FEDERAL TAX LAW AND ISSUES RELATED TO THE COMMONWEALTH OF PUERTO RICO

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
on September 29, 2015

Prepared by the Staff
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INTRODUCTION AND SUMMARY

The Senate Committee on Finance has scheduled a public hearing for September 29, 2015, entitled, "Financial and Economic Challenges in Puerto Rico." This document,[1] prepared by the staff of the Joint Committee on Taxation, provides an overview and analysis of Federal tax laws relating to the Commonwealth of Puerto Rico and other U.S. territories, summarizes recent prominent changes in Puerto Rican tax law, and describes the economy of Puerto Rico, in part by comparison to economic measures for the United States as a whole.

Puerto Rico is one of 13 territories of the United States under the jurisdiction of the Department of the Interior.[2] Puerto Rico and two other territories, Navassa Island and the U.S. Virgin Islands, are in the Caribbean Sea. Ten territories – American Samoa, Baker Island, Guam, Howland Island, Jarvis Island, Johnston Atoll, Kingman Reef, Midway Atoll, the Northern Mariana Islands, and Wake Atoll – are in the Pacific Ocean.

Puerto Rico became a territory in 1898 and a commonwealth 1952.[3] Puerto Rico is represented in the U.S. Congress by a non-voting resident commissioner in the House of Representatives. Residents of Puerto Rico are generally U.S. citizens.

Following common current and historical usage, this document uses the term "possession" interchangeably with "territory."

The economy of Puerto Rico differs from the economies of U.S. states. As measured by per-capita Gross Domestic Product ("GDP"), Puerto Rico is poorer than any one of the states of the United States.[4]

The application of the Federal tax rules to Puerto Rico and the other territories varies from one territory to another. Three territories, Guam, the Northern Mariana Islands, and the U.S. Virgin Islands, are referred to as mirror Code possessions because the Internal Revenue Code of 1986, as amended (the "Code")[5] serves as the internal tax law of those territories (substituting the particular territory for the United States wherever the Code refers to the United States). A resident of one of those territories generally files a single tax return only with the

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[1] This document may be cited as follows: Joint Committee on Taxation, *Federal Tax Law and Issues Related to the Commonwealth of Puerto Rico* (JCX-132-15), September 28, 2015.

[2] The source of information about the territories included in this paragraph and the paragraph that follows is the website of the Office of Insular Affairs of the Department of the Interior: http://www.doi.gov/oia/index.html.

[3] The Northern Mariana Islands are also a commonwealth. Commonwealth status typically involves a legal relationship with the United States that is embodied in a written mutual agreement. The 11 territories other than Puerto Rico and the Northern Mariana Islands generally have less developed legal relationships with the United States. Their governments are generally constituted by U.S. Federal statutes referred to as organic acts.

[4] The 50 states of the United States and the District of Columbia are referred to in this document as the "States."

[5] Unless otherwise noted, section numbers in this document are sections of the Code.

territory of which the individual is a resident, and not with the United States. American Samoa and Puerto Rico, by contrast, are non-mirror Code possessions. These two territories have their own internal tax laws, and a resident of American Samoa or Puerto Rico may be required to file an income tax return with both the territory of residence and the United States.

Federal tax rules apply to the territories in a manner that is different from their application in relation to both the States and foreign countries. Broadly, an individual resident of a territory is exempt from U.S. tax on income that has a source in that territory but is subject to U.S. tax on U.S.-source and non-possession-source income. A corporation that is organized in a territory is generally treated as a foreign corporation for U.S. tax purposes. On the other hand, a number of Code provisions have effect in one or all of the territories as if the territories were States. For example, the tax credit for research and experimentation has been available for research conducted in a territory. Historically, the Federal tax rules also have included preferences for territory activities. Until its expiration in 2006, the section 936 possession tax credit permitted qualifying U.S. corporations a credit against their U.S. tax liability in respect of possession-source income.[6] After section 936 expired, a similar, temporary provision was enacted for American Samoa activities, and the section 199 domestic production activities deduction was expanded temporarily to include production activities conducted in Puerto Rico. These temporary rules for American Samoa and Puerto Rico were extended multiple times but most recently expired at the end of 2014.

Questions related to the Federal tax rules' application to Puerto Rico and the other territories include whether the application should be uniform across the territories; whether the application should be based on a single principle such as State treatment or foreign country treatment; and whether U.S. bilateral income treaties should in any cases include the territories in their scope.

[6] The section 936 credit was phased out during the 10-year period starting in 1996. During this phase-out period, the Puerto Rico economic activity credit of section 30A was available for trade or business activity in Puerto Rico.

I. DEMOGRAPHIC AND ECONOMIC DATA

Demographic overview

Puerto Rico differs from the United States along a number of demographic and economic dimensions.[7] Table 1, below, provides a demographic overview of the United States and Puerto Rico. The Puerto Rican population is generally older than the U.S. population and is experiencing greater population outflows than inflows. In 2015, 17.5 percent of Puerto Ricans are ages 65 and over, while a smaller percentage, 14.9 percent, of the U.S. population is in that age range. In contrast, 17.7 percent of Puerto Ricans are ages 14 and younger in Puerto Rico, while a larger percentage, 19.0 percent, of the U.S. population is in that age group.

Population flows also differ between the United States and Puerto Rico. While approximately four people, per 1,000 people on net, migrated to the United States in 2015, approximately three people, per 1,000 on net, migrated out of Puerto Rico.

Table 1.−Demographic Information (2015)

	United States	**Puerto Rico**
Mid-Year Population	321,368,864	3,598,357
0 - 14 Years	19.0%	17.7%
15 - 64 Years	66.1%	64.8%
65 Years and Over	14.9%	17.5%
Life Expectancy at Birth (Years)	79.7	79.3

Source: U.S. Census International Database.

Economic data

As measured by per-capita gross domestic product ("GDP"), Puerto Rico is poorer than each State as well as the country as a whole. In 2013, Puerto Rico had a per-capita GDP of $28,289, while the poorest State, Mississippi, had a per-capita GDP of $34,800 and the United

[7] In this section, the United States encompasses the 50 States and the District of Columbia.

States had a per-capita GDP of $52,716.[8] Puerto Rico also has a higher unemployment rate than any State. In August 2015, the unemployment rate in Puerto Rico was 11.6 percent, while West Virginia had an unemployment rate of 7.6 percent (highest in the United States) and the United States as a whole had an unemployment rate of 5.1 percent.[9]

Workforce compensation is generally lower in Puerto Rico than in the United States. As Table 2, below, shows, median and mean wages in the United States were greater than that in Puerto Rico in May 2014.

Table 2.−Wage Data for the United States and Puerto Rico (May 2014)

	United States	**Puerto Rico**
Median Wage	$17.09	$9.42
Mean Wage	$22.71	$13.23
Annual Mean Wage	$47,230	$27,510

Source: Bureau of Labor Statistics.

[8] The GDP figure for Puerto Rico comes from the World Bank, and the GDP figures for the United States and Mississippi are from the Bureau of Economic Analysis. Population figures are from the U.S. Census Bureau.

[9] Bureau of Labor Statistics.

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

A. Overview of the U.S. Tax Provisions Related to U.S. Territories

1. In general

While U.S. statutory laws apply to the U.S. possessions, and natives of U.S. possessions are U.S. citizens or nationals, for tax purposes the Code generally treats the U.S. possessions as foreign countries. When the Code uses the term in a geographical sense, the "United States" includes only the 50 States and the District of Columbia.[10]

The term "possession" is not used consistently in the Code, and its meaning varies. For purposes of assessment and collection of Federal taxes, the possessions are generally treated in the same manner as the States, except as provided in the Revised Organic Act of the Virgin Islands and the Organic Act of Guam with respect to certain taxes covered over to the treasuries of the U.S. Virgin Islands and Guam.[11] Taxes imposed by the Code in any possession are collected under the direction of the Secretary. Taxes with respect to any individual to whom section 931 or 932(c) applies are covered into the Treasury of the specific possession of which the individual is a bona fide resident.[12]

Income derived from U.S. possessions is ordinarily treated as foreign-source income. Entities organized in U.S. possessions are generally treated as foreign persons. Of the various trust territories and possessions of the United States, only those with local taxing authorities that have entered into a tax coordination agreement with the United States, that is, American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands, are provided special treatment in the Code.[13]

As part of their legal relationships with the United States, three of the possessions have so-called "mirror" systems of taxation. In Guam,[14] the Commonwealth of Northern Mariana

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

[11] Sec. 7651.

