Commonwealth of Puerto Rico
Tax Reform Assessment Project

Unified Tax Code of Puerto Rico:

Tax Policy Implementation Options

General Explanation of Principal Options

October 31, 2014

Table of Contents

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2. General Explanation of Principal Options

Overview

This document addresses principal options with respect to changes to the existing consumption (sales and excise) taxes, individual income tax, business taxation, property tax and penalties. The discussion of the first three topics is organized as follows: Current Law; Reasons for Change; Description of Options; Analysis; and Revenue Effect. The latter two topics are discussed more summarily. The "Description of Options" section for each tax generally sets forth a single option. In each case there are many other options that could be considered to achieve different revenue, distributional or economic goals. In general, those alternatives are discussed and quantified in the "Revenue Effect" section relating to each tax.

2.1 Revise Consumption Tax to Provide a Goods and Services Tax (GST)

2.1.1 Current Law

A 6% sales tax is levied on every sale of a taxable item in Puerto Rico.[1] Further, a use tax is levied, at the same rate, on the use, storage, or consumption of a taxable item in Puerto Rico (collectively, the "IVU").[2]

The 78 municipalities also levy sales and use tax at the rate of 1% on the same tax base and with the same limitations – effectively bringing the sales and use tax rate to 7%.[3] The municipalities also have the right to levy the tax on food.

The sales tax is levied on all tangible personal property other than:

- Money;
- Certain vehicles and vessels;
- Certain petroleum products; and
- Electricity and water. [4]

The tax also is levied on all services and admission fees other than:

- Services rendered to a person in business (with the exception of certain defined services including bank charges, cleaning and laundry services, certain leasing of motor vehicles, telecommunication services, waste pickup services, security services, and certain repair and maintenance services);
- Services provided by the Government of Puerto Rico;
- Defined professional services and certain tax return services;
- Educational services;
- Certain financial services (including insurance services);

1 PRIRC § 4020.01.

2 PRIRC § 4020.02.

3 PRIRC § 6080.14.

4 PRIRC § 4010.01(gg).

- Healthcare services; and
- Services rendered by businesses with a turnover of less than US$50,000. [5]

There are a number of sales and use tax exemptions, which can be based on:

- The nature of the good or service being supplied; or
- The person by whom, or to whom, the good or service is being supplied. [6]

Key exemptions based on the nature of the good or services being supplied include:

- Taxable items sold for use or consumption outside of Puerto Rico;
- Taxable items introduced to Puerto Rico for a temporary period;
- Promotional material;
- Admission to school athletic events;
- Food and prescription drugs;
- Equipment for the disabled;
- Leasing of real property;
- Child care and elderly care services;
- Funeral services;
- Solar electric equipment;
- Certain healthcare equipment;
- Uniforms, materials and textbooks; and
- Items introduced into Puerto Rico as a result of transfer of a residence.

Key exemptions based on the person by whom, or to whom, the good or service is being supplied include:

- Manufacturing plants on the purchase or raw material or equipment;
- Government agencies on the purchase of taxable items;
- Sales made by churches; and
- Certain sales made by manufacturers or wholesalers.

A merchant may be relieved of the requirement to withhold tax on sales to merchants holding an Eligible Reseller Certificate.[7]

A manufacturing plant or eligible reseller may request an Exemption Certificate or an Eligible Reseller Certificate exempting it from the payment of the sales and use tax in respect of the purchase of items for sales to persons who may acquire the goods exempt from tax for sale as a non-taxable items, where the manufacturing plant or eligible reseller makes 80% of their sales to such persons.[8]

Any merchant who acquires goods for resale may request a Reseller Certificate, which will identify the reseller as able to claim a credit. A registered merchant holding a Reseller Certificate

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[5] PRIRC § 4010.01(nn).

[6] PRIRC § 4030.01 to PRIRC § 4030.21.
[7] PRIRC § 4020.07(d).
[8] PRIRC § 4030.02.

can claim a credit for sales tax paid on purchases of taxable items for resale.[9] This credit is limited to 75% of the tax liability reflected in the return. The Secretary has the authority to prescribe by regulation an increase or decrease in the percentage of credit that may be claimed.

Where a credit exceeds the tax payable in a particular month, the credit may be carried forward until used in full. If the merchant can demonstrate that, due to the nature of the merchant's business, the credit will never be used, the Secretary may authorize a refund of the accumulated credits.

Various other credits are available for items such as bad debts, merchandise returns, and purchases of products manufactured in Puerto Rico.

Merchants are required to file monthly sales and use tax returns and make payments by the twentieth of the month following the month in which the transactions occurred. Further, Use Tax Returns on Importations are required to be filed by the tenth of the month following the month in which the importation took place.[10]

Merchants are required to file a single state return by entity. However, merchants are also required to file separate municipality returns by location.

2.1.2 Reasons for Change

Sales and use taxes constituted 7.1% of internal tax revenues in Puerto Rico. Excise taxes constituted 11.9% of internal tax revenues. In comparison, globally, all consumption taxes (including excise taxes) account for almost 31% of revenue collected by OECD governments.[11] GST type taxes typically account for 20% of total revenue. This indicates that Puerto Rico's current consumption tax regime taxes a narrower base than the global benchmark and that the tax system is more reliant on income and corporate taxes. Moreover, there are inefficiencies within the system that result in unrealized revenue and there is evidence of a large underground economy in Puerto Rico with sales tax evasion affecting all aspects of society.

This evasion appears to be driven, in part, by the complexity of the current IVU and, in part, by the impression that the cost of compliance is greater than cost of evading, particularly due to reporting obligations in multiple municipalities. Further, the decentralized administration of the tax hampers decision making and gives rise to differences in interpretation of the tax base.

The current sales and use tax base is relatively broad. Nonetheless, currently excluded goods and services and exemptions increase the complexity of the tax regime and cost of administration by raising inevitable issues associated with determining whether a particular good or service is exempt. The exclusions and exemptions narrow the base of the consumption tax, foregoing revenue and creating the potential for distortion of economic decisions based on the operation of the tax.

The existing system often taxes business inputs even though the acquired goods are for business purposes. The inappropriate taxation of business inputs may result in the distortion of production decisions. The cascading of the tax through the supply chain increases the effective tax rate on consumers.

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[9] PRIRC § 4050.04.

[10] PRIRC § 4041.02 and PRIRC § 4042.03.

[11] OECD (2012), *Consumption Tax Trends 2012: VAT/GST and Excise Rates, Trends and Administrative Issues*, OECD Publishing, p. 11.

A credit system for goods acquired for resale requires the carrying forward of credits, which can create cashflow burdens. Further, the discretionary power in the Secretary to refund tax where merchants can demonstrate they will be in a regular refund position creates uncertainty.

The existing system is overly burdensome for taxpayers. It is estimated that the sales tax compliance rate is in the neighborhood of 56%, an obviously unacceptable number. While the elimination of the requirement to file sales and use tax returns by location rather than by entity has simplified the compliance process to a certain extent, the requirement to file separate municipality returns and use tax returns for imports imposes significant compliance costs. The inconsistency between the municipalities in the administration of the tax, combined with a lack of information sharing between the municipalities and Department of Treasury, hampers decision making and gives rise to differences in interpretation of legislation. For example, there are inconsistencies in determining the point in time a merchant is considered to have commenced trading – upon first sale, first payment of payroll, or upon laying the first stone of the establishment.

2.1.3 Descriptions of Options

The existing consumption tax structure could be replaced by a broad-based single rate Goods and Services Tax ("GST") with regressivity relief accomplished through direct transfer payments. Financial services, residential housing, water and electricity would be exempt. Certain goods and services subject to excise tax could also be exempt. (See excise tax discussion below.) Businesses below a certain level of receipts, for example $75,000, would not be required to register. Regressivity relief would be calculated to assure that households below a specified income level would not incur any additional tax burden under the new system. All consumption taxes would be collected and administered at the Commonwealth level and proceeds distributed to the municipalities from a dedicated fund pursuant to a revenue sharing formula

2.1.4 Analysis

GST, also known as Value Added Tax ("VAT"), is recognized as the most efficient consumption tax both in terms of revenue for governments and neutrality towards domestic and international trade. It is the most common consumption tax utilized today. Over 150 countries and 33 of the 34 OECD countries have implemented some form of GST.[12] Its recognized capacity to raise revenue in a neutral and transparent manner has contributed to its virtually universal adoption.

A broad based GST with a single rate minimizes compliance cost and, from an economic perspective, is the best policy choice.[13] From an efficiency perspective, a moderate GST rate with a broad base and few exemptions is preferable to a higher rate with exemptions.

The move to a GST would lead to enhanced compliance and revenue when compared to current law. 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.

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[12] OECD (2012), *Consumption Tax Trends 2012: VAT/GST and Excise Rates, Trends and Administrative Issues*, OECD Publishing, p. 28.

[13] OECD (2012), *Consumption Tax Trends 2012: VAT/GST and Excise Rates, Trends and Administrative Issues*, OECD Publishing, p. 73.

The key features of the GST system would be:

- A single rate;
- GST on goods and services and on importation;
- GST relief for exported goods and services;
- Limited exemptions (i.e., financial services, residential accommodation, water, electricity and perhaps certain goods and services subject to excise tax));
- Low compliance costs for businesses and government;
- Neutrality between businesses; and
- Transparency in respect of its administration.

GST has a significant number of benefits over single stage consumption taxes. GST is charged at each leg of the supply chain, with a credit provided where the item has been purchased for business purposes, until the item is purchased by the final consumer who bears the ultimate burden of the tax. As GST is collected at various stages along the supply chain, rather than at a single stage, it is a more robust tax when it comes to revenue protection. This permits a lower rate, which in turn reduces the incentive for evasion.

Further, a GST is a relatively self-enforcing tax. A GST has formal invoicing requirements. In the absence of a valid invoice, a purchaser is unable to claim a tax credit. This creates an incentive for a purchaser to request an invoice. These invoices create an auditable paper trail. Also, due to the invoice-credit nature of the tax, transactions should appear on both the supplier's and the purchaser's tax returns, therefore providing better opportunities to detect evasion. Further, the tax authorities have a record of a taxpayer's purchases through the credit mechanism. This enables tax authorities to estimate what a reasonable level of sales should be. This is particularly useful at the retail level where there may not be a purchaser claiming a credit that would allow the matching of transactions.

Finally, GST is more conducive to growth than direct taxes because it is a business neutral tax that does not distort economic choices.[14] By definition, a GST exempts from taxation the normal rate of return on an investment, thus eliminating the "tax wedge" in investment decisions. A broad based GST applied at a single rate is economically efficient because it does not distort consumer spending and saving choices or the allocation of capital. In addition, because exports are not taxed, but imports are, a GST system does not discriminate between foreign and domestic products.

2.1.4.1 Exemptions

This topic is discussed in detail in Appendix E.

Exemptions increase the cost of collection (administration costs for the government and compliance costs for businesses). There are frequent disputes over which goods and services are included in the tax base. Exemptions also create political pressure for other businesses/industries requesting exemption.

[14] Asa Johansson, Christopher Heady, Jens Arnold, Bert Brys, and Laura Vartia, ''Tax and Economic Growth,'' OECD Economics Department Working Paper No. 620, pp. 42-45, Jul. 11, 2008, ECO/WKP (2008)28, p. 18.

Exemptions may also affect business decisions. Under a GST, suppliers making exempt supplies cannot claim credits or refunds for GST paid on their purchases. This creates an incentive to self-supply or vertically integrate rather than incur GST charged by third party suppliers.

Finally, a business that makes both exempt and taxable supplies may need to make complex calculations to determine how much GST it has paid on its purchases related to taxable supplies and can therefore be claimed as a credit or refund.

Consequently, any exemptions that are adopted should be carefully considered from a policy perspective and what they are intended to achieve. Ebrill et al[15] state "Exemptions are abhorrent to both the logic and the function of a VAT" as they narrow the tax base, result in taxation of business inputs, distort business decisions and result in tax cascades.

The majority of the currently existing exemptions would be eliminated. Food, education, healthcare, water, electricity and items currently subject only to excise tax are likely to be the most sensitive areas from a political and public relations perspective.

Rather than providing exemptions for food, education, and healthcare, regressivity issues related to the GST should be addressed by cash transfer payments to a defined class of taxpayers to eliminate the tax burden associated with the purchase of these necessities. Exemptions relieve all purchasers from the burden of the tax and therefore can be costly from a revenue perspective. Indeed, uniform application of the tax across all income levels should provide sufficient revenue to finance regressivity relief to the lowest income levels.

New Zealand is a good example. The evidence available at the time of introduction suggested that while the bottom 20% of households allocated between 23% and 29% of their budgets to food, the top two deciles spent between 7% and 10% of their budgets on food. However, overall, upper income households spent twice as much as low-income households. Of every NZ$100 spent on food in New Zealand, the least well off spent NZ$6.50, whereas the most wealthy spent NZ$12. Thus, taxing all food made revenue available to redistribute and supplement the income of the poor. [16]

Some jurisdictions exempt healthcare and education to ensure there is no competitive distortion between education or healthcare provided by the public and private sectors. While such exemptions can effectively result in subsidizing those sectors, they create significant administrative difficulties in determining which goods or services should fall within the exemption.

The treatment of water and electricity is a special case in Puerto Rico. The pre-tax cost of both of these commodities is already extremely high and subjecting them to an additional GST tax would impose unacceptable additional costs on consumers. As both are supplied by government authorities and are not in competition with the private sector, the exemption of these types of supplies is manageable.

Similarly, there are a number of goods and services that are currently subject to excise taxes but not IVU. The receipts from a number of those taxes are dedicated to particular uses and in four cases are pledged to secure revenue bonds. If the threshold decision is made to eliminate double taxation of these items the question arises as to whether that should occur by subjecting them to GST and reducing the excise tax or exempting them from GST and keeping the current excise

[15] Ebrill et al, *The Modern VAT,* International Monetary Fund, 2001.
[16] Ian Dickson and David White, *Tax Design Insights from the New Zealand Goods and Services Tax Model,* Working Paper Series, Work Paper No. 60, Victoria University of Wellington, Apr. 2008, p 6.

tax. In the case of excise taxes that are pledged to secure revenue bonds the least burdensome alternative could be to exempt those goods and services from excise tax.

2.1.4.2 Regressivity Relief

The practical and political key to acceptance of a broad based GST is the provision of adequate relief from the regressive nature of the tax. "Adequate" is not a self-defining term. The appropriate level of relief is a policy decision that is informed by a desired distribution of the tax burden. But no matter the ultimate outcome, it is generally agreed that certain levels of household income (a policy decision determined by elected officials) should not bear tax on their purchase of necessities (also a policy decision determined by elected officials).

As an empirical matter, to the extent data exist by household income levels on consumption of specific items (such as food, housing, medicine, education), it is possible to mitigate the consumption tax burden rather precisely by a cash payment to the taxpayer. The cash payment can either be a payment based on taxes paid on actual amounts spent by the taxpayer or can be calculated in bands using average consumption by income level. The distribution goals can be attained by adjusting the payment to those households. Using a precise calculation requires an extensive system to monitor (both from a technology and manual operational perspective).

The question then arises as to how the relief is to be delivered and what systems exist to ensure that it is being delivered only to those entitled to receive it. The delivery system can be accomplished using one or some combination of the following:

- Direct disbursement to households;
- Tax Credits; and
- Electronic Benefit Transfer System.

2.1.4.2.1 Direct Disbursement to Households

Historically, payments have been in the form of checks or warrants. This system is more expensive than other options. The distribution of checks requires a mailing address which is problematic for some people in the lower socioeconomic strata. If a mailing address is not practical, it requires the taxpayer to physically go to a government location to obtain the check. Furthermore, the lower socioeconomic strata tend to be disproportionately underserved by the banking system, which results in high fees paid to check cashing establishments. Thus this disbursement option tends to be costly to administer, inconvenient to the taxpayer and may provide a lower net benefit to the taxpayer.

2.1.4.2.2 Tax Credits

A second option to deliver the regressivity payments is to provide a tax credit. This can be done either by using the income tax system or at point of sale for sales taxes. Using the income tax as a basis for the payments is generally done on an annual basis. The delay in relief for most recipients would require them to pay the tax and wait for up to a year for reimbursement. The same delay would occur if the credit were refundable. Thus, this method would not provide timely relief. While this option could be cost efficient for the Commonwealth, it will be counterproductive for the intended purpose of the regressivity payment system.

2.1.4.2.3 Electronic Benefit Transfer System

Recently, payments have migrated to an electronic funds transfer. In the case of government disbursements, payroll and other disbursements are increasing done via ACH payments or direct deposit. In the case of benefit payments, the disbursements are increasing using an Electronic Benefit Transfer system or EBT Card. The EBT cards are less costly to administer (prepare, distribute and account for), provide timely benefits through online management and provide increased ability to track, control and potentially monitor usage. An electronic benefit system can also increase and standardize customer service by reducing the taxpayers need to interact with the limited operating hours of government operations in a finite number of locations. The EBT Cards and potential increased customer service hours assist the taxpayers by limiting the interference with their workplace requirements.

2.1.4.2.4 Puerto Rico's Electronic Benefit Transfer System

The above analysis indicates that the best option for the regressivity payment system is an electronic benefit system. The Puerto Rico Department of the Family currently administers an EBT system to issue health, human and social cash benefits to eligible participants via a magnetically encoded payment card. Key programs included in the EBT system are: Nutritional Assistance Program (NAP), Temporary Assistance for Needy Families (TANF), child support and child welfare payments, and other human and social programs. A recipient may have one EBT card, with multiple benefit types, or accounts, associated to an EBT card depending on program type and eligibility.

Eligible recipients use their EBT card to make purchases at approximately 6,000 certified participating retailers in Puerto Rico. Cash benefits may be used to purchase items at a participating retailer, as well as to obtain cash-back or make a cash withdrawal from a participating ATM machine.

Once eligibility and level of benefits are determined, information is transferred to the Commonwealth's EBT contractor and an account is established in the recipient's name, and benefits are deposited electronically in the account on a specified frequency each month. A debit card, similar to a bank issued debit or credit card, is issued and a personal identification number (PIN) is assigned or chosen by the recipient to give access to the account.

The Puerto Rico NAP program provides for up to 25% of the benefits in cash that can be legally spent at any retailer and the remaining benefits must be spent for the purchase of food in certified retailers. Puerto Rico has approximately 670,000 families (approximately 1,300,000 recipients) receiving benefits totaling approximately $133,000,000 in monthly benefits in EBT card payments. The two primary EBT cards in Puerto Rico are the Family Card (NAP and TANF accounts) and the Unica Card (child support and other programs). Each health and social program has a unique account on the EBT card. A recipient eligible for more than one program may have multiple program accounts on the same EBT card. Programs may have different allowable costs, program requirements or compliance accordingly to federal and/or local laws.

