy which Puerto Rico offers generally to industries producing articles not subject to Federal excise taxes.

Finally, the bill provides that all revenues derived from the application of the Federal internal revenue laws in 1994 and 1995 within the State of Puerto Rico would be deposited into the Treasury of Puerto Rico as a transitional statehood grant to the new State to assist in maintenance of government services and infrastructure, and to minimize the impact on local revenues of the transition from being a foreign tax jurisdiction (bill sec. 213(e)(3)). The measure of the amount of income which is so derived would be

[34] A technical change might be appropriate to clarify the intent of the Committee on Energy and Natural Resources. It may be likely that, for excise tax purposes, the specific rule provided for by bill section 213(a) would control, rather than the more general rule of bill section 213(d).

determined according to such transitional rules or other provisions as Congress may have enacted prior to January 1, 1994.

In addition to the foregoing express transitional rules, the bill would require various studies aimed at determining what changes in Federal laws applicable to Puerto Rico, or in the administration of those laws, would be appropriate after statehood (e.g., bill secs. 208(b) and 213(b)).

C. Independence

Should independence be certified as having obtained a majority of the votes cast in the referendum, the bill provides for the Puerto Rico legislature to set in motion the election of delegates to a constitutional convention, and, after a constitution is adopted by the convention, an election by the people for its ratification or rejection. In addition, the bill provides for the establishment of a Joint Transition Commission to be appointed in equal numbers by the President of the United States and the presiding officer of the constitutional convention.

The bill provides for the President of the United States to recognize Puerto Rico's independence by proclamation shortly after (1) the Governor of Puerto Rico certifies the results of an election of officers of the Republic of Puerto Rico called for under the ratified constitution, and (2) the approval, in accordance with the constitutional processes of Puerto Rico and the United States, of specific arrangements for (a) the use of military areas by the United States in Puerto Rico, and to meet United States defense interests, and (b) the continuation or phaseout of Federal programs. The bill provides that U.S. recognition of independence would take effect as of a date chosen by the presiding officer of the constitutional convention (with the advice of the person elected as head of state of the Republic), shortly after receipt of the U.S. proclamation recognizing Puerto Rican independence, on which date the government of the Republic would take office. The bill provides for a proclamation of independence to be made by the Puerto Rican head of state immediately upon taking office. The bill also provides that upon the proclamation of independence, all U.S. laws applicable to the Commonwealth of Puerto Rico immediately prior to the proclamation shall no longer apply in the Republic of Puerto Rico, unless specifically otherwise stated.

The arrangements regarding military areas and Federal programs are to be negotiated by task forces established by the Joint Transition Commission, and would be required under the bill to accomplish certain goals. For example, the arrangements for continuation or phaseout of Federal programs must provide that all Federal pension programs shall continue as provided by U.S. law. Under the bill, the United States may be required to pay annually to the Republic of Puerto Rico a grant equal to the amount estimated by the Comptroller General of the United States based on the total amount of grants, programs, and services, including Medicare, provided by the Federal Government in Puerto Rico in the year in which independence is proclaimed (except for those grants, programs, and services, which will otherwise continue under the bill).[35] The annual grants would begin in the fiscal year following the year independence is proclaimed and be made through the ninth year following the certification of the status referendum.

The bill provides that once the results of the referendum are certified (that is, before actual independence), Puerto Rico would no longer be deemed to be a part of the United States for the purposes of acquiring citizenship of the United States by place of birth. In addition, no person born outside of the United States after the proclamation of independence would be a citizen of the United States at birth if the parents of such person acquired U.S. citizenship (under now-existing law) solely by virtue of being born, prior to the proclamation of independence, in Puerto Rico. The bill does not affect the citizenship, however, of any person born prior to the date of the certification of the referendum. Also, the bill provides various rights under U.S. immigration laws for Puerto Rican individuals who were born after independence or certification of the referendum or who otherwise never were U.S. citizens.

The bill provides for three specific measures relating to Federal taxes. First, effective on the date of proclamation of independence, the tax credit allowed under Code section 936 would become unavailable with respect to income or investments from activity in Puerto Rico (bill sec. 317(a)). Second, the bill would provide for the establishment of a task force by the Joint Transition Commission that would be charged with negotiating appropriate tax treaties to govern relations between the United States and Puerto Rico, which agreements would be approved by the government of Puerto Rico and the United States in accordance with their respective constitutional processes (bill sec. 317(b)). Finally, while the bill provides that the outstanding debts of the Commonwealth of Puerto Rico at the time of the independence proclamation shall be assumed by the Republic, the bill also provides that the tax treatment of any such obligations shall be unaffected by the proclamation of independence "to the extent that similar obligations issued by states are so treated" (bill sec. 319).

Section 316(b) of the bill provides for the establishment of a Task Force on Trade to consider and develop specific provisions between the United States and Puerto Rico following independence. This subsection also expresses Congress's willingness to consider a mutual free trade arrangement if negotiated. According to the report of the Committee on Energy and Natural Resources, "free-trade" in this case

> Does not mean that there would be open trade of all goods between the two nations, but that to the extent there are limitations on imports or exports, those limitations would be as mutually agreed and would, overall, provide mutual benefits to each nation and would assist each in meeting its trade and economic development objectives.[36]

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[35] A technical change might be necessary to clarify the intent of the Committee on Energy and Natural Resources. The bill seems to provide that the grant will equal the Comptroller General's estimate of the total *number* of grants, programs, and services discontinued, rather than the total *amount* of such discontinued grants, programs and services.

[36] S. Rep. No. 101-120, at 46-47.

In the absence of such an agreement, the bill provides that Puerto Rico shall be afforded most favored nation status, and, provided that Puerto Rico meets the requirements under the CBI, designation as a beneficiary under the CBI.

D. Commonwealth

Should commonwealth be certified as having obtained a majority of the votes cast in the referendum, new provisions relating to the commonwealth status of Puerto Rico would become effective October 1, 1991. The bill would generally amend the rules of both the House and the Senate to expedite review of certain recommendations of the Puerto Rican government (where such recommendations are adopted by the Puerto Rico legislature and that fact is certified by the Governor to the Speaker of the U.S. House of Representatives and the President of the Senate) that particular Federal laws should not apply to Puerto Rico (bill sec. 403(a) and (b)). Under the bill, such a recommendation becomes law through enactment of a joint resolution of Congress approving the recommendation. (This provision would not apply, however, to any Federal statutory law (1) establishing grants or services to individual U.S. citizens, (2) relating to citizenship, or (3) pertaining to foreign relations, defense, or national security (bill sec. 403(c)).) Under the rule changes provided by the bill, if a resolution covered by the bill is introduced in the House or Senate, then it must be referred to committee, and absent a report by the committee by the end of 45 days after referral, it shall be in order for a member favoring the resolution to move to discharge the committee from further consideration. The bill sets conditions on the consideration and debate of this motion, as well as the consideration and debate of the underlying resolution, in the latter case limiting debate to not more than 10 hours, equally divided.

The bill also sets forth a mechanism under which the Governor of Puerto Rico could require agency review and judicial review of Federal regulations which apply to Puerto Rico but which the Governor determines are inconsistent with the policy, set forth in the bill, of enhancing the Commonwealth relationship to enable the people of Puerto Rico to accelerate their economic and social development, to attain maximum cultural autonomy, and in matters of government to take into account local conditions in Puerto Rico (bill secs. 402(b) and 404).

The bill provides that the Governor of Puerto Rico may enter into international agreements to promote the international interests of Puerto Rico as authorized by the President of the United States and consistent with the laws and international obligations of the United States (bill sec. 403(d)). The bill also would give Puerto Rico the right (confined by the limits of U.S. international obligations) to impose tariff duties on foreign origin products imported into Puerto Rico from outside the customs territory of the United States (bill sec. 406).

III. ANALYSIS OF THE BILL

A. Overview

In analyzing the implications of the tax policy choices for the three status options, it may be useful to have established principles by which to evaluate the options. The report of the Committee on Energy and Natural Resources identified three principles to guide consideration of the bill: an even playing field, politically, for the three political parties with regard to the status options; a smooth economic transition; and an adjustment that is revenue-neutral to the Treasury over a period of time, to the extent possible.

Other principles could be used to guide the analysis. For example, some would argue that the treatment of Puerto Rico under statehood or independence should be the same as other States or independent countries, respectively, regardless of the other effects of this treatment. Others believe that the special circumstances of Puerto Rico require continuing assistance over some term, regardless of the status chosen.

There may be conflicts in practice among certain of these principles. It may be difficult to provide for an even political playing field under the three status options while still providing for a revenue-neutral transition without substantial economic disruptions.