[12] Sec. 7654.

[13] See Rev. Proc. 2006-23, 2007-1 C.B. 900. In addition to these five jurisdictions, other territories may be considered possessions of the United States for political purposes but are not generally accorded special status under the Code or by Treasury. But see, *e.g.*, section 274(h)(3)(A) (defines "North American area" to include the United States, its possessions and the Trust Territory of the Pacific Islands, as well as Canada and Mexico) and Rev. Rul. 2011-26, 2011-1 C.B. 803 (explains the current status of the entities that were part of the Trust Territory when 274(h) was enacted, and rules that "possessions" includes, in addition to the five discussed in this pamphlet, Baker Island, Howland Island, Jarvis Island, Johnston Island, Kingman Reef, the Midway Islands, Palmyra Atoll, Wake Island, and any other United States islands, cays, and reefs that are not part of the 50 states or the District of Columbia).

[14] The 1950 Organic Act of Guam, 48 U.S.C. sec. 1421i(h) (2012).

Islands[15] and the U.S. Virgin Islands,[16] the United States Federal income tax laws are in effect (are "mirrored") as the local territorial income tax laws. Revenues under the mirror codes are generally paid to the treasuries of the possessions. Not all of the Code is mirrored; generally, only the income tax provisions of the Code are mirrored.[17] In the tax statutes as in effect in each of these possessions, the name of the possession is substituted for "United States," and vice-versa. Although the reverse substitution is not explicitly described in any of the operative statutes for the possessions, two-way mirroring has been required to give effect to the intent of the mirroring requirement. To the extent that mirroring would produce a result manifestly incompatible with the Code or other provisions of the United States Code, mirroring is not required.[18]

The Tax Reform Act of 1986 (the "1986 Act") granted authority to Guam, the Commonwealth of Northern Mariana Islands and American Samoa to cease use of the mirror system, and authorized the U.S. Virgin Islands to impose local taxes at variance from the rates in the Code as mirrored. It repealed the relevant rules that provide coordination between the Federal statutes and the statutes as mirrored in Guam, American Samoa and the Northern Mariana Islands and amended the coordination rules for the U.S. Virgin Islands. The changes are not yet in effect for Guam or the Northern Mariana Islands, because the effective date is contingent upon the existence of an implementation agreement, and the contingency has not been met.[19]

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[15] Covenant to Establish a Commonwealth of the Northern Mariana Islands in Political Union with the United States of America ("Covenant"), Act of March 24, 1976, Pub. L. No. 94-241, 48 U.S.C. sec. 1801 (note) (2012); President Ronald Reagan, "Placing Into Full Force and Effect the Covenant With the Commonwealth of the Northern Mariana Islands, and the Compacts of Free Association With the Federated States of Micronesia and the Republic of the Marshall Islands," Proclamation No. 5564, 51 Fed. Reg. 40,399-400 (Nov. 3, 1986).

[16] Act July 12, 1921, ch 44, 42 Stat. 123, popularly known as the Naval Service Appropriation Act, 1922, codified at 48 U.S.C. sec. 1397 (2012).

[17] For example, 48 USC 1421i(d) specifies that for Guam, the mirrored sections include most of subtitle A (income tax), chapters 24 and 25 (withholding tax), and subtitle F (administrative) as applicable to the income tax.

[18] *Gumataotao v. Director of Revenue and Taxation of Guam*, 236 F.3d 1077 (9th Cir. 2001) ["Only those provisions of the I.R.C. that are "manifestly inapplicable or incompatible with the intent of [the Income Tax Section]" do not apply to Guam taxpayers. *48 U.S.C. § 1421i(d);* see *Sayre & Co. v. Riddell, 395 F.2d 407, 410 (9th Cir. 1968)* (en banc) ("Sayre") (G.T.I.T. "mirrors" the Code except where "manifestly inapplicable or incompatible")."]

[19] The special effective date for the revision of section 931 and repeal of section 935 is provided in section 1277(b) of the 1986 Act, stating "The amendments made by this subtitle shall apply with respect to Guam, American Samoa, or the Northern Mariana Islands (and to residents thereof and corporations created or organized therein) only if (and so long as) an implementing agreement under section 1271 is in effect between the United States and such possession." Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 1277(a), (b), 100 Stat. 2085, 2600 (1986).

2. Income taxation of individuals

The United States generally imposes income tax on the worldwide income of U.S. citizens and residents. Thus, all income earned by a U.S. citizen or resident, whether from sources inside or outside the United States, is taxable whether or not the individual lives within the United States. All U.S. citizens and residents whose gross income for a taxable year is not less than the sum of the personal exemption amount and the basic standard deduction are required to file an annual U.S. individual income tax return.

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

Generally, special U.S. income tax rules apply with respect to U.S. persons who are bona fide residents of U.S. possessions and who have possession-source income or income effectively connected with the conduct of a trade or business within a possession.[20] The term bona fide resident means a person who meets a two-part test with respect to American Samoa, Guam, the U.S. Virgin Islands, Puerto Rico, or the Northern Mariana Islands as the case may be, for the taxable year. First, an individual must be present in the U.S. possession for at least 183 days in the taxable year.[21] Second, an individual must (1) not have a tax home outside such possession during the taxable year and (2) not have a closer connection to the United States or a foreign country during such year.

Individual residents living in U.S. possessions generally are subject to either a single- or double-filing system with respect to their income. Individual residents subject to section 931 or 933 (that is, bona fide residents of American Samoa and Puerto Rico) operate under a double-filing system. Under a double-filing system, income that is not exempt from U.S. tax under section 931 or 933, and meets certain filing thresholds, must be reported to the United States on a U.S. return. An individual resident of a territory with a double-filing system who has income from sources outside the territory of which the individual is resident (for example, a Puerto Rican resident individual with non-Puerto Rican-source income) must file a U.S. tax return and may also be required to file a return with the territory of residence. Income reported on a U.S. return by a bona fide resident of a U.S. possession is generally subject to the same U.S. tax treatment that applies to individuals resident in the United States.

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[20] For more detail about these special rules, see generally, Joel D. Kuntz and Robert J. Peroni, *U.S. International Taxation*, "U.S. Taxation Relating to Possessions" (Warren Gorman and Lamont-RIA, 2005), Part D.

[21] Sec. 937(a). Treasury regulations provide guidance related to meeting the presence test, including exceptions for certain extended absences from the possession. Treas. Reg. sec. 1.937-1.

In contrast, an individual subject to section 932(c) or 935 (that is, a bona fide resident of the U.S. Virgin Islands, Northern Mariana Islands, or Guam[22]) generally are subject to a single-filing system. Under a single-filing system, income is reported in one jurisdiction, based on bona fide residency. A bona fide resident of a territory with a single-filing system generally files a tax return only with that territory and not with the United States. In a single-filing system, income is typically allocated between the U.S. possession and the United States through a cover-over mechanism. Cover-over generally refers to the collection of certain taxes and fees by the U.S. Treasury and subsequent payment of such taxes and fees to the governments of the territories as specified.