The Department of the Family contracts with the Government Development Bank (GDB) and EVERTEK to administer the EBT system. The GDB is responsible for batch processing, account settlements and reconciliations, reporting, a 24 hour-7 day a week customer service help desk for beneficiaries (assistance from EVERTEK) and maintains a web-portal with account information for beneficiaries. EVERTEK is the ATM provider and handles the electronic transfers for individual accounts on the EBT cards.

Hacienda is positioned to deliver regressivity relief by leveraging the existing contracts and Memorandums of Understanding (MOUs) with the GDB and EVERTEK. Regressivity relief is an extension of existing government assistance programs. The GDB began conducting a financial analysis of the cost to issue payments via check, ACH and electronic benefits. There may be cost efficiencies through the creation of a government card, which could include regressivity relief payments as well as tax refunds, if applicable.

States such as Georgia, Oklahoma, South Carolina, New York and Connecticut have implemented an electronic benefit system for government payments, including tax refunds.

2.1.4.2.5 Regressivity Relief Payments Leveraging an EBT System through Enterprise Architecture

Because of the scale and scope of the project, Hacienda should undertake a robust Enterprise Architecture project. The Enterprise Architecture will enable Hacienda to expand the current EBT system to fit the specific requirements, benefits and outcomes for regressivity relief payments to eligible participants. Enterprise Architecture helps reduce and manage the complexities of a transformational project that will link the tax administration business processes and organizational alignment with information technology system requirements and security to effectively and efficiently deploy a regressivity relief electronic benefit system.

There are four key reference models in the KPMG Enterprise Reference Architecture (KERA) to address the architectural domains at a strategic level:

1. **Capability Model** – The Capability Model is the business and application domain reference model which provides the foundation for Hacienda stakeholders to gain understanding of the business-centric view of the organization, goals and processes. Also the Capability Model facilitates prioritization of business or system capabilities specific to initiatives and prioritized scope for transformations

2. **Software Services Model** – The Software Services Model is the application domain reference model that provides a set of software functions to be aligned with models in other architecture domains. Also, it assists in determining the functional scope of information systems needed for identifying the current EBT system software, legacy system gap assessment, application portfolio rationalization assessment and potential vendor software fit-gap assessment

3. **Conceptual Data Model** – The Conceptual Data Model is the data domain model that describes the data to be shared by business processes (across departments, agencies or other entities) and facilitates the semantic interoperability requirements between organizations and supporting IT system

4. **Deployment Model** – The Deployment Model is the technology and security domain reference model that outlines the software, security zones, components and services

2.1.4.2.6 KERA Toolkit

KERA has been applied and deployed successfully on engagements to accelerate the planning, design and delivery of a transformation initiative. The KERA toolkit focuses on mitigating potential challenges using four elements:

- **Scoring** – Scoring focuses on client specific assessments. Tasks include reviewing high-level functional requirements (as outlined in a tax administration deliverable), IT fit-gap (legacy IT and other Department solutions) and an application portfolio rationalization.

- **Modeling** – Modeling focuses on the client specific blueprints. Tasks include reviewing targeting operating models (as outlined in tax administration deliverables), business and systems architecture, elaborating business and system requirements.
- **Prioritizing** – Prioritizing focuses on client specific roadmaps. Tasks include reviewing client strategic plans, prioritized list of business and technology requirements and associated business cases.
- **Costing** – Costing focuses on client specific transformation estimates. Tasks include initial scoping estimates and release specific funding estimates.

Benefits

Implementing KERA allows Hacienda to take one step closer to fulfilling the goals of Tax Reform: designing a more equitable tax system for all Puerto Ricans. Additionally, the Treasury will be equipped with a state of the art delivery system that includes:

- Integrated set of reusable tools, reference models and methods and courseware to support the design, planning, budgeting and implementation of a large tax design transformation
- Rigorous approach to the address complexities and challenges associated with IT-enabled transformations
- Business process mapping to prioritize requirements
- Leverages existing target operating model (TOM) elements within the Tax Administration work stream deliverables as a foundation for requirements
- Enables key stakeholders ability to provide emergency relief, if needed

Policy and Implementation Decisions:

Ultimately the rate and delivery vehicle for regressivity relief must be made by the Commonwealth's leadership. Decisions must be made regarding the regressivity payment frequency and whether the new system will be directly linked with existing EBT cards for alternate programs. Legal opinions regarding the ability to tax necessities will be required and potential support from other Federal agencies should be assessed. A policy decision concerning the extent or level of regressivity relief (income level and eligibility requirements) must be reached. Finally, eligibility and compliance monitoring systems must be created and implemented.

2.1.4.3 Non-taxation of Business Inputs

Under the current IVU business inputs are often taxed where goods are not acquired for resale.

A consumption tax should not tax business inputs or intermediate business transactions. The taxation of business inputs can result in the distortion of production decisions (potentially creating an incentive for vertical integration) and the cascading of the tax through the supply chain increasing the effective tax rate imposed on consumers.

From an operational perspective, the GST will be very similar to the current IVU with credits being provided for business acquisitions. The two key differences will be:

- A full credit will be given for all goods or services acquired for business purposes rather than only for goods acquired for resale or manufacturing; and
- Excess credits will be refunded rather than be carried forward.

A poor refund system can do significant harm to taxpayer acceptance of the tax and voluntary compliance. Failure to refund excess credits timely undermines the core principal of a GST – intermediate transactions between firms should not bear a GST cost.[17] It will also undermine the neutrality of the tax as business decisions will be influenced by the GST cash flow costs they may face. Therefore, it will be essential to ensure robust processes are in place to facilitate timely issuance of refunds.

2.1.4.4 Municipalities

The current structure with respect to municipalities is unnecessarily complex. However, the municipalities rely extensively on the revenue from this source. Consequently, any changes to the existing system have to accommodate that reality. One option is to centralize collection of the GST at the Commonwealth level and create a dedicated fund of some portion of the receipts to be distributed according to a pre-determined revenue sharing formula.

2.1.5 Revenue Effect

The revenue and distributional effects of a GST depend upon a number of principal factors: the tax base, tax rate, amount of regressivity relief and the compliance rate. The first set of tables below show the results of a 16% and 14% GST with exemptions for financial services, residential housing, water, electricity, fuel and hotel occupancy, appropriate regressivity relief, a small business registration level of $75,000 and a compliance rate of 75%. The second set of tables show the distributional effects of the two different tax rates.

GST ONLY, Exemptions on WATER, ELECTRICITY, FUEL, HOTEL OCCUPANCY		
Variable	**14% GST, 75% Compliance**	**16% GST, 75% Compliance**
Annual GST Collection	$5,860	$6,665
(Regressivity Relief)	($1,209)	($1,445)
(COFINA Payment): Per Treasury	($700)	($700)
(Loss of Revenue from IVU)	($1,150)	($1,150)
(Loss of Income Tax)	($121)	($125)
Annual Revenue Net of GE effects	$2,679	$3,246

[17] Ibid.

Distribution of GST Burden (14% GST)

Household Income	Households	Current IVU Liability	Share of Tax Weighted By Number of Households	Proposed 14% GST Liability (net of regressivity relief)	Share of Tax Weighted By Number of Households
Less than $21,800	681,339	$381	7.72%	$382	2.36%
Greater than $21,800, less than $33,000	233,080	$194	11.48%	$365	6.60%
Greater than $33,000, less than $50,000	215,568	$198	12.67%	$696	13.61%
Greater than $50,000, less than $69,500	116,015	$147	17.51%	$518	18.81%
Greater than $69,500, less than $84,200	45,579	$67	20.17%	$233	21.60%
Greater than $84,200	84,950	$188	30.44%	$746	37.02%
Total	1,376,531	$1,176	100.00%	$2,939	100.00%

Distribution of GST Burden (16% GST)

Household Income	Households	Current IVU Liability	Share of Tax Weighted By Number of Households	Proposed 16% GST Liability (net of regressivity relief)	Share of Tax Weighted By Number of Households
Less than $21,800	681,339	$381	7.72%	$382	2.09%
Greater than $21,800, less than $33,000	233,080	$194	11.48%	$398	6.37%
Greater than $33,000, less than $50,000	215,568	$198	12.67%	$791	13.68%
Greater than $50,000, less than $69,500	116,015	$147	17.51%	$589	18.92%
Greater than $69,500, less than $84,200	45,579	$67	20.17%	$266	21.72%
Greater than $84,200	84,950	$188	30.44%	$849	37.22%
Total	1,376,531	$1,176	100.00%	$3,275	100.00%

The final table shows the revenue effect of exempting food, medicine, medical services and education from the GST base.

Category to Exempt from GST Base	Total GST Collection at 14%	Revenue Loss at 14%	Total GST Collection at 16%	Revenue Loss at 16%
Tax all goods and services except water, electricity, fuel and hotel occupancy ($75K SBE)	$5,860	-	$6,665	-
Exempt Food	$5,166	$694	$5,873	$793
Exempt Medicine	$5,473	$387	$6,224	$441
Exempt Medical Services	$5,311	$549	$6,039	$627
Exempt Educational Services	$5,663	$197	$6,440	$225

2.2 Excise Taxes

2.2.1 Current Law

Excise tax receipts (excluding Law 154) for the fiscal year ending June 30, 2014 were $1.38 Billion, of which $919 Million was committed to the General Fund.

The provisions of Subtitle C of the Puerto Rico Internal Revenue Code of 2011 govern the imposition and administration of the excise tax regime in Puerto Rico, which also includes certain taxes on gambling and the levying of license fees on certain wholesalers and retailers, Subtitle C levies an excise tax on the sale, consumption, use, transfer or acquisition in, or the introduction into, Puerto Rico of the following articles[18]:

- Locally manufactured and imported cement;
- Sugar;
- Plastic products;
- Introduction or manufacture of cigarettes;
- Gasoline;
- Aviation fuel;
- Gas oil;
- Diesel oil;
- Crude oil;
- Unfinished oils, oil byproducts, and any other hydrocarbon mixtures (excluding natural gas); and
- Motor vehicles.

The tax is only paid once and the rates are specific to the particular article.

[18] PRIRC § 3020.01.

The rates are as follows:[19]

Cement	**6 cents for each hundredweight or fraction thereof.**
Sugar	14 cents on each pound or fraction thereof.
Plastic products	6.6 cents of the taxable price in Puerto Rico on specified plastic products that do not meet certain standards.
Cigarettes	$16.15 on every 100 cigarettes or fraction thereof ($17 from July 1, 2015).
Gasoline	16 cents on each gallon or fraction thereof.
Aviation fuel	3 cents on each gallon or fraction thereof.
Gas oil or diesel oil	4 cents on each gallon or fraction thereof.
Any other fuel	8 cents on each gallon or fraction thereof.
Crude oil, unfinished oils and end products derived from oil and other hydrocarbon mixtures	$9.25 per barrel or fraction thereof (subject to an annual inflation adjustment).
Vehicles – cars	$750 to 40% of the taxable price of the vehicle depending on the value and age of the vehicle.
Vehicles – truck tractors	17% of the taxable price of the vehicle.
Vehicles – buses	20% of the taxable price of the vehicle.
Vehicles – trucks, motorcycles and ATVs	10% of the taxable price of the vehicle.
Vehicles – manual hook or non-heavy equipment trailer	6.6% of the taxable price of the vehicle.
Vessels and heavy equipment	7% on the suggest retail price or cost respectively.
Smokeless tobacco	$1.00 per pound of chewing tobacco or fraction thereof. $3.02 per pound of snuff or fraction thereof.

The sections setting out the rates of excise tax also include a number of exemptions (e.g., certain ambulances, cigarettes for export and certain types of fuel when acquired by certain businesses are exempt).

[19] PRIRC § 3020.02 to § 3020.09.

Excise tax is required to be reported as follows:[20]

- Every importer is required to submit an excise tax statement on all articles introduced from abroad at the time of the payment of the excise taxes;
- Bonded dealers introducing vehicles, vessels or heavy equipment need to file an excise tax statement no later than 10 days following the taking of possession of those vehicles;
- For merchandise introduced by mail or air carriers, the excise tax statement must be filed no later than five days following the taking of possession of the merchandise;
- Merchants who introduce taxable items subject to use tax must include the excise tax information in the monthly use tax filing, where those merchants have given the required deposit; and
- A bonded importer or manufacturer of articles subject to excise tax should file a monthly return no later than the 10th day of the month following the date of the introduction or manufacture of such articles.

A number of exemptions or reliefs exist (subject to certain conditions), including:[21]

- A refund on a portion of the excise tax paid on certain vehicles powered by alternative or combined energy;
- Articles in transit, for export or returned to Puerto Rico;
- Vehicles for public transportation;
- Vehicles acquired or introduced by consular officers and employees;
- Specially modified vehicles acquired by handicapped persons;
- Certain vehicles acquired by churches;
- Vehicles acquired for donation to the Puerto Rican Police and Municipal Governments for police related work;
- Raw materials and certain equipment acquired for manufacturing processes;
- Limited amounts of cigarettes for travelers and cigarettes sold to foreign flagged ships;
- Articles sold in air and maritime terminal stores to persons leaving Puerto Rico;
- Certain vehicles for non-profit charitable institutions;
- Articles acquired by government agencies for official use;
- The introduction of vehicles by persons in government service who have been transferred to Puerto Rico;
- Contaminated gasoline or diesel oil;
- A refund of 11 cents for each gallon of gasoline which has been used in sea and air travel between Puerto Rico and foreign destinations; and
- Ships used to provide towing or bunkering services.

Subtitle C also levies a tax of 10% on certain gambling winnings obtained in banks and 20% on all winnings from pools, betting against the bank, daily doubles, and subscription funds or from any other betting transactions legally authorized on the racetracks of Puerto Rico.[22]

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[20] PRIRC § 3020.10.
[21] PRIRC § 3030.03 to § 3030.21.
[22] PRIRC § 3040.02.

Further, this Subtitle levies a five cent tax on each betting slip, 15 cents on each daily double, exact, betting against the bank and any other bet legally authorized, and 25 cents on each bet on a game of checkers made at a horse racing agency.[23]

Finally, this Subtitle levies annual license fees on wholesalers and retailers of goods subject to excise taxes, arms dealers, alcohol retailers, certain coin operated machines, operators of free-port stores, and on sea, air and land carrier business.[24]

A room tax of 9 or 11 percent is levied on hotel rooms depending upon whether there is a "casino" associated with the hotel.

The following table shows receipts and uses of the excise and room taxes.

Excise and Room Taxes Revenues for the year ended June 30, 2014				
Excise Taxes:	**General Fund Revenues**	**Special Revenue Fund Revenues**	**Total Revenues**	**Special Fund or Public Corporation Name**
Alcoholic Beverages	266,542.00	0.00	266,542.00	
Tobacco Products	171,108.00	30,376.00	201,484.00	Office of Services to Former Governors and 5 Public Corp.
Petroleum Products (Jet Fuel)	4,042.00	0.00	4,042.00	
Motor Vehicles	392,043.00	0.00	392,043.00	
Horces Races	16,354.00	0.00	16,354.00	
Insurance Premiums	42,642.00	0.00	42,642.00	
Cement	716.00	0.00	716.00	
Slot Machines	21,910.00	0.00	21,910.00	
Other Excise Taxes - mainly PVC Products	3,489.00	192.00	3,681.00	Agricultural Development Fund
Sugar and Coffee	0.00	8,333.00	8,333.00	Agricultural Development Fund
Petroleum Products	0.00	255,590.00	255,590.00	PR Highway Authority (Pledged for Revenue Bonds)
Gasoline	0.00	156,018.00	156,018.00	PR Highway Authority (Pledged for Revenue Bonds)
Diesel and Gas Oil	0.00	10,210.00	10,210.00	PR Highway Authority (Pledged for Revenue Bonds)
Total Excise Taxes	918,846.00	460,719.00	1,379,565.00	
Room Taxes	0.00	65,642.00	65,642.00	PR Tourist Company (Pledged for Revenue Bonds)
	918,846.00	526,361.00	1,445,207.00	

Source: Puerto Rico Office of Management and Budget

2.2.2 Reasons to Change

Only alcohol and tobacco are subject to the current IVU/IVA regime. All the goods and services listed above would be subject to the GST if it is implemented as described in the preceding section. Thus, those goods and services currently exempt from the IVA/IVU regime would be subjected to a significantly higher tax burden than exists under current law. Moreover, the proceeds of seven taxes are dedicated to particular uses. And the proceeds from four secure debt obligations.

2.2.3 Descriptions of Options

The question arises as to whether it is necessary or appropriate to subject any or all of these goods or services to both excise tax and GST. If double tax is to be avoided, it should be accomplished, if possible, by reducing the excise tax rather than exempting the item from the GST. Thus, the automobile excise tax could be replaced by the GST. However, as noted below,

[23] PRIRC § 3040.03.

[24] PRIRC § 3050.01 to § 3050.04.

due to the complications associated with renegotiating existing debt security arrangements, double tax on fuel and hotel rooms could be eliminated by exempting those items from GST.

2.2.4 Analysis

The extent to which any or all of these items should be subjected to both GST and Excise tax is a political question. However, implementing a decision to avoid double taxation raises structural issues, particularly with respect to dedicated funds. Ideally, to maintain the symmetry of the GST base and avoid the problems with exemptions that have been identified in the GST discussion, all the goods and services listed above would be subject to GST and the excise tax reduced in an amount sufficient to maintain the current tax burden. If that were done, an annual dedicated appropriation from the general fund would be necessary to assure sufficient liquidity to service the debt obligations of the Highway Fund and Tourist Commission. The need to assure funding for the other designated recipients could be re-examined. However, it may be too burdensome to renegotiate security arrangements, in which case double tax relief will have to occur through GST exemption.

The need to continue funding for the other designated recipients could be re-examined.

2.2.5 Revenue Effect

Assuming that only tobacco and alcohol will be subject to both GST and excise tax, the aggregate revenue raised by those two items will increase due to their inclusion in the GST base. With respect to vehicles, the aggregate revenue will not change materially but it will come from the GST rather than the excise tax.

2.3 Revise Individual Income Tax to Simplify Tax Base, Reduce Number of Income Taxpayers and Lower Rates

2.3.1 Current Law

Individual residents of Puerto Rico are subject to Puerto Rico income tax on their worldwide income. A resident individual's income tax liability includes: (1) the regular tax on "net income"; (2) the amount of tax paid at preferential rates on certain items of income; and (3) the alternative minimum tax. Net income means "gross income" reduced by certain exemptions, deductions, and income subject to preferential tax rates.[25] Individuals must calculate "adjusted gross income" to determine the amount of certain deductions and exemptions allowed in computing net income. Individuals may reduce their tax liability by certain tax credits.

2.3.1.1 Gross Income

Gross income means all income, gains, or profits from whatever source received or derived, other than certain items specifically excluded from gross income.[26] Items of gross income include: compensation for personal services, interest, dividends, capital gains, trade or business income, and income from certain pensions or annuities.[27]

Items excluded from gross income include: life insurance; gifts and inheritances; compensation for injuries or sickness; income from discharge of certain debts; child support payments; federal

[25] PRIRC § 1031.05.
[26] PRIRC § 1031.01.
[27] PRIRC § 1031.01(a).

social security payments; certain death benefits; and net long-term capital gain from the sale of certain new construction property.[28]

Over 40 categories of income are exempted from gross income. Key exemptions include: interest on certain debt obligations; certain amounts paid by an employer under a flexible benefits plan; employer contributions to health insurance plans; dividends received from certain organizations; lottery prizes; income from pensions or annuities; unemployment compensation; distributions from nondeductible individual retirement accounts; and gain from the sale or exchange of a principal residence or qualified property by certain individuals.[29] One particularly noteworthy series of exemptions are those provided by Law 22 which was enacted to entice high net worth individuals to relocate to Puerto Rico. It provides a total exemption from Puerto Rico income tax for all passive income realized or accrued after such individuals become residents of Puerto Rico. As of June, 2014, 288 exemption decrees had been issued under Law 22.

2.3.1.2 Adjusted Gross Income

Adjusted gross income is determined by subtracting certain "above-the-line" deductions from gross income (after exemptions).[30] These deductions primarily are for business and investment related expenses, as well as for alimony payments.[31]

2.3.1.3 Deductions from Adjusted Gross Income

In determining net taxable income, the Code also allows numerous "below-the-line" deductions from adjusted gross income. Key deductions available to individuals not engaged in a trade or business include: home mortgage interest; charitable contributions; interest on student loans; contributions to certain retirement or pension accounts; medical expenses above a certain threshold; contributions to an education or health savings account; and casualty losses on a principal residence not covered by insurance.[32] Additional deductions are available for individuals engaged in a trade or business.

If an individual taxpayer has $20,000 or more of income subject to preferential tax rates (discussed below), below-the-line deductions are disallowed to the extent allocable to income subject to preferential tax rates.[33]

The Code generally also allows a personal exemption deduction of $3,500 ($7,000 for married taxpayers filing joint returns), and a $2,500 dependent exemption deduction with respect to certain minor and elderly dependents.[34]

2.3.1.4 Regular Tax on Net Income

Regular income tax for resident individuals is determined by applying the tax rate schedule to net taxable income. The tax rate schedule is broken into five income tax brackets. The brackets for taxable years beginning in 2014 are:[35]

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[28] 42 PRIRC § 1031.01(b). The exclusion for new construction property is found in Acts 132-2010 and 216-2011, as amended.
[29] PRIRC § 1031.02.
[30] PRIRC § 1031.03.
[31] *Id.*
[32] PRIRC § 1033.15.
[33] PRIRC § 1033.20.
[34] PRIRC § 1033.13.
[35] PRIRC § 1021.01(a)(4).

Net Taxable Income Tax
Not over $12,000
0%

Over $12,000 but not over $26,000
7% of the excess over $12,000

Over $26,000 but not over $42,750
$980 plus 14% of the excess over $26,000

Over $42,750 but not over $62,750
$3,325 plus 25% of the excess over $42,750

Over $62,750
$8,325 plus 33% of the excess over $62,750

2.3.1.5 Income Subject to Preferential Tax Rates

The Code provides special preferential tax rates—or allows individuals to elect special tax rates—for certain items of income. Some of the special tax rates include:

- 10% rate on long-term capital gains[36];
- 10% (or 17%) rate on interest from deposits in certain types of accounts[37];
- 10% rate on eligible dividend distributions from certain corporations[38]; and
- 20% rate on distributions from certain retirement accounts.[39]

2.3.1.6 Alternative Minimum Tax

Certain resident individuals are subject to an alternative minimum tax equal to the excess of the tax on alternative minimum net taxable income over their regular tax liability.[40] Very generally, alternative minimum net taxable income is computed in the same way as net taxable income, except that certain exemptions and deductions from gross income are disallowed.[41]

2.3.1.7 Tax Credits

An individual may reduce his or her tax liability by available tax credits. The laws of Puerto Rico provide numerous refundable and nonrefundable tax credits. Tax credits are allowed for, amongst other things, investments in certain industries (e.g., film or tourism) or qualified investment funds,[42] investments in certain housing and development projects,[43] and the purchase of a new or existing home.[44] Additional credits are available for individuals engaged in a trade or business.[45]

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[36] PRIRC § 1023.02.
[37] PRIRC § 1023.04.
[38] PRIRC § 1023.06.
[39] PRIRC § 1023.09.
[40] PRIRC § 1021.02.
[41] Id.
[42] See, e.g., Acts 78-1993, 225-1995, 3-1987, 46-2000, and 27-2011.
[43] See, e.g., Acts 98-2011, 212-2002, and 140-2001.
[44] PRIRC § 1052.03 and .04.
[45] PRIRC § 1052.02(b).

2.3.1.8 Filing Obligations

The following categories of individuals must file Puerto Rico income tax returns: (1) every individual resident of Puerto Rico who is an individual or married taxpayer and has gross income (after exemptions) over $5,000; (2) every individual nonresident of Puerto Rico for all or part of the year who is a citizen of the United States and who has Puerto Rico source gross income (after exemptions) in excess of $5,000, unless the tax on the income has been fully paid at source; (3) every alien individual nonresident of Puerto Rico who has taxable Puerto Rico source gross income for the taxable year, unless the tax on the income has been fully paid at source; and (4) every individual whose alternative minimum net taxable income is $150,000 or more.[46]

2.3.2 Reasons for Change

The computation of individual income tax liability is inordinately difficult due primarily to the existence of exclusions, credits and preferential rates for certain forms of income as well as the need to calculate alternative minimum taxable income. While the base of the individual income tax contains relatively few itemized deductions, the special rates, exemptions and credits reduce potential revenue and produce an uneven distribution of the tax burden. One effect of these special provisions is to tax wage income more heavily than capital income, thus creating horizontal inequity.

These special provisions are called tax expenditures. Tax expenditures are "revenue losses attributable to provisions of the… tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability. Special income tax provisions are referred to as tax expenditures because in many cases they are substantively analogous to direct outlay programs, and the two can be considered as alternative means of accomplishing similar budget policy objectives….Tax expenditures are similar to … direct spending programs that are available as entitlements to those who meet the statutory criteria established for the programs.[47]"

Tax expenditures affect the amount and distribution of the tax base. They also alter economic or social behavior. Thus it is important to understand who they affect, how much they cost and how they operate in order to assess their effect. Once identified, the tax expenditure can be analyzed as a direct spending program. Those eligible for the program can be identified and, if sufficient data exist, the cost of the provision can be compared to its benefits.

Economic efficiency, spending and/or rate reductions, and/or increased revenues could occur through the repeal or reduction of tax expenditures. But one must be clear about how much can realistically be accomplished by that form of base broadening. The largest individual tax expenditures are retirement savings incentives, the home mortgage interest deduction, interest exclusions and capital income rate preferences.

Apart from the political constituency that supports each of those items, one must recognize that many of them are spending programs that cannot be cut off without real economic consequences that must be analyzed and addressed. A number of the existing tax expenditures could be redesigned to provide benefits in a more rational way: for example, converting them to [refundable] credits that phase out as incomes rise.

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[46] PRIRC §106.01.

[47] Joint Committee on Taxation, Background Information on Tax Expenditure Analysis and Historical Survey of Tax Expenditure Estimates, JCX-15-11 (February 28, 2011).

Appendix A contains estimates of the static revenue loss attributable to most individual income tax expenditure provisions of the Puerto Rican tax code. It also shows the percent of the tax benefit enjoyed by taxpayers taxed at the highest marginal tax rate as well as the number of taxpayers claiming the benefits. Due to data limitations, it does not contain an estimate for the loss attributable to the provisions dealing with employer provided health insurance benefits, nor does it contain an estimate for the loss attributable to the provisions that provide a fair market value basis increase for property that is transferred at death and permit the deferral of gain on like kind exchanges.

2.3.3 Description of Options

Significant structural and compliance simplification, horizontal equity and revenue can be attained by the elimination or modification of existing tax preferences. With exception of the preferences relating to retirement benefits, health benefits, mortgage interest and charitable contributions every tax expenditure listed in Appendix A could be repealed. The home mortgage interest and charitable contribution deductions could be modified to achieve a more rational subsidy structure. For example, the former could be redesigned as a tax credit, the benefit of which would phase out as income increases. The benefit of the latter could be restricted principally to contributions to Puerto Rican charities. The retirement benefit provisions could be modified to make distributions fully taxable. Law 22 could be repealed.

The revenue obtained by modifying or eliminating tax preferences could be used to eliminate income tax liability for a significant number of households as well lower existing tax rates.

The analysis below assumes, **as an example**, exemption levels of $35,000 for singles taxpayers and $70,000 for married couples filing jointly.

The rate structure for single filers would be 15% for income above $35,000, 20% for income above $125,000 and 30% for income above $200,000. For married couples filing jointly the rates would be 15% for income above $70,000, 20% for income above $125,000 and 30% for income above $200,000.

2.3.4 Analysis

One initial observation is important. The elimination of the tax expenditures described below (except to the extent they are refundable credits under existing law) will have no impact on those individuals who do not have income tax liability under the tax structure described above. The distributional consequences of the hypothetical tax changes are described in the Revenue Effect section below.

2.3.4.1 Credits

As detailed in Appendix A, many of the existing tax credits are utilized by a limited number of taxpayers and none have been subjected to a cost-benefit analysis. By design, these credits (as well as many of the special rates, deductions, exemptions and exclusions) distort the tax base, create horizontal inequity and promote economic inefficiency. The burden of proof for retention of any of them should be a demonstration that the value of the intended tangible benefit exceeds the revenue cost.

2.3.4.2 Deductions

2.3.4.2.1 Charitable Contribution Deduction

The charitable contribution deduction could be re-examined. The rationale for special tax provisions for charitable giving is to encourage that activity. However, like any other tax expenditure the existence of the provision creates a revenue loss that must be offset. Moreover, as an analytic matter it is a government subsidy program pursuant to which the expenditure of government funds is determined by private individuals. Some question whether those who do not choose to make charitable contributions should bear the economic burden of the choices made by others. That is a political decision.

Assuming a charitable contribution deduction is retained, the deduction could be limited to contributions to Puerto Rican charities or other external charities designated by the Secretary as having significant charitable activities in Puerto Rico. There is no apparent reason for Puerto Rican taxpayers to be subsidizing charitable activity that has no discernible benefit to Puerto Rico.

If the charitable contribution deduction were limited as suggested a statutory structure to determine eligible Puerto Rican entities would have to be enacted and an administrative procedure created. The exempt organization provisions of the U.S. Internal Revenue Code provide one model.

2.3.4.2.2 Home Mortgage Interest Deduction

The home mortgage interest deduction is a prime example of a tax expenditure. A tax on economic income does not allow the deduction of expenses that produce non-taxed income. Home mortgage interest is an expense related to exempt income — the imputed rental value of the home it finances. Thus, it is a tax expenditure. When analyzed as a government spending program, the deduction is available only to those who own their homes, not to those who rent. Thus, it encourages homeownership. But while it is available to all taxpayers who have mortgages on their homes, the deduction is of no value to those without income tax liability and the value of the deduction increases as the taxpayer’s tax bracket increases. When translated into a government program to subsidize housing, it is a program that provides greater government subsidies to high income taxpayers than to lower income taxpayers and provides no subsidy at all for homeowners who do not have tax liability.

There is a fear that total elimination of the subsidy would adversely affect housing prices and the housing market. However, if the subsidy is to be retained it could be redesigned to direct the benefits to those who most need it. In the first instance the benefit could be redesigned as a tax credit to assure that the benefit does not increase as income becomes higher. Because the subsidy is arguably not necessary for higher income individuals, it could be phased out as incomes increase. Finally, if the subsidy is to be provided to the lowest income categories, it could be made refundable.

The following is a hypothetical nonrefundable credit designed to meet the foregoing objectives:

If taxable income is:	The credit is:
Not over $125,000	Smaller of (a) 15 % of mortgage interest expense and (b) $5,250
Over $125,000, but not over $140,000	Smaller of (a) 12 % of mortgage interest expense and (b) $4,200
Over $140,000, but not over $155,000	Smaller of (a) 9 % of mortgage interest expense and (b) $3,150
Over $155,000, but not over $170,000	Smaller of (a) 6 % of mortgage interest expense and (b) $2,100
Over $170,000, but not over $185,000	Smaller of (a) 3 % of mortgage interest expense and (b) $1,050
Over $185,000	$0

The table below shows the value of a home mortgage interest subsidy under (a) current law, (b) current structure of the deduction and the tax rates and exemption levels described above, and (c) as a tax credit under the rates and exemption levels described above.

AGI Before Ded	Mortgage Expense Deduction	30% of AGI Limit	Max Deduction	AGI After Ded	Current Tax With Deduction	Proposed Tax With Deduction	Current Tax Without Deduction	Proposed Tax Without Deduction	Current Tax Reduction (value of ded)	Proposed Tax Reduction (value of ded)	Credit (value of ded)
12,000	35,000	3,600	3,600	8,400	$0	$0	$0	$0	$0	$0	$5,250
26,000	35,000	7,800	7,800	18,200	$434	$0	$980	$0	$546	$0	$5,250
42,750	35,000	12,825	12,825	29,925	$1,530	$0	$3,325	$0	$1,796	$0	$5,250
62,750	35,000	18,825	18,825	43,925	$3,619	$0	$8,325	$0	$4,706	$0	$5,250
100,000	35,000	30,000	30,000	70,000	$10,718	$0	$20,618	$4,500	$9,900	$4,500	$5,250
125,000	35,000	37,500	35,000	90,000	$17,318	$3,000	$28,868	$8,250	$11,550	$5,250	$5,250
140,000	35,000	42,000	35,000	105,000	$22,268	$5,250	$33,818	$11,250	$11,550	$6,000	$4,200
155,000	35,000	46,500	35,000	120,000	$27,218	$7,500	$38,768	$14,250	$11,550	$6,750	$3,150
170,000	35,000	51,000	35,000	135,000	$32,168	$10,250	$43,718	$17,250	$11,550	$7,000	$2,100
185,000	35,000	55,500	35,000	150,000	$37,118	$13,250	$48,668	$20,250	$11,550	$7,000	$1,050

2.3.4.3 Social Security

Social security receipts constitute economic income. While sometimes described as "insurance", social security is in fact a transfer payment that has not been actuarially determined. The increased exemption levels in the income tax option provide tax exemption for social security payments received by approximately 80 percent of filers. As to the balance, a 20 percent exclusion recognizes that some portion of a social security payment has been "financed" by tax payments that could be viewed as creating a "basis" in the amounts received.

2.3.4.4 Preferential Rates for Capital Income

An income tax does not distinguish between wage and capital income. The preferential treatment of capital income creates horizontal inequity and requires disproportionate taxation of wage income to achieve revenue goals.

The traditional rationalization for preferential treatment of capital income is that it encourages saving because it increases the after tax rate of return on investment as compared to labor. While it is true that the after tax rate of return on investment is increased relative to wage income it is by no means clear that the preferential rate in fact induces increased investment. Moreover, even if that were demonstrable as a general proposition, it questionable whether, with the exception of the exclusion for interest on Puerto Rican debt obligations and certain bank accounts, the existing capital income preferences have any material positive effect on the Puerto Rican economy. Other than those exceptions, the existing capital income preferences are not targeted to investments in Puerto Rico. Thus, Puerto Rican wage earners are subsidizing capital investments that have no relationship to the Puerto Rican economy. Preferential rates for dividends and capital gain on the sale of corporate stock are also rationalized as alleviating the burden of "double" taxation of corporate income. Options regarding elimination of "double" taxation of corporate income (and the need for a tax preference for dividends and capital gain) are discussed below.

2.3.4.5 Step up in Basis

The failure to tax unrealized appreciation in property held at death is one of the most glaring omissions from a comprehensive income tax base, producing horizontal inequity, inefficient resource allocation and substantial revenue loss. Step-up induces individuals to hold property until death. It creates an artificial impediment to sales that would normally occur and therefore distorts normal capital flows.

Horizontal inequity is illustrated by this simple example: A and B are siblings. Each bought stock X for $100,000. It is now worth $3 million and each has decided to sell. A meets B in the street outside their broker's office just after A has executed her trade and before B is going to do the same thing. A car hits them and both die. Assuming a 20-percent income tax rate, A's heirs receive $2,420,000. B's heirs get the stock with a new basis of $3 million and can sell the next day and pocket the entire $3 million. That is an indefensible result. If B borrowed money using the stock as collateral, B had the use of the appreciation during his life and the debt can be repaid from the tax free proceeds of the sale of the stock after B's death. That is also indefensible.

There are two polar ways that such unrealized appreciation can be included in the income tax base. The first is by providing that the basis of such property carries over to the transferee (the current rule with respect to property transferred by gift). The second is by treating death as an income tax realization and recognition event. The optional system adopts the latter principle, but provides an election to defer recognition of the realized gain until the sale of illiquid assets and provides a carryover basis for property transferred to a spouse.

The fundamental rule is that death is an income tax realization and recognition event with respect to any marketable property held by a decedent/donor that is transferred to any beneficiary other than a spouse or public charity. The transfer of non-marketable property at death to any beneficiary other than a spouse or public charity will be an income tax realization event and the gain calculated, but, at the election of the recipient of the property, the tax would not be due ("recognized") until the property is sold. Interest at a market rate, payable annually, would be charged on the deferred tax liability to assure that the present value of the deferred tax is equal to the tax that would be paid if death were a recognition event.

All lifetime transfers, other than those to a spouse or a public charity, will be income tax recognition events, subject to appropriate loss limitation rules. Property transferred to a spouse or public charity would receive a carryover basis with a special rule for split interest transfers.

Principal residences transferred at death would be exempt from the realization regime and would receive a date of death value, as would tangible personal property other than collectibles. No other property would be exempt from this system. Anti-avoidance rules would be enacted to deter the creation of non-marketable interests to defer recognition.

The tangible personal property exclusion is based on the premise that most of such property is not appreciated in value and in any event it is not likely that cost basis records exist. Including "collectibles" in the regime provides a boundary for the exclusion, although it admittedly introduces identification issues. The principal residence exclusion is based on a combination of pragmatism and administrative convenience. Experience in administering existing law with respect to collecting the tax on gain realized on lifetime sales of residences indicates that this is an area in which compliance can best be described as shoddy. One does not generally want to reward shoddy compliance with tax exemption, but in this instance it may be appropriate.

The proposed realization/recognition regime proceeds from the premise that to the extent possible all income tax accounts should be closed upon a taxpayer's death. The deferral election for non-marketable property addresses liquidity concerns posed by those assets. The exemption for property transferred to a spouse is simply an extension of the principle that the spousal unit is treated as a single unit for tax purposes so that such transfers are "non-events" for tax purposes. Exempting transfers to public charities preserves current law with respect to the transfer of appreciated property to such entities.

2.3.4.6 Preferential Rates for Retirement Plan Distributions

The tax structure for retirement benefits is substantively a consumption tax, i.e., the tax base is reduced by the retirement contribution (saving). The two principal methods are (1) an immediate deduction for retirement savings with full inclusion of distributions or (2) no deduction for contributions but no inclusion of distributions. If tax rates remain the same those two models are economic equivalents.

By definition, in both of these structures, the normal rate of return on the retirement contribution is tax free (the well-recognized "immediate deduction-yield exemption" equivalence). The existing Puerto Rican system departs from the conceptual consumption tax model—and actually creates a tax subsidy for retirement benefits - due to the fact that distributions from qualified plans enjoy preferential rates and exclusions. There is no policy justification for this additional subsidy. Distributions should be fully taxed as ordinary income.

2.3.5 Revenue Effect of Income Tax Changes

The following tables show the revenue and distributional effects of the income tax base changes described above at exemption levels of $35,000 for singles/$70,000 for married couples filing jointly and at two different rate schedules. The effective rate of tax at various income levels is also shown.

Income tax rate schedule Single / Married <35 0 / <70 0 35-125 15% / 70-125 15% 125-200 20% / 125-200 20% >200 30% / >200 30%	Filers	Income Tax Under Proposed Structure ($ Millions)	Income Tax Under Current Structure ($ Millions)	Decrease (%)
Less than $21,800	493,960	$0	$10	100.00%
Greater than $21,800, less than $33,000	189,106	$0	$72	100.00%
Greater than $33,000, less than $50,000	169,742	$47	$221	78.65%
Greater than $50,000, less than $69,500	75,765	$95	$214	55.78%
Greater than $69,500, less than $84,200	29,839	$70	$152	54.15%
Greater than $84,200, less than $100,000	18,643	$74	$146	49.43%
Greater than $100,000, less than $140,000	22,012	$159	$273	41.75%
Greater than $140,000, less than $200,000	10,964	$171	$240	28.99%
Greater than $200,000, less than $300,000	4,906	$161	$204	21.29%
Greater than $300,000	4,078	$733	$547	-34.10%
Total	1,019,015	$1,509	$2,079	27.43%

Income tax rate schedule Single / Married <35 0 / <70 0 35-62.5 15% / 70-125 15% 62.5-100 20% / 125-200 20% >100 30% / >200 30%	Filers	Income Tax Under Proposed Structure ($ Millions)	Income Tax Under Current Structure ($ Millions)	Decrease (%)
Less than $21,800	493,960	$0	$10	100.00%
Greater than $21,800, less than $33,000	189,106	$0	$72	100.00%
Greater than $33,000, less than $50,000	169,742	$47	$221	78.54%
Greater than $50,000, less than $69,500	75,765	$96	$214	55.02%
Greater than $69,500, less than $84,200	29,839	$78	$152	48.86%
Greater than $84,200, less than $100,000	18,643	$85	$146	42.08%
Greater than $100,000, less than $140,000	22,012	$203	$273	25.52%
Greater than $140,000, less than $200,000	10,964	$209	$240	12.84%
Greater than $200,000, less than $300,000	4,906	$181	$204	11.55%
Greater than $300,000	4,078	$751	$547	-37.27%
Total	1,019,015	$1,650	$2,079	20.64%

2.3.6 Combined Revenue and Distributional Effects of GST and Income Tax Changes

The following four tables show the combined revenue and distributional consequences of the GST and Individual Income Tax changes combined at two different rate schedules. The first two tables present the results at the 14% GST rate and the second two tables present the results at the 16% GST rate.

14% GST

Income tax rate schedule Single Married <35 0 <70 0 35-125 15% 70-125 15% 125-200 20% 125-200 20% >200 30% >200 30%	Households	Income Tax Under Current Structure	IVU	Total Income and Sales Tax	Proposed Income Tax	Proposed GST of 14% (net of regressivity relief)	Total Income and GST	Increase Per House hold
Less than $21,800	681,339	$10	$381	$392	$0	$392	$392	$0
Greater than $21,800, less than $33,000	233,080	$72	$194	$266	$0	$381	$381	$491
Greater than $33,000, less than $50,000	215,568	$221	$198	$419	$44	$696	$740	$1,491
Greater than $50,000, less than $69,500	116,015	$214	$147	$361	$89	$518	$607	$2,116
Greater than $69,500, less than $84,200	45,579	$152	$67	$218	$66	$233	$299	$1,768
Greater than $84,200, less than $100,000	27,587	$146	$45	$192	$70	$180	$250	$2,121
Greater than $100,000, less than $140,000	25,428	$273	$48	$321	$150	$190	$340	$764
Greater than $140,000, less than $200,000	18,741	$240	$45	$285	$161	$177	$338	$2,823
Greater than $200,000, less than $300,000	10,045	$204	$33	$237	$152	$130	$282	$4,429
Greater than $300,000	3,149	$547	$17	$564	$691	$68	$759	$61,859
Total	1,376,531	$2,079	$1,176	$3,255	$1,421	$2,965	$4,387	

14% GST

Income tax rate schedule Single / Married <35 0 / <70 0 35-62.5 15% / 70-125 15% 62.5-100 20% / 125-200 20% >100 30% / >200 30%	Households	Income Tax Under Current Structure	IVU	Total Income and Sales Tax	Proposed Income Tax	Proposed GST of 14% (net of regressivity relief)	Total Income and GST	Increase Per House hold
Less than $21,800	681,339	$10	$381	$392	$0	$392	$392	$0
Greater than $21,800, less than $33,000	233,080	$72	$194	$266	$0	$396	$396	$559
Greater than $33,000, less than $50,000	215,568	$221	$198	$419	$45	$696	$741	$1,495
Greater than $50,000, less than $69,500	116,015	$214	$147	$361	$92	$518	$610	$2,140
Greater than $69,500, less than $84,200	45,579	$152	$67	$218	$74	$233	$308	$1,956
Greater than $84,200, less than $100,000	27,587	$146	$45	$192	$81	$180	$261	$2,528
Greater than $100,000, less than $140,000	25,428	$273	$48	$321	$194	$190	$384	$2,508
Greater than $140,000, less than $200,000	18,741	$240	$45	$285	$200	$177	$377	$4,919
Greater than $200,000, less than $300,000	10,045	$204	$33	$237	$173	$130	$303	$6,532
Greater than $300,000	3,149	$547	$17	$564	$717	$68	$785	$70,165
Total	1,376,531	$2,079	$1,176	$3,255	$1,576	$2,981	$4,557	

16% GST

Income tax rate schedule Single Married <35 0 <70 0 35-125 15% 70-125 15% 125-200 20% 125-200 20% >200 30% >200 30%	Households	Income Tax Under Current Structure	IVU	Total Income and Sales Tax	Proposed Income Tax	Proposed GST of 16% (net of regressivity relief)	Total Income and GST	Increase Per House-hold
Less than $21,800	681,339	$10	$381	$392	$0	$392	$392	$0
Greater than $21,800, less than $33,000	233,080	$72	$194	$266	$0	$469	$469	$868
Greater than $33,000, less than $50,000	215,568	$221	$198	$419	$40	$791	$832	$1,917
Greater than $50,000, less than $69,500	116,015	$214	$147	$361	$82	$589	$671	$2,670
Greater than $69,500, less than $84,200	45,579	$152	$67	$218	$66	$266	$332	$2,489
Greater than $84,200, less than $100,000	27,587	$146	$45	$192	$72	$205	$278	$3,118
Greater than $100,000, less than $140,000	25,428	$273	$48	$321	$173	$217	$390	$2,732
Greater than $140,000, less than $200,000	18,741	$240	$45	$285	$179	$201	$380	$5,091
Greater than $200,000, less than $300,000	10,045	$204	$33	$237	$154	$148	$302	$6,497
Greater than $300,000	3,149	$547	$17	$564	$641	$77	$718	$49,052
Total	1,376,531	$2,079	$1,176	$3,255	$1,409	$3,355	$4,764	

16% GST

Income tax rate schedule Single / Married <35 0 / <70 0 35-62.5 15% / 70-125 15% 62.5-100 20% / 125-200 20% >100 30% / >200 30%	Households	Income Tax Under Current Structure	IVU	Total Income and Sales Tax	Proposed Income Tax	Proposed GST of 16% (net of regressivity relief)	Total Income and GST	Increase Per House-hold
Less than $21,800	681,339	$10	$381	$392	$0	$392	$392	$0
Greater than $21,800, less than $33,000	233,080	$72	$194	$266	$0	$450	$450	$787
Greater than $33,000, less than $50,000	215,568	$221	$198	$419	$44	$791	$836	$1,936
Greater than $50,000, less than $69,500	116,015	$214	$147	$361	$90	$589	$679	$2,741
Greater than $69,500, less than $84,200	45,579	$152	$67	$218	$73	$266	$338	$2,634
Greater than $84,200, less than $100,000	27,587	$146	$45	$192	$79	$205	$285	$3,379
Greater than $100,000, less than $140,000	25,428	$273	$48	$321	$191	$217	$407	$3,410
Greater than $140,000, less than $200,000	18,741	$240	$45	$285	$197	$201	$398	$6,039
Greater than $200,000, less than $300,000	10,045	$204	$33	$237	$170	$148	$318	$8,024
Greater than $300,000	3,149	$547	$17	$564	$705	$77	$782	$69,286
Total	1,376,531	$2,079	$1,176	$3,255	$1,549	$3,336	$4,885	

2.4 Revise Domestic Business Income Taxation to Simplify the Corporate Tax Base, Reduce the Number of Corporate Taxpayers and Rationalize Flow-Through Taxation Regimes

Domestic Business Taxation

Choice of Entity

2.4.1 Current Law

Business owners have broad flexibility to conduct business activities in Puerto Rico through numerous forms of legal entities. Individual business owners also may conduct their activities as sole proprietorships, which do not involve a separate legal entity. Under current law, the taxation of income earned by a business typically depends on the type of entity through which the business is conducted. For income tax purposes, Puerto Rico business entities generally are taxed either: (1) as regular corporations; (2) as pass-through entities; or (3) pursuant to a special tax regime. Some business entities may elect the manner in which they are taxed.

2.4.1.1 Corporations

Regular corporations are subject to two levels of taxation. The income of a regular corporation is taxed at the corporate level when the income is earned, and the shareholders of a regular corporation are taxed on dividend distributions of the corporation's after-tax income. The shareholders also are subject to tax on gain from the sale of stock in a regular corporation. Business trusts generally are treated as regular corporations for income tax purposes.

2.4.1.2 Pass-Through Entities

The Puerto Rican tax rules contain a number of different regimes relating to business entity taxation that generally provide for only one level of tax to be incurred with respect to earnings. Certain of the regimes provide "pass-through" treatment so that owners of the entity are taxed by reference to the income and losses of the entity.

Entities legally formed as partnerships generally are taxed on a pass-through basis under rules similar to the U.S. federal income tax rules applicable to partnerships. Limited liability companies ("LLCs") generally are treated as corporations for Puerto Rico income tax purposes, unless the LLC elects to be treated as a partnership or corporation of individuals or the LLC elected to be treated as a partnership for U.S. federal income tax purposes. This rule applies regardless of whether an LLC has a single member or multiple members. Unlike U.S. law, Puerto Rico does not treat a single member LLC as an entity disregarded as separate from its owner for income tax purposes.

A corporation or partnership that meets certain eligibility requirements may elect to be treated as a corporation of individuals, a special entity that is taxed under a simplified pass-through regime

A professional corporation generally is taxed as a regular corporation, unless it elects to be taxed as a corporation of individuals.

A Special Employee-Owned Corporation ("SEOC") is a corporation for legal purposes that is taxed based on a blend of cooperative and pass-through principles.

2.4.1.3 Special Entities

The Code provides for several additional types of entities that generally are not taxed at the entity level. An entity that qualifies as a real estate investment trust ("REIT") or registered investment company ("RIC") is exempt from tax in Puerto Rico so long as it distributes at least 90 percent of its earnings on an annual basis. REIT and RIC shareholders generally are subject to tax on distributed earnings.

The Code also provides an exemption or reduced rate of taxation for income earned by an International Banking Entity or International Financial Entity.

2.4.2 Reasons for Change

The availability of multiple forms of legal entities with varying tax treatments creates undue complexity and distorts taxpayer behavior. In most cases, there is no compelling reason to tax a business's income on a pass-through versus entity-level basis solely by reference to the legal form through which the business is conducted. Indeed, as discussed in below, efficiency and simplification generally are best served by allowing most domestic businesses to be taxed primarily at the individual level via a pass through regime, regardless of the legal form of the business. Certain business entities, however, always should be taxed as corporations.

2.4.3 Description of Options

One option to reduce complexity and encourage pass-through taxation is to allow most business entities to elect to be treated as pass-through entities for income tax purposes, regardless of whether the business was formed as a corporation, a partnership, or an LLC. Similar to the U.S. entity classification rules (commonly referred to as the "check-the-box" rules), any business entity that is not treated as a "per se" corporation for income tax purposes (an "eligible business entity") may elect to be taxed as a pass-through entity. An eligible business entity that satisfies the requirements to be treated as a corporation of individuals may elect to be taxed either as a corporation of individuals or a regular partnership. An eligible business entity that does not elect to be taxed as a pass-through entity generally will be taxed as a regular corporation. Consistent with current law, a business entity with a single owner that does not choose to be taxed as a corporation is respected as a separate tax entity, 100% of whose items of income, deduction, credit and loss flow-through to its owner (rather than being disregarded as separate from its owner, as is the case under the U.S. "check-the-box" rules). Thus, a single member LLC, for example, may be taxed either as a corporation or a pass-through entity.

Certain business entities automatically will be classified as per se corporations for income tax purposes. These entities may not elect to be taxed on a pass-through basis. Per se corporations could include publicly traded corporations, banks, insurance companies, and business entities with, for example, more than 200 owners.

2.4.4 Analysis

Allowing eligible business entities to elect to be treated as pass-through entities for income tax purposes will reduce complexity in many cases and further the goal of increasing the number of domestic business entities that are taxed on a pass-through basis, thus allowing a more accurate measurement of income at the individual level. It is anticipated that many eligible business entities that currently are taxed as corporations will elect to be taxed either as corporations of individuals or partnerships. As discussed in below, transition rules will be needed to allow business entities to convert from corporate to pass-through status in a tax efficient manner.

Corporations

2.4.5 Current Law

A regular corporation is subject to Puerto Rico income tax as an entity separate from its shareholders. A regular corporation's income generally is subject to two levels of taxation: the income is taxed at the corporate level when earned and is taxed again at the shareholder level when distributed as dividends. This section provides a general overview of corporate level taxation.

2.4.5.1 Gross Income Less Exclusions and Exemptions

The gross income of corporations includes all gains, compensation for services performed, income from sales and dealings in properties, rent, interest, dividends, partnership profits, transactions in securities, and any other gains, profits, and income derived from any source whatsoever.).

The Code provides numerous exclusions and exemptions from gross income for items such as interest on certain obligations (e.g., obligations issued by the government of Puerto Rico), dividends received from certain corporations (e.g., dividends from limited dividends corporations), and income from the conduct of certain activities (e.g., rents from the lease of property in the Historic Zone). In addition, corporations may qualify for various tax incentives designed to stimulate economic development and reduce unemployment. Corporations qualifying for such incentives may obtain certain relief from Puerto Rico income, property, and municipal taxes. The income that is exempted under such tax incentives laws is excluded from gross income when determining the Puerto Rico corporate income tax liability.

There also are certain transactions in which the gain realized is not recognized for tax purposes and, therefore, is excluded from gross income. In general, the reason for not recognizing such gains is that the underlying transaction is not considered sufficient to break the continuity of the investment. Such is the case, for example, with certain exchanges of like kind property, certain involuntary conversions, certain corporate reorganizations, transfers to a corporation controlled by the transferor, property received by a corporation in a complete liquidation of its controlled subsidiary, securities exchanged for securities of the same corporation, and certain transfers of qualified securities to an employee stock ownership plan.

2.4.5.2 Net Taxable Income

The net taxable income of a corporation is determined by reducing gross income less exclusions and exemptions by allowable business deductions. Expenses incurred during the taxable year by a corporation that are directly connected to its business activities are generally deductible provided they are ordinary, necessary, reasonable, and not in violation of public policy. In general, the rules for the deductibility of the business expenses of a corporation closely follow the rules applicable under the U.S. Internal Revenue Code. Examples of allowable deductions include dividends received from certain Puerto Rico corporations, business debts that become worthless, contributions to pension or other qualified retirement funds, and charitable contributions.

The Code also limits the ability of corporations to deduct certain expenses that might otherwise qualify as a business expense. For example, life insurance premiums paid by a corporation on the life of an officer, employee, or person financially interested in the trade or business of the corporation, when the corporation is directly or indirectly the beneficiary of the policy, are not deductible. In addition, corporations are only allowed to deduct capital losses to the extent of capital gains, with a five-year carryover of the excess capital losses.

A corporation's net operating loss for a taxable year may be carried forward to offset up to 90% of the corporation's liability in a subsequent year.[48] If a corporation acquires, by reorganization or by the liquidation of a controlled corporation, substantially all the assets and liabilities of the acquired corporation, the net operating loss of the acquired corporation may only be used to

[48] Net operating losses incurred in tax years beginning January 1, 2005 through December 31, 2012 may be carried forward 12 years. Net operating losses incurred in tax years beginning after December 31, 2012 may be carried forward 10 years.

reduce the net income of the acquiring corporation derived from the same commercial activity or trade or business that generated the loss. Also, if a corporation undergoes a change in ownership, the use of its net operating loss in subsequent years may be limited.

Capital expenditures are included as part of the basis of an acquired or improved asset. Depending on the asset and the circumstances involved, such capital expenditures will be depreciated, amortized, or depleted pursuant to the applicable depreciation, amortization, or depletion rules, or included as part of the basis until the asset is sold or disposed of.

2.4.5.3 Corporate Tax Rates including Patente Nacional

Income tax liability is generally determined by applying the corresponding Puerto Rico income tax rate to net taxable income. The regular tax rate for corporations is 20%. Corporations also are subject to a graduated surtax on net taxable income in excess of $25,000, with rates ranging from 5% to 19%. In addition to the regular tax and surtax, corporations are subject to an alternate minimum tax in certain situations when the regular tax liability is less than the alternative minimum tax liability. For taxable years commencing after December 31, 2012, a portion of tax liability of certain Puerto Rico corporations having gross revenues above certain amounts is based on gross revenues. This is the Patente Nacional.

In addition, certain items of income are taxed at special rates, and the tax on such items must be computed separately and added to the income tax on the net taxable income not subject to special rates. For example, net long-term capital gains may be taxed at the flat tax rate of 20%.[49] In addition, dividends paid to non-Puerto Rico corporations that are not engaged in a trade or business in Puerto Rico from Puerto Rico earnings are generally subject to a flat 10% tax. Non-Puerto Rico corporations or partnerships operating in Puerto Rico thus may be subject to a 10% branch profit tax and the withdrawal from doing business in Puerto Rico by a non-Puerto Rico corporation is considered a taxable event.

An accumulated earnings penalty tax may be imposed if a corporation is determined to have been formed or used to prevent the imposition of income tax on its shareholders by accumulating corporate earnings instead of distributing such earnings to the shareholders.

Individual shareholders of a non-exempt Puerto Rican corporation are taxed at 15% on dividends received from the corporation, and Puerto Rican resident individuals are taxed at 15% on capital gains from sales of stock in such corporations.[50]

2.4.5.4 Tax Credits

The income tax liability that is finally due is determined by deducting allowable tax credits from the income tax determined in the manner described above. The Code and various incentive Acts provide numerous tax credits for investments in certain activities (*e.g.*, tourism, agriculture, and waste disposal and treatment).

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[49] Act 77-2014, Passed July 1, 2014, increased the corporate capital gain rate from 15%.
[50] Act 77-2014 increased the individual dividend and capital gain rates from 10% to 15%.

2.4.6 Reasons for Change

A classical corporate tax system (such as the current system), in which tax is collected independently at the individual and corporate levels, will almost always lead to distortions and to a higher aggregate tax burden on domestic business activity than a pass through or integrated regime. The rate, base, and structure of the corporate tax system also interacts with the individual tax system both in terms of rule complexity as well as overall tax burden. The current corporate tax regime is neither necessary nor appropriate for most non-publicly traded businesses. There were 42,740 corporate tax returns filed in 2011. Of that number, 38,838 reported net income of $60,000 or less. Equity, efficiency and simplification are best served by allowing businesses with relatively small numbers of owners to be taxed primarily at the individual level via a pass-through regime, particularly when the entity has little taxable income (see discussion of existing regimes and suggested changes below). Where the equity of a business is publicly-traded (there currently are six publicly traded corporations), or where the investors are not Puerto Rican resident individuals, it is preferable to collect a tax at the corporate level.

Without regard to the number of entities to which it applies, the current corporate tax regime contains alternative minimum taxes, multiple rates, and numerous exemptions, credits, and exclusions that create complexity, distort economic choices, and produce horizontal inequities. Unless justified on a cost-benefit basis, elimination of these provisions (listed in Appendix B) would materially simplify the system and reduce economic distortions.

Certain corporations also are subject to the Patente Nacional, the corporate tax that is determined on the basis of gross receipts. The stated purpose of this alternative minimum tax is to assure that businesses with significant revenues in Puerto Rico make an appropriate tax contribution to the general revenues. However, an unapportioned gross receipts tax has the potential to subject high volume, low margin businesses to tax liabilities that far exceed the amounts that would be due if the tax base was income. Indeed, it is possible for entities with no taxable income to be responsible for significant tax payments on the basis of their gross receipts. The Patente Nacional is not the appropriate tool to achieve the desired revenue objective

2.4.7 Description of Options

The objective of domestic corporate tax reform is to create, within specified revenue goals, a simple, transparent, and equitable system that will raise sufficient revenue and encourage economic activity in the Commonwealth.

2.4.7.1 Conform Individual and Corporate Tax Rates

The highest corporate income tax rate (including the surtax) currently is higher than the highest individual income tax rate. Conforming the corporate tax rate to the highest individual tax rate would reduce distortions that arise when the rates are different. Further distortions would be eliminated by taxing dividends received from Puerto Rican corporations and gain on the sale of stock in a Puerto Rican corporation at ordinary rates. The preferential treatment of dividends and gains on sales of stock is usually justified as a means to alleviate the burden that results from imposing tax at both the corporate and shareholder level. These rules, however, are imperfect, create opportunities for tax avoidance, and increase complexity (in part by the adoption of additional rules to try and combat the tax avoidance that the preferential treatment created in the first place). By making pass-through taxation available to virtually all small business, the inequities of full taxation at both the corporate and shareholder level can be avoided in the vast majority of cases. In the case of publicly-traded corporations (at least those with a single class of stock and no undue concentration of ownership), consideration should be given to fully or partially forgiving the shareholder level tax—although in order to maintain the integrity of the system, losses on sale of such stock would have to become non-deductible.

2.4.7.2 Repeal Certain Tax Preferences

The Code and various incentive Acts provide numerous tax preferences to corporations. A list of corporate tax expenditures is attached as Appendix B. The cost of many of these preferences does not appear to justify the benefits, and the multitude of preferences creates undue complexity and distorts economic decisions. Further, many of the tax preferences are claimed by only a small number of taxpayers.

2.4.7.3 Repeal the Patente Nacional and Audit Inbound Companies Suspected of Transfer Pricing Abuse and Other forms of Base Erosion

There is wide consensus that the Patente Nacional should be repealed. The Patente Nacional is, in economic terms, a consumption tax. The revenue lost by repeal can be replaced by revenue from the economically equivalent GST described above. Further, inbound companies suspected of transfer pricing and base erosion abuse should be identified and audited and, if necessary, robust transfer pricing and base erosion rules enacted.

2.4.7.4 Repeal or Limit the Alternative Minimum Tax

The corporate alternative minimum tax ("AMT") regime adds additional complexity and taxpayer burden to an already complex regime. Depending on the extent to which corporate tax preferences are reduced or eliminated, consideration should be given to repealing or limiting the scope of the AMT.

2.4.7.5 Repeal the Accumulated Earnings Tax

If corporate and individual tax rates are conformed, the accumulated earnings tax would no longer serve a meaningful purpose and therefore could be repealed.

2.4.8 Analysis

2.4.8.1 Conform Individual and Corporate Tax Rates

One principal objective of reform is to reduce the number of taxpayers subject to the corporate tax regime. Increasing the number of businesses subject to a single layer of tax simplifies the business tax system, enhances economic efficiency, and reduces distortions in business decision making (e.g., whether to engage in debt or equity financing, how and when to make distributions, and how to organize business activity). It also could have salutary enforcement and compliance consequences.

When the individual income tax rate is equal to or less than the corporate tax rate, there is an incentive for business owners to choose pass-through taxation rather than corporation taxation to avoid two layers of taxation on business earnings. This is particularly true when corporate dividend distributions are taxed at ordinary individual tax rates. Eliminating the graduated corporate tax rates and setting the rate at the highest individual rate should create an economic (mathematical) incentive for every eligible business entity to elect pass-through taxation because of the graduated rate structure of the latter as compared to the flat rate of the former. As discussed below, transition rules should be adopted to allow business entities to convert from corporate to pass-through taxation with minimal or no tax cost. Although a pass-through entity is not itself a taxpayer, in order to aid in collection, consideration should be given to requiring withholding to be done at the entity level.

Where the equity of a business is publicly traded, it is generally preferable to collect a final tax at the corporate level due to the complexity of allocating income and providing pass-through information statements to a large and frequently changing population of shareholders. In these circumstances, there is little or no potential for using a corporation to avoid or defer the imposition of Puerto Rican tax at shareholder level and thus, in theory, there is no need for further tax at the shareholder level on distributions or sales of corporate stock. Significant rule complexity can arise, however, from an attempt to define the boundaries where such treatment does not facilitate avoidance and to deal with situations where a corporation may cross those boundaries as its ownership changes. These considerations are what generally make most "integrated" corporate tax regimes relatively complex. Given the small number of corporations that would not be eligible to either elect pass-through taxation under the proposed entity classification rules or obtain negotiated incentives under Law 73 (see below), it is unclear whether there would be material benefit from adopting an integrated regime. Rather, the most straightforward approach may be to conform the individual and corporate tax rates, thus giving eligible business entities a strong incentive to choose a pass-through regime and to continue to alleviate the potential over taxation of inbound investment via negotiated decrees. Note, however, that the considerations may differ depending on the ultimate resolution of issues relating to Law 154 (see below).

For publicly-traded companies where flow-through taxation is impractical, it may be possible to mitigate the avoidance possibilities of providing shareholder level relief from taxation of dividends and capital gains. This is particularly true if shareholders are denied a deduction for loss on the sale of publicly-traded stock (while this may seem unfair, it is just as appropriate to ensure that deductions are not claimed at both the corporate and shareholder level as it is to try and prevent gains from being taxed at both levels). Shareholder level relief should be limited, however, to shareholders of publicly-traded corporations that have only a single class of stock, no more than, e.g. 10 percent of which is owned by any single shareholder (taking into account related party attribution).

2.4.8.2 Repeal Certain Tax Preferences

Appendix B lists all of the current corporate tax expenditures. The Appendix also lists the number of entities taking advantage of each preference item for the 2011 tax year, as well as the static revenue loss attributable to each item, to the extent data was available. One striking aspect of the list is the limited number of entities taking advantage of many of these preferences, indicating that repeal would in essence terminate limited special interest provisions that have not, to our knowledge, been subjected to any cost benefit analysis. As discussed below in the economic analysis section, repeal of the tax preferences would produce sufficient revenue to partially finance the corporate rate cut described below.

2.4.8.3 Repeal the Patente Nacional

The Patente Nacional apparently was enacted to address the perceived opportunity under existing law for domestic subsidiaries of U.S. parent corporations that do not have tax decrees under Law 73 to manipulate inter-company charges to reduce their Puerto Rican source income to reduce or eliminate Puerto Rican tax liability. The Patente Nacional was intended to ensure that inbound businesses with significant Puerto Rico revenues make an appropriate economic contribution to the Commonwealth. A gross receipts tax, however, is not the optimal means to address this concern. A more appropriate solution is to create robust transfer pricing and base erosion rules to ensure that income that is attributable to Puerto Rico is properly calculated and taxed. Further, to our knowledge, none of the inbound companies that the Patente Nacional was intended to target has been audited to examine whether it has engaged in transfer pricing abuse or other forms of base erosion. A comprehensive audit of these companies should be conducted, and, to the extent that abuse is detected, an appropriate legislative or regulatory response can be implemented.

The imposition of a GST in place of the Patente Nacional also could offset the lost revenues from repeal and would in many respects collect tax from a similar base.

2.4.8.4 Repeal or Limit the Alternative Minimum Tax

The purpose of the AMT is to ensure that a corporation cannot eliminate its income tax liability through the excessive use of certain corporate tax preference items. The AMT regime significantly increases complexity and taxpayer burdens. The benefits of maintaining the AMT regime must be weighed against these costs. To the extent corporate tax reform includes the repeal or reduction of corporate tax preference items—thereby reducing the incremental difference between net income for regular tax purposes and alternative minimum net income for AMT purposes—further consideration should be given to whether the incremental revenues justify the continued existence of the AMT regime. An alternative to repealing the corporate AMT regime in its entirety is to limit the scope of the regime to only large businesses with gross revenues above a certain threshold (*e.g.*, $5 million).

2.4.8.5 Repeal the Accumulated Earnings Tax

As discussed above, when the individual tax rate is equal or close to the corporate tax rate, individual business owners generally prefer pass-through taxation. Thus, if corporate and individual tax rates are conformed, it is unlikely that individual business owners will elect corporate taxation over pass-through taxation solely for the purpose of avoiding current shareholder level taxation on the business's earnings. Accordingly, the accumulated earnings tax no longer would be needed to prevent the abuse for which it was enacted.

Pass-Through Entities

2.4.9 Current Law

The Puerto Rican tax rules contain a number of different regimes relating to business entity taxation that generally provide for only one level of tax to be incurred with respect to earnings. Certain of the regimes provide "pass-through" treatment so that owners of the entity are taxed by reference to the income and losses of the entity. Others provide for an exemption from tax at the entity level so long as certain requirements are met, including the distribution of a baseline portion of annual earnings. Other regimes go even further, reducing or eliminating both entity-level and shareholder-level taxes with respect to specifically described earnings.

2.4.9.1 Pass-Through Entities

2.4.9.1.1 Partnerships

With limited exceptions, prior to the enactment of the 2011 Puerto Rico Income Tax Act (the "2011 Act"), entities legally formed as partnerships were taxed as corporations. Following the 2011 Act, entities legally formed as partnerships generally are taxed on a flow-through basis under rules similar to the U.S. federal income tax rules applicable to partnerships. However, losses with respect to such partnerships can be used only to offset income from other pass-through entities (i.e., other partnerships, corporations of individuals, and special partnerships) and cannot offset income from other sources. A partner generally is subject to withholding ("remittances") by the partnership with respect to its allocable share of partnership income.

From a tax perspective, a conversion from corporation to partnership status is treated as a liquidation of the corporation followed by the formation of a partnership; the liquidation often is taxable. However, the 2011 Act generally treated these deemed liquidations as tax-free during a transition period, with the entity generally becoming subject to special rules, such as the recapture of certain items, deemed distribution of accumulated earnings and profits, and a 10-year built-in gain recognition period during which a corporate level tax would apply.

Although some of the operative tax rules for partnerships are similar to the operative rules for corporations of individuals, as a general matter, the partnership rules are more complex than the rules for corporations of individuals (described below). The partnership rules, however, allow for more flexible economic arrangements than the corporation of individuals rules. In addition, the partnership rules impose no requirements relating to earning Puerto Rican source income to qualify for taxation as a partnership.

2.4.9.1.2 Limited Liability Companies

Although an entity legally formed as a limited liability company ("LLC") generally is subject to tax as a corporation, it can elect to be taxable as a partnership or a corporation of individuals. With limited exceptions, however, an LLC must be taxed under the partnership rules if it is treated as a partnership or a "disregarded entity" under the laws of a foreign jurisdiction (such as the U.S. "check-the-box" regulations). If an LLC elects partnership status at a time after its formation, the transition from corporation to partnership status for tax purposes gives rise to a deemed liquidation of the corporation; this liquidation can be taxable for current conversions. An LLC with a single owner is regarded as a separate entity for Puerto Rican tax purposes.

2.4.9.1.3 Corporations of Individuals

A corporation of individuals is a corporation or a partnership that elects to be treated as a corporation of individuals and that meets certain eligibility requirements. The eligibility requirements are similar, but not identical, to the eligibility requirements for "S corporations" under U.S. law. Among other things, a corporation of individuals must: (1) be organized under the laws of Puerto Rico, a U.S. state, or the District of Columbia; (2) be engaged in the active conduct of a trade or business solely in Puerto Rico; (3) have no more than 75 shareholders; and (4) have only shareholders that are individuals, estates, and certain kinds of trusts. In addition, only 10 percent of gross receipts of a corporation of individuals can be derived from passive activities or from sources outside of Puerto Rico. These eligibility requirements limit the businesses that can use the corporation of individual's regime.

A corporation of individuals is taxed on a flow-through basis so that income and losses generally flow through and are taxed only at the owner level. As in the case of partnerships and special partnerships, losses of a corporation of individuals can only be used to offset income from other pass-through entities. In addition, an owner of a corporation of individuals is subject to withholding by the corporation with respect to his or her share of corporate income. There also are taxes that can apply as a result of a corporation's conversion to corporation of individuals status (such as certain recapture taxes and a 10-year built-in gain recognition period during which a corporate-level tax would apply).

2.4.9.1.4 Special Partnerships

Rules relating to "special partnerships" were made applicable to qualifying local law partnerships, LLCs, and corporations for taxable years beginning after December 31, 1984. In order to qualify as a special partnership, an electing entity must derive at least 70 percent of its gross income for each taxable year from sources within Puerto Rico and from certain defined activities (such as construction, land, substantial rehabilitation of buildings, sale or rental of buildings, manufacturing generating substantial employment, tourism, agriculture, exports, films, infrastructure, and green energy).

A special partnership is taxed as a pass-through entity. Like a partnership or a corporation of individuals, its income and losses flow through and are taxed at the owner level. The rules relating to the taxation of special partnerships evolved significantly over the years. Although the special partnership rules currently are similar in some respects to those applicable to partnerships, there are some differences between the regimes. For example, to address certain aggressive tax planning that took place in the past regarding partners' use of losses, the special partnership rules provide that liabilities of a special partnership do not increase a partner's basis in its partnership interest. In addition, for a period, flow-through losses could not reduce a partner's net income by more than 50 percent, although this limitation is no longer applicable. Partners of special partnerships are subject to withholding with respect to their shares of partnership income; however, the withholding rates applicable to foreign partners not otherwise engaged in a trade or business in Puerto Rico can be lower than under the partnership rules.

As a result of the 2011 Act, no special partnership elections have been allowed for taxable years beginning after December 31, 2010. However, special partnerships in existence at that time were grandfathered. There are procedures pursuant to which special partnerships currently can convert into partnerships in transactions that are exempt from immediate tax.

2.4.9.1.5 Special Employee Owned Corporations

The tax regime relating to Special Employee-Owned Corporations ("SEOCs") was introduced in 1990 to promote certain labor incentives for manufacturing entities that were operating in Puerto Rico following the repeal of section 936 of the U.S. Internal Revenue Code (relating to the possessions tax credit). Although a SEOC legally is a corporation, the taxation of such entities is a blend of cooperative and flow-through principles. For example, a SEOC takes into account various deductions and credits on its information tax return and then passes certain items through to its members. A SEOC may have regular members (employees of the SEOC), special members (customers), and corporate members. Regular members must control the SEOC's management.

We are not aware of any studies addressing whether the SEOC rules have achieved their intended objectives.

2.4.9.2 Single-Level of Tax for Certain Investment Entities

2.4.9.2.1 Real Estate Investment Trusts

The Puerto Rican Code has provided special tax rules for real estate investment trusts ("REITs") since 2000. The REIT provisions generally follow the U.S. tax model, with numerous requirements relating to shareholder dilution, property ownership and operation, and required distributions. Property ownership must be focused in Puerto Rico by virtue of a requirement that 75 percent of gross income be derived from, among other sources, rents from real property located in Puerto Rico and interest on obligations secured by mortgages on real property located in Puerto Rico. A REIT is exempt from entity level tax in Puerto Rico so long as it distributes at least 90 percent of its earnings on an annual basis. REIT shareholders generally are subject to tax at a rate of 10 percent on distributed earnings, which tax is withheld at the source.

Anecdotal evidence indicates that the REIT regime may not be operating as it originally was intended. The regime apparently was directed at encouraging Puerto Rican entrepreneurs to invest in local real estate through such entities. Because of the dilution requirements patterned after U.S. rules, however, the target audience has not found the regime attractive, as these parties are used to taking larger ownership stakes in real estate investments. As a result, of the few REITs that have been formed in Puerto Rico, most (and possibly all) have been formed by U.S. entrepreneurs.

2.4.9.2.2 Registered Investment Companies

Provisions relating to registered investment companies ("RICs") initially were adopted as part of the Puerto Rico Income Tax Act of 1954. These rules have been amended over the years, most recently as part of the 2011 Act. As with REITs, a RIC will incur no tax at the entity level as long as at least 90 percent of its earnings are distributed annually. RIC shareholders generally are subject to tax at a rate of 10 percent on distributed earnings, which tax is withheld at the source. Exempt dividends and dividends from industrial development income are excludible from income.

In 2013, the Puerto Rican rules were altered fairly significantly in an attempt to promote economic activity and public interest in Puerto Rico. Dividends from a U.S. RIC now generally are taxed at ordinary income rates for Puerto Rican residents, creating a disincentive for Puerto Rican residents to invest in U.S. RICs. In addition, effective for taxable years beginning after December 31, 2013, a RIC qualifying under the Puerto Rico Investment Companies Act of 2013 and satisfying certain additional rules may qualify as an "exempt investment trust." The "eligible sources" of income for an exempt investment trust generally must relate to the promotion of economic activity and public interest in Puerto Rico or the raising of Puerto Rican capital. A qualifying exempt investment trust is subject to more favorable rules in that the trust is exempt from tax regardless of its level of distributions, and eligible shareholders are completely exempt from Puerto Rican tax on eligible distributions. An exempt investment trust also may elect to be taxed as a partnership, and members will be exempt from tax on income allocated by such entities.

2.4.9.3 Exempt or Reduced-Reduced Rate Income at Entity Level

2.4.9.3.1 International Banking Entities

The regime for International Banking Entities ("IBEs") has been in place since 1989 and apparently was intended to encourage banking activities in Puerto Rico for clients outside of Puerto Rico and for capital deposits used outside of Puerto Rico. An IBE is entitled to an income tax exemption for net income generated by its qualifying activities. If the IBE operates as a branch or unit of a bank, the tax exemption is limited to 20 percent of the total net income of the bank. No income tax withholding applies to dividends paid from income generated by the qualifying activities.

An IBE was required to apply for IBE status. Once IBE status was granted, the IBE became subject to the applicable rules provided under Act 52. After September 25, 2012, no new applications have been accepted for IBE status; however, renewals of IBE licenses could still be processed and existing licenses remained in effect. Although existing IBEs can apply to be

International Financial Entities ("IFEs"), described below, the IBE rules are generally more favorable than the IFE rules.

2.4.9.3.2 International Financial Entities

Since September 25, 2012, a separate regime for IFEs has been in effect. An IFE is subject to rules that are similar to the rules applicable to IBEs, except that tax at a rate of 4 percent is applicable to net income from qualifying activities (subject to the same 20 percent limitation for IFEs operated by a bank). Income tax withholding applies to dividends at a rate of 6 percent on dividends paid from income generated by the qualifying activities. Upon approval of the licensing request, the IFE operates under a tax exemption decree that provides for the IFE's tax treatment. The tax exemption decree is effective for a period of 15 years, with two possible renewal extensions of 15 years each. The tax rate for the last possible 15-year period can range from 4 percent to 10 percent. No exemption decrees (other than renewals) can be issued for IFEs after December 31, 2019.

2.4.10 Reasons for Change

Two alternative sets of considerations should be taken into account in analyzing reform efforts with respect to pass-through entities. The first set involves an analysis of largely duplicative regimes and a determination of whether certain regimes may be eliminated or combined. The second set relates to encouraging a large segment of the business community currently operating in corporate form to convert to taxation under a pass-through regime. More specifically, as part of the effort to transition more businesses to a pass-through regime, certain adjustments relevant to the operation of the pass-through regimes may be considered to (1) make such regimes accessible to such a broad group of taxpayers, and (2) prevent abuse by taxpayers operating under such regimes.

2.4.10.1 Consolidating Duplicative Regimes

Regimes relating to the taxation of entities that are largely duplicative, with only slight differences, force taxpayers to expend effort in making choices that may have de minimis consequences. Also, if taxpayers can choose between different entity regimes that are designed to promote the same policies and activities, they often will choose the one that results in the lowest tax, possibly resulting in a loss to government revenues.

From the tax administrator's perspective, significant resources must be expended in developing and maintaining rules and procedures necessary to properly administer alternative regimes. In addition, training audit teams to enforce such duplicative regimes consumes scarce resources that could be deployed more efficiently elsewhere.

As new regimes are created, it is useful to analyze whether existing regimes continue to be necessary to promote the policies that originally justified such regimes. It also can be productive to periodically evaluate specific regimes to determine the extent to which the regimes are being used and are promoting the policies that are intended. Periodic accumulation of data and statistics with respect to the various regimes can be useful in undertaking these analyses to corroborate the effectiveness of current regimes that are intended to promote distinct policies.

As is readily apparent from the description of current law, there is significant overlap between a number of the regimes that are currently in place for subjecting business income to one level of tax. In certain situations, regimes have been left in place when new regimes were adopted that provide similar tax treatment. For example, the regime for special partnerships was retained after the more broad-based regime for partnerships was enacted in 2011. Similarly, the regime for IBEs was left in place after the modified regime for IFEs was adopted. In both situations, only grandfathered entities continue to be taxed under the prior regimes; no new entities can elect special partnership or IBE status. Thus, a different set of rules can apply to similarly situated businesses.

There is less of an overlap between certain other regimes. For example, although partnerships and corporations of individuals provide similar pass-through treatment for their owners, the corporation of individuals rules offer the benefit of simplicity for businesses with simple capital structures (provided those businesses can meet the requirements regarding the type and source of income). By contrast, the operative tax rules applicable to partnerships are more complex, but provide for more flexible economic arrangements. Thus, differences in businesses and capital needs provide justification for retaining simple corporation of individuals rules as well as more complex partnership tax rules.

Some of the other regimes, as currently structured, appear to be underutilized. For example, there are very few REITs. Also, most (if not all) existing RICs are operating under longstanding rules; however, the new exempt interest trusts, which are intended to promote economic activity and public interest in Puerto Rico, have been in effect for only a relatively short period thus far.

2.4.11 Description of Options

2.4.11.1 Consolidating Duplicative Regimes and Eliminating Unnecessary Regimes

2.4.11.1.1 Special Partnerships and Partnerships

It appears that entities currently operating under the special partnership regime could operate under the 2011 Act partnership regime with minimal disruption. Accordingly, consideration should be given to eliminating the rules for special partnerships and allowing such entities to convert to partnerships on a tax efficient basis.

2.4.11.1.2 SEOCs

Given the lack of studies regarding SEOCs, it is not clear whether the objectives of the SEOC regime are being achieved or whether the regime could be eliminated without negatively affecting the level of Puerto Rican manufacturing activities. It may be prudent to have a study conducted to determine whether the economic benefits of the regime justify its continued existence. If these special tax rules are not encouraging the stated goals, such entities might be converted to partnerships with little disruption.

2.4.11.1.3 REITs

If anecdotal evidence regarding the limited use of REITs is accurate, consideration could be given to eliminating the REIT regime and allowing existing REITs to remain subject to the REIT rules for a transition period. Thereafter, tax efficient conversion to partnership status could be permitted for such entities.

2.4.11.1.4 RICs

Usage of the new exempt investment trusts should be monitored, and if after some reasonable time it appears that the economic benefits in Puerto Rico sought through the promotion of such entities will not be realized, the regime for these entities should be eliminated.

2.4.11.1.5 IBEs

The IBE rules could be repealed and IBEs could be allowed a short grace period to request licenses for treatment as IFEs. Such entities would become subject to the IFE regime upon the issuance of a tax exemption decree.

2.4.12 Analysis

2.4.12.1 Consolidating Duplicative Regimes and Eliminating Unnecessary Regimes

2.4.12.1.1 Special Partnerships and Partnerships

There would seem to be little justification for retaining the separate special partnership and partnership regimes that exist under current law. Although certain foreign investors may incur a higher tax burden with respect to their existing investments under the partnership regime than under the grandfathered special partnership rules due to differences in withholding amounts, the elimination of the special partnership rules would seem to present little threat to the level of future investment by those investors. Furthermore, providing a benefit to parties by reference to historical ownership of certain entities does not promote a level playing with respect to such property investment.

The transition to the 2011 Act partnership regime seemingly would be simple for grandfathered special partnerships that were formed as partnerships or LLCs under the relevant jurisdictional law. Because juridical corporations cannot be taxed as partnerships under existing law, however, some accommodation would have to be made for special partnerships that are legally formed as corporations. If non-traded corporations generally are allowed to elect taxation as a partnership, no further adjustment to the rules would be required. If not, transition rules could provide that a special partnership could elect to be taxed as a partnership without any immediate tax on the conversion and without generating recapture of specified items from the period it was a special partnership, notwithstanding its legal status as a corporation.

Special partnerships that become partnerships no longer would be subject to the requirement that at least 70 percent of their gross income be derived from within Puerto Rico and be from certain specified business activities. Under current law, grandfathered special partnerships that have difficulty meeting this requirement can convert to partnership status anyway; thus, not imposing this requirement in the future should not have a significant impact on Puerto Rican economic activity.

2.4.12.1.2 SEOCs

The SEOC rules are complicated, and it is not readily apparent that the regime is well designed to accomplish its intended purpose of promoting labor incentives for manufacturing taking place in Puerto Rico. Depending on the outcome of the study suggested above, it may make sense to repeal the SEOC rules and allow existing SEOCs to convert to partnerships without triggering any immediate tax and without being subject to recapture.

2.4.12.1.3 REITs

Given what apparently is limited use of REITs by Puerto Rican entrepreneurs fourteen years after adoption of the original legislation, it appears that such a regime may not be useful in an economic environment like Puerto Rico's. While immediate elimination of the rules could impose an undue hardship on the limited real estate concerns that are operating under this regime, the adoption of transition rules that would allow the parties investing in such entities to properly reap a justifiable portion of the anticipated benefits without continuing those benefits in perpetuity may be appropriate. There is precedent in the United States in relation to the taxation of publicly traded partnerships for grandfathering the current tax treatment of entities for 10 years prior to transition to taxation as a corporation. Given the generally passive nature of REITs, providing for tax efficient conversion to partnership status following termination of REIT status could be appropriate.

2.4.12.1.4 RICs

Rules relating to the taxation of exempt investment trusts were adopted with the intent of encouraging economic development in Puerto Rico. Given the significant limitations on the permissible activities and investments of such entities, it is not clear that the exempt investment trust regime will be successful in achieving its goals. Accordingly, this regime should be monitored, and if usage of the entity indicates that the desired goals are not being achieved, the regime should be eliminated.

2.4.12.1.5 IBEs

The IBE regime is applicable only to grandfathered entities and is intended to encourage the same activities as the current IFE regime. There would seem to be little justification for retaining the IBE regime under these circumstances. IBEs do not operate under tax exemption decrees and have no vested right with regard to their current treatment. In transitioning existing IBEs to IFEs, IBEs should submit to an expedited IFE licensing process. Prior qualification as an IBE could be a favorable, heavily weighted, factor in granting an IFE license, so as to ease concerns that ultimate conversion may be improbable. Although current IBEs may complain about losing a tax status that is more favorable than that accorded to IFEs, it is valid to question whether taxpayers who were fortunate enough to operate under the prior regime should continue to benefit from a lower tax rate than their competitors indefinitely.

2.4.12.2 Accounting for Broader Usage of Pass-Through Entities

In considering whether to allow entities currently operating under the corporate tax system to transition into a pass-through tax regime, it will be important to evaluate the pass-through regimes that will be made available for conversion and whether the current regimes are well designed to accommodate the businesses that would be the subject of the conversions.

As an initial matter, it is important to recognize that over 90 percent of corporations operating in Puerto Rico have less than $60,000 of annual income. It is likely that the individuals running these businesses lack the sophistication and resources to operate under a tax regime with a high degree of complexity. While pass-through taxation generally is thought to be beneficial, due to the avoidance of a second level of tax, any variance from a basic capital structure and cash-funding of asset acquisitions and operations can introduce significant complexity to the tax reporting exercise for such entity. To the extent possible, the promotion of a straight-forward pass-through reporting regime for the relatively simple businesses would seem important.

Of equal importance, if a materially broader group of taxpayers will be given access to one or more pass-through regimes, there should be a heightened sensitivity to opportunities for abuse that might be facilitated through such regimes. While many of the parties who would convert to a pass-through regime will operate simple businesses and will not be inclined toward (or possess the sophistication to engage in) such abusive transactions, it should be assumed that this will not be the case for all who are encouraged to operate under such a regime.

A corporation of individuals is a relatively simple tax regime that presents little opportunity for abuse. The regime requires that the entity have only one class of stock. With such a simple capital structure, income allocations must be pro rata and thus are quite straightforward. The inability to undertake non-pro rata allocations also provides some limit on the opportunities for abuse. The inability to include liabilities in shareholder basis (for purposes of sheltering losses and distributions) also is a significant limitation on abuse potential.

Given the simplicity and limited opportunity for abuse inherent in the corporation of individuals, it seems that this regime should be made available and encouraged for many of those who would convert. The current rules provide that a corporation of individuals will terminate if the corporation has gross receipts other than from the conduct of a trade or business in Puerto Rico in excess of ten percent for the taxable year. Not only does the rule restrict activities to Puerto Rico, but it also necessitates the earning of a high level of gross income that is trade or business income rather than passive investment income. The rule, while arguably encouraging economic activity in Puerto Rico, provides a barrier to usage for some. The importance of making such a simple tax regime available to a broader constituency arguably should outweigh the reasons originally supporting the imposition of this limitation. Accordingly, consideration should be given to eliminating this limitation. In connection with the elimination of this limitation, steps should be taken to ensure that the corporation of individuals could not be used by individuals to avoid the limitation on deductibility of investment expenses under section 1033.02(a). Requiring that such expenses must be "separately stated" and allocated to the owners as separate items subject to the limitation would seem to provide adequate protection. Further, there is no compelling reason to limit the availability of corporation of individual's status to entities with 75 or less owners. Under this option, any eligible business entity with 200 or less owners may elect to be taxed as a corporation of individuals, so long as the entity satisfies the other applicable requirements.

In addition, given a target audience of taxpayers who may be relatively unsophisticated, there is a risk that numerous taxpayers will make "footfault" errors that cause disqualification as a corporation of individuals. A relief provision currently exists for excusing "inadvertent terminations" with the approval of the Secretary of the Treasury. However, in recognition that many of the mistakes will be "innocent" and cause no real compromise of the tax system, consideration should be given to implementing expedited procedures for correcting such errors and retroactively reinstating corporation of individual's status.

Business entities with more sophisticated capital structures or a shareholder base in excess of, e.g., 200 persons will not qualify as a corporation of individuals. If such businesses operating as corporations are allowed to convert to pass-through status, a partnership will be the most rational regime for these entities.

As noted above, partnerships are very flexible entities. Allocations of income and loss can be very flexible, non-recognition treatment generally is provided in connection with the contribution and distribution of assets, and partners are entitled to include their share of liabilities in the basis of their partnership interests. With such flexibility comes a heightened potential for abuse, and encouraging additional businesses to operate as partnerships could open the door to such abusive transactions. In this regard, many of the abusive transactions that have occurred in Puerto Rico in the past apparently have involved the use of allocated liabilities in the adjusted basis of partnership interests. Rules should be adopted to prevent the re-emergence of such abusive transactions.

Currently, the rules relating to special partnerships prevent partners from including partnership liabilities in the basis of their partnership interests. This rule has the benefit of simplicity, although some would view such a rule as improperly denying tax benefits to parties who take on true risk with respect to debt financed transactions through guarantees, indemnification arrangements, etc. The "at-risk" rules under the U.S. Internal Revenue Code try to strike a balance in this regard – these rules generally permit taxpayers to claim benefits in the form of tax losses only to the extent that taxpayers truly are bearing risk of loss with respect to the expenditures that generate the losses. This regime illustrates a potentially more fair, albeit more complicated, option and should be considered. The U.S. at-risk regime includes certain rules that provide favorable treatment for "qualified nonrecourse financing" relating to certain nonrecourse debt attributable to real estate. Given the nonrecourse nature of the debt, partners who share in such debt do not truly undertake risk with respect to such debt. If the desire is to provide credit only for debt with respect to which a partner is truly at-risk, the rules relating to qualified nonrecourse financing should not be adopted.

2.4.12.3 Transition from Corporate to Pass-Through Regime

As previously described, it would be more efficient for many of the businesses currently operating under tax rules applicable to corporations to instead operate under a pass-through regime. In order to promote transition to the more efficient model of taxation, consideration should be given to permitting many of the entities that currently are taxable as corporations to convert with minimal or no tax cost to taxation under a pass-through regime.

In analyzing the parameters of entity transition rules, a number of factors must be taken into account. First, it is necessary to determine what entities within the pass-through regime would be available for conversion from taxation as a corporation. Once a decision is made with respect to the available entities, consideration must be given to the tax cost of the conversion. Issues related to the future taxation of converted entities also must be considered in light of decisions relating to the chosen taxation of the conversion transaction. Finally, if favorable transition rules are adopted relating to entity conversions, the duration of such transition relief must be determined.

With respect to the entities available for conversion, it seems that any entity that would not be taxable as a per se corporation under the entity classification rules discussed above should be permitted to efficiently convert into either (1) a corporation of individuals (if requirements for qualification can be satisfied), or (2) a partnership. Corporations that could qualify as a corporation of individuals should be strongly encouraged to convert to such an entity. The rules for operating under this regime are much simpler and generally will accommodate the needs of smaller businesses with simple capital structures. In addition, transition issues and the potential for abuse with respect to such entities generally are more straightforward. Other non-per se entities should be permitted to convert to the partnership tax regime.

There is precedent in the Puerto Rican tax system for permitting favorable transition from corporate to pass-through treatment. Most recently, as part of the 2011 Act, a partnership or LLC that was subject to tax as a corporation was permitted to become taxable as a partnership effective as of the first day of the entity's taxable year beginning after January 1, 2011. Under these rules, on the last day of the taxable year beginning prior to January 1, 2011, the partnership or LLC that was taxable as a corporation was treated as transferring its assets and liabilities to its partners or members in liquidation of the partnership or LLC, and immediately thereafter the partner or member contributed the distributed assets and liabilities to an entity that was treated as a partnership for tax purposes. The transition provision stated that, except for limited situations, no gain or loss would be recognized in connection with the distribution by the entity taxable as a corporation, and the contribution transaction would be analyzed under the general non-recognition provision applicable to partnerships. The exceptions where gain or income could be recognized paralleled the rules that apply when a corporation converts to a corporation of individuals. Specifically, upon conversion, the partnership or LLC that was taxable as a corporation was required to: (1) recapture LIFO benefits; (2) recapture benefits of flexible or accelerated depreciation; (3) recognize deferred income under long-term contracts; (4) recognize deferred income from installment sales; and (5) treat earnings and profits as if they were currently distributed. In addition, a corporate tax would be imposed on the entity treated as a partnership with respect to built-in gain as of the date of conversion if recognized within a 10-year period following conversion.

A similar approach could be taken with respect to entity conversions under the new regime, although in the interest of encouraging more taxpayers to convert into a more rational tax regime for their businesses, consideration may be given to forgoing the deemed distribution of earnings and profits and 10-year built-in gain period. The other recapture and recognition provisions relate to tax-advantaged elections or alternatives that the corporation affirmatively took advantage of, and it seems more rational to recapture or recognize those amounts in all events.

In many situations, the total adjusted basis of the stock held by shareholders will be higher than the adjusted basis of the assets held by the corporation. In those situations, by electing to convert to a corporation of individuals or partnership on a largely tax-free basis, shareholders could realize some detriment, as they would lose the adjusted basis in their stock, and the adjusted basis in the corporation of individuals stock or partnership interests would be determined by reference to the bases of the assets that were deemed distributed to these persons (each holder would succeed to a proportionate part of the basis of each distributed asset based on a ratio determined as the value of the holder's equity interest over the total value of all outstanding equity interests, and the basis of such holder's interest in the corporation of individuals or partnership would equal to total basis of the portion of the assets deemed contributed by such holder.) This appears to have been the construct for conversions from a partnership or LLC taxed as a corporation to taxation as a partnership in 2011, and in that context, the parties still had to account for the deemed distribution of earnings and the 10-year built-in gain recognition period. In addition, parties wishing to convert to a corporation of individuals still would have the option to convert under the existing regime, in which case the shareholders would preserve their stock basis, but at the cost of the deemed distribution of earnings and 10-year built-in gain recognition period.

The adoption of a conversion mechanic that equates inside asset basis and outside basis in equity interests will facilitate rational reporting on a going forward basis with respect to the converted entities, particularly those that are partnerships. The partnership tax regime generally operates on the assumption that inside asset basis should equal outside equity interest basis.

The economic rights of partners generally will be accounted for by reference to "capital accounts." In general, a partner's ultimate rights upon liquidation of a partnership should equal the partner's initial capital account in a partnership, increased by "book" income allocations and the value of property contributions, and reduced by "book" loss allocations and the value of property distributions. Under the proposed regime for partnerships, following conversion, initial capital accounts for each partner would be set at the amount that the partner would be entitled to receive if the partnership sold its assets for fair market value on the date of conversion and liquidated. Each partner would have a share of adjusted basis in the partnership assets equal to such partner's adjusted basis in its partnership interest. The difference between a partner's capital account and its share of inside basis would be taken into account under principles similar to the principles relating to contributed property under section 1071.04(c) of the Puerto Rican Code. Each partner would have a proportionate share of built-in gain or loss in each asset determined by reference to the partner's built-in gain or loss in its partnership interest. Following these rules, if all partnership assets are sold, and the partnership liquidates, distributing cash to each partner consistent with such partner's economic share, the partner should recognize no gain in connection with the liquidating distribution. This result is consistent with a properly operating partnership tax regime.

With respect to the corporation of individual's regime, the allocation regime should be more straightforward. The concept of "capital accounts" is not relevant in the context of corporations of individuals. Instead, given the "single class of stock" capital structure, all allocations of income and loss are simply made on a pro rata basis.

Finally, a decision must be made regarding the period during which conversions may be accomplished on the tax-favored basis. When entities previously were allowed to convert in connection with the 2011 Act, the relevant entities were provided with a one-time opportunity to convert as of the entity's first taxable year beginning after January 1, 2011. Anecdotal evidence indicates that many entities that could have benefited from such an election failed to take advantage of this option. In order to provide a greater opportunity to educate the relevant constituency of the presence of the conversion option and the benefits that might be obtained, consideration should be given to a longer period of e.g. three years when entities may take advantage of this conversion option.

Beyond the initial transition period, any non-per se entity taxable as a corporation could be allowed to convert to pass-through status for Puerto Rican tax purposes. After a reasonable transition period during which favorable conversion conditions are permitted, however, the more traditional tax treatment would apply, including recognition of gain upon the deemed liquidation of the entity taxable as a corporation (except for certain controlled subsidiary liquidations.

2.5 Rationalize Allocation of Incentives for Inbound Business Taxation

2.5.1 Current Law

2.5.1.1 In General

The taxation of income of nonresident aliens, foreign corporations, and foreign partnerships ("foreign persons") generally depends on the source of the income and whether the foreign person is engaged in the conduct of a trade or business in Puerto Rico. A foreign person that is not engaged in a trade or business in Puerto Rico is subject to Puerto Rico income tax only on certain items of Puerto Rico source income. A foreign person that is engaged in the conduct of a trade or business in Puerto Rico is subject to Puerto Rico income tax on all income effectively connected with that trade or business ("ECI"). If a foreign person is engaged in a trade or business in Puerto Rico at any time during a taxable year, all Puerto Rico source income and gains received by the person during the year are treated as ECI. Non-Puerto Rico source income is treated as ECI only if the income consists of a certain type of income, the foreign person has an office or other fixed place of business in Puerto Rico, and the income is attributable to that office or fixed place of business. A branch profits tax is imposed on the withdrawal of assets from

Puerto Rican operations in order to equalize the treatment of foreign corporations that do business directly in Puerto Rico and those which operate through a Puerto Rican subsidiary.

2.5.1.2 Law 73 and Law 135

Inbound investment in Puerto Rico has long been encouraged by tax subsidies. The Economic Incentives for the Development of Puerto Rico Act ("Law 73") became effective on July 1, 2008. Law 73 replaced the Tax Incentives Act of 1998 ("Law 135"), which continues to apply to a number of decrees that were issued prior to 2008. While there are some differences between the two Laws, the substantive parameters are generally the same. Because Law 73 governs current grants, this discussion will focus on Law 73.

Under Law 73, exemption decrees are issued to qualifying businesses by the Office of Industrial Tax Exemption. The Puerto Rico Industrial Development Company ("PRIDCO") is responsible for the promotion of the incentives program.

Law 73 provides reduced tax rates on net industrial development income of exempt businesses and reduced withholding tax rates on payments made by exempt businesses (generally 4% and 12%, respectively, or alternatively, 8% and 2%, respectively), as well as additional deductions for acquiring, constructing, or remodeling certain buildings, structures, machinery and equipment, and tax credits for purchases of Puerto Rico manufactured products, for special eligible investments, for investment in energy producing machinery and equipment, for reduction of energy costs, and for investment in strategic projects. Dividends or profit distributions by an exempt business of industrial development income to its shareholders or partners are not subject to tax. In addition, the Law provides a 90% exemption from property taxes, 100% exemption from municipal license taxes during the first 3 semesters of operations and at least 60% thereafter, and 100% exemption from excise taxes and sales and use taxes with respect to the acquisition of raw materials and certain machinery and equipment used in exempt activities. The length of the exemption period generally is 15 years and generally may be extended for an additional 10 years. Businesses eligible for the exemption include manufacturing and service units, owners of properties used by exempt businesses, research operations, energy suppliers, recyclers, value added activities related with the Las Americas Port and various other ports, software developers, renewable energy equipment assemblers, certain specified strategic projects, the construction of social interest housing and the planning and development of self sustainable housing projects, and repair, maintenance and overhaul of aircraft.

2.5.1.3 Law 20

Law 20, the "Export Services Act," enacted in 2012, is the latest business incentive measure. It is intended to encourage local businesses to expand their operations in Puerto Rico and foreign businesses to move their operations to Puerto Rico, by providing preferential tax treatment to businesses that export certain services from Puerto Rico to customers around the world. Eligible businesses must obtain an exemption decree to receive benefits under Act 20.

To be eligible for benefits under Law 20, a business must have an office or bona fide establishment located in Puerto Rico that carries out, or may carry out, "Eligible Services" that are either "Export Services" or "Promoter Services."

Eligible Services (to the extent provided for export) include: research and development; advertising and public relations; economic, environmental, technological, scientific, managerial, marketing, human resources, computer, and auditing consulting services; consulting services for any trade or business; commercial arts and graphic services; drafting of construction plans and engineering, architectural, and project management services; professional services such as legal, tax, and accounting services; centralized management services that include, but are not limited to strategic location, planning, and budgetary services carried out at the headquarters or similar regional offices of an entity engaged in rendering such services; electronic data processing centers; computer program development; voice and data telecommunications between persons located outside Puerto Rico; call centers; shared service centers that include, but are not limited to accounting, finance, tax, auditing, marketing, engineering, quality control, human resources, communications, electronic data processing, and other centralized management services; storage and distribution centers of companies engaged in the business of transportation of items and products that belong to third parties, known as "hubs"; educational and training services; hospital and laboratory services; investment banking and other financial services insofar as these services are provided to foreigners; and any other service designated by the Secretary of the Department of Economic Development and Commerce of Puerto Rico.

An Eligible Service is considered a service provided for export (i.e., an Export Service) if such service is rendered for the benefit of a person or entity that is not a resident of Puerto Rico and the service does not have a connection with Puerto Rico.

Certain services that have a connection with Puerto Rico (and thus fail to qualify as Export Services) may qualify as Eligible Services if they constitute Promoter Services. Promoter Services are services provided to non-resident persons related to the establishment of a new business in Puerto Rico.

To receive benefits under Law 20, a Puerto Rico service provider must apply for and receive a tax exemption decree from the Department of Economic Development and Commerce of Puerto Rico. A tax exemption decree constitutes a binding contract between the service provider and the Government of Puerto Rico, and benefits are guaranteed for the term of the decree regardless of a subsequent change in law. The decree will have a term of 20 years, with a possible 10 year extension.

The tax benefits under Law 20 include:

1) 4% fixed income tax rate on net income derived by an Eligible Business from Export Services;

2) 3% fixed income tax rate on net income derived by an Eligible Business from Export Services if more than 90% of the Eligible Business's income is derived from Export Services and the Export Services are considered "Strategic Services" under the Act;

3) 100% exemption from Puerto Rico income tax on dividend distributions received by shareholders or members of an Eligible Business that holds an exemption decree; and

4) 100% exemption from personal and real property taxes during first five years of operations for personal and real property used by an Eligible Business that provides services related to corporate headquarters, call centers, or shared service centers. After the first five years, a 90% exemption applies for the remaining term of the decree.

2.5.1.4 Law 154

2.5.1.4.1 Background

Law 154, enacted on October 25, 2010, materially affects the tax burden borne by inbound investors. Law 154 modified the Puerto Rico Internal Revenue Code to expand the circumstances in which a foreign person may be treated as engaged in a trade or business in Puerto Rico and to treat certain income derived by foreign persons as Puerto Rico source ECI, and thus subject to Puerto Rico income tax. Law 154 applies only to foreign persons who engage in high volumes of transactions with related parties engaged in business within Puerto Rico. As a result, there is a very high overlap between those multinational groups whose Puerto Rican subsidiaries have been granted decrees under Law 73 and those who are subject to Law 154.

Prior to the enactment of Law 154, an office or other fixed place of business of a Puerto Rico person was attributed to a foreign person only if the Puerto Rico person had the authority to negotiate contracts in the name of the foreign person, the Puerto Rico person regularly exercised that authority or maintained an inventory of merchandise from which it regularly filled orders on behalf of the foreign person, and the Puerto Rico person was not a general commission agent, broker, or other independent agent acting in the ordinary course of its business. Law 154 expanded this rule to attribute the office or fixed place of business of a Puerto Rico resident to a related foreign person if the related parties engage in certain types of transactions (the "Related Party Attribution Rule"). If the Related Party Attribution Rule applies, a portion of the foreign person's income is treated as Puerto Rico source ECI, and thus subject to Puerto Rico income tax (the "Source Rule"). Law 154 also adopted an excise tax (the "Excise Tax") that is imposed on certain foreign persons in lieu of the income tax that the foreign persons would pay under the Source Rule.

Two features of the law are very important to understanding its history and its function. As an initial matter, the decrees granted pursuant to Law 73 severely restricted Puerto Rico's ability to collect revenues directly from the operating Puerto Rican subsidiaries of multinational corporations. By taxing the Puerto Rican source income (as redefined) of related parties dealing with those subsidiaries, the decrees were circumvented and Puerto Rico was able to tax income related to the activities governed by the decrees without violating their terms. In addition, the regime has had the benefit of generally allowing U.S. groups to claim a credit against their U.S. taxes for the amounts paid under Law 154, while still benefitting from indefinite deferral of the U.S. tax on the income reported by the Puerto Rican subsidiary. As a result, the impact of the tax on the worldwide effective tax rate of the group is substantially less than it would be in the case of a tax imposed directly on the Puerto Rican subsidiary.

2.5.1.4.2 The Operation of Law 154

2.5.1.4.2.1 Related Party Attribution Rule

The Related Party Attribution Rule applies in situations where a foreign person (a "Foreign Purchaser") purchases goods from a related [51] company that manufactures property or performs services in Puerto Rico (the "Seller"), and, for the taxable year or any of the three preceding taxable years, one of the following requirements is satisfied:

[51] Corporations are related for this purpose if they are members of the same controlled group. Corporations generally are members of the same control group if one corporation owns, directly or indirectly, at least 50 percent of the total voting power and value of stock of the other corporation, or a common parent owns, directly or indirectly, at least 50 percent of the total voting power and value of the stock of each corporation.

1) The Seller’s total gross receipts from the sale to the Foreign Purchaser of personal property manufactured or produced in Puerto Rico, or from the performance of services in Puerto Rico for or on behalf of the Foreign Purchaser, accounted for at least 10% of Seller’s gross receipts;

2) The Foreign Purchaser’s purchases of personal property manufactured or produced in Puerto Rico by the Seller, or services performed in Puerto Rico by the Seller, accounted for at least 10% of the total costs of the Foreign Purchaser’s purchases of property or services;

3) The Foreign Purchaser earns commissions with respect to property manufactured or produced in Puerto Rico by the Seller, or services performed in Puerto Rico by the Seller, and such commissions account for at least 10% of the amount of the Foreign Purchaser’s commissions or other fees from similar transactions; or

4) The Foreign Purchaser facilitates the Seller’s sale of personal property manufactured or produced in Puerto Rico, or the performance of services in Puerto Rico, and, together with the transactions in the first three categories, the facilitated transactions account for at least 10% of the gross receipts of the Seller or at least 10% of the gross receipts of the Foreign Purchaser.

Law 154 provides an anti-abuse rule that disregards any transaction, or series of transactions, if one of the principal purposes of the transaction or series of transactions is the avoidance of the Related Party Attribution Rule.

2.5.1.4.2.2 Source Rule

If a Foreign Purchaser satisfies the Related Party Attribution Rule and otherwise maintains an office or other fixed place of business in Puerto Rico, or is treated as maintaining an office or fixed place of business in Puerto Rico apart from the Related Party Attribution Rule, a portion of the Foreign Purchaser’s income is treated as income from Puerto Rico sources. If a Foreign Purchaser that is not otherwise engaged in a trade or business in Puerto Rico has income that is treated as Puerto Rico source income under the Source Rule, the Foreign Purchaser is treated as engaged in a trade or business in Puerto Rico and the Puerto Rico source income is treated as ECI (and thus subject to Puerto Rico income tax).

The Source Rule applies if the Seller’s gross receipts from sales to the Foreign Purchaser of personal property manufactured or produced in Puerto Rico, and services performed for or on behalf of the Foreign Purchaser in Puerto Rico, does not exceed $75,000,000 for any of the three preceding taxable years. If the Seller’s gross receipts exceed $75,000,000 for any of the three preceding years, the Foreign Purchaser is subject to the Excise Tax in lieu of the income tax that the Foreign Purchaser would owe on any income treated as Puerto Rico source income under the Source Rule.

The portion of a Foreign Purchaser’s income that is treated as Puerto Rico source income under the Source Rule is determined by multiplying the total amount of the Foreign Purchaser’s income by a fraction based on four equal factors: property, payroll, sales, and purchases (the “Apportionment Formula”). The numerator of the Apportionment Formula is the sum of four fractions: (1) the value of real or tangible personal property owned and used by the Foreign Purchaser in Puerto Rico over the value of the Foreign Purchaser’s total worldwide real and tangible personal property; (2) the amount the Foreign Purchaser paid or accrued in Puerto Rico for compensation over the Foreign Purchaser’s total worldwide compensation expense; (3) the

Foreign Purchaser's sales in Puerto Rico over the Foreign Purchaser's total worldwide sales; and (4) the Foreign Purchaser's purchases of property in Puerto Rico over the Foreign Purchaser's total worldwide purchases of property. The denominator of the Apportionment Formula is four.

If a Foreign Purchaser believes the Apportionment Formula has operated or will operate to subject a greater portion of its income to taxation than is reasonably attributable to business or sources within Puerto Rico, the Foreign Purchaser may file an objection to the application of the Apportionment Formula and propose an alternative method of apportionment that it believes to be proper under the circumstances.

If a Foreign Purchaser subject to the Source Rule is unwilling or unable to provide sufficient documentation to support its computation of the Apportionment Formula, and the Foreign Purchaser does not file a timely objection to the use of the Apportionment Formula, 50 percent of the Foreign Purchaser's gains, profits, and income from the sale or exchange without Puerto Rico of personal property manufactured or produced in whole or in part within Puerto Rico will be treated as ECI.

The Related Party Attribution Rule and Source Rule apply to income accruing after December 31, 2010.

2.5.1.4.2.3 Excise Tax

The Excise Tax is imposed on the value of certain personal property and services acquired by a foreign person from a related Puerto Rico entity with gross receipts of at least $75,000,000 if the foreign person has, or is treated as having, an office or fixed place of business in Puerto Rico under the Related Party Attribution Rule or through an agent, and the related party transactions exceed a certain threshold. Similar to the Related Party Attribution Rule, the Excise Tax only applies if Foreign Purchaser acquires personal property manufactured or produced in Puerto Rico and services performed in Puerto Rico from a member of the same controlled group, or where one person provides distribution or facilitation services for another member of the same controlled group, that during any of the three preceding taxable years account for:

1) At least 10% of the Seller's total gross receipts from the sale of personal property manufactured or produced in Puerto Rico, or from the performance of services in Puerto Rico;

2) At least 10% of the total cost of the Foreign Purchaser's acquisitions of personal property and services;

3) At least 10% of the total amount of the Foreign Purchaser's commissions or other fees; or

4) In the case of transactions facilitated by the Foreign Purchaser, such transactions, together with the transactions in the first three categories, account for at least 10% of the total gross receipts of the Seller or at least 10% of the total gross receipts of the Foreign Purchaser from facilitation services.

If the aforementioned requirements are satisfied, the Excise Tax is imposed at a 4% rate on the value of the tangible property manufactured in whole or in part in Puerto Rico and the services performed in Puerto Rico in connection with the manufacture or production of tangible property that the Foreign Purchaser acquires from Seller. The Excise Tax provides an anti-abuse rule that disregards any transaction, or series of transactions, if one of the principal purposes of the transaction or series of transactions is the avoidance of the Excise Tax.

The Excise Tax liability is imposed on the Foreign Purchaser but is collected and remitted by the Seller. A Foreign Purchaser that is subject to the Excise Tax is allowed a credit for taxes paid to any U.S. state on the acquisition of tangible property manufactured or produced in Puerto Rico, or services performed in Puerto Rico by certain persons in connection with the manufacture or production of tangible property.

As originally enacted, the Excise Tax rate was scheduled to be phased out and eliminated after 2016. In 2013, the Excise Tax was extended at a 4% rate through 2017.

2.5.2 Reasons for Change

2.5.2.1 In General

It is generally believed that in the absence of the benefits granted under statutes such as Law 73 and Law 20, existing foreign investors would reduce or eliminate their business activities in Puerto Rico and the procurement of new inbound investment would be severely hampered. Given the direct revenue contribution, as well as the significant economic contribution made by these companies, that would be an unacceptable result. Thus, this project assumes that Puerto Rico must maintain a robust incentives program in order to maintain and attract inbound investment. However, certain subsidy programs, such as Law 20, can be strengthened to ensure that they achieve their stated objectives. Additionally, further study is needed to evaluate whether the optimal design features of the current subsidy programs may be improved or may lie outside the tax area.

2.5.2.2 Law 154

Although there is to some extent a sense of dissatisfaction with Law 154, in-depth conversations with companies currently benefitting under Law 73 and 154 that are also subject to Law 154 suggest a general acceptance of the current regime. Like any taxpayers, the companies would prefer a lower tax burden, and there is a measure of concern relating to the issues discussed below. Nonetheless, the companies did not suggest a wholesale replacement or reworking of the Law 154 regime. Rather there was a measure of consensus that if similar amounts of revenue are to be raised from the constituency affected by Law 154, it would be best to do so by extending the existing regime.

2.5.2.2.1 Complexity

The Related Party Attribution Rule, Source Rule, and Excise Tax are without doubt a very complex set of rules. Although the Tax Reform Committee that was convened in 2010 believed that the Related Party Attribution Rule and Source Rule would be simpler to implement than a combined reporting system that treated a Puerto Rico manufacturer and its related foreign affiliates as a single unitary business subject to tax in Puerto Rico, the Tax Reform Committee recognized that the Related Party Attribution Rule and Source Rule also could be difficult to administer. Accordingly, the legislature adopted the temporary Excise Tax to apply in certain cases in lieu of the income tax that otherwise would be owed under the Source Rule.

The Statement of Motives to Law 154 explains that "[t]he benefits in the administration and oversight of an excise tax such as this one are particularly significant in the use of high volume manufacturers." Thus, while the simpler Excise Tax applies to certain Puerto Rico manufacturers or service providers with gross receipts from related-party transactions in excess of $75,000,000, the more complex Related Party Attribution Rule and Source Rule apply to Puerto Rico entities with gross receipts below that threshold. Further, all taxpayers will be subject to the more complex rules when the Excise Tax expires after 2017.

2.5.2.2.2 Temporary Nature

The Related Party Attribution Rule and Source Rule were intended to constitute permanent changes to the Code. The Excise Tax, on the other hand, was intended to be a temporary provision. The Statement of Motives to Law 154 explains that the "temporary excise tax as an alternative to the Income Source Rule would be in effect exclusively for a six (6) year period and would gradually drop during this period of time in order to facilitate the implantation of the fiscal responsibility measures of this Administration." In 2013, however, the Excise Tax was extended at a flat 4% rate through 2017.

2.5.2.2.3 Uncertainty regarding the Creditability of the Excise Tax for U.S. Federal Income Tax Purposes

The United States generally allows a U.S. corporation to elect to claim a credit against its U.S. income tax liability for income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country. Puerto Rico generally is treated as a foreign country for purposes of the U.S. Internal Revenue Code. Accordingly, a U.S. corporation generally is eligible to claim a credit against its U.S. income tax liability for income taxes paid to the government of Puerto Rico.

The United States also allows a credit for any tax paid to a foreign country in lieu of a tax on income, war profits, or excess profits. The Excise Tax was enacted with the expectation that it would be treated as a creditable tax for U.S. tax purpose because the excise tax is imposed in lieu of the income tax that a Foreign Purchaser otherwise would be required to pay pursuant to the Source Rule. Some taxpayers and practitioners have expressed uncertainty, however, as to whether the Excise Tax is a creditable tax for U.S. tax purposes.

Following the enactment of Law 154, U.S. taxpayers asked the U.S. Internal Revenue Service and Treasury Department to issue a ruling regarding the creditability of the new Excise Tax. On April 18, 2011 the U.S. Internal Revenue Service issued Notice 2011-29,[52] stating that:

> The IRS and the Treasury Department are evaluating the Excise Tax. The provisions of the Excise Tax are novel. The determination of the creditability of the Excise Tax requires the resolution of a number of legal and factual issues. Pending the resolution of these issues, 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. This notice is effective for Excise Tax paid or accrued on or after January 1, 2011. Any change in the foreign tax credit treatment of the Excise Tax after resolution of the pending issues will be prospective, and will apply to Excise Tax paid or accrued after the date that further guidance is issued.

Although this was a taxpayer-favorable Notice, the Notice did not eliminate taxpayer uncertainty because the Notice can be revoked prospectively at any time.

[52] 2011-16 I.R.B. 663.

2.5.2.2.4 Constitutionality

Some taxpayers and practitioners also have raised concerns regarding the constitutionality of Law 154. Specifically, these parties have questioned whether the law violates the so-called "Dormant Commerce Clause" of the U.S. Constitution. Very generally, the "Commerce Clause" of the U.S. Constitution provides that the U.S. Congress shall have the power "to regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."[53] In addition to this affirmative grant of authority, the U.S. Supreme Court has long held that the Commerce Clause, by negative implication, forbids the states from enacting laws that discriminate against or unduly burden interstate commerce.[54] This negative implication is known as the Dormant Commerce Clause. The U.S. Court of Appeals for the First Circuit has held on two occasions that Puerto Rico "is subject to the constraints of the dormant Commerce Clause doctrine in the same fashion as the states."[55] Although modeled on state income taxes which employ worldwide apportionment fractions to impose tax on amounts of income that may be greater than what is reported by in-state affiliates on their separate books, a critical difference between Law 154 and such regimes is that Law 154 does not attempt to collect the tax from the Puerto Rican affiliate, but rather from the non-Puerto Rican (frequently U.S.) affiliate through an imputation of nexus. This distinguishes Law 154 from regimes that have been previously held to be constitutional, and thus creates at least some measure of uncertainty in this regard as well.

2.5.2.2.5 Taxpayer Response

Law 154 was quickly enacted with little input from taxpayers or tax practitioners. In addition to objections to the substance of Law 154, many taxpayers and their representatives criticized the government for failing to involve them in the legislative process and to provide them with an opportunity to review the law and provide their comments and concerns before the law was enacted. The Legislative Assembly is aware of these criticisms and has solicited the comments and concerns of interested parties in developing a replacement for Law 154.

2.5.3 Description of Options

2.5.3.1 Examine and Rationalize Existing Incentives

The current incentives structure should be examined to determine whether, on a prospective basis, there are more efficient alternatives to encourage the desired investment activity. Further, all incentive programs should be subject to periodic rigorous cost-benefit review.

2.5.3.2 Amend Law 20 to Require a Certain Threshold of Specific Puerto Rico Economic Activity as a Condition of Awarding Grants

Consideration should be given to amending Law 20 to condition the receipt of benefits under the Law on a certain minimum threshold of activity in Puerto Rico, based either on number of employees, payroll expense, or property owned in Puerto Rico.

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[53] Article I, Section 8, Clause 3.

[54] *See, e.g., Cooley v. Board of Wardens of Port of Philadelphia*, 13 L.Ed. 996 (1852).

[55] *Trailer Marine Transport Corp. v. Vazquez*, 977 F.2d 1, 7 (1st Cir. 1992); *see also Antilles Cement Corporation v. Fortuno*, 670 F.3d 310, 327 (1st Cir. 2012).

2.5.3.3 Extend Law 154 Excise Tax

Consideration should be given to a short extension (*e.g.*, five years or less) of the Law 154 excise tax.

2.5.4 Analysis

2.5.4.1 Examine and Rationalize Existing Incentivizes

As noted above, this project assumes that Puerto Rico must continue to grant benefits under statutes such as Law 73 and Law 20 to maintain and encourage inbound investment. 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 existing and inbound investors appears to be the most promising way to attract and maintain inbound investment. However, if the tax system is chosen as the delivery mechanism for these incentives, the structure of the incentive programs must be carefully designed to assure that the benefits are targeted. Moreover, the arrangements negotiated by PRIDCO should be subjected to regular, rigorous cost benefit analysis and the incentives adjusted if necessary.

2.5.4.2 Amend Law 20 to Require a Certain Threshold of Specific Puerto Rico Economic Activity as a Condition of Awarding Grants

A company should not be entitled to benefits under Law 20 unless the company makes a certain minimum contribution to the Puerto Rico economy. The efficacy and objectives of Law 20 would be improved by requiring companies that receive benefits under Law 20 to maintain a minimum threshold of either employees, payroll expense, or business property in Puerto Rico.

2.5.4.3 Extend Law 154 Excise Tax

The Commonwealth needs the revenue from Law 154 (estimated at approximately $2 billion for FY 2015), and the inbound sector appears to be the most viable source to obtain the bulk of that revenue. Although the major inbound companies initially objected to the enactment of Law 154 – in particular the lack of transparency in connection with the legislation that brought it into being, those companies now seek certainty, predictability, and sustainability of the Puerto Rican laws that determine their Puerto Rican tax burden rather than attempting to rewrite past history. While in an ideal world it would be preferable from a tax policy standpoint to replace Law 154 with a simpler regime, the majority of the major inbound companies were unable to identify an alternative regime that they would find preferable to Law 154 (based on the assumption that Puerto Rico will continue to impose a similar tax burden on inbound companies regardless whether Law 154 is continued or repealed). Further, none of the major inbound companies indicated that an extension of Law 154, in and of itself, would cause them to revisit their investments in Puerto Rico. Accordingly, a short extension (no more than five years) of the Law 154 excise tax appears to be the best option for the Commonwealth to meet its short-term revenue needs.

In connection with the process, possible responses of the U.S. federal government acting through its Treasury Department and Internal Revenue Service were considered. For both political and tax policy reasons, it seems likely that the federal government would be more accepting of a short-term extension of the Law 154 excise tax, as compared to a permanent or long-term extension of the excise tax. There is reason to believe the latter action would be much more likely to cause the U.S. Treasury Department to revisit the 2011 Notice.

2.5.4.4 Elimination of Branch Profits Tax

The options to amend the taxation of Puerto Rican corporations generally do not do away with withholding taxes on dividends paid to foreign shareholders. The retention of the taxation of dividends in general (including withholding) is to prevent the use of corporations in creating artificial losses or otherwise avoiding taxes properly collected at the shareholder level. In the case of branch operations of a foreign corporation, these considerations are not relevant. Therefore, in connection with the changes to the taxation of domestic corporations (and in particular making flow-through taxation more generally available) consideration should be given to eliminating the branch profits tax.

2.6 Property Tax

2.6.1 Current Law

Property taxes are the primary source of funding for the municipalities of Puerto Rico. Property tax receipts were $979, 398 000 in FY 2012-13 of which $631.7 million was attributable to real property taxes and $347.69 million was attributable to personal property taxes.

Puerto Rico imposes property tax on real property located in Puerto Rico and personal property located in Puerto Rico that is used in a trade or business. Property taxes are imposed by the Municipal Property Tax Act of 1991 ("MPTA"),[56] and taxes are collected by the Municipal Revenue Collection Center (commonly known by its Spanish acronym as "CRIM"). Property taxes are partly imposed by the government of the Commonwealth and partly by each municipality, but all property taxes are collected by the CRIM based on a single combined rate.

The Commonwealth levies a tax on all non-exempt real and personal property located in Puerto Rico equal to 1.03% of the assessed value of the property.[57] The municipalities generally are authorized to levy a tax of up to 4% of the appraised value of all personal property and up to 6% of the appraised value of all real property.[58] The municipalities also have limited authority to assess additional property tax.[59] The combined tax rate for real property generally ranges from 8%-10% and the combined tax rate for personal property generally ranges from 6%-8%.[60]

2.6.1.1 Taxable Property

All personal property and real property located in Puerto Rico is presumed to be taxable unless an exemption applies.[61]

2.6.1.2 Real Property

Real property includes land, subsoil, and all structures, objects, machinery, and devices attached to a building or fixed on the ground in a permanent manner.[62]

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[56] Codified at 21 LPRA § 5001 et. seq.
[57] 21 LPRA § 5002.
[58] 21 LPRA § 5001.
[59] 21 LPRA § 5002.
[60] See Ríos-Méndez and Alemar-Escabí, 7320 T.M., Business Operations in Puerto Rico, Part IV.G.2.
[61] 21 LPRA § 5061.
[62] 21 LPRA § 5061.

2.6.1.3 Personal Property

Personal property generally includes all property other than real property.[63] The MPTA specifically provides that personal property includes: machinery, containers, instruments, and other devices not attached to a building or land in a permanent nature; livestock; money; bonds, stock, and other financial instruments; and copyrights, trademarks, franchises, and concessions.[64]

2.6.1.4 Exemptions

The MPTA expressly exempts numerous categories of property from personal and real property tax.[65] Exempt property includes: household personal property strictly for personal use; certain intangible property such as bank accounts; the first $15,000 of the value of real property resided in by its owner; property of the United States or the Commonwealth of Puerto Rico; property held by municipalities for public use; stock, bonds, promissory notes, and other securities or debts issued by Puerto Rico entities or certain foreign entities; property owned by nonprofit organizations and hospitals; motor vehicles subject to the payment of license plates; livestock and the structures and equipment for raising them; certain watercraft; real property located in historic zones; renewable energy equipment; and property of international banking institutions.[66]

2.6.1.5 Assessment and Collection

2.6.1.5.1 Personal Property

Personal property is assessed based on the book value of the property as of January 1 of each year.[67] Book value means the cost of acquisition or production of the personal property adjusted for depreciation, obsolescence, or other factors as reflected in the accounting books and records in accordance with generally accepted accounting principles.[68] If book value does not reasonably reflect fair market value the personal property may be assessed based on fair market value.[69]

Every person that is engaged in a trade or business and owns personal property used in that trade or business as of January 1 must file a personal property tax return for that taxable year.[70] Persons that own only exempt personal property on January 1 generally do not need to file a property tax return.[71] Every for-profit corporation with sales over $3,000,000 must submit certified financial statements with its property tax return and have the return reviewed by a CPA.[72] Effective December 25, 2013, the return of these corporations also must include certain supplemental information.[73]

The personal property tax return is due on May 15 immediately following the January 1 assessment date.[74] For taxable years commencing after December 31, 2013, the self-assessed

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63 *Id.*

64 *Id.*

65 See generally 21 LPRA §§ 5002, 5003, 5151.

66 *Id.*

67 21 LPRA § 5204.

68 21 LPRA § 5202(g).

69 21 LPRA § 5204.

70 21 LPRA § 5203(a).

71 21 LPRA § 5203(b).

72 21 LPRA § 5203(c).

73 21 LPRA § 5203(c), modified by Act No. 163-2013.

74 21 LPRA § 5205(a).

tax on personal property must be paid through four equal estimated payments due on August 15 and November 15 of the current year, and February 15 and March 15 of the following year.[75]

2.6.1.5.2 Real Property

Real property is assessed according to its status and condition as of January 1 of each year.76 The Commonwealth has not conducted a real property reassessment since 1958. As a result, all real property taxes are based on the assessed valuation of real property in fiscal year 1957-58.[77] New construction also is assessed based on what the value of the property would have been in 1958. Accordingly, the overall assessed valuation of real property for taxation purposes is substantially lower than the actual fair market value. Real property taxes must be paid in two equal installments by July 1 and January 1 immediately following the assessment dates.[78] No tax return is required to report and pay real property tax.

2.6.2 Reasons for Change

A primary objective of property tax reform is to create an efficient and equitable revenue stream that will enable each municipality to "stand on its own bottom."

Many object to the personal property tax in general, but more specifically the inclusion in the tax base of business inventories. 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. Indeed the New York Federal Reserve has noted that Puerto Rico, in comparison with states in the United State, has "a notably low reliance on property taxes."[79]

The current system has multiple deficiencies when compared to international best practices. Options to improve the system include repeal of the personal property tax, updating and maintaining real property values at current fair market value, creating systems to capture new construction and improvements, consideration of differential rates for different property uses, creating a modern system for recording property transfers, consideration of a real property transfer tax, devising a system for allocating property tax receipts and a systematic examination of the current structure for administering the tax.

2.6.3 Description of Options

If the scope of the engagement is expanded, subsequent reports will quantify the economic and distributional effects of the options described above as well transition options to implement the new regime most efficiently.

[75] 21 LPRA § 5205(h).
[76] 21 LPRA § 5068.
[77] *See* Commonwealth of Puerto Rico, Financial Information and Operating Data Report (Oct. 18, 2013), available at http://www.gdbpr.com/spa/documents/commonwealthreport.pdf.
[78] 21 LPRA § 5091.
[79] [Fed Report, p.16].

2.7 Penalties

2.7.1 Current Law

The current Puerto Rico Tax Code[80] has an extensive set of provisions that provides for penalties, additions to tax, and surcharges for various acts, omissions, and violations of the Puerto Rico tax laws. These penalties and additions to tax apply to any taxes, license fees, or levies with respect to the income taxes; estate and gift taxes; excise taxes; sales and use taxes, and alcohol beