Commonwealth of Puerto Rico

Tax Reform Assessment Project

Unified Tax Code of Puerto Rico:

Tax Policy Implementation Options

Executive Summary

October 31, 2014

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1. Executive Summary

1. 1 Scope of Project

On August 17, 2013, the Governor of the Commonwealth of Puerto Rico issued an Executive Order creating a Tax Reform Advisory Group to analyze the current tax system, its rules and administration and report its conclusions and recommendations to build an effective and fair tax system. The Executive Order explicitly recognized the need to take measures to address the fiscal crisis facing the Commonwealth. It also implied that those measures should not have an adverse impact on the working class or consumers.

The Executive Order enumerated a number of specific factors to be considered:

- The interaction of the components of the state and local tax system and its impact on individuals and businesses;
- The need to restructure, eliminate or extend these components to achieve the desired revenue objectives and simultaneously facilitate economic development
- Analysis of existing tax preferences to determine their effectiveness, elimination or restructuring to align them with the Commonwealth's economic development plan
- Analysis of the current system's promotion of equity in the distribution of the tax burden between the working class and the business and industrial base of the economy
- Evaluation of the current structure of tax administration to improve compliance and efficiency
- Comparison of the tax structure of Puerto Rico with successful tax structures of countries with similar economic and social priorities, and
- The views of diverse interest groups.

On March 18, 2014, KPMG contracted with the Treasury to make a full assessment of the Puerto Rican tax structure and to develop a full report and set of alternative scenarios for Treasury to evaluate for a simplified tax system that will provide the desired revenues through a more streamlined and effective system that should also result in more effective oversight. Analysis of the individual income tax was specifically excluded from the scope this contract. Analysis of the property tax was not included.

On May 6, 2014, KPMG contracted with the Treasury to expand the scope of the engagement to include the individual income tax.

Subsequent meetings with the Secretary of the Treasury and her colleagues refined the goals of the project to include the following:

- Produce adequate revenue
- Distribute the burden of taxation fairly
- Promote economic growth
- Increase international competitiveness of products, workers and businesses
- Minimize interference with private decision making
- Streamline compliance and administration

1.2 Methodology

KPMG has examined the existing statutory and administrative structure applicable to the major revenue sources of Puerto Rico.

1.2.1 Meetings

In addition to two meetings with the Governor's Tax Reform Advisory Group, KPMG has met with, or spoken to, representatives of the principal stakeholder groups in Puerto Rico and received and reviewed submissions from a number of them. Specifically, among others, KPMG met or spoke with the individuals, company representatives and organizations.[1]

The Secretary of the Treasury asked a number of these groups to present their views on the following topics:

1. The effectiveness of the current tax system to incentivize the productive, industrial, and entrepreneurial base of the Puerto Rican economy.
2. The greatest inefficiency of the current tax system to promote economic development in Puerto Rico.
3. The interaction between the state and municipal tax systems and its impact on individuals, business owners and industries, and thus the economic development of Puerto Rico.
4. Their preference, if any, between various forms of consumption tax, i.e., the general excise tax, sales and use tax (IVU) and the value added tax (VAT).
5. Evidence of the cost- benefit of existing tax credits.
6. Tax policies for economic development adopted by other countries that Puerto Rico should emulate.
7. The type of industry/economic activity that Puerto Rico should continue to stimulate or start to stimulate to promote its economic development.
8. The model Puerto Rico tax system should examine the consequences of:
    - Emphasis on income taxes
    - Emphasis on consumption taxes
    - Broad base and low rates
    - High rates and subsidized basis
    - Contributory exemptions / exclusions in order to encourage economic activity versus to provide tax fairness

In general, the responses to the first two topics identified structural complexity, instability, internal inconsistency, inefficient administration and inadequate enforcement as general

[1] Melba Acosta Febo, Karolee Garcia, Tony Flores, Yanis Blanco Santiago, Maria Mena, Edwin Rios, Angel Marzan, Antonio Medina Comas, Jaime Yordan-Frau, Juan Zaragoza, PR Chamber of Commerce, PR Industrial Association, PIA, Food Marketing and Distribution Chamber, PR Products Assocation, United Center of Retailers, PR Hotel & Tourism Association, Community Pharmacies Association, Restaurant Association, PR Economist Association, PR Society of Certified Public Accountants, PR Association of Financial Analysis, PR Lawyers College – Tax Committee, PR Banks Association, PR Insurance Companies Association, PR Mortgage Bankers Association, PR General Contractors Association, PR Homebuilders Association, PR Engineer College, Colegio de Arquitectos y Paisajistas, Jose Ventura, Etienne Durand, Juan Agosto Alicea, Jose Fernandez, Carlos del Rio, PR Automobile Dealers, Abbvie, Microsoft, Hewlett-Packard, Eli Lilly, Baxter, Amgen, Bristol Myers Squibb, Astra Zeneca, Johnson & Johnson, Merck, T-Mobile, Flamboyan, Fresenius.