As a general rule, the principles for determining whether income is U.S.-source are applicable for purposes of determining whether income is possession source. In addition, the principles for determining whether income is effectively connected with the conduct of a U.S. trade or business are applicable for purposes of determining whether income is effectively connected to the conduct of a possession trade or business. However, except as provided in regulations, any income treated as U.S.-source or as effectively connected with the conduct of a U.S. trade or business is not treated as income from within any possession or as effectively connected with a trade or business within any such possession.[23]

For purposes of the foreign earned income exclusion, the U.S. possessions are not treated as foreign countries. Thus, residents of U.S. possessions do not qualify for the foreign earned income or housing exclusion under section 911 of the Code because they are not considered resident abroad.[24]

U.S. citizens who relinquish their citizenship and U.S. residents who terminate their long-term residency may be subject to special tax rules intended to limit any tax benefits from expatriation. Certain persons expatriating before June 17, 2008 are subject to an alternative tax regime for a period of 10 years if they meet certain income and net-worth thresholds or they fail to comply with certain U.S. Federal tax obligations.[25] Certain persons expatriating after June 16, 2008, are treated as if all property was sold on the day before their expatriation date for its fair market value.[26] U.S. citizens and lawful permanent residents who leave the United States and establish residency in one of the possessions are generally not considered to have either

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[22] The repeal of section 935 is not yet effective for Guam or the Northern Marianas, due to failure to meet the condition in the special effective date provided in section 1277(b) of the 1986 Act, which states, "The amendments made by this subtitle shall apply with respect to Guam, American Samoa, or the Northern Mariana Islands (and to residents thereof and corporations created or organized therein) only if (and so long as) an implementing agreement under section 1271 is in effect between the United States and such possession." Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 1277(a), (b), 100 Stat. 2085, 2600 (1986).

[23] Sec. 937(b).

[24] Treas. Reg. secs. 1.911-2(g),(h).

[25] Sec. 877.

[26] Sec. 877A.

relinquished their U.S. citizenship or terminated their U.S. residency; however, the special source rules may apply to U.S. citizens and residents that leave the United States and establish residency in American Samoa, the Northern Mariana Islands, or Guam during the 10-year period beginning when the person first becomes a resident.[27]

3. Income taxation of corporations

U.S. corporations

U.S. corporations are subject to U.S. income tax on their worldwide income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income is generally deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F[28] and the passive foreign investment company rules.[29] A foreign tax credit is generally available to offset, in whole or in part, the U.S. tax owed on this foreign-source income, whether earned directly by the domestic corporation, repatriated as a dividend, or included under one of the anti-deferral regimes, subject to certain limitations.

Foreign corporations

Foreign corporations with U.S.-source income generally are subject to U.S. tax on a net basis at graduated rates on income effectively connected to a U.S. trade or business. U.S.-source passive income paid to a foreign corporation is generally taxed on a gross basis at a withholding rate of 30 percent. With limited exceptions, the United States generally does not tax foreign-source income of foreign corporations that are not owned by U.S. shareholders.

Corporations formed in the U.S. possessions generally are treated as foreign corporations for U.S. tax purposes. The United States therefore generally does not impose tax on the business income of possessions subsidiaries of domestic corporations, but subpart F may cause passive and mobile income to be taxed currently. Corporations organized in the U.S. territories and not owned by U.S. shareholders generally are not subject to U.S. tax on territory-source or other foreign-source income.

Notwithstanding the general rule that a company organized in a U.S. possession is a foreign corporation for U.S. tax purposes, certain qualifying corporations are deemed not to be

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[27] See section 1277(e) of the 1986 Act. Under this special source rule, gains from dispositions of certain property held by a U.S. person prior to becoming a resident in American Samoa, the Northern Mariana Islands, or Guam are treated as income from sources within the United States for all purposes of the Code.

[28] Secs. 951-964.

[29] Secs. 1291-1298.

foreign corporations for purposes of the 30-percent gross-basis tax on passive income and the branch profits tax. Under this rule, U.S.-source fixed or determinable annual or periodical income such as a dividend, interest, rent, or royalty received by a corporation created or organized in American Samoa, Guam, the U.S. Virgin Islands, or the Northern Mariana Islands is not subject to the 30-percent gross-basis tax provided that certain local ownership and activity requirements are met.[30] Those possessions similarly provide a zero rate of gross-basis tax on territory-source payments made to corporations organized in the United States.

A more limited rule for Puerto Rico provides that if a corporation created or organized in Puerto Rico receives a U.S.-source dividend, and the Puerto Rican corporation satisfies the same local ownership and activity requirements just described, the 30-percent gross-basis tax is reduced to 10 percent.[31] This rule applies only so long as Puerto Rico imposes a withholding tax on dividends paid to U.S. corporations not engaged in a Puerto Rico trade or business at a rate not greater than 10 percent.[32]

4. Estate and gift taxation

U.S. citizens and residents

A U.S. citizen or resident is subject to estate tax on the value of property, wherever situated, transferred at death. The taxable estate is equal to the decedent's worldwide gross estate, less allowable deductions (including the marital deduction). Certain credits are allowed, including the unified credit, which directly reduce the amount of the estate tax.[33]

A U.S. citizen or resident is subject to gift tax on a transfer of property by gift during life made directly or indirectly, in trust or otherwise. The gift tax applies to transfers of property by citizens and residents regardless of where the property is situated. The amount of a taxable gift is determined by the fair market value of the property on the date of the gift. An annual exclusion (adjusted periodically for inflation)[34] applies to gift given in a calendar year.[35]

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[30] Sec. 881(b)(1). The local ownership and activity requirements are that (A) at all times during the taxable year foreign persons own directly or indirectly less than 25 percent in value of the stock of the corporation; (B) for the three-year period ending with the close of the taxable year, at least 65 percent of the corporation's gross income is shown to the satisfaction of the Secretary to be effectively connected with the conduct of a trade or business in the territory of residence or the United States; and (C) no substantial part of the income of the corporation is used directly or indirectly to satisfy obligations to persons who are not bona fide residents of the territory of residence or of the United States. Ibid.

[31] Sec. 881(b)(2)(A).

[32] Sec. 881(b)(2)(B).

[33] The unified credit amount is the tax computed on an exemption amount of $5.43 million for 2015 (indexed for inflation). The estate tax rate is 40 percent.

[34] Sec. 2503(b). The annual gift tax exclusion amount for 2015 is $14,000.

A U.S. citizen residing in a U.S. possession is treated as a citizen for estate and gift tax purposes unless he acquired U.S. citizenship solely by reason of birth or residence within the possession.[36]

Nonresident aliens

The estate of a nonresident alien generally is taxed at the same estate tax rates applicable to U.S. citizens, but the taxable estate includes only property situated within the United States that is owned by the decedent at death (and certain property transferred during life subject to reserved interests or powers). This estate generally includes the value at death of all real and personal tangible property situated in the United States and certain intangible property, such as stock of a domestic corporation, considered to be situated in the United States.[37] The estate of a nonresident alien is allowed a unified credit of $13,000[38] and under treaty may instead be allowed a pro rata portion of the generally applicable unified credit.

Nonresident alien individuals are subject to gift tax with respect to certain transfers by gift of U.S.-situated property under the same tax rate schedule applicable to U.S. citizens. The tax applies only where the value of the transfer exceeds the annual exclusion amount.[39] Such property includes real estate and tangible property located within the United States. Nonresident aliens generally are not subject to U.S. gift tax on the transfer of intangibles, such as stock or securities, regardless of where such property is situated.

A U.S. citizen residing in a possession is treated as a nonresident alien for estate and gift tax purposes if the individual's U.S. citizenship was acquired solely by reason of birth or residence within the possession.[40] Estates of decedents who are treated as nonresident aliens for purposes of this rule are allowed a credit against the estate tax equal to the greater of $13,000 or that proportion of $46,800 which the value the decedent's gross estate situated in the United States bears to the value of the entire gross estate wherever situated.[41]

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[35] The unified credit (with a basic exclusion amount of $5.43 million in 2015) is allowed in computing the gift tax on lifetime transfers and transfers at death. Just as the unified credit is a single credit against tax and gifts and bequests, the 40-percent tax rate applies to both gifts and bequests.

[36] Secs. 2208 (estate tax) and 2501(b) (gift tax).

[37] For these purposes the United States means the 50 States and the District of Columbia.

[38] Sec. 2102(b). This credit shelters the first $60,000 of the taxable estate from Federal estate tax.

[39] The annual exclusion amount is $14,000 for 2015 (indexed for inflation).

[40] Sec. 2209 (estate tax) and 2501(c) (gift tax).

[41] Sec. 2102(b)(2).

5. Payroll taxes

Employees and employers in the United States are subject to payroll taxes for the Federal Insurance Contributions Act ("FICA") that fund Social Security and certain Medicare benefits, Federal unemployment insurance payroll tax ("FUTA"), and the withholding tax for Federal income tax.[42] FICA imposes tax on employers based on the amount of wages paid to an employee during the year. The tax imposed is composed of two parts: (1) the old age, survivors, and disability insurance ("OASDI") tax as a percentage of covered wages; and (2) the Medicare hospital insurance ("HI") tax amount, also a percentage of covered wages. In addition to the tax on employers, each employee is subject to FICA taxes equal to the amount of tax imposed on the employer. The employee-level tax generally must be withheld and remitted to the Federal government by the employer. Certain categories of services and employment are often exempt from FICA, including foreign agricultural workers with appropriate visas.

Similar FICA payroll tax obligations generally apply to persons in any of the U.S. possessions.[43] In contrast, employees and employers in the possessions are generally not subject to the withholding at source for Federal income tax, although they are subject to withholding for local taxes.[44] These payroll obligations of the employers are generally applicable to Federal agencies with personnel in the possession. Only Puerto Rico and the U.S. Virgin Islands are within the scope of the FUTA obligations.[45] Wages paid to persons employed in Puerto Rico or the U.S. Virgin Islands are subject to FUTA on wages for each calendar year paid by a covered employer to each employee. Federal unemployment insurance payroll taxes are used to fund programs maintained by the local jurisdictions for the benefit of unemployed workers. Employers in such jurisdictions with programs approved by the Federal government may qualify for a credit of 5.4 percentage points against the 6.0 percent tax rate, making the minimum, net Federal unemployment tax rate 0.6 percent.[46]

6. Excise tax

U.S. excise taxes generally do not apply within the U.S. possessions. However, U.S. excise taxes equal to the taxes on domestically produced articles are imposed on articles of manufacture brought into the United States from Puerto Rico and the Virgin Islands and

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[42] Secs. 3121(a) and 3402(a).

[43] Internal Revenue Service, *Federal Tax Guide for Employers in the U.S. Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands* (Publication 80 Circular SS), 2012.

[44] Under section 3401(a)(8), most wages paid to U.S. persons for services performed in one of the possessions are excluded if the payments are subject to withholding by the possession, or, in the case of Puerto Rico, the payee is a bona fide resident of the possession for the full year.

[45] Section 3306(j) provides that for purposes of the FUTA tax, the term State includes both Puerto Rico and the Virgin Islands.

[46] While the gross FUTA tax rate was 6.2 percent (until July 2011), the net rate was 0.8 percent. The credit is not available to employers who are delinquent in repaying a Federal loan.

withdrawn for consumption or sale.[47] These taxes are generally covered over to the respective treasuries. Articles imported from the United States into Puerto Rico, the Virgin Islands, Guam, and American Samoa are generally exempt from U.S. excise tax; however articles imported from the United States into Puerto Rico and the Virgin Islands are subject to a local excise tax equal to the tax imposed under the revenue laws of the United States.[48] Provisions related to the allowance of drawback[49] on excise tax on articles exported from the Unites States are extended to like articles when shipped from the United States to Puerto Rico, the Virgin Islands, Guam, or American Samoa.[50]

7. Tax incentives

The Code contains other provisions that provide incentives for certain activities. Some of the provisions expand the incentives provided for State and local jurisdictions to the U.S. possessions while others are specifically targeted at certain activities within a specific U.S. possession. Examples of State and local incentives that apply to U.S. possessions include the exclusion of interest on State and local bonds,[51] the credit for research and experimentation,[52] and the low-income housing credit.[53]

8. Tax treaties

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

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[47] Sec. 7652.

[48] Sec. 7653.

[49] A drawback is a refund of certain duties, taxes and fees paid by the importer of record and granted to a drawback claimant upon the exportation, or destruction of eligible articles upon which the duties, taxes and fees have been paid. The purpose of drawback is to place U.S. exporters on equal footing with foreign competitors by refunding most of the duties, taxes and fees paid on imports used in domestic manufacturing intended for export.

[50] Sec. 7653(c).

[51] Sec. 103. Section 103(c)(2) defines State to include any possession of the United States.

[52] Sec. 41. The credit is generally not available to foreign research; however, section 41(d)(4)(F) defines foreign research to be research conducted outside the United States, the Commonwealth of Puerto Rico, or any possession of the United States.

[53] Sec. 42. Section 42(h)(8)(B) defines State to include a possession of the United States.

There are no bilateral tax treaties between any of the possession and any foreign country. In addition, U.S. treaties typically do not include the possessions in the definition of United States for treaty purposes. However, for purposes of identifying the scope of exchange of information agreements, the possessions are included.[54] Treaties further provide procedures under which inconsistent positions taken by the treaty countries on a single item of income or deduction may be mutually resolved by the two countries. To the extent that inconsistent positions are taken by the Internal Revenue Service ("IRS") and the taxing authority of one of the possessions, relief from double taxation may be available by negotiation between the two taxing agencies. Each of the U.S. possessions has an agreement (variously styled as coordination, exchange of information, or implementation agreements) that permits entry into a memorandum of understanding to resolve such conflicts. The process for seeking such relief is similar to that available under competent authority procedures.[55]

[54] See, *e.g.*, *Agreement between the Government of the United State of America and the Government of the Republic of Panama for Tax Cooperation and the Exchange of Information Relating to Taxes Tax Information Agreement between United States and Panama*, entered into force April 18, 2011.

[55] See section 1.02 of Rev. Proc. 2006-23, 2007-1 C.B. 900.

B. Overview of U.S. Tax Provisions Related to Puerto Rico

1. In general

Although Puerto Rico is generally treated as a foreign country for U.S. tax purposes, a person born in Puerto Rico is typically treated as a U.S. citizen for U.S. tax purposes. As a result of the hybrid foreign-domestic treatment, the general principles of U.S. taxation are qualified by many special rules applicable to U.S. citizens and residents of, and U.S. persons doing business in, Puerto Rico. In many cases, these special rules have the effect of dividing tax authority between the U.S. Federal government and the government of Puerto Rico. Other rules are designed to prevent U.S. Federal tax laws from negating tax incentives used by Puerto Rico to attract investors. The United States has also used tax incentives to assist Puerto Rico in obtaining economic development through investments by U.S. companies. The argued need for these special tax incentives has been attributed, in part, to what some observers contend are the additional costs imposed on investing in Puerto Rico because of its status as a U.S. possession.[56]

2. Income taxation of individuals

Under the Jones Act,[57] Puerto Rico is deemed to be a part of the United States for purposes of acquiring U.S. citizenship by place of birth. Thus, a person born in Puerto Rico is typically a U.S. citizen for U.S. tax purposes. In contrast with the general rule that the United States imposes tax on all income of a U.S. citizen irrespective of the citizen's country of residence and irrespective of the U.S. or foreign source of the income, income derived from sources within Puerto Rico by an individual who is a bona fide resident of Puerto Rico for an entire taxable year generally is excludible from U.S. gross income and thus exempt from U.S. taxation even if the individual is a U.S. citizen.[58]

Income excludible from U.S. gross income under section 933 is generally subject to taxation by Puerto Rico. Items of income derived from sources outside of Puerto Rico by U.S. citizens who reside in Puerto Rico generally are subject to U.S. taxation. The principles that generally apply for determining income from sources within and without the United States also generally apply in determining income from sources within and without a possession. In addition, the principles for determining whether income is effectively connected with the conduct of a U.S. trade or business are applicable for purposes of determining whether income is effectively connected to the conduct of a possession trade or business. Except as provided in regulations, any income treated as U.S.-source or as effectively connected with the conduct of a

[56] See, for example, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, pp. 999-1000, available at http://www.jct.gov/jcs-10-87.pdf.

[57] 39 Stat. 951 (1917).

[58] Sec. 933.

U.S. trade or business is not treated as income from within any possession or as effectively connected with a trade or business within any such possession.[59]

A bona fide resident of Puerto Rico is an individual that meets a two-part test for the taxable year. First, the individual must be present in Puerto Rico for at least 183 days in the taxable year. Second, the individual must (1) not have a tax home[60] outside Puerto Rico during the taxable year and (2) not have a closer connection[61] to the United States or a foreign country during such year.[62]

3. Income taxation of corporations

In general, a corporation organized under the laws of Puerto Rico is a foreign corporation for U.S. tax purposes. The United States taxes foreign corporations only on income that has a sufficient nexus to the United States. This taxation includes a 30-percent tax on the gross amount of a foreign corporation's fixed, determinable, annual, or periodic income from U.S. sources and taxation under the corporate income tax on net income that is effectively connected with the conduct of a U.S. trade or business.

As described previously, the gross-basis withholding tax rate on U.S.-source dividends paid to a corporation created or organized in Puerto Rico is lowered from 30 percent to 10 percent.[63] The lower rate applies only if the Puerto Rican corporation satisfies the same local ownership and activity requirements for exclusion from the 30-percent tax for U.S.-source income received by a corporation organized in American Samoa, Guam, the Northern Mariana Islands, or the U.S. Virgin Islands.[64] If, as described previously, Puerto Rico increases its withholding tax on dividends paid to U.S. corporations not engaged in a Puerto Rican trade or business above 10 percent, the reduction of the 30-percent U.S. tax ceases to have effect.[65]

4. Payroll taxes

Employers and employees in Puerto Rico are subject to FICA and FUTA.[66] Certain statutory exceptions from the definition of wages for FICA and FUTA purposes do not apply in the case of employers and employees in Puerto Rico. For example, the exceptions from the

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[59] Sec. 937(b).

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

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

[62] Sec. 937(a).

[63] Sec. 881(b)(2).

[64] See sec. 881(b)(2)(A)(ii). The requirements are listed at sec. 881(b)(1)(A), (B), and (C).

[65] Sec. 881(b)(2)(B).

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

definition of wages for amounts under an educational assistance program or a dependent care assistance program[67] do not apply because the exceptions are by reason of specific Code sections (i.e., sections 127 and 129) that are not applicable in the case of Puerto Rico employers and employees.

5. Excise taxes

In general

U.S. excise taxes generally do not apply within the U.S. possessions. However, U.S. excise taxes equal to the taxes on domestically produced articles are imposed on articles of manufacture brought into the United States from Puerto Rico and withdrawn for consumption or sale.[68] These taxes are generally covered over to the Treasury of Puerto Rico. A special excise tax rule also applies when articles manufactured in the United States are shipped to Puerto Rico. In such cases, the articles are exempt from Federal excise taxes and, upon being entered in Puerto Rico, are subject to a tax equal in rate and amount to the excise tax imposed in Puerto Rico upon similar articles of Puerto Rico manufacture. [69]

Cover over of excise taxes on Puerto Rico products

Revenues collected by the United States from the excise taxes imposed on certain articles coming into the United States from Puerto Rico generally are covered over to the Puerto Rico Treasury.[70] With respect to otherwise eligible excise taxes imposed on articles not containing distilled spirits, revenues are covered over to Puerto Rico only if the cost or value of materials produced in Puerto Rico plus the direct costs of processing operations performed in Puerto Rico equal at least 50 percent of the value of the article at the time it is brought into the United States. Moreover, no cover over is permitted on such articles if Puerto Rico provides a direct or indirect subsidy with respect to the article which is of a different kind or in an amount greater than the subsidies which Puerto Rico generally offers to industries producing articles not subject to Federal excise tax.

With respect to Federal excise taxes imposed on articles containing distilled spirits that are manufactured in Puerto Rico and shipped into the United States, revenues are covered over to the Puerto Rico Treasury only if at least 92 percent of the alcoholic content of such articles is attributable to rum. The amount of excise taxes covered over to Puerto Rico from such articles cannot exceed $10.50 per proof gallon. This limitation was temporarily increased to $13.25 for articles brought into the United States after June 30, 1999, however the increase in the limitation does not apply to articles brought into the United States after December 31, 2014.

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

[68] Sec. 7652.

[69] Sec. 7653.

[70] Sec. 7652(a).

Cover over of excise taxes on rum imported from other countries

A provision of the Code added by the Caribbean Basin Economic Recovery Act provides a special rule for excise taxes collected on rum imported into the United States from any country.[71] Such excise taxes are covered over to the treasuries of Puerto Rico and the U.S. Virgin Islands, under a formula prescribed by the Treasury Department for the division of such tax collections between Puerto Rico and the U.S. Virgin Islands.[72] The formula for division of excise tax collected from other countries is roughly based on the relative market share of rum produced in Puerto Rico and the U.S. Virgin Islands. The law stipulates that the Puerto Rico share not exceed 87.626889 percent and not fall below 51 percent. This formula resulted in approximately 88 percent of revenues from rum excise taxes being covered over to Puerto Rico in fiscal year 2014.

6. Tax incentives

The generally applicable section 199 deduction for income from domestic production activities was expanded temporarily to include production activities conducted in Puerto Rico.[73] For purposes of computing the wage limitation for the deduction, wages include wages paid for services performed in Puerto Rico. This provision is not applicable to tax years beginning after December 31, 2014.

[71] Present law section 7652(e), enacted as part of Pub. L. No. 98-67, August, 5, 1983.

[72] The cover-over for these taxes is subject to the $10.50 per-proof gallon (temporarily increased to $13.25 for articles imported into the United States before 2015) limitation described previously.

[73] Sec. 199(d)(8).

III. OVERVIEW OF PUERTO RICO TAX LAW[74]

A. Corporate and Business Income Tax

A corporation organized in Puerto Rico owes tax on its total net taxable income derived from any source whatsoever.[75] The corporate tax rate is a flat 20 percent, plus a graduated surtax increasing with net income from five percent to 39 percent.[76] There is a corporate alternative minimum tax ("AMT") that requires a corporation to pay the greater of 20 percent of an adjusted calculation of net income, or the total of the 20-percent corporate tax plus corporate surtax.[77]

A foreign corporation engaged in a trade or business in Puerto Rico is subject to Puerto Rico income tax at the same corporate income tax rates, including the surtax and the AMT, but only with respect to income that is effectively connected to that trade or business.[78]

Foreign corporations that are not engaged in a trade or business in Puerto Rico are taxed on particular income from sources within Puerto Rico at a rate of 29 percent for interest from related persons and 10 percent on dividends. The AMT does not apply to foreign corporations that are not engaged in a trade or business in Puerto Rico.[79]

A corporation may elect to pay a flat 10-percent rate of tax on non-exempt interest income on bonds, notes or other similar obligations issued by certain corporations or partnerships that are domestic or derive substantial income from Puerto Rico, and mortgage loans on residential property located in Puerto Rico.[80]

Effective for taxable years beginning after December 31, 2010, general partnerships, limited partnerships, and joint ventures are not subject to entity-level income taxation.[81]

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[74] This description of the tax laws of Puerto Rico relies largely on the following secondary source: Ríos-Méndez and Alemar-Escabí, 2650-3rd T.M., Business Operations in Puerto Rico. The description is intended to serve as a general overview; many details have been omitted and simplifying generalizations made. All citations to the Laws of Puerto Rico Annotated (L.P.R.A.) are current as of the year of the most recent English translation available on Lexis. This description generally does not include changes made by tax legislation enacted in May 2015, other than the value-added tax described below.

[75] Ríos-Méndez and Alemar-Escabí, 2650.05(B).

[76] 13 L.P.R.A. § 30071 (2011).

[77] 13 L.P.R.A. § 30073 (2011).

[78] 13 L.P.R.A.§30441(b) (2011).

[79] 13 L.P.R.A. § 30441(a) (2011).

[80] 13 L.P.R.A. § 30085 (2011).

[81] Ríos-Méndez and Alemar-Escabí, 2650.08(A).

For acquisitions after 2010, an excise tax applies to a controlled group member's acquisition from another group member of personal property manufactured or produced in Puerto Rico and services performed in Puerto Rico.[82]

B. Individual Income Tax on Residents

Individuals who are residents of Puerto Rico are subject to Puerto Rico income tax on their worldwide income.[83] Marginal individual income tax rates range from zero percent to 33 percent.[84] There is also an individual AMT.[85]

Individual residents in Puerto Rico are generally subject to withholding tax on certain dividend payments at a rate of 10 percent on dividends and partnership distributions from Puerto Rico corporations and partnerships and from non-Puerto Rico corporations and non-Puerto Rico partnerships having at least 80 percent of their gross income effectively connected to a trade or business in Puerto Rico.[86] Individuals also have the option of being taxed at a flat 10-percent rate on taxable interest from Puerto Rico banks or corporations.[87] Capital gains may be taxed at 10 percent.[88]

C. Value-Added Tax[89]

In legislation enacted on May 29, 2015, the Puerto Rico government introduced a value-added tax ("VAT"). When it takes effect, the VAT will be imposed at a rate of 10.5 percent on all taxable items introduced into Puerto Rico. If the seller charges tax in the sale of the item the goods will not be subject to VAT. The sale of exported goods, export of services, and the sale of items which constitute raw material and items for manufacturing are exceptions to the VAT and are taxed at zero percent. Other transactions exempt from the VAT include, among others, financial services, sale of gasoline, food sales, real property sales, some leases of real property, and education services. In general, the VAT is scheduled to take effect on April 1, 2016.[90]

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[82] The IRS and Treasury Department are evaluating the excise tax and have concluded that the IRS will not challenge a taxpayer's position that the excise tax is a tax in lieu of an income tax under section 903 (and therefore creditable). See Notice 2011-29, 2011-16 I.R.B. 663 (April 18, 2011).

[83] Ríos-Méndez and Alemar-Escabí, 2650.10(A).

[84] 13 L.P.R.A. § 30061 (2011); P.R. Act No. 72, effective May 29, 2015.

[85] 13 L.P.R.A. § 30062 (2011).

[86] 13 L.P.R.A. § 30086 (2011).

[87] 13 L.P.R.A. § 30085 (2011).

[88] 13 L.P.R.A. § 30082 (2011).

[89] Ríos-Méndez and Alemar-Escabí, 2650.10(A).

[90] EY, "Puerto Rico Becomes First US Jurisdiction to Adopt VAT System," June 2, 2015, available online at http://www.ey.com/GL/en/Services/Tax/International-Tax/Alert--Puerto-Rico-becomes-first-US-jurisdiction-to-adopt-VAT-system.

D. Puerto Rico Tax Incentives

1. The Export Services Act (2012)

Puerto Rico offers both Puerto Rico corporations and non-Puerto Rico corporations various tax incentives intended to stimulate economic development. Under the Export Services Act (2012), Puerto Rico provides qualifying businesses a reduced income tax rate of four percent.[91] To be eligible, a corporation, limited liability company, partnership, or other juridical person must have an office or a bona fide establishment in Puerto Rico and must provide eligible services to nonresidents and foreign entities.[92] Eligible services include research and development, advertising and public relations, consulting, graphic design, construction, engineering, architectural design, accounting, legal services, electronic data processing, computer program development, voice and data telecommunications, call centers, centralized management services, storage and distribution, education, training, hospital and laboratory services, financial services, and any other service that the Secretary determines is in the best interest of the social and economic well-being of Puerto Rico, considering the number of jobs created, payroll, and investment.[93]

If a business qualifies, and it provides services that do not relate to profitable activities in Puerto Rico, the sale of property for use in Puerto Rico, or advising and lobbying with respect to the laws Puerto Rico, the income from such services qualifies for the reduced tax rate to the extent that the services are provided to nonresidents and foreign entities.[94]

Income from "promoter services" provided to new businesses also qualifies for a reduced rate of tax for one year, regardless of whether the services relate to business or profitable activities in Puerto Rico, the sale of property for use in Puerto Rico, or advising and lobbying with respect to the laws Puerto Rico.[95]

Businesses that are otherwise eligible for the four-percent rate may pay a fixed rate of three percent if (i) more than 90 percent of all gross income derives from the rendering of services to nonresidents and foreign entities, and (ii) the export services are considered strategic services that "benefit the socioeconomic development of Puerto Rico" according to factors such as the pre-existence of an industry to render such services in Puerto Rico, the importance of the service in the international market, and the employment of Puerto Rico residents.[96]

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[91] 13 L.P.R.A. § 10832(a) (2012).

[92] 13 L.P.R.A. § 10831(f) (2012).

[93] 13 L.P.R.A. § 10831(g) (2012).

[94] 13 L.P.R.A. § 10831(m) (2012).

[95] 13 L.P.R.A. § 10831(m) (2012).

[96] 13 L.P.R.A. § 10832(a) (2012).

In addition to reduced fixed rates of tax, companies may qualify for exemptions from personal and real property taxes, and exemptions on municipal and state taxes.[97]

Benefits under the Export Services Act last for 20 years, with a possibility for ten-year extension.[98]

2. The Individual Investors Act (2012)[99]

Puerto Rico offers a 100-percent tax exemption on interest and dividends to "resident individual investors." To qualify, an individual must not have resided in Puerto Rico at any time during the 15-year period ending on January 17, 2012, and the individual must become a resident of Puerto Rico after January 17, 2012 and prior to 2036. A qualifying individual is exempt from Puerto Rico tax on capital gains attributable to the period after the individual became a Puerto Rico resident. If gain is deemed to have accrued before the individual became a Puerto Rico resident, the tax rate is 10 percent for gain recognized during the first 10 years of residence and five percent for gain recognized after that 10-year period.[100]

3. Economic Incentives for the Development of Puerto Rico Act ("EIDA")[101]

Benefits under the EIDA are available with respect to enumerated business activities, such as commercial manufacturing, science and medical laboratories, renewable energy production for consumption in Puerto Rico, recycling, investment banking, electronic data processing, public relations, commercial software development, hydroponic agriculture, strategic public-private partnerships, purifying and bottling water (tax credits only), and construction of affordable public housing.

Qualifying businesses generally are eligible for a reduced income tax rate of four percent on income related to exempt activities and a withholding tax rate of 12 percent on royalty payments, or they may elect to pay an eight-percent income tax rate and a two-percent withholding rate on payments of royalties for use of intangibles in Puerto Rico. There is also a 90-percent exemption from property taxes and 100-percent exemption from municipal license taxes during the initial period of operations and an exemption of at least 60 percent thereafter. Eligible funds and financial institutions receiving passive income derived from exempt businesses and other designated investments are fully exempt from income and municipal license taxes.

The Act provides tax credits for purchases of products made in Puerto Rico, credits for jobs created, research and development credits, credits for payments made to non-Puerto Rico

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[97] Ríos-Méndez and Alemar-Escabí, 2650.15(Q); 13 L.P.R.A. § 10833(a) (2012).

[98] 13 L.P.R.A. § 10836 (2012).

[99] Ríos-Méndez and Alemar-Escabí, 2650.15(R).

[100] Ríos-Méndez and Alemar-Escabí, 2650.15(R).

[101] P.R. Act No. 73, § 2(d)(1) (May 28, 2008).

residents for the right to use intangible property in exempt operations, credits for strategic projects such as the construction of dams and reservoirs, and industrial investment credits.

4. Tourism tax incentives[102]

Businesses engaged in eligible tourism-related activities may qualify for 90-percent or 100-percent exemption from tax on income tax for tourism-related activities, 100-percent exemption from dividend and profit distributions, 90-percent exemption from property taxes, and 100-percent exemption from municipal license and excise taxes. There is a 50 percent credit for qualifying tourism industry investment. Interest from financing tourism projects paid to financial institutions is exempt from income tax.

5. Agricultural tax incentives[103]

Bona fide farmers may qualify for a 90-percent income tax exemption on earnings derived directly from agriculture. There are 100-percent exemptions from property tax, municipal license taxes, and excise taxes. Interest earned on investment in agriculture is exempt from income tax.

6. Tax incentives for hospital facilities[104]

Qualifying hospital facilities are eligible for a 50-percent exemption for net taxable income derived from rendering hospital services, 100-percent exemption from property tax, 100-percent exemption from excise taxes on equipment expressly designed for medical diagnosis and treatment, and 100-percent exemption from municipal taxes. There is a 50-percent exemption for interest from investment in operating or modernizing hospital units.

7. Tax incentives for the film industry[105]

Income derived directly from film projects may qualify for a flat four-percent rate of tax. Qualifying businesses receive a 90-percent property tax exemption, 100-percent municipal license tax exemption, 100-percent excise tax exemption, and tax credits for expenses. There are similar preferential rates, exemptions, and credits for entities that obtain grants to develop studios or other permanent facilities to carry out film projects.