Certain principles suggest that the analysis of tax policy should not be made in isolation from the analysis of outlay programs. The principle of revenue neutrality (relative to present law) implies that the large increase in Federal benefits provided to Puerto Rican residents that some believe would occur under statehood, for example, would have to be offset by increased levels of Federal tax revenue derived from Puerto Rico. If a similar level of benefits were not provided to Puerto Rico under the other status options, then revenue neutrality would require a lower Federal tax burden on Puerto Rico. Thus, the amount of tax revenue derived under the various status options would differ and would depend on the level of Federal benefits provided, if revenue neutrality were to be maintained. As the incidence of changes in Federal outlays would likely differ substantially from the incidence of changes in Federal taxation as it affects Puerto Rico, the net effect on Puerto Rico's economy would also require the analysis of both changes. Also, it may be appropriate to distinguish between funds provided to the Government of Puerto Rico and funds or benefits provided to the residents of Puerto Rico.

On the other hand, one may, for certain purposes, evaluate tax policy in isolation from benefit changes. For example, the principle that Puerto Rico should be treated no differently than any other State or independent country, depending on the status chosen, suggests that the appropriate tax treatment would follow from U.S. tax treatment of the other States and countries, respectively, independent of changes in Federal outlays and benefits. Having designed tax provisions to meet tax policy goals, the level of benefits could be adjusted appropriately.

B. Statehood Provisions

1. Application to Puerto Rico of the Internal Revenue Code

General application

If Puerto Rico becomes a U.S. State, its residents would, in the ordinary course of events, become U.S. Federal taxpayers subject to the Internal Revenue Code of the United States as currently applied to inhabitants of the other 50 States. Although the bill contemplates statehood taking effect near the end of 1991, the bill provides that the current tax treatment applicable to Puerto Rico is continued until January 1, 1994. Thus, the bill contains a transitional rule which delays application of ordinary U.S. tax rules to Puerto Rican persons and provides that revenues from certain taxes applicable to the State of Puerto Rico would be provided to the Treasury of Puerto Rico during a transitional period.

The intent of the rule is in part to allow Puerto Rico additional time to amend its tax laws in order to avoid placing an otherwise extraordinary tax burden on Puerto Rican persons.[37] It can be argued that Puerto Rican taxes are likely to be reduced after statehood to the extent that prior governmental functions of the Commonwealth are assumed by the Federal government, and thus are financed by Federal taxes rather than Puerto Rican taxes. The validity of this argument turns on larger budgetary issues concerning the relative levels of Federal and State spending in Puerto Rico after statehood.

The Committee on Energy and Natural Resources has taken the position in its report that the local income tax laws of Puerto Rico are sufficiently different from U.S. Federal tax laws that immediate application of the Federal income tax laws would be unworkable (S. Rep. No. 101-120 at 36). The committee concluded that new taxes should commence at the beginning of a taxable year and that Treasury would need lead time in order to properly administer and enforce the tax laws (*id.*). On the other hand, some believe that a delay of approximately two years before application of Federal income tax laws is unnecessary or otherwise inappropriate. (See Part III.B.4., below, discussing constitutional issues raised by this provision of the bill.) The Committee on Energy and Natural Resources stated that it expected the tax-writing committees to address the issue of overall transitional requirements for application of the Federal internal revenue laws in a manner which would best provide for a smooth transition for the new State (*id.* at 36-37).

At some point in the future, however, the Federal income tax laws would apply to Puerto Rican residents in the same manner as they apply to any residents of the other 50 States and the District of Columbia. Any tax imposed by the State of Puerto Rico would constitute a State tax. As is true for other States, income and prop-

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[37] Currently, local Puerto Rican taxes are said to raise approximately $2 billion in local revenues (S. Rep. No. 101-120, at 36).

erty taxes paid to the Puerto Rican government would generally be deductible for Federal tax purposes under the Code as it now reads sales taxes would not be deductible by individuals.

Once the U.S. tax laws do take effect in 1994, under the bil there will be a two-year period during which all revenues derived from the application of the Federal internal revenue laws withir the State of Puerto Rico will be deposited into the Treasury o Puerto Rico. Neither the bill nor the Energy and Natural Re sources Committee report elaborates on the method by which thi amount is to be measured, except to say that the measure of the amount which is so derived will be determined according to such transitional rules or other provisions as Congress may have en acted prior to January 1, 1994. Although the further statutory in terpretation of this language is in one sense a question of spending (rather than taxation), in another sense the existing usages of ta laws that divide taxing jurisdiction among different government may be viewed as informative. In the case of income tax, the amount treated as derived from application of U.S. tax law i Puerto Rico could be, for example, the revenues from Puerto Rica resident individuals and Puerto Rican corporations on their incom that would not be taxed by the United States if Puerto Rico wer still a Commonwealth, plus revenues from the Puerto Rico sourc income of foreign persons and the income of such persons effective ly connected with the conduct of a trade or business in Puerto Rico As another possibility, the amount could be revenues from incom of any person effectively connected with the conduct of a trade o business in Puerto Rico. Many other variations are possible.

Individuals

The Internal Revenue Code imposes lower generally statutor rates of income tax on individual taxpayers than does the Puert Rican tax system. In addition to rate differences, differences be tween specific deductions, exemptions and credits available unde Federal, as opposed to Puerto Rican law, would also affect the dif ferences in net tax liabilities before and after statehood takes ful effect. The addition of Federal income tax to current Puerto Rica tax would increase the individual income tax burden in Puert Rico. It is reasonable to expect, however, that Puerto Rico would adjust its tax system to reflect the changed fiscal responsibilities o statehood.

One important item of Federal law not currently part of Puert Rican tax law is the refundable earned income credit. Unde present Puerto Rican law, for example, for a married couple wit two children, income tax may be due when income exceeds $8,600 Partly as a result of the earned income credit, in the same cas under present U.S. law there would be no net income tax liabilit until income exceeds $15,600. Moreover, the refundable credit ma result in refunds in excess of tax liability for many Puerto Rica individuals with earned income below certain levels. Because the area median family income in Puerto Rico is likely below the phaseout range of the credit (which starts at $10,240 in 1989), the maximum credit amount or a significant portion thereof may be available to a disproportionately higher percentage of Puerto Rican citizens than to those of any other State.[38]

Some have expressed concern that the combination of eligibility for Federal means-tested benefits, and the imposition of U.S. Federal individual income tax in addition to Puerto Rico tax, may discourage employment and earnings in Puerto Rico after statehood. The disincentive for employment, it is argued, would be strongest for low-wage workers. Because the average income level is lower in Puerto Rico than in any existing State, it follows that the disincentive effects may be of greater importance to the economy of Puerto Rico than of any other State.

Others point out that the U.S. income tax system provides for higher income tax thresholds than the Puerto Rico system, and thus may not have an effect on many low-income workers. To the extent that Puerto Rico reduces its level of income taxation as a result of statehood, the combined level of U.S. and Puerto Rican tax would be lower than a purely static comparison would suggest. It is possible that the new Puerto Rican state tax system would have higher income tax thresholds than the existing system, and thus the tax burden on the lower income groups would be reduced. Thus, some conclude, the income tax system under statehood would not reduce and might actually increase individual incentives for employment relative to the current situation.

The application of U.S. Federal estate and gift taxation to Puerto Rico may significantly alter the estate and gift tax consequences of transfers by Puerto Rican individuals. For example, the taxable estate of a Puerto Rican decedent may be exempt from estate and gift tax under existing Puerto Rico law, due to the exclusion for certain property located in Puerto Rico. Under the bill, such an estate would be taxable by the United States if the individual dies after 1993. The "soak-up" tax under current Puerto Rico law may or may not be viewed as also imposing a tax on such an estate after 1993, and that tax, if not amended, might affect not only the division of the revenue generated by taxing the estate between the State and Federal governments, but in addition the total amount of tax owed on the estate. It may be that Puerto Rico would adjust its estate tax system to reflect the new status of Puerto Rico as a State.

Business operations

In the case of corporations, the Internal Revenue Code also imposes lower statutory rates of income tax than does the Puerto Rican tax system. However, the widespread availability of tax incentives under the Puerto Rican tax system implies that many business enterprises may have greater tax liability under the Internal Revenue Code than under the Puerto Rican system. The increase arising from imposition of Federal tax would be most dramatic for those enterprises eligible for Industrial Zone and other exemptions from Puerto Rican tax. The introduction of the Federal

[38] Median family income in Puerto Rico is calculated to be $5,923 in 1979. This compares to $14,591 in Mississippi (the lowest level of any present State) and a national average of $19,917. Memorandum to Senator Moynihan, "Effects of the Proposal For A Referendum on the Status of Puerto Rico," Congressional Research Service, August 1, 1989, at p. 5.

tax system therefore may reduce the variation in tax burden among different business enterprises but greatly increase the ta burden for corporations most able to use current Puerto Rican ex emptions and deductions. Some have suggested that the increase tax burden may discourage future economic development; other believe that a more even distribution of tax among businesse could lead to a more efficient allocation of capital and labor.

Unlike the U.S. tax system, Puerto Rico does not treat partner ships as nontaxable pass-through entities, except for "special part nerships." The imposition of the U.S. tax system could significantl influence the choice of business entity utilized, encouraging i some cases use of partnerships in Puerto Rico.