shortcomings of existing law. Specific responses focused on the perceived negative effects of a high corporate tax rate for domestic corporations, the Patente Nacional and the related failure to have an articulated transfer pricing policy, Law 154, the personal property tax and the outdated valuation base for the real property tax. The responses also noted a culture of tax evasion, promoted by a lack of adequate enforcement personnel, technology and process, particularly the inability to reconcile information received from multiple taxing jurisdictions. The latter observations are noted here. However, their analysis is principally within the scope of the work stream that will focus on tax administration.

Those who chose to comment on the third topic noted the negative effects of the need to comply with potentially different rules and filing regimes in 78 municipalities as well the central government.

Responses to the fourth topic varied. One consistent theme was the unnecessary complexity that resulted from three different consumption tax regimes (excise taxes, IVU and IVA). Another theme was broadening the consumption tax base by eliminating special exemptions and increasing revenues by raising the rate. While there was no consensus as to which form of consumption tax was preferable, a number of respondents favored a broad based VAT with no exemptions. The ability to avoid the IVU was noted.

With respect to topic 5, virtually all respondents agreed that existing credits, exemptions and other preferences should be subjected to cost-benefit and compliances analyses. While there was uniform sentiment that preferences should be reduced, none were specifically identified.

There were no suggestions as to what alternative economic development policies should be considered or adopted.

Manufacturing, tourism and agriculture were identified as industries or economic activities that should be promoted. In particular, the negative effect of uncertainty resulting from Law 154 was noted.

Finally, with respect to the topic 8, most agreed that a broad based, low rate tax was to be preferred. A number suggested increasing consumption tax rates and using the increased revenue to reduce income taxes.

As noted in footnote 1, KPMG has also met or spoken with representatives of the Controlled Foreign Corporations (CFCs) with respect to their operations in Puerto Rico. Hypothetically accepting the proposition that their aggregate tax burden, expressed either as an absolute dollar amount or as a percentage of GDP, will not decline over the short term, the consensus of the CFCs was that they needed predictability, certainty and sustainability with the respect to the tax structure applicable to them. To the extent relevant to their operations, they also expressed a desire to retain creditability for U.S. tax purposes of the excise tax paid by them under Law 154.

1.2.2 Revenue and Macroeconomic Estimate Methodology

During the course of the project, KPMG's economics team met with government officials including staff at the Treasury (Melba Acosta Febo, Secretary of Treasury; Edwin Rios, Chief Economist; Waheed Murad, Economist, Tony Flores, Project Director),Puerto Rico Planning Board (Julio Cesar Hernandez Correa, Director; Juan Cruz Urbina,Director; Marta Rosa Bauza), Institute of Statistics of Puerto Rico (Mario Marazzi, Executive Director of the Puerto Rico Institute of Statistics), Department of Human Resources (Silvia Soto-Perez, Assistant Secretary for Planning; Vance E. Thomas Rider, secretary of the Department of Human Resources),, Government Development Bank (Fernando Lugo, Economist); and academics (Angel L Ruiz, Professor at School of Economics Inter American University of Puerto Rico; Juan Villeta Trigo, Professor at the University of Puerto Rico).

They examined original source data supplied by both the Treasury and the Planning Board and reviewed prior economic studies and analyses including studies conducted by various authors in the publication The Economy of Puerto Rico, authored by Susan Collins et al, and studies published by the NY Fed. Finally, KPMG's economists met informally with a number of individuals with expertise in various facets of the economy of Puerto Rico, including Sergio Marxuach, Public Policy Director with the Center for a New Economy, Miguel Soto, Director at the Center for a New Economy, Juan Lara, Chief Economist at Advantage Consulting, Vicente Feliciana, President at Advantage Consulting, Adam Lavier, Managing Director Millstein & Co, and Jorge F. Freyre, President at Applied Research, Inc.

In assessing the impact of the Puerto Rican tax laws it was necessary to develop estimates of how taxes ultimately affect prices paid by consumers, incomes received by workers, investors and retirees and effects on economic growth. To do this, KPMG developed a Computable General Equilibrium (CGE) model of the Puerto Rican economy that applies methods of estimating the economic burden of taxes that have been developed by academic experts and applied to real world tax systems by government agencies in the United States and elsewhere. The specific methods used to estimate the burden of consumption taxes and payroll taxes are similar to those used by the U.S. Department of the Treasury and the Congressional Joint Committee on Taxation to estimate the effects of proposed tax changes in the United States.

KPMG used data and studies described above to estimate the impact of taxes in Puerto Rico.[2] The staff at the Treasury provided KPMG with taxpayer level personal income tax data for the year ended 2012, company level corporate income tax data for the year ended 2011, company level income tax data for exempt corporations[3] for the year ended 2010, Law 154 Receipts, and 2013 estimated Patente Nacional estimated data using 2011 corporate tax data. In addition, staff at the Treasury provided KPMG with NAICS level Sales and Use tax data for fiscal years 2009 through 2012 and excise tax data for automobiles, alcoholic beverages and other categories for the 2012 and 2013 fiscal years. Puerto Rico Office of Management and Budget provided data on excise taxes for the 2014 fiscal year.

In addition, KPMG obtained data from the Puerto Rican Planning Board on key national accounts, current accounts and budgetary variables to construct a robust macroeconomic model of the Puerto Rican economy.

Finally, KPMG obtained data on labor market and demographic variables from sources such as US Bureau of Labor Statistics, Government Development Bank for Puerto Rico, US Census Bureau, United Nations Population Division, Bureau of Economic Analysis, Federal Reserve, Congressional Budget Office, and the Economic Intelligence Unit.

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[2] Detailed discussion of the data files used for KPMG analysis can be found in the "*Documentation of Personal Income Tax, Business Tax, Consumption Tax, National Accounting, and Other Macro Data" deliverable.*

[3] Corporate tax data on exempt business was limited to a subset of the variables in the tax returns and was provided for the taxable years 2011 and 2012. In addition, exempt business tax data for 2010 was provided.

The following is a summary of the features and capabilities of the computable general equilibrium (CGE) model and macroeconomic forecasting model (PRM) that have been created for Puerto Rico. A detailed description of the model is available as a separate deliverable.

KPMG has created a model of the economy of Puerto Rico that is designed specifically to estimate the impacts of tax policy changes on tax revenues collected as well as effects on national output for Puerto Rico. The model belongs to a family of models that are referred to as computable general equilibrium ("CGE") models because they are able to simulate the interactions of all of the participants in a modern economy — producers, households, government, exporters and investors in response to changes in the economic environment that lead to a new equilibrium. These models capture the behavioral effects expected from producers, consumers, and investors in response to changes they face in input costs, prices, or the expected returns on investment. For the tax reform project, the primary purpose of these models is to derive the economic impacts of proposed tax changes and the concomitant effects on tax revenue. The model is particularly useful for understanding the revenue potential of a GST imposed on each sector of the Puerto Rico economy as well as other proposed changes to corporate, personal, excise or sales taxes.

Using an initial snapshot of the Puerto Rico economy derived from official industry statistics and a large range of other data available for Puerto Rico, the CGE model traces the consequences of a change to the economy where responses by agents in the model depend on such things as prices, production activity, income, preferences, technological progress and macroeconomic factor constraints. This approach yields solutions that give great detail about effects by industry, commodity, and factors of production.

KPMG has also developed a macroeconomic forecasting model for Puerto Rico to allow for longer term simulation and policy analysis and for projecting the CGE model forward in time. This model was developed to project the following key GDP expenditure aggregates and labor market variables:

- GDP (in constant prices);
- Private consumption (in constant price);
- Government consumption (in constant price);
- Investment (in constant price);
- Exports (in constant price);
- Imports (in constant price);
- Employment; and
- Consumer Price and Wage inflation.

Because these variables are considered to be the key underlying drivers of a wide range of budgetary and fiscal variables, the PRM model can be used as a reference forecasting tool and as a core model for multiple purposes by extending specific variables to a disaggregated level.

The models can be applied to perform economic analysis and forecasting on an ongoing basis by economists in Puerto Rico, to be trained and supported by the developers as needed.

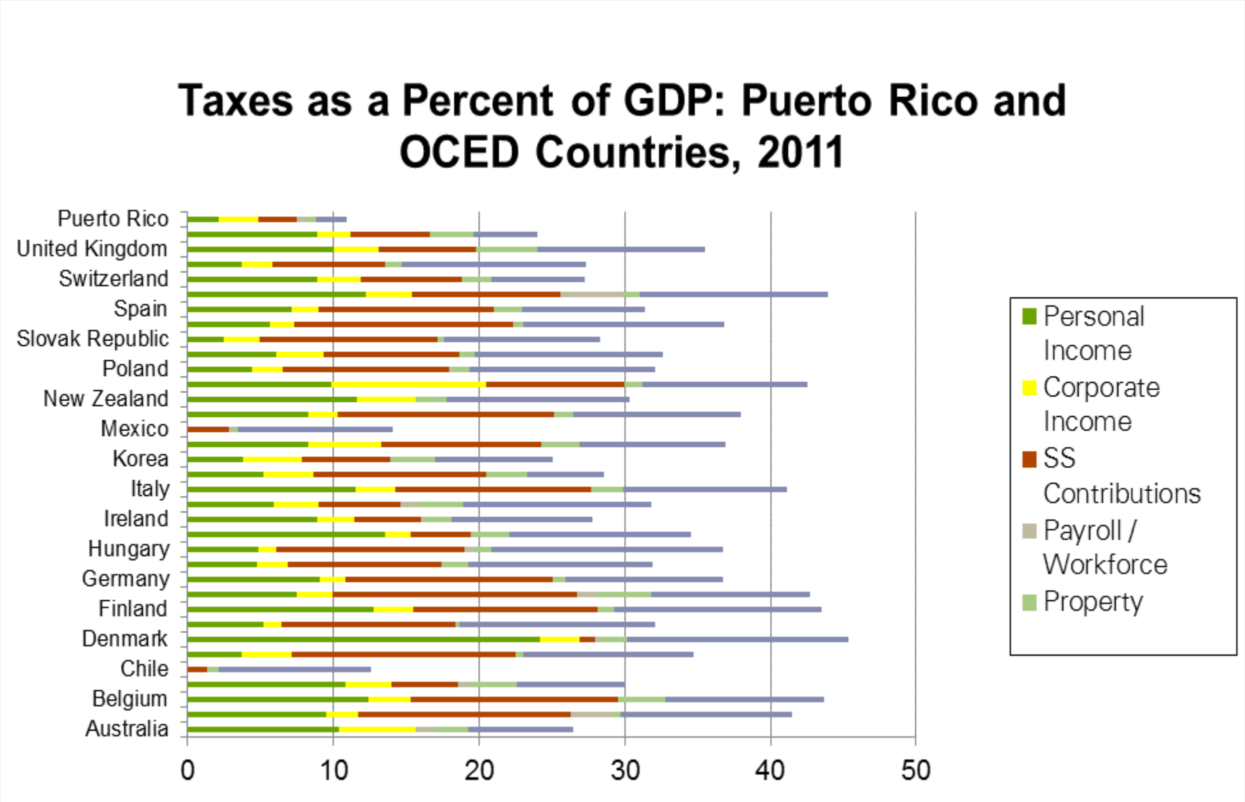
The combination of the PRM with the CGE model gives Puerto Rico a substantial modeling asset that can now be used for tax reform and other economic analyses.

1.3 Summary of Principal Findings

1.3.1 High Level Observations

The current income and consumption tax structures are inordinately complex, due principally to a plethora of special provisions that for the most part were adopted in a haphazard manner over time generally to provide incentives for particular forms of economic activity. These special provisions have never been subjected to a cost benefit analysis. As shown in Tables 1 and 2, revenue from consumption and income taxes are below peer jurisdictions.

Table 1: Taxes as a Percentage of GDP in Puerto Rico Compared to Selected Jurisdictions[4]



[4] (*) While Table 1 uses GDP as the measure of comparison across countries, the results are similar when using GNP as the measure of comparison. Puerto Rico taxes as a percentage of GNP is closer to 15% but still substantially lower than the tax liability of the peer countries shown.

Table 2: Tax Collections as Percent of GDP -- Comparison of Puerto Rico to OECD Countries

	Puerto Rico	Average	Range
Personal Income	2.2%	8.3%	2.2 - 24.2%
Corporate Income	2.7%	3.0%	1.2 - 10.70%
SS Contributions	2.75%	9.00%	0.00 - 16.70%
Payroll/Workforce	0.21%	0.41%	0.00 - 4.44%
Property	0.75%	1.76%	0.29 - 4.16%
Goods/Services	2.216%	10.77%	2.06 - 15.91%
Total	10.66%	33.19%	

Table 3 presents data on the distribution of income and tax liability and shows that less than 10 percent of filers are responsible for almost 78 percent of income tax receipts.