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[102] P.R. Act No. 74 (July 10, 2010).

[103] 13 L.P.R.A. § 10408 (1997).

[104] P.R. Act No. 168 (June 30, 1986).

[105] P.R. Act No. 27 (Mar. 4, 2011).

8. Tax incentives for construction and rehabilitation of social interest housing and middle class housing[106]

On sale of a qualifying housing unit, there is an exemption of up to $5,000 of the gain from the sale of each unit of social interest housing, and an exemption of up to $2,500 of the gain from the sale of each unit of middle class housing. On leasing housing units to low or moderate income families there is an exemption for rental income up to 10 percent of the yield on capital investment in the housing unit. There are also exemptions from property taxes for qualifying businesses.

9. Tax incentives for promoting Major League Baseball games

Compensation to players, managers, and referees in Major League Baseball games in Puerto Rico may be subject to a 20-percent income tax rate.[107] Puerto Rico excludes from gross income all income derived by Major League Baseball teams in connection with games played in Puerto Rico.[108] Entities that promote or otherwise administer the games played in Puerto Rico exclude income from such activities in calculations of gross income for tax purposes.[109]

10. Green energy incentives[110]

There are tax exemptions for businesses engaged in production and sale of green energy on a commercial scale for consumption in Puerto Rico. Businesses that qualify are eligible for a reduced income tax rate of four percent and a withholding tax rate of 12 percent on royalty payments to non-Puerto Rico resident companies. There are also exemptions for property taxes, municipal license taxes, excise taxes, and sales and use taxes. Gain from sale of shares by shareholders in corporations engaged in such businesses are taxed at a rate of four percent.

[106] P.R. Act No. 47 of June 26, 1987, as amended; 17 L.P.R.A. §§891–901.

[107] 13 L.P.R.A. § 8412A(2).

[108] 13 L.P.R.A. § 8422(b)(47).

[109] 13 L.P.R.A. § 8422(b)(47).

[110] P.R. Act No. 83 (July 19, 2010).

IV. LEGAL ANALYSIS

U.S. Federal tax rules related to the U.S. territories vary from one territory to another. Under Federal law, Guam, the Northern Mariana Islands, and the U.S. Virgin Islands have mirror Code tax systems, while American Samoa and Puerto Rico have their own tax systems. The Internal Revenue Code and other Federal laws also include more specific rules that treat U.S. territories differently from (or, in some cases, the same as) one another. A broad question for consideration is whether this disparate treatment advances traditional tax policy goals of fairness to U.S. persons and general economic efficiency.

A related question is, regardless of whether there is variation or uniformity in the U.S. Federal tax rules that apply to the U.S. territories, what broad principles, if any, should underlie the U.S. rules? For example, should U.S. tax rules related to the territories be guided by the principle that the territories are similar to States of the United States? Or, by contrast, should the U.S. tax rules operate as if the territories were more like foreign countries?

A specific application of the question whether U.S. territories should be viewed as similar to States or foreign countries is in the context of bilateral income tax treaties. U.S. income tax treaties generally do not include the U.S. territories in the definition of United States and generally do not treat territory residents as U.S. residents. Consequently, among other things, in the absence of specific treaty or internal law rules to the contrary, treaty reductions in source-basis withholding tax rates do not apply to payments made by or to a corporation organized in one of the U.S. territories and individual residents of the territories do not benefit from treaty reductions in source-basis taxation. A question is whether this general approach to the scope of U.S. income tax treaties is appropriate.

A. Uniform or Varied Treatment

As described previously, income tax arrangements between the United States and the U.S. territories are broadly divided into mirror Code and non-mirror Code systems. Federal law requires Guam, the Northern Mariana Islands, and the U.S. Virgin Islands to have mirror Code tax systems under which the income tax laws in force in the United States also are in force in Guam, the Northern Mariana Islands, and the U.S. Virgin Islands.[111] These mirror Code systems include single filing requirements under which, for example, bona fide residents of Guam, the Northern Mariana Islands, and the U.S. Virgin Islands generally file income tax returns with the governments of the territories of which they are residents, and not with the IRS.[112] By contrast, Federal law does not require that the income tax laws in force in the United States also be in force in American Samoa and Puerto Rico. Consequently, American Samoa and Puerto Rico have their own tax systems.[113] In contrast with a bona fide resident of Guam, the Northern Mariana Islands or the U.S. Virgin Islands, a bona fide resident of American Samoa or Puerto Rico is not automatically entitled to file an income tax return only with the American Samoa or Puerto Rico government. American Samoa-source income of a bona fide American Samoa resident and Puerto Rico-source income of a bona fide Puerto Rico resident, however, is generally exempt from U.S. income tax.[114]

The Code and other Federal laws also include more specific rules that treat U.S. territories differently from – and in some cases, the same as – one another. For example, following the expiration of the section 936 possession tax credit, two temporary, but different, rules were enacted for activities in American Samoa and Puerto Rico. The generally applicable section 199 deduction for income from domestic production activities, which in its original form did not apply to activities in a U.S. territory, was made available in respect of production activities carried out in Puerto Rico.[115] A credit similar to the possession tax credit was enacted only for activities in American Samoa.[116] These two rules originally expired at the end of 2007 but were extended in subsequent public laws through the end of 2014.

As another example, the 30-percent gross-basis withholding tax rules for U.S.-source payments to foreign corporations, and the branch profits tax applicable to a U.S. trade or

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[111] See 48 U.S.C. secs. 1397 (U.S. Virgin Islands), 1421(i) (Guam), and 1801 (the Northern Mariana Islands).

[112] See secs. 932(c), 935(b).

[113] As described previously, however, American Samoa's income tax rules largely parallel the U.S. rules. For a description of the tax rules of the Commonwealth of Puerto Rico, see Joint Committee on Taxation, *An Overview of the Special Tax Rules Related to Puerto Rico and an Analysis of the Tax and Economic Policy Implications of Recent Legislative Options* (JCX-24-06), June 23, 2006, pp. 22-36.

[114] See secs. 931(a) (American Samoa), 933(1) (Puerto Rico).

[115] Sec. 199(d)(8).

[116] Pub. L. No. 109-432, sec. 119 (which also expired at the end of 2011).

business of a foreign corporation, include special provisions for corporations organized in the U.S. territories. A corporation organized in American Samoa, Guam, the Northern Mariana Islands, or the U.S. Virgin Islands is not considered a foreign corporation for purposes of the 30-percent withholding tax or the branch profits tax so long as the corporation satisfies certain requirements intended to ensure a sufficient connection to the territory or the United States.[117] Consequently, the 30-percent withholding tax does not apply to U.S.-source payments to such a corporation, and branch profits tax is not imposed on the corporation's income from U.S. operations. By contrast, a corporation organized in Puerto Rico that satisfies the same connection requirements benefits from a more limited rule: U.S.-source dividends that it receives (but not other U.S.-source payments) are subject to a reduced rate of U.S. withholding tax of 10 percent so long as Puerto Rico imposes a withholding tax on dividends paid to U.S. corporations of no greater than 10 percent.[118]

A third example of a specific rule is a case in which the Code does not differentiate among the U.S. territories. Interest income from a bond issued by a possession government is excluded from gross income.[119]

A question is whether the variation in the tax rules applicable to the U.S. territories – both in the general distinction between mirror and non-mirror Code systems and in narrower Federal rules that often distinguish among the territories – is appropriate. The variation might be viewed as appropriately reflecting different historical, economic, legal, and political considerations among the territories. As a recent example, it might be argued that the expiration of the possession tax credit, which had been allowed for activities in any possession, would have disproportionately affected economic activity in American Samoa and Puerto Rico had the special temporary rules described above not been enacted for those territories. It might be difficult to verify this claim empirically even if the claim has had anecdotal support.

The mirror and non-mirror Code arrangements between the United States and the territories represent resolutions of a particular issue in the historical relationships of the territories and U.S. governments and are part of an overall legal structure for the territories. Moreover, the economies of the territories differ greatly from one another, and these differences could be considered to justify differences in taxation. On the other hand, States of the United States differ from one another in their economic, historical, and political circumstances, but the U.S. Federal tax rules for the most part do not explicitly distinguish among the States. Moreover, uniform treatment of the territories might be expected to reduce aggregate administrative and compliance costs. This result, though, might depend on the particular sort of uniformity adopted.

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[117] Sec. 881(b)(1).

[118] Sec. 881(b)(2).

[119] Section 103(c)(2).

B. Principles for Territories-Related Tax Rules

No single principle underlies existing U.S. tax rules applicable to the U.S. territories. In many ways the U.S. tax rules treat the territories as they do foreign countries. Thus, for example, unless specified otherwise in a particular provision, the term "United States" does not include the territories.[120] A corporation organized in a territory is considered a foreign corporation and is taxable in the United States only on its U.S.-source income.[121] And U.S. taxpayers are generally allowed a foreign tax credit for territories income taxes.[122] Certain tax rules outside the income tax likewise treat territories as foreign countries. For instance, a U.S. citizen who is a resident of a possession at the time of his death is considered a non-U.S. resident for purposes of the estate tax if the individual acquired his U.S. citizenship solely because he was a citizen of the possession or because he was born or resided in the possession.[123]

In other contexts, however, the territories are treated more like States of the United States. As described previously, territories are treated as States for purposes of the tax exemption for interest income on State and local bonds. The research and experimentation tax credit is generally not permitted in respect of research conducted outside the United States, but it is allowed for research carried out in any possession.[124] Under the domestic manufacturing deduction provision described previously, Puerto Rico was temporarily treated as a State of the United States. The section 911 exclusion for foreign earned income and employer-provided housing costs is not available for income earned in a possession or for costs of housing in a possession.[125] And the refundable child tax credit allowed to a taxpayer with three or more children under a computation based on social security taxes that the taxpayer pays is allowed to otherwise qualifying territory residents because those residents are generally subject to social security taxes on their possession-source (and U.S.-source) income.[126]

Recent tax legislation has provided special payments to the territory governments, thereby treating the territories differently from both States and foreign countries. A tax credit for individuals enacted in 2009, a tax credit for employers of newly hired workers enacted in 2010, and a tax credit for hiring certain veterans enacted in 2011 required the U.S. government to

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

[121] Sec. 7701(a)(4), (5), (9), (10).

[122] Sec. 901(b)(1).

[123] Sec. 2209.

[124] Sec. 41(d)(4)(F).

[125] See sec.1.911-2(g), (h).

[126] See secs. 24(d), 3101(a), 3121(b), (e)(2). For a fuller description of present law and a legislative proposal related to the refundable child tax credit for residents of Puerto Rico, see Joint Committee on Taxation, *An Overview of the Special Tax Rules Related to Puerto Rico and an Analysis of the Tax and Economic Policy Implications of Recent Legislative Options* (JCX-24-06), June 23, 2006, pp. 78-82.

compensate mirror Code possession governments for the costs of those tax credits and to compensate non-mirror Code possession governments for costs of providing the same benefits to their residents.[127]

The U.S. tax rules applicable to the territories could be modified so that the rules as a whole reflect the principle that the territories are like States or the principle that the territories are like foreign countries. It is not clear, however, whether either of those principles or another principle would be an improvement over present law. Territories are much poorer than States, and their economies are different from the economies of States. These observations may argue against an overarching principle of treating the territories as States. They do not, however, necessarily favor the principle of treating the territories as foreign countries. The economies of the territories differ from the economies of both the States and some foreign countries. In other areas of the law – trade, for example – territories are generally treated as part of the United States. In part because the territories are subject to the authority of the Federal government, the Federal government has an interest in the welfare of territory residents that contrasts with the Federal government's stance toward residents of other countries. Given these considerations, and given the unique histories of the U.S. territories' relationships with the United States, it is understandable that neither foreign country treatment nor U.S. State treatment – nor any other single principle – underlies the U.S. Federal tax regime for the territories.

[127] See Pub. L. No. 111-5 (Feb. 17, 2009), sec. 1001; Pub. L. No. 111-147 (Mar. 18, 2010), sec. 102(d); Pub. L. No. 112-56 (Nov. 21, 2011), sec. 261(f).

C. Income Tax Treaties

U.S. bilateral income tax treaties generally define the United States as not including the U.S. territories and generally do not treat territory residents as residents of the United States.[128] Consequently, in the absence of rules to the contrary, treaty reductions of source-basis taxation do not apply to individuals resident in, or corporations organized in, the territories.

It is understandable that U.S. income tax treaties do not cover the U.S. territories: Individuals resident in the territories are generally taxed in the United States in a manner more similar to non-U.S. residents than to U.S. residents, and corporations organized in the territories likewise are subject to U.S. tax in a manner more similar to foreign corporations than to domestic corporations. Moreover, territory residents may benefit from favorable tax regimes in the territories, such as the U.S. Virgin Islands' economic development incentives and the more recently enacted Puerto Rican tax incentives described previously. If U.S. income tax treaty benefits were conferred on territory residents, consideration would need to be given to whether those benefits should be restricted in any way as a result of preferential tax regimes in the territories. Restrictions on treaty benefits as a result of territory tax preferences would be consistent with the long-standing U.S. treaty policy against tax sparing.

On the other hand, the exclusion of territory residents from treaty benefits such as reductions in source country taxation may be in tension with the goals of some U.S. internal laws applicable to the territories. For example, the possession tax credit was intended to encourage economic activity in the territories. Economic activity might be discouraged, though, if, because they are not eligible for the benefits of U.S. income tax treaties, territory residents with cross-border income must pay more in source country income taxes on that income than their peers in the United States or foreign countries would face on the same income. Economic development similarly might be hampered if potential foreign investors in mirror Code territories face 30-percent gross-basis withholding tax on dividends and other payments from those territories rather than the lower treaty rates that would apply to U.S.-source payments.

In treaty negotiations with Spain, the Treasury Department has recognized that U.S. income tax treaties might be used to facilitate cross-border investment in the territories. The protocol to the 1990 income tax treaty between the United States and Spain provides, in paragraph 3, that the two treaty countries agreed to initiate, "as soon as possible," the negotiation of a protocol to extend the application of the treaty to Puerto Rico, "taking into account the special features of the taxes applied by Puerto Rico." In paragraph 2 of a memorandum of understanding accompanying a 2013 protocol to the 1990 treaty, the United States and Spain commit to "initiate discussions as soon as possible, but no later than six months after the entry

[128] For examples of a typical definition of the United States and a typical definition of resident, see United States Model Income Tax Convention of November 15, 2006, Article 3(1)(i) (excluding U.S. territories from the definition of United States) and Article 4(1) (excluding from the definition of a resident of a contracting state "any person who is liable to tax in that State in respect only of income from sources in that State").

into force of the 2013 Protocol, regarding the conclusion of an appropriate agreement to avoid double taxation on investments between Puerto Rico and Spain."[129]

The concern that imposition of the mirror Code 30-percent withholding tax might discourage inbound investment also underlay the Guam Foreign Investment Equity Act.[130] Under that law, the rate of gross-basis withholding tax imposed on a Guam-source payment to a nonresident individual or a foreign corporation is generally the same as the rate of tax that would apply if Guam were treated as part of the United States for purposes of U.S. income tax treaty obligations. Because Guam is a mirror Code territory, in the absence of this law, the generally applicable U.S. withholding tax rate of 30 percent would apply to Guam-source cross-border payments. By permitting treaty reductions of withholding tax to apply to these payments, the law extends mirror Code treatment to the treaty context. One question is whether enactment of the same or a similar rule for the other mirror Code territories (the Northern Mariana Islands and U.S. Virgin Islands) merits consideration. By contrast, American Samoa and Puerto Rico have the discretion under their non-mirror Code tax systems to reduce or eliminate source-basis taxation of American-Samoa-source and Puerto-Rico-source payments to foreign investors. A special rule like the one enacted for Guam therefore is unnecessary.

[129] The 2013 protocol has been signed, transmitted to the Senate, and reported favorably to the full Senate by the Foreign Relations committee, but it has not been ratified.

[130] Pub. L. No. 107-212 (Aug. 21, 2002). See also H.R. Rep. No. 107-48, Apr. 24, 2001; S. Rep. No. 107-173, June 24, 2002.