2. Code Section 936

Phaseout of credit

Section 213(d) of the bill provides a special transition rule fo Code section 936. Under this rule, the credit previously allowe under section 936 with respect to income or investments from ac tivity in Puerto Rico would be reduced to the following percent ages:

Taxable years beginning in:	*Percen*
1994	8
1995	6
1996	4
1997	2
1998 and thereafter	

Under the bill, a qualified possessions corporation that onl earns income attributable to Puerto Rican activities in 1991, 199 and 1993 will pay no U.S. income tax on that income. In 1994, th same company would receive only 80 percent of the benefit provic ed under section 936, and therefore would be required to pay U.S tax equal to 20 percent of its pre-credit tax liability. This phaseou of section 936 benefits would continue ratably until 1998, when th company would pay full U.S. income tax on its income from Puert Rican operations.

Legal issues

Section 213(d) of the bill provides that in implementing the sec tion 936 credit phaseout, Congress would explicitly retain the righ to enact appropriate transitional rules, and the Secretary of th Treasury would be authorized to promulgate such regulations a would be necessary. Apart from the currently unspecified transi tion rules contemplated by the bill, statutory phaseout of the sec tion 936 credit in the bill raises, by itself, certain questions.

For example, under present law only U.S. corporations are affect ed by the section 936 credit. The credit is not relevant to foreig corporations, including those organized under the laws of Puert Rico, because they generally incur no U.S. tax liability from th pursuit of solely Puerto Rican activities. Under the bill, as of Janu ary 1, 1994, companies that were incorporated under Puerto Rica law will be considered U.S. domestic corporations for U.S. tax pur poses, absent an additional change in law. It might be argued tha under the language of the bill, such Puerto Rican companies would then be able to elect the use of section 936 assuming they satisfy the other qualification requirements contained in that section. Thus, a Puerto Rican corporation that earns all of its income from Puerto Rican sources would avoid paying any U.S. income tax prior to 1994, and with the use of the section 936 credit, receive partial U.S. tax relief from 1994 through 1997. (It is unclear whether this result represents the intent of the Committee on Energy and Natural Resources.)

It may be necessary to consider whether the grant of a transitional phaseout of section 936 by the bill should serve only to phase in gradually U.S. tax liabilities for those companies that previously received benefits under that section, or should also serve to gradually phase in U.S. tax liabilities for most Puerto Rican corporations that had previously not benefited from section 936. No such gradual phasein applies to Puerto Rican individuals. Depending on tax rates faced by a Puerto Rican corporation, such a broad phasein simply may provide a temporary reduction in income tax liabilities. This potential benefit may be unrelated to the transitional concerns expressed by the Committee on Energy and Natural Resources.

Another issue involves the determination of the source of income earned by a qualified possessions corporation. Section 936(a)(1)(A) provides for a credit against U.S. tax on foreign source income only. Upon Puerto Rico's admittance as a State, income earned from sources within Puerto Rico would generally be treated as U.S. source income for all purposes of the Internal Revenue Code. Thus, U.S. tax on such income technically would not be eligible to be offset by the section 936 credit. This treatment would virtually eliminate all benefit of the section 936 credit to qualified possessions corporations over the transitional period unless their income was of such a nature as to be susceptible to resourcing to a foreign country or possession. If the transitional rule currently in the bill, or any similar phaseout of section 936 is adopted, the treatment of Puerto Rican source income for this purpose may need to be clarified.

A third issue involves the treatment of Puerto Rican taxes. Section 936(c) provides that any tax imposed by a foreign country or possession of the United States with respect to income of a qualified possessions corporation that is taken into account in computing the section 936 credit shall not be treated as a tax that is either creditable under the foreign tax credit rules or deductible by such corporation. This rule operates to deny a qualified possessions corporation a double benefit since the section 936 credit operates to spare the corporation any U.S. income tax on its possession source income. Beginning in 1994, income taxes paid to Puerto Rico will no longer be considered taxes paid to a foreign country or a possession of the United States. Rather, they will be taxes paid to a State, which are generally deductible for U.S. tax purposes. As a result, based on the technical language of section 936(c), the disallowance of a deduction for income taxes related to income which is eligible for the section 936 credit would not apply to taxes paid to Puerto Rico. During the transition period, this inapplicability might permit both a deduction and a credit under section 936 fo the same tax, unless amendments were made.

The interplay of the deduction of Puerto Rican taxes and th phaseout of section 936 is illustrated by the following example Assume that in 1994 a qualified possessions corporation earns $10 of income solely from its operations in Puerto Rico, and pays $20 o income tax to Puerto Rico. If Puerto Rican taxes are treated a nondeductible under section 936(c), the company would have a pre section 936 credit U.S. tax liability of $34. Under present law, th section 936 credit would offset the company's entire U.S. tax liabil ity. However, pursuant to the phaseout of section 936, the compan is allowed a benefit equal to only 80 percent of the credit allowe under present law. Thus, under one reading of the bill, the compa ny's net tax liability for 1994 would be $6.80.[39] If, on the othe hand, the taxpayer were allowed to deduct Puerto Rican tax, it pre-credit U.S. tax liability would be $27.20, 80 percent of which i $21.76. Therefore, under the bill a taxpayer might plausibly tak the position that it is entitled to a section 936 credit in 1994 o $21.76 against a pre-credit tax liability of $27.20, resulting in a ne U.S. tax liability of $5.44. The difference between $6.80 and $5.4 (i.e., $1.36) represents U.S. tax on the portion of Puerto Rican taxe paid by the company corresponding to the portion of its income no eligible for the 936 credit.[40]

It would appear proper to allow a deduction for those taxes pai to the new State of Puerto Rico attributable to the portion o income that is not granted section 936 benefits during the phaseou period, since no double benefit is available to the qualified posses sions corporation with respect to such taxes. Under this view, th correct amount of net U.S. tax in the above example would b $5.44. Taxes paid to a foreign country or U.S. possession attributa ble to income not eligible for the section 936 credit pursuant to th transition rules could properly be regarded as creditable, assumin the requirements for the foreign tax credit were otherwise met.

Economic issues

Background.—The gross domestic product of Puerto Rico grew a an average rate of 5.2 percent per year between 1950 and 1979 Manufacturing had been the dominant source of growth in Puert Rican development in the post-World War II era, as manufacturin employment grew from 9 to 20 percent of total employment durin the same period. Since 1980, however, real growth has declined t rates similar to U.S. rates, with gross domestic product growing percent between 1979 and 1983, and 4 percent between 1983 an 1988. The proportion of manufacturing jobs has declined from 2 percent to 18 percent of employment during the past eight years

Section 936 may have played a significant role in the economi development of Puerto Rico. It is estimated that there were 88,57 employees in 527 qualified possessions corporations that were en gaged in manufacturing in 1983.[41] In 1988, there were approxi-

[39] $34.00 x (1 - .80) = $6.80
[40] $20.00 x .20 x .34 = $1.36.
[41] *The Operation and Effect of the Possessions Corporation System of Taxation, Sixth Report* Department of the Treasury, March, 1989. (Sixth Possessions Report).

ately 157,000 manufacturing jobs and a total of over 870,000 jobs Puerto Rico. Section 936 companies may account for around half manufacturing employment in Puerto Rico, but only about a nth of total employment. Because the measured value-added per nployee is higher in the manufacturing sector than in other secrs (and even higher in section 936 companies), qualified possesons corporations account for a relatively greater percentage of oss domestic product than of employment.

Some argue that the effect of section 936 companies on Puerto ican employment goes beyond the direct employment by section 36 companies. Employment is stimulated, it is argued, in sectors the economy which purchase output of or supply goods to qualied possessions corporations. In addition, as qualified possessions rporations' employees' wages may exceed the income they would herwise earn, employment is increased by the consumption ending of these employees. Some estimates claim that between ne and three additional jobs are created for each employee of a ualified possessions corporation.[42]

The Treasury Department and others argue that the indirect fect of section 936 on Puerto Rican employment is weak, and that timates showing large effects are flawed on both theoretical and chnical grounds.[43] In addition, they contend that looking at the umber of workers employed by section 936 companies overstates e effect of section 936 on employment. They maintain that many these employees would, in the absence of section 936, be otherise employed, although perhaps at lower rates of pay.

The efficiency of section 936 as an incentive for economic development is in dispute. Proponents assert that section 936 is crucial r attracting capital-intensive manufacturing companies, particurly in chemicals and electronics, which have spurred Puerto ican development and led to major increases in employment and ages.

Opponents argue that the effect on employment is limited and e costs far exceed the benefits. The Treasury Department estiated that the tax benefits of section 936 were $18,523 per qualied possessions corporation employee in 1983, which equalled 125 ercent of employee compensation. The changes made by the Tax quity and Fiscal Responsibility Act of 1982 (TEFRA) helped lower e ratio of tax benefits to employee compensation from 148 perent of employee compensation in 1982 and further reductions may ccur in the future because of post-1982 changes in section 936.[44] fficiency considerations led the Reagan Administration to propose eplacing section 936 with a wage credit in 1985.[45]

Elimination of section 936.—The effect of eliminating section 936 n the Puerto Rican economy depends on the reaction of qualified ossessions corporations and the significance of these companies to e Puerto Rican economy. The phaseout of section 936 benefits ould expose qualified possessions corporations to levels of tax-

[42] Such estimates are discussed in *Sixth Possessions Report*, at 55.

[43] *Sixth Possessions Report.*

[44] *Sixth Possessions Report.*

[45] *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity,* May 985. *See also, Tax Reform for Fairness, Simplicity, and Economic Growth, Vol. 2,* Department of e Treasury, November 1984.

ation to which they previously had not been subject. Certain cor panies that have made substantial investments in manufacturir operations in Puerto Rico, both in terms of physical plant and the development of a reliable and skilled workforce, may concluc it would be most efficient to maintain their operations in Puer Rico. Indeed, some level of direct U.S. investment in Puerto Ri may continue regardless of the availability of section 936 benefit

Other companies that located in Puerto Rico primarily becau of the U.S. tax benefits may conclude that the after-tax return no longer adequate to maintain operations in Puerto Rico. The operations may be eliminated, moved to the United States, or r placed by operations conducted through a foreign subsidiary in foreign country where generous tax holidays or other incentive pr grams may be available. In addition, the decision to locate futu operations in Puerto Rico will be adversely affected, all else tl same, by the loss of section 936 benefits.

The effect of any reduced U.S. investment in Puerto Ri through qualified possessions corporations is uncertain. The di pute regarding the direct and indirect employment effects of se tion 936 is echoed in the analysis of the effect of the phaseout c the Puerto Rican economy. To the extent both the direct and inc rect effects are small, the elimination of section 936 benefits ma have a limited impact on Puerto Rican employment and wage However, given the relatively high unemployment levels in Puer Rico, the ability for the economy to absorb workers displaced fro qualified possessions corporations may be limited, and increase unemployment may result.

Qualified possession source investment income.—A substanti amount of retained earnings from Puerto Rican operations of qua fied possessions corporations has been invested in certain Puer Rican financial institutions in order to generate QPSII. Once tl tax incentive for qualified possessions corporations to reinve those amounts in Puerto Rico is removed, it is possible that tho funds will be repatriated to U.S. parent companies or used els where. The phaseout of section 936 will reduce the subsidy that h been available to certain Puerto Rican financial institutio through the lower interest rates required on QPSII funds. The co of funds may increase and the amount of financial capital availab to Puerto Rican financial institutions may be reduced. The effe on the ability of Puerto Rican business to raise funds wou depend, however, on the extent that existing QPSII funds actual expand the pool of funds available to Puerto Rican enterpris rather than being invested elsewhere or displacing other func available to Puerto Rican businesses.

3. Excise taxes and customs duties

Notwithstanding the general delay of Internal Revenue Code a plicability to Puerto Rico until 1994, the bill specifically provid that, effective on the date of admission to statehood, all Feder excise taxes are applicable to Puerto Rico in the same manner a they apply to other States (bill sec. 213(a)). However, the bill fu ther provides that all revenues derived from excise taxes made a plicable to Puerto Rico by the bill, as well as the current paymer provided by permanent indefinite appropriations of customs duti nd equivalency excise tax payments on alcohol, are generally to e covered over to Puerto Rico as a statehood grant until Congress asses a law providing otherwise (but not before October 2, 1998). hus, unlike other States, the Puerto Rican State Treasury would eceive the receipts from the Federal excise taxes instead of the ederal Government. As under current law, however, excise taxes ould not be covered to Puerto Rico with respect to any article ther than an article containing distilled spirits) if Puerto Rico rovides a direct or indirect subsidy with respect to the article nlike subsidies offered to industries producing articles not subject Federal excise taxes.

The application of Federal excise taxes in addition to existing uerto Rican excise taxes (see the Appendices) could result in in-reases in the prices of certain articles. Puerto Rico might adjust s excise taxes, however, in response to the imposition of Federal ax. Under the bill, Puerto Rico would be in the unique position here revenue from Federal excise taxes made applicable in the tate of Puerto Rico would be transferred to the State govern-ient.[46] In effect, the Federal excise tax could be viewed as a State ax, except that the rates would be set and collection performed by e U.S. government.

. Uniformity clause

The U.S. Constitution grants to the Congress the power to lay nd collect "Taxes, Duties, Imposts and Excises, . . . but all Duties, nposts and Excises shall be uniform throughout the United tates." U.S. Const., art. I, sec. 8, cl. 1.[47] As indicated by the ab-ence of the word "taxes" from the clause setting forth the rule of niformity (the "uniformity clause"), the rule applies only to the ubset of taxes encompassed by the terms "duties, imposts and ex-ises." In addition, it is clear from other parts of article I that the niformity clause does not apply to the subset of taxes denoted in e Constitution as "direct" taxes, which are subject to "apportion-ient" requirements rather than "uniformity" (*see* sec. 2, cl. 3; sec. , cl. 4).

Thus, insofar as the bill provides for special treatment of Puerto ico as to any particular "duties, imposts [or] excises" once Puerto ico becomes a State, it may be appropriate to examine whether e application of such a tax under the bill is or is not "uniform."

Duty, impost or excise

As described above, the bill's application of Federal income tax-tion to a new State of Puerto Rico differs in at least two respects, uring a period beginning on or after October 1, 1991, and ending

[46] As noted above, section 208(a) of the bill provides that, unless a different treatment is ex-ressly provided, all U.S. laws shall have the same force and effect within the State of Puerto ico as they did within the Commonwealth of Puerto Rico immediately prior to the date of ad-ission to statehood. The bill is somewhat unclear whether the provisions of current law section 652 that provide for cover over to Puerto Rico of excise tax revenues would be repealed effec-ve prior to 1994 because they are inconsistent with section 213 of the bill, in which case, after uerto Rico becomes a State, only those revenues from excise taxes "which became applicable " Puerto Rico pursuant to the bill would be covered over to the Puerto Rican Treasury (at ast through October 1, 1998).

[47] Note that there is no comparable limitation on the spending power of Congress. *See, e.g., Ielvering v. Davis*, 301 U.S. 619 (1937) (Congress has discretion to determine that the general elfare is served by an expenditure program that addresses local problems).

during 1998, from the application of such taxation to the existi States.[48] First, the Federal income tax would not be applied to t new State of Puerto Rico until January 1, 1994. Second, the incor tax credit provided by section 936 of the Code would be phased o over a period that would end during 1998, rather than terminat immediately upon statehood. Thus, the preliminary issue in a uniformity clause analysis of the provisions of the bill is wheth the Federal income tax constitutes a duty, impost or excise, as su terms are used in the uniformity clause.

Some believe that the Federal income tax does constitute such duty, impost or excise, although judicial pronouncements on t issue have not followed a consistent path. For example, the S preme Court in *Pollock v. Farmers' Trust and Loan Co.*, 157 U 429 (1895), considered the classification of a tax on income fr real property by reference to the source of the income, and char terized such a tax as equivalent to a tax on real property. T Court thus distinguished authorities that treated a tax imposed interest and professional income as a duty, impost or excise, a classified the tax on income from property as a direct tax subject the apportionment requirement. However, the Supreme Court su sequently held in *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911), th a tax on corporations measured by income was not a direct tax b an excise on the privilege of doing business in the corporate for and thus subject to the requirement of uniformity rather than a portionment.

In 1913, the sixteenth amendment exempted income taxes fro the apportionment clauses and thereby mooted the primary signi cance of the classification of a tax as direct or not. However, t Supreme Court in *Brushaber v. Union Pacific Railroad Co.*, 2 U.S. 1 (1916), rejected an interpretation of the sixteenth amen ment that would view the Federal income tax as a direct tax th is exempt from the apportionment requirement. Under such an i terpretation, the income tax would be arguably exempt (as a dire tax) also from the uniformity requirement. Instead, the Court i terpreted the sixteenth amendment to prevent the classification an income tax by reference to the source of the income, whi could "take an income tax out of the class of excises, duties, a imposts and place it in the class of direct taxes." *Id.* at 19. Ther fore, despite the fact that some aspects of an income tax have be classified as direct, it may be fairly argued that the Federal incon tax as a whole is subject to the requirements of the uniformi clause.

Uniformity

According to Justice Story, the purpose of the uniformity clau

> was to cut off all undue preferences of one State over another in the regulation of subjects affecting their common interests. Unless duties, imposts, and excises were uniform, the grossest and most oppressive inequalities, vitally affecting the pursuits and employments of the people of

[48] As discussed above, there would be no differences between Puerto Rico and the pre-existi States in the imposition of excise taxes (as distinguished from the expenditure of excise tax c lections).

different States, might exist. The agriculture, commerce, or manufactures of one State might be built up on the ruins of those of another; and a combination of a few States in Congress might secure a monopoly of certain branches of trade and business to themselves, to the injury, if not to the destruction, of their less favored neighbors.[49]

ther experts, scholars and judges have concurred.[50]

The uniformity clause does not require that all affected taxes fall ually or proportionately on each State or region. The clause re- ires only that a tax operate "with the same force and effect in ery place where the subject of it is found." *Head Money Cases*, 2 U.S. 580, 594 (1884) (upholding as uniform a tax on immigrants rough seaports but not on immigrants through inland cities). ius, there is no prohibited geographic discrimination merely be- use the subject of a tax is distributed disproportionately across e country. Similarly, in the case of the uniformity requirement of e bankruptcy clause (U.S. Const., art. I, sec. 8, cl. 4), "[t]he uni- rmity provision does not deny Congress power to take into ac- unt differences that exist between different parts of the country, d to fashion legislation to resolve geographically isolated prob- ms." *Regional Rail Reorganization Act Cases*, 419 U.S. 102, 159 974).

Most recently, the Supreme Court held that an exception for cer- in Alaskan crude oil from the Crude Oil Windfall Profit Tax Act 1980 did not violate the tax uniformity clause. *United States v. asynski*, 462 U.S. 74 (1983). That Act was "designed to impose rel- ively high tax rates where production cannot be expected to re- ond very much to further increases in price and relatively low x rates on oil whose production is likely to be responsive to ice." H.R. Rep. No. 96-304, 96th Cong., 2d Sess. 7 (1980), cited in *asynski*, at 77. To that end, Congress exempted certain classes of from the tax, including a relatively limited subset of the oil pro- ced in Alaska, denoted "exempt Alaskan oil." Exempt Alaskan was defined geographically, by reference to the Arctic Circle d the Alaska-Aleutian Range.

The exemption reflected the considered judgment of Congress at unique climatic and geographic conditions required that oil oduced from a specified area be treated as a separate class of oil. R. Rep. No. 96-817, 96th Cong., 2d Sess. 103 (1980). The Supreme urt found that Congress had before it ample evidence of the dis- oportionate costs and difficulties associated with extracting oil om this region. The Court stated that it could not fault the deter- ination of Congress, based on neutral factors, that this oil re- ired separate treatment. 462 U.S. at 85. Nor was there any evi- nce that Congress sought to benefit Alaska for reasons that uld offend the purposes of the uniformity clause (for example, by

[49] 1 J. Story, *Commentaries on the Constitution of the United States* sec. 957 (T. Cooley ed. 3), cited in *United States v. Ptasynski*, 462 U.S. 74, 81 (1983).

[50] See 2 M. Farrand, *The Records of the Federal Convention of 1787*, pp. 417-418 (1911). See 3 *Annals of Cong.* 378-379 (1792) (remarks of Hugh Williamson); Address of Luther Martin he Maryland Legislature (Nov. 29, 1787), reprinted in 3 M. Farrand, *supra*, at 205 (all cited in *synski*, at 81-82).

intending to grant Alaska an undue preference at the expense of other oil-producing States), especially in view of the fact that the tax generally fell heavily on Alaskan oil. *Id.* at 77-78 (n.5). Accordingly, the exemption was held not to violate the uniformity clause.

The Supreme Court in *Ptasynski*, following the analysis of the *Regional Rail Reorganization Act Cases* decision, opined that the uniformity clause gives Congress wide latitude in deciding what to tax, and does not prevent Congress from considering geographically isolated problems. If Congress defines the subject of the tax in nongeographic terms, the uniformity clause is satisfied. *Id.* at 84. Identifying the subject of a tax in terms of its geographic boundaries does not render the tax invalid, but rather triggers a close examination of the classification to see if there is prohibited discrimination in light of the purposes of the uniformity clause. *Id.* at 85.

Some have argued that the exemption of the new State of Puerto Rico from the entire scheme of Federal income taxation cannot be justified in a manner that would be consistent with the uniformity clause as it has been interpreted under existing case law. They distinguish *Ptasynski* on several grounds, including the fact that the preferred tax status of Puerto Rico under the bill is not offset by substantial Federal tax burdens on Puerto Rico; in *Ptasynski*, by contrast, Alaska overall bore a large share of windfall profits tax burdens while only a small subset of Alaskan oil was exempt. Thus, it is argued that the proposed delay in applying Federal income taxation to the State of Puerto Rico would violate the uniformity clause. In addition, it has been argued that section 936, which is intended to promote the economic development of U.S. possessions, provides to Puerto Rico precisely the kind of preference that the uniformity clause prevents among States.

It has been further argued that the temporary nature of the differences in tax treatment provided to Puerto Rico under the statehood option of the bill would not make such differences any less offensive to the uniformity clause of the Constitution. There is apparently no authority under the uniformity clause that directly considers whether a temporary nonuniformity would violate the clause. However, the Supreme Court did invalidate a transition provision in the enabling act under which Oklahoma was admitted as a State, which provision would have prevented Oklahoma from moving its State capital from Guthrie to Oklahoma City for a period of six and one-half years after Oklahoma's admission as a State. In *Coyle v. Smith*, 221 U.S. 559 (1911), the Court ruled that Congress is not authorized, by the power to admit new States (U.S. Const., art. IV, sec. 3) or otherwise, to impose a term or condition on the admission of a new State that would render the new State "less or greater, or different in dignity or power," from the pre-existing States. *Id.* at 566. The Court held that Congress did not have the power to include an otherwise unconstitutional provision in the Act under which Oklahoma was admitted to the Union, even though the provision was temporary.

Others argue, however, that special tax treatment of Puerto Rico, whether temporary or permanent, would not violate the uniformity clause. In fact, the Committee on Energy and Natural Resources has taken the latter view with respect to temporary differences, stating that it

> believes Congress has substantial authority under the territorial and statehood clauses of the Constitution to provide for non-identical economic treatment under statehood if such treatment is reasonable, transitional, and necessary. The provisions of Section 213 [of the bill] are not only reasonable, but necessary in order to provide: Federal agencies the time needed to implement certain new taxes and social programs in Puerto Rico, Puerto Rico with the time needed to modify local tax and social program laws, and to avoid extremely serious disruptions to the economy of Puerto Rico during the transition from commonwealth status to statehood.[51]

It may be argued that the uniformity clause raises serious con-erns as to the validity of the tax provisions provided under the tatehood option of the bill. All other things being equal, some ight view it as preferable, from a constitutional view, for Con-ress to address the general administrative problems of transition y providing a sufficient delay between the status referendum in 991 and the date of actual admission of Puerto Rico as a State, ather than by delaying the application of Federal income taxation o Puerto Rico for any period after admission. On the other hand, here are bases on which to distinguish the authorities relied on by ome for the proposition that the bill is unconstitutional. The com-ittee may consider whether or not such distinctions are material.

The intent and purpose of the uniformity clause, as explained by ustice Story, may have been to prevent a combination of States rom setting differential tax provisions that would harm the eco-omic interests of another State or States. Even in *Coyle v. Smith*, he temporary measure that was invalidated was an attempt by he existing States to deny the new State of Oklahoma a state ower protected by the Constitution—namely, the power to locate s state capital. The seven-year phaseout of section 936, in con-rast, would be a temporary benefit granted to Puerto Rico by the urrent States intended to ease the economic integration of a new tate. Similarly, the two-year delay in imposing Federal taxation enerally in Puerto Rico would be a temporary benefit granted to uerto Rico by the current States that would ease the administra-ive burdens of moving to full statehood treatment under the Inter-al Revenue Code. Some would argue that the concerns addressed y the uniformity clause may not be implicated as severely where he only differential taxation applies in a reasonable transition eriod between present law and full uniformity.

In addition, the Supreme Court in *Ptasynski* was "reluctant to isturb [Congress's] determination" by finding a violation of the niformity clause where Congress "has exercised its considered udgment with respect to an enormously complex problem." 462 J.S. at 86. Accordingly, it may be argued that a set of transitional rovisions for the admission of a State, such as the one crafted by he Committee on Energy and Natural Resources to address actual roblems that are unique to Puerto Rico, satisfies the requirements f the uniformity clause. If the Committee on Finance chooses to

[51] S. Rep. No. 101-120, at 39.

adopt transition provisions at all similar to those reported out by the Committee on Energy and Natural Resources, then to the extent the Finance Committee can further articulate the specific rationale for such provisions, it may thereby strengthen the argument that the uniformity clause is satisfied.

C. Independence Provisions

1. Citizenship

Under the bill, if independent status is chosen by the Puerto Rican voters, Puerto Rico would no longer be deemed to be part of the United States for the purpose of acquiring U.S. citizenship by reason of place of birth after the date of certification of the referendum. In addition, no person born outside of the United States after the proclamation of independence would be granted U.S. citizenship at birth as a result of being born to parents who acquired U.S. citizenship solely by virtue of being born in Puerto Rico prior to the proclamation of independence. The U.S. citizenship status of persons born in Puerto Rico prior to certification of the referendum would remain unchanged.

The bill does not address the U.S. citizenship status of persons born in Puerto Rico, or born to Puerto Rican-born parents, after certification of the referendum but before the proclamation of independence. Because the interval between those two events is uncertain under the bill, and because status as a U.S. citizen has U.S. tax consequences, the committee may choose to consider what the citizenship consequences of birth in that interval would be, and whether it would be desirable (as a matter of certainty of tax administration or otherwise) to conform the dates applicable to citizenship determinations under the bill so that they are all based either on the date of certification or the date of proclamation of independence.

The bill also does not expressly address the effect that Puerto Rican independence would have on the existing Code provision that exempts Puerto Rican residents who are U.S. citizens from the U.S. tax otherwise imposed on a U.S. citizen's worldwide income (Code sec. 933). There may be little policy reason to retain a complete and unlimited exclusion from taxable income for income earned from Puerto Rican sources by U.S. citizens who reside in Puerto Rico.[52] Those individuals could be eligible, however, to claim the benefits of either the foreign earned income exclusion (sec. 911) or the foreign tax credit (sec. 901) with respect to certain income earned outside of the United States.

In some cases, however, it may be argued that the logic of a section 933 exception will continue to apply. Absent section 933, Puerto Rican resident individuals who retain U.S. citizenship sub-

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[52] Similar tax treatment afforded to U.S. corporations with operations in Puerto Rico under section 936 is expressly eliminated under the bill. The bill states generally that all U.S. laws applicable to the Commonwealth of Puerto Rico immediately prior to the proclamation of independence shall no longer apply in the Republic of Puerto Rico (bill sec. 308(a)(2)). Some might argue that the specific repeal of section 936 with respect to Puerto Rico (bill sec. 317(a)) suggests that the Committee on Energy and Natural Resources intended bill section 308(a)(2) to have no effect on the application of U.S. law to the U.S. tax obligations of individuals or corporations. Alternatively, it might be argued that section 933 is a U.S. law applicable to the Commonwealth of Puerto Rico and as such that it is repealed in under bill section 308(a)(2).

ıequent to the proclamation of independence may be faced with J.S. income tax return filing responsibilities for the first time. As ›reviously discussed, a U.S. citizen is relieved from the requirenent of filing a tax return if his gross income for the taxable year s less than the sum of the amount of the personal exemption and he amount of the applicable standard deduction. Although section)11 excludes (up to $70,000) the foreign earned income of a U.S. citzen from gross income, the benefits of section 911 must be express-y elected by such person on his U.S. individual income tax return or the taxable year. Alternatively, the foreign tax credit rules do ıot exclude foreign source income from gross income. Rather, they ›rovide a tax credit against the taxpayer's U.S. tax liability, subect to certain limitations, for foreign taxes paid with respect to uch income. In cases where foreign taxes on a particular taxpay-ır's income are not as high as U.S. taxes, the credit still leaves a esidual U.S. tax liability. Thus, U.S. citizens resident in Puerto Rico who have heretofore avoided filing U.S. income tax returns as ı result of the application of section 933, may be required to pay J.S. tax or to file U.S. tax returns for future taxable years, depending upon the resolution of the issue regarding the future application of section 933.

After Pureto Rican independence, U.S. citizens resident in Puerto Rico would not be treated as residents of a possession for ›urposes of the relief from estate and gift taxation provided under ections 2209 and 2501(a) of the Code (discussed above in Part .A.1). Accordingly, effective for decedents dying and gifts made ıfter the effective date of Puerto Rican independence, all U.S. citiens resident in Puerto Rico would be subject to worldwide U.S. state and gift taxation on the same basis as U.S. citizens resident n any other foreign country. However, individuals born after inde-›endence who do not become citizens or residents of the United States would not be subject to Federal estate or gift taxation.

:. Code section 936

Immediate elimination

Under section 317(a) of the bill, effective on the date of proclamaion of independence by Puerto Rico, the section 936 credit would ıot be allowed with respect to income or investments from Puerto Rican activity. Thus, as of such date, all taxable income earned by ualified possessions corporations from the active conduct of a rade or business in Puerto Rico and the QPSII related to the in-estment of section 936 profits in Puerto Rico would be subject to J.S. tax.

The effects of eliminating the use of section 936 for U.S.-owned ›usiness operations may not be as severe as might appear at first lance. The income attributable to the conduct of an active trade ›r business in a foreign country by a foreign corporation owned by J.S. persons is generally not subject to current U.S. taxation. Such ncome of the foreign corporation generally is taxable only when epatriated to the U.S. owner. If there is sufficient U.S. ownership of the corporation, as is typically true of existing qualified possesions corporations, an indirect credit for foreign taxes paid on the orporation's income is available, with limitations.

Thus, if a U.S. person uses a foreign corporation (e.g., one orga nized under Puerto Rican law) instead of a U.S. corporation to d business in Puerto Rico, the effective burden of U.S. tax on activ business income in Puerto Rico may be small due to the benefits o deferral. It is often pointed out that the effective burden of a ta deferred for a sufficiently long period of time approaches that o exemption. It is also possible that excess foreign tax credits avai able from other sources may be applied against the U.S. tax o income from Puerto Rico.

Some argue, however, that the effects of the elimination of sec tion 936 may not be easily mitigated. Reorganizing existing quali fied possessions corporations as foreign corporations may no always be practicable. Also, the imposition of U.S. tax upon a dis tribution to the U.S. owner imposes a tax burden, even though de ferred, that may not currently exist. Lastly, investment incom may be subject to immediate U.S. tax, with a foreign tax credit and may not be eligible for deferral.

Tax-sparing implications if retained

As originally introduced, the bill contained a provision tha would have continued the application of section 936 with respect t Puerto Rico under the independence option. This provision was de leted by the Committee on Energy and Natural Resources. B doing so, the committee made the bill more consistent with genera U.S. international tax policy. As a general principle, the Unite States taxes domestic corporations on their worldwide income However, section 901 prevents the double taxation of certain for eign source income with respect to which the taxpayer has paid o accrued foreign tax by allowing a credit for such tax up to th amount of the U.S. tax attributable to such income. Generally, for eign countries provide similar treatment either by allowing a for eign tax credit or by only subjecting to tax income earned fron sources within the taxing jurisdiction. The section 936 credit oper ates differently than the foreign tax credit in that the allowance o a credit is not dependent upon the existence of a foreign tax liabil ity of the taxpayer. Thus, the section 936 credit is considered a tax sparing credit.

Section 936 has operated in the past as a mechanism to encour age investment by domestic corporations in U.S. possessions i order to assist in the development of the economies of those posses sions. As some possessions may assess little or no tax on U.S. com panies that establish operations within their borders, such oper ations have in many cases produced tax-free income to qualifie possessions corporations. The U.S. does not provide a tax-sparin credit to companies that operate in independent foreign countries and has resisted all efforts by capital-importing countries to in clude tax-sparing credits in tax-treaty relationships with th United States.

If Puerto Rico becomes an independent country, it would be in consistent with U.S. tax treaty policy for the United States to con tinue to allow a tax-sparing credit to companies with operations i Puerto Rico. To do so would discriminate against U.S. companie with operations in other foreign countries. However, any incom tax paid to Puerto Rico with respect to income from Puerto Rica sources should generally qualify as a foreign income tax that is eligible for the foreign tax credit, thereby granting companies with Puerto Rican operations the same treatment as afforded to other companies with multinational operations. As previously discussed, most qualified possessions corporations are currently benefitting from full or partial tax exemptions from Puerto Rican tax. Whether or not those exemptions would continue subsequent to the proclamation of independence would be a decision to be made independently by the Puerto Rican government.

3. Excise taxes

The bill does not contain a specific provision governing excise taxes in the event that Puerto Rico should become an independent republic. However, section 308 of the bill provides a general rule that (except as otherwise provided) upon a proclamation of independence, all laws of the United States applicable to Puerto Rico immediately prior to independence would no longer apply. This apparently would result in repeal of present-law sections 7652 and 7653 of the Internal Revenue Code. Thus, upon a proclamation of independence, articles manufactured in Puerto Rico and shipped to the United States (and *vice versa*) would be treated as articles shipped from (and to) a foreign country for excise tax purposes, and Federal excise tax revenues (including rum excise taxes) would no longer be covered over to the Puerto Rican Treasury pursuant to section 7652 but instead would be retained by the U.S. Treasury.

4. Tax treaty negotiation and ratification

Section 317(b) of the bill provides for the establishment of a Task Force on Taxation to negotiate appropriate tax treaties to govern relations between the United States and Puerto Rico. Under the bill, any agreements so negotiated must be approved by the government of Puerto Rico and the United States in accordance with their respective constitutional processes. In the case of the United States, entry into a treaty requires transmittal of the treaty by the President to the Senate, consent by two-thirds vote of the Senate, and ratification of the Senate-approved treaty by the President.

From the standpoint of the United States, the bill could potentially alter the normal course of treaty negotiations. The bill appears to give the Joint Transition Commission, rather than the President, the ability to appoint the negotiators representing the United States. By contrast, U.S. tax treaties are ordinarily negotiated for the United States by officials of the Office of Tax Policy within the Treasury Department, who have broad areas of responsibility in the formation of U.S. statutory and treaty tax policy. The Committee on Finance may wish to consider whether the bill should take the job of negotiating U.S.-Puerto Rico tax treaties away from the office that may be most sensitive to the favorable or unfavorable precedential effect of a Puerto Rican treaty by changing the ordinary method for designating the individuals who would negotiate the treaty.

Given the bill's apparent requirement that ordinary constitutional procedures for the approval of any U.S.-Puerto Rico tax treaty, once negotiated, be followed, it should be possible under the bill to prevent the entry into a treaty containing what the U.S. govern-

ment views as an inappropriate treaty policy for dealing witl
Puerto Rico. The treaty negotiated would presumably be subject t
Senate advice and consent, and Presidential ratification, as is tru
for any other treaty. Any concerns that the Senate and the Execu
tive Branch might have about provisions that are inappropriate fo
a U.S.-Puerto Rico treaty would therefore have opportunity for ex
pression prior to any such treaty entering into force. It may b
argued, however, that the process of obtaining a treaty that ca
pass the Senate and be ratified would be more efficient if the nego
tiators were chosen by one or both of those branches directly
rather than indirectly through the Joint Transition Commission
The Committee on Finance may wish to clarify the procedur
under which any treaty would be negotiated and to express it
views as to which types of treaty provisions it views as appropriat
or not (e.g., tax-sparing).

5. Tax-exempt bonds

The bill provides that if the interest on bonds issued by Puert
Rico currently is exempt from tax in the United States, the inte
est on those bonds would continue to be exempt from tax whe
held by a United States taxpayer after Puerto Rico's proclamatio
of independence. The bill does not affect the treatment of an
bonds issued by Puerto Rico after its proclamation of independence
Thus, such bonds would be treated similarly to the indebtedness o
any other foreign country when held by a taxpayer in the Unite
States; that is, the interest on such bonds would be subject to tax

When U.S. taxpayers purchase the bonds of corporations, foreig
governments, and the Federal Government itself they recogniz
that they are liable for tax on the interest paid by those bonds. Be
cause purchasers of bonds generally seek the highest net retur
consistent with their preferences for risk, tax exemption enable
State and local governments, including Puerto Rico, to sell bonds t
United States taxpayers at interest rates which generally are lowe
than those offered by corporations, foreign governments, and th
Federal Government. Because a bond's coupon rate generally i
fixed at the time of its sale, revocation of tax exemption for bond
which were initially issued as tax-exempt bonds would create sub
stantial reductions in the market value of the bonds, and potential
ly create substantial capital losses for the bondholders, unless spe
cific covenants provide otherwise.

For example, assume a taxpayer holds a bond whose interest i
tax-exempt, which pays a coupon rate of $10 per year, and wil
repay the bondholder $100 in 10 years. Assume the discount rate i
10 percent. This bond would be worth $100 (the present value o
the annual coupon payments plus the payment of $100 in the tentl
year). If the tax exemption of this bond were revoked, the bond
holder's net after-tax income from the annual coupons might be $7
Now the bond would be worth $81.56 (the present value of the ne
after-tax coupon payments plus the payment of $100 in the tentl
year). This represents nearly a 20-percent reduction in the value o
the bond. Retaining tax exemption for outstanding tax-exemp
bonds might forestall the creation of potential windfall losses i
connection with tax-exempt bonds of Puerto Rico for which tax ex
emption is revoked.

The interest saving which accrues to Puerto Rico under present w is the result of the Federal Government foregoing the collec- on of tax on the interest paid by Puerto Rico to its bondholders. s such, tax exemption creates a subsidy from the Federal Govern- ent to Puerto Rico on its interest costs. After independence, the x subsidy for interest on newly issued bonds would no longer be ovided. Puerto Rico would have to compete with corporations, the deral Government, and other foreign governments when selling nds. Consequently, Puerto Rico's future interest costs would be gher than if tax exemption were retained.

CBI participation

The bill provides that in the absence of a U.S.-Puerto Rico utual free trade agreement, Puerto Rico would qualify for desig- tion as a beneficiary country under the CBI, assuming it is not squalified for any of the reasons that would statutorily disable e President from designating it as a beneficiary country. Thus, der the bill, assuming that the Republic of Puerto Rico also en- red into a suitable agreement for the exchange of tax informa- n with the United States, at some future time Puerto Rican com- nies might be eligible for FSC status by the terms of the bill, and rtain Puerto Rico convention expenses would be eligible for de- ction. In addition, the non-tax benefits flowing from CBI benefi- ry status might also apply to Puerto Rico.

D. Enhanced Commonwealth Provisions

Code Section 936

The bill does not address the operation of section 936 as it relates the enhanced commonwealth status option. It is apparently as- med that section 936, to the extent that it continues to be part of e Code, would continue to apply to Puerto Rico if such option re selected. It is further apparently assumed that any subse- ent modifications to section 936 by Congress would be applicable Puerto Rico.

Treaties

The bill provides that the Governor of Puerto Rico may enter to international agreements to promote the international interest Puerto Rico as authorized by the President of the United States nsistent with the laws and international obligations of the nited States. The committee may wish to consider whether this ovision should be modified insofar as it relates to tax treaties.

Some have argued that the fact that Puerto Rico is not generally vered by tax treaties has adversely affected Puerto Rico. The mmittee on Finance may wish to consider the issue of whether ch treaties or other international agreements would be desirable not, and if desirable, whether existing law or the bill (to the tent, if any, that the bill changes existing law [53]) should be anged to facilitate entry into such treaties. For example, some ay argue that Puerto Rico should have the ability to negotiate

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[53] *Cf.* Davidson, "Tax Sparing: A Question of Treasury Policy or Puerto Rico Politics," 35 *Tax tes* 731, 734 (1987).

treaties with capital exporting nations that would provide for ta sparing, thus giving Puerto Rico an additional source of tax-favore foreign capital in addition to the capital attracted by section 936 c the Code.

However these issues are resolved, it may be appropriate to con sider further refinements to the procedure by which any Puert Rico international agreements would be authorized under the bil For example, the Constitution provides that treaties may only b entered into with the advice and consent of the Senate. Therefore if the Federal Government is to give the Commonwealth a right t enter into international obligations affecting taxes consistent wit U.S. laws and treaties, the committee may find it desirable tha Senate advice and consent be required before the President author izes the entry into such obligations by the Commonwealth.

3. Application of Federal law

The bill generally provides for repeal of Federal laws insofar a they apply to Puerto Rico, upon a joint resolution of Congress ap proving a recommendation for such repeal submitted to Congres by the Government of Puerto Rico, and amends both the Senat and House rules that would otherwise be applicable to the proces of passing such a joint resolution so as to provide a "fast-track" procedure. Among other things, the Senate rule amendment woul curtail unlimited debate that might otherwise be permitted. A compared to current law fast-track procedures that exist, for exam ple, under the Congressional Budget Act and certain other provi sions,[54] the bill may be viewed as relatively unique insofar as i extends such procedures to initiatives of the Government of Puert Rico that seek to override existing legislation. However, the bil does not provide for the application of this rule to any Federal stat utory law (1) establishing grants or services to individual U.S. citi zens, (2) relating to citizenship, or (3) pertaining to foreign rela tions, defense, or national security.

Such a procedure for repeal of laws applicable to Puerto Ric raises the question whether it is appropriate to adopt fast-track procedures for proposals initiated by the Government of Puert Rico to repeal Federal legislation insofar as it relates to Puert Rico, when such procedures necessarily must give this legislatior precedence over other legislation applicable to the entire Unitec States or, indeed, other possessions. It may also be appropriate t consider whether the provision should apply to tax legislation bu not to legislation involving Federal benefits, citizenship, foreign re lations, defense, and national security.

As to the desirability of using the fast-track procedure here some may argue that if the United States is to remain in a Com monwealth relationship with Puerto Rico, and Congress is to have certain unique powers and responsibilities with respect to Puert Rico that it would not have if Puerto Rico were a State or inde pendent country, Congress should be required to deal promptly with effects of its legislation (including possibly unknown and unin tended effects) on Puerto Rico. Were Puerto Rico an independent

[54] A list of resolutions which are currently privileged for consideration in the House of Repre sentatives may be found in House Document 100-248, 100th Cong., 2d Sess. 865-66 (1988).

ıuntry, no such effects might exist in the typical case; were it a ;ate, Puerto Rico would have its own representatives in Congress exercise directly a Puerto Rican voice in U.S. legislation. On the her hand, it may be argued that priorities among categories of ongressional business generally need not be fixed in advance, ›sent unusual needs. It may be argued that the interests of ıerto Rico in repealing existing legislation (or existing tax legisla- on) do not rise to the level of such unusual need.

Finally, the tax law contains several provisions, described above, at have proven to be of particular interest to various Puerto ican constituencies. By channeling certain expressions of these in- rests through the bill's procedures, the bill may be thought to ve more weight, in some cases, to the views of the Governor and gislature of Puerto Rico. On the other hand, the bill may be ewed as restricting the freedom of Congress to fashion its own re- onses to these views.

Regulatory review

The bill sets forth certain broad policies, including the accelera- on of Puerto Rican economic and social development, and (in mat- rs of government) the taking into account of local conditions in ıerto Rico. The bill requires that all agencies (as that term is de- ıed in the Administrative Procedure Act, 5 U.S.C. sec. 551), which r this purpose may include the Treasury Department and the In- rnal Revenue Service (IRS), be guided by those policies. If and to e extent Treasury and IRS may engage in rulemaking "pursuant title 5, United States Code, section 553," [55] Treasury and IRS e to include in the concise general statement of the basis and ırpose of any final rule, the views or arguments submitted to em that raise a question of the consistency of the rules with ose policies.[56]

When Treasury publishes a final rule in the Federal Register :her than a rule issued after notice and hearing required by stat- e [57]) that by its terms applies in the Commonwealth of Puerto co, the Governor may, within a fixed period, require the Treas- y to reconsider the rule in light of the policies set forth in the ll. The bill requires publication in the Federal Register, within a :ed period, of a Treasury finding with respect to the objections of e Governor. If the Treasury finds that it has no discretion to ake the rule inapplicable to Puerto Rico, or to vary the terms of application to Puerto Rico, or if it finds that there is a national terest that the rule be applicable to Puerto Rico as published, en under the bill the Governor, if aggrieved by such finding, can

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[5] It has been said by at least one lower court that rules which are "interpretative" are :empt from the rulemaking requirements of sec. 553." *National Restaurant Ass'n v. Simon,* F. Supp. 993, 999 (D.D.C. 1976). It is not entirely clear whether the Committee on Energy l Natural Resources intended to include rulemaking involving such interpretative rules by its of the phrase "pursuant to title 5, United States Code, section 553."

[6] The bill is unclear on the nature of the concise general statement required, and may need a hnical change to clarify the intent of the Committee on Energy and Natural Resources. *Com- e* bill section 404(b) *with* S. Rep. No. 101-120 at 50.

[7] There is apparently no general statutory notice and hearing requirement applicable to tax ulations in general. *See* Code sec. 7805; 5 U.S.C. 553(c) (1988).

petition for review of that finding in the U.S. Court of Appeals fo either the First Circuit or the District of Columbia Circuit.[58]

This provision raises constitutional and administrative question For example, it may be appropriate to consider whether, and th extent to which, this provision expands the jurisdiction of th courts to hear complaints about tax regulations,[59] as well as th appropriateness of having issues about the impact of Treasury reg ulations on Puerto Rican economic and social development an other policy issues adjudicated in the Federal courts. Under cu rent law, judicial determinations regarding the validity of Treasur regulations typically arise in specific tax controversies between taxpayer and the IRS, and are generally circumscribed by defe ence to the agency's judgment as applied to the relevant statute and legislative history.[60] Moreover, the general rule under th Anti-Injunction Act is that no suit for the purpose of restrainin the assessment or collection of any tax shall be maintained in an court by any person, whether or not such person is the perso against whom such tax was assessed (Code sec. 7421(a)). Declarat ry judgments with respect to Federal taxes may be similarly barre in the general case (28 U.S.C. sec. 2201 (1982); *cf. Alexander "Americans United" Inc.,* 416 U.S.C 752, 759 n.10 (1974)). The bil in contrast, would provide that without a specific taxpayer contr versy, a court may be asked to weigh generalized policy objective with respect to Puerto Rico against tax policies embodied in speci ic tax statutes and regulations and determine on the basis of tha weighing process what remedy (if any) may be appropriate. Som may argue that Puerto Rico does not have an alternative legal wa to challenge the validity of tax regulations, and that it therefor would be appropriate for the Governor to be permitted to litigat in advance the appropriateness of those regulations. *Cf. Sout Carolina v. Regan,* 465 U.S. 367 (1984) (holding that the Anti-Ir junction Act did not bar a State from challenging under the tent amendment to the Constitution a regulation restricting the form i which States could issue tax-exempt bonds). Others may argue tha it is sufficient for such challenges to be made by affected taxpayer They may also argue that the bill permits overly broad prospectiv relief from regulations insofar as the right of judicial review pr vided might not be conditioned on the existence of equitable juri diction (e.g., the bill might be read to provide the Governor a righ of judicial review without requiring a demonstration that enforc ment of the regulation would cause irreparable harm). Finall some may argue that the weighing process necessitated by compar son of any regulation with the broad policy statement set forth i the bill would be more appropriately addressed outside the Judic ary branch of government.

[58] On the other hand, there is no explicit procedure for judicial review prescribed by the bi for a case in which either the Treasury finds an inconsistency between the rule and the poli announced in the bill, and makes some change in the original regulation in accord with term specified in its finding, or no finding as required by the bill is published in the Federal Registe

[59] It may be, for example, that the use of judicial review under this provision would be limit more or less severely by limitations based on justiciability doctrines (e.g., those regarding whet er a matter brought before a Federal court is a case or controversy, whether it involves over political questions, whether it is ripe, and whether the parties have standing).

[60] *E.g., National Muffler Dealers Ass'n v. United States,* 440 U.S. 472 (1979).

APPENDIX A:

Selected Federal Excise Tax Rates

Tax	Tax rates
Alcohol Beverage Excise Taxes:	
1. Distilled spirits	$12.50 per proof gallon.
2. Wines:	
Not more than 14 percent alcohol.	17 cents per wine gallon.
14 to 21 percent alcohol	67 cents per wine gallon.
21 to 24 percent alcohol	$2.25 per wine gallon.[1]
Artificially carbonated wines.	$2.40 per wine gallon.
Champagne and other sparking wines.	$3.40 per wine gallon.
3. Beer	$9 per barrel (31 gallons) generally.
Tobacco Excise Taxes:	
1. Cigars:	
Small cigars (weighing no more than 3 pounds per thousand).	75 cents per thousand.
Large cigars (weighing more than 3 pounds per thousand).	8.5 percent of wholesale price (but not more than $20 per thousand).
2. Cigarettes:	
Small cigarettes (weighing no more than 3 pounds per thousand).	$8 per thousand (i.e., 16 cents per pack of 20 cigarettes).
Large cigarettes (weighing more than 3 pounds per thousand).	$16.80 per thousand.[2]
3. Snuff, chewing tobacco, pipe tobacco:	
Snuff	24 cents per pound.
Chewing tobacco	8 cents per pound.
Pipe tobacco	45 cents per pound.

Selected Federal Excise Tax Rates—Continued

Tax	Tax rates
C. Highway Trust Fund Excise Taxes: [3]	
1. Gasoline	9 cents per gallon.
2. Diesel fuel	15 cents per gallon generally.
3. Special motor fuels (incl. alcohol fuels from petroleum)	9 cents per gallon.
D. Airport and Airway Trust Fund Excise Taxes: [4]	
1. Air passenger ticket tax	8 percent of amount paid.
2. International departure tax	$3 per person.
3. Domestic air cargo tax	5 percent of amount paid.
E. Communications Excise Tax:	
Local and toll (long-distance) telephone and teletypewriter services.	3 percent of amount paid.[5]

[1] Wines containing more than 24 percent alcohol are taxed as distilled spirit

[2] Large cigarettes measuring more than 6.5 inches in length are taxed at th rate prescribed for small cigarettes, counting each 2.75 inches (or fraction) as or cigarette.

[3] These taxes are currently scheduled to expire after September 30, 199

[4] These taxes are currently scheduled to expire after December 31, 199

[5] This tax is currently scheduled to expire after December 31, 1989.

APPENDIX B:

Selected Puerto Rican Excise Tax Rates

Tax	Tax rates
Cigarettes	$3.15 per 100 cigarettes.
Gasoline	16 cents per gallon.
Aviation Fuel	3 cents per gallon.
Gas Oil or Diesel Oil	8 cents per gallon.
Crude Oil	Up to $6.00 per barrel, depending on the market price for crude oil.
Sugar	7 cents per pound.
Automobiles	14 to 85 percent of taxable price,[1] depending on weight and horsepower of automobile.
Other articles not subject to specific excise tax or exempt from excise tax.	5 percent of taxable price.

[1] For purposes of Puerto Rican excise taxes, "taxable price" generally means 72 rcent of the sales price for articles manufactured in Puerto Rico and 132 percent the article's factory f.o.b. price for articles imported into Puerto Rico.

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