Table 3: 2013 Income Tax Liability by Income Class (In Millions of USD)[5]

Income Level	Filers	Tax Liability (Excluding SS & Medicare)	Share of Tax (Excluding SS & Medicare)	Tax Liability (Including Social Security and Medicare)	Share of Tax (Including Social Security and Medicare)
Less than $20,000	538,026	$4	.2%	$368	9.6%
Between $19,999 and $40,000	319,108	$191	9.2%	$791	20.6%
Between $39,999 and $60,000	107,107	$270	13.0%	$604	15.7%
Greater than $59,999	89,459	$1,614	**77.6%**	$2,079	54.1%
Total	**1,053,700**	**$2,079**	**100.0%**	$3,842	**100.0%**

[5] Distributional analysis based on 2012 individual tax returns provided by Department of Treasury.

As a distributional matter, the current consumption taxes are regressive as indicated by the fact that tax liabilities are higher for the lower income groups as shown in Table 4

Table 4: 2013 Sales Tax Liability by Income Class[6]

Income bracket	Total Sales Tax Liability (In Millions)	Liability Per HH	Liability As Fraction of HH Income
0 to $21,790	$381	$560	5.5%
$21,800 to $33,000	$194	$833	3.1%
$33,050 to $69,500	$345	$1,042	2.2%
$69,600 to $84,170	$66	$1,464	1.9%
Greater than $84,170	$187	$2,209	1.5%

Table 5: 2013 Vehicle, Gasoline, Alcohol, & Tobacco Excise Tax By Income Class

Income Range	Number of Households	Average Income	Excise Tax Liability Per Household	Share of Total Liability/Pct of Households	Liability as Percent of Income
Less Than $21,800	681,339	$10,163	$503.37	31.28%/49.50%	4.95%
$21,800 to $33,000	233,080	$27,107	$749.50	15.93%/16.93%	2.76%
$33,050 to $69,500	331,584	$47,011	$1,024.60	30.99%/24.09%	2.18%
$69,600 to $84,170	45,579	$75,990	$1,416.75	5.89%/3.31%	1.86%
Greater than $84,170	84,590	$142,953	$2,052.02	15.90%/6.17%	1.44%

[6] Figures based on expenditure shares on goods and services provided by the Department of Labor and Human Resources and allocated to income groups.

Capital income bears a smaller tax burden than labor income.

Table 6: 2012 Total and Capital Income Reported by Income Level (In Millions of USD)

Income Level	Total Income	Capital Income Subject to Preferential Rates	Pct of Income Taxed At Preferential Rates
Less than $20,000	$5,499	$1.3	0.02%
Between $19,999 and $40,000	$9,111	$3.9	0.04%
Between $39,999 and $60,000	$5,151	$10.6	0.21%
Greater than $59,999	$10,394	$490.5	4.72%

The existing consumption tax exempts numerous goods and services, the consequences of which are reduced revenue, complexity, increased administrative cost and tax avoidance opportunities. Indeed the current compliance rate is estimated to be 56 percent. The taxation of business inputs can result in the distortion of business decisions and the cascading of tax throughout the supply chain, increasing the effective tax rate on consumers. The current carry-forward mechanism for goods acquired for resale together with the discretionary power of the Secretary of the Treasury to refund excess credits creates cash-flow burdens and uncertainty. The adoption of a broad based goods and services tax ("GST") could mitigate these deficiencies.

The income tax base has numerous provisions that distort horizontal equity, promote economic inefficiency, impede compliance and enforcement and that have not been subjected to a cost benefit analysis. These special provisions ("tax expenditures") together with the static revenue loss associated with each and the number of taxpayers claiming the benefits are listed in Appendix A. The aggregate static revenue loss attributable to the 83 identified provisions exceeds $1.138 billion—more than half of individual income tax receipts. Fifty three of the preferences are claimed by less than 1000 taxpayers. The revenue gained from eliminating selected preferences could be used to increase exemption levels and reduce rates.

The existing tax structure for domestic business activity is also inordinately complicated. Business tax expenditures are listed in Appendix B. In part due to historical reasons (the unavailability of flow-through tax treatment for partnerships), 42,740 corporate tax returns were filed in 2011. Of those, 38,838 showed taxable income of less than $60,000. While a simplified "classical" corporate tax system could be retained to deal with publicly traded corporations and corporations with complex capital structures, small and closely-held businesses could be strongly encouraged to convert to a simplified "flow-through" regime in which the business income is subject to tax only at the owner level.

The Patente Nacional is an apportioned gross receipts tax and is economically equivalent to a retail sales tax or a GST. As such it could be repealed and the revenue replaced by an increase in other consumption tax rates.

The concern about base erosion through aggressive transfer pricing or other techniques is best addressed by comprehensive audits of entities that are suspected of engaging in this activity. The results of those audits will dictate the path necessary to contain or eliminate the problems that have been identified.

The current flow-through tax structure contains redundant regimes. There is no reason to have more than one generally available flow-through regime with simple, easy to apply rules that would be reserved for entities with simple capital structures and only Puerto Rican resident individuals as owners. An alternative system, for more complex business entities could be adopted. Other flow-through and generally tax favored business regimes could be subjected to a cost-benefit analysis and terminated or converted to other existing regimes if appropriate.

Puerto Rico has long relied on an ad hoc variety of investment incentives to encourage and maintain inbound economic activity. The enactment of Law 154 undermined the implicit premise of these incentives and has created an unstable atmosphere with respect to the ultimate tax burden to be borne by inbound investors. The objective in this regard is to create a transparent, sustainable regime that will encourage the expansion of existing investment as well as attract new investment while maintaining the tax contribution of this sector.

The real property tax base is significantly undervalued. It has been suggested that the real property tax base be revalued and the revenue from such a revaluation (and possible rate revision) be used to eliminate the personal property tax and perhaps augment general revenues. Many also object to the personal property tax in general, but more specifically the inclusion in the tax base of business inventories. Finally, the need to comply with potentially different rules in 78 jurisdictions creates substantial uncertainty and compliance burdens.

1.3.2 The Fundamentals of Reform

As noted above, the objectives of tax reform are to ensure adequate revenues to the Commonwealth and promote economic growth by broadening the tax base, assuring an equitable distribution of the tax burden and enhancing compliance. Options to achieve those objectives will be explored below.

The existing consumption tax structure could be replaced by a broad-based single rate GST with regressivity relief accomplished through direct transfer payments. The move to a GST would lead to enhanced compliance and revenue when compared to the current system. The tax rate would be a function both of revenue needs and the desirability of using consumption tax revenues to reduce the tax burden in other areas, particularly the individual income tax, or to replace revenues lost through repeal of existing provisions, such as the Patente Nacional.

The income tax could be simplified by eliminating or modifying virtually all existing tax expenditures. The revenue from the elimination or modification of tax expenditures, together with that available from consumption tax reform, would permit the number of taxpayers subject to income tax liability to be drastically reduced, primarily by introducing a higher exemption level. The number of brackets could be reduced and perhaps rates reduced as well. The elimination of tax expenditures would simplify tax reporting. Information reporting and matching, particularly with respect to wages, interest, dividends, basis of assets and amounts realized on the sale of securities would significantly increase compliance.

The analysis and options with regard to the taxation of business income should be viewed in two separate categories. The first is the regime applicable to business enterprises that are domestically owned. That category includes not just corporations, but also unincorporated businesses, sole proprietorships and various entities that are taxed in form or substance as pass-through entities. Options to reform the taxation of the former include eliminating multiple rates, repealing the corporate alternative minimum tax, repealing the Patente Nacional, examining existing corporate tax expenditures, analyzing the extent to which the current regime permits "earnings stripping" and adopting a robust transfer pricing regime. With respect to unincorporated businesses, the principal options involve simplification of the existing structure by limiting the options for most pass-through regimes.

The second category is the regime applicable to "inbound" investment. Laws 73 and 20 provide PRIDCO a wide range of tax and other benefits to negotiate with inbound investors. A broad based low rate tax regime (such as that of Ireland) would not attract material amounts of investment and would reduce the revenue collected from domestic corporate business activity. Thus, as a practical matter, negotiation of individual arrangements with inbound investors appears to be the most promising way to attract and maintain that investment. In that regard, the statutory conditions for Law 20 grants should be reviewed, particularly with respect to requiring specific levels of economic activity in Puerto Rico. Moreover, the arrangements negotiated by PRIDCO should be subjected to regular, rigorous cost benefit analysis and the incentives adjusted if necessary.

The existing property tax regime should be examined carefully. Property taxes in Puerto Rico constitute a smaller percentage of GDP than in comparable jurisdictions. Consideration should be given to increasing the percentage of revenue that is raised by the property taxes in a manner that distributes the burden of the tax equitably. Moreover, property taxes are the principal funding mechanism for the 78 municipalities. As such they play an important role in the overall municipal finance structure of the Commonwealth. One goal of property tax reform could be to create a system that will enable the municipalities to be fiscally autonomous.

The existing penalty regime should also be reviewed. The objective is to produce a transparent, coherent penalty structure that can be administered consistently and efficiently.

1.4 Options

1.4.1 Consumption Tax

The four basic options for consumption taxation are:

- Retain and enhance the current system;
- Convert to a pure sales and use tax;
- Return to the General Excise tax; or
- Adopt a broad-based goods and services tax.

While the ultimate decision for the tax policy is the responsibility of the Commonwealth, one option that achieves the major goals of tax reform is presented below.

Leading practices suggest a broad-based consumption tax:

- Implemented by over 150 countries (wide implementation experience to draw upon);
- Neutral in the production chain and exports;

- Compliance and administrative costs are minimized; and
- Staged collection through the production chain maximizes timing of receipt and amount of revenue and minimizes avoidance opportunities.

Base includes all goods and services except
- Exported goods and services;
- Financial services;
- Residential housing;
- Electricity;
- Water;
- Fuel; and
- Hotel Services.

In addition, small businesses are exempted from registration.

Cash payments to low income households (regressivity relief) to eliminate totally the tax burden on purchases of food, medical expenses, education and clothing:
- Blanket exemptions are more expensive than targeted relief;
- Any exemption system creates definitional issues that require administrative guidance;
- Tracing exempt v. non-exempt goods and services through the supply chain creates difficult administrative and compliance issues; and
- Identifying tax avoidance becomes a challenging enforcement burden.

Identify, and eliminate where appropriate, double taxation of items subject both to GST and specific excise taxes.
- Assure that any changes do not reduce revenues received by dedicated funds (e.g., the PR Highway Fund)
- Collect all consumption taxes at the Commonwealth level and distribute proceeds from a dedicated fund to municipalities pursuant to a revenue sharing formula.

A tax at 16% with above parameters, appropriate regressivity relief and a 75 percent compliance rate will raise $4,520 Million annually net of payments to COFINA.
- Appropriate regressivity relief will assure that the overall tax burden of low income households is not increased

1.4.2 Individual Income Tax

Repeal or modify most existing tax expenditures (detailed in Appendix A):
- Repeal preferences for capital income with exception of interest on Puerto Rico debt obligations
- Repeal Law 22
- Include 80 percent of social security payments in income
- Repeal “step up” in basis for property held at death and treat certain gifts of appreciated property as income tax realization events
- Maintain current health care benefit structure
- Maintain current retirement benefit structure except repeal preferential rates for retirement plan distributions
- Limit charitable contribution deduction to contributions to Puerto Rico charities or other charities as designated by the Treasury Secretary
- Convert the home mortgage interest deduction to a tax credit that phases out as income increases
- Repeal alternative minimum tax

Increase income tax exemption

- Based on 2012 individual income tax data, exemption of $35,000 for single taxpayers/$70,000 for married couples with expanded tax base eliminates income tax liability for approximately - 835,000 of 1,019,015 filers

Create new rate schedule of:

- 15% for income between $35,000 and $125,000 for singles, $70,000 and $125,000 for married couples
- 20% for income between $125,000 and $200,000 for singles and married couples
- 30% for income above those amounts

The effective tax rates under the above parameters are:

Income	Tax Single Filer	Tax : Married Filing Jointly	Effective Rate Single Filer	Effective Rate Married Filing Jointly
$35,000	$0	$0	0.00%	0.00%
$70,000	$5,250	$0	7.5%	0.00%
$100,000	$9,750	$4,500	9.75%	4.50%
$125,000	$13,500	$8,250	10.80%	6.60%
$200,000	$28,500	$23,250	14.30%	11.63%
$300,000	$58,500	$53,250	19.50%	17.75%

1.4.3 Domestic Business Income Taxation

Repeal the tax preferences noted in Appendix B.

Repeal Patente Nacional

Repeal alternative minimum taxes.

Impose a flat 30% rate (or the rate that is equal to the highest individual rate) on corporate income

- Provides an incentive to convert to pass-through taxation

Provide generous transition relief to encourage existing corporations to convert to pass-through regimes

Rationalize pass-through taxation to create a simple regime for small businesses with Puerto Rice individual owners

1.4.4 Inbound Business Taxation

Examine and rationalize existing incentives

- Subject grants to rigorous periodic cost benefit review

Amend Law 20 to require specific Puerto Rico economic activity as a condition for awarding grants

Consider short term (e.g., five years) extension of the law 154 excise tax

- Necessary for revenue purposes
- Provides improved planning certainty for affected taxpayers

- Could be reduced if specified economic and revenue goals are attained.

1.5 Summary of Projections

The following tables illustrate the revenue, distributional and macroeconomic consequences of the options outlined above, individually and in combination. The parameters of any of the options may be altered and these results will change. The results of other options are set out in the Attached General Explanation.

Table 7 compares the current General Fund receipts with receipts under the above parameters.

Table 7

	Current Law		Proposed Law (1)			
	2014 General Fund Tax Receipts (in $ millions)	General Fund Tax Receipts as a % of Total GF Receipts	General Fund Tax Receipts (in $ millions)	General Fund Tax Receipts as a % of Total GF Receipts	Difference ($)	Difference (%)
Individual Income Tax	$1,979	21.91%	$1,409	12.21%	($570)	-28.80%
Corporate Income Tax - Regular Companies	$1,435	15.88%	$996	8.63%	($439)	-30.59%
Corporate Income Tax - Exempt Companies	$479	5.30%	$479	4.15%	$0	0
Withholding Tax Receipts	$900	9.96%	$900	7.80%	$0	0
Law 154 Receipts	$1,902	21.05%	$1,902	16.48%	$0	0
Sales and Use Tax	$595	6.59%	$0	0.00%	($595)	-100%
Excise Tax	$919	10.17%	$482	4.18%	($437)	-47.55%
Property Tax Receipts	$20	0.22%	$20	0.17%	$0	0
Licenses	$20	0.22%	$20	0.17%	$0	0
GST	$0	0.00%	$4,545	39.39%	$4,545	-
Other Taxes	$52	0.58%	$52	0.45%	$0	0
Non-tax and external	$733	8.11%	$733	6.35%	$0	0
Total	$9,034	100.00%	$11,538	100.00%	$2,504	27.72%

(1) Proposed tax revenues are based on (a) a GST of 16% with 75% compliance rate and a $75,000 small business exemption, with GST exemptions on financial services, residential housing, water. electricity, fuel and hotel services, (b) an income tax structure with exemption levels of $70K/$35K for married filing jointly/single taxpayers, (c) a flat tax of 30% on regular corporations with an expanded tax base.

Table 8 focuses on consumption tax. It assumes a 75 percent compliance rate and shows the consequences of a 16 percent broad-based GST. Note that financial services, residential housing, water, electricity, fuel and hotel services are exempted from GST.

Table 8

Variable	16% GST with 75% compliance rate
Annual GST Collection	$6,665
(Regressivity Relief)	($1,420)
(COFINA Payment): Per Treasury	($700)
GST Net of COFINA and Reg Relief	$4,545
(Loss of IVU)	($1,150)
Change in Real GDP	-0.53%

Tables 9a and 9b show the income tax liabilities of representative single and married filers at various income levels.

Table 9a

Representative Single Taxpayer		
Income	Current Tax	Proposed Tax
$20K	$159	$0
$30K	$737	$0
$50K	$2,864	$723
$75K	$6,887	$4,775
$100K	$13,857	$8,129
$150K	$23,596	$16,560
$200K	$36,470	$28,215
$300K	$51,608	$50,234
$500K	$127,398	$118,053

Table 9b

Representative Married Taxpayer		
Income	Current Tax	Proposed Tax
$20K	$83	$0
$30K	$262	$0
$50K	$1,440	$0
$75K	$4,430	$143
$100K	$9,186	$2,889
$150K	$20,901	$11,824
$200K	$37,196	$22,678
$300K	$56,315	$52,130
$500K	$116,432	$106,598

Table 10 shows the combined effects of the above described GST and individual income tax options on taxpayers at various income levels.

Table 10

Income bracket	Households	Current Income Tax ($M)	Current Consumption Tax ($M)	Current Total Tax ($M)	Share of Total Tax (%)	Proposed Income Tax ($M)	Proposed Consumption Tax ($M)	Proposed Total Tax ($M)	Share of Total Tax (%)	Increase In Total Tax per HH ($)
0 to $21,790	681,339	$10	$724	$735	16.89%	$0	$735	$735	13.30%	$0.00
$21,800 to $33,000	233,080	$72	$369	$441	10.13%	$0	$559	$559	10.13%	$508.11
$33,050 to $69,500	331,584	$434	$685	$1,120	25.73%	$123	$1,581	$1,704	30.84%	$1,761.40
$69,600 to $84,170	45,579	$152	$131	$283	6.50%	$66	$300	$367	6.64%	$1,836.59
Greater than $84,170	84,950	$1,411	$362	$1,773	40.74%	$1,220	$939	$2,159	39.09%	$4,548.32
Total	1,376,531	$2,079	$2,272	$4,351	100.00%	$1,409	$4,115	$5,524	100.00%	

1.6 Transition

Effective transition is an important element in the tax reform process. The following issues must be addressed:

- Maintaining adequate cash flow for the Commonwealth
- Providing sufficient time to implement the administrative changes necessary to implement the new system
    - Implementation of a GST typically takes 18 months to two years, although that could be less in Puerto Rico due to the steps already taken to implement the IVA.
- Protecting economic arrangements that were premised on existing law
    - Providing appropriate phase-in provisions
- Engaging in a robust, comprehensive public education effort, particularly with respect the introduction of the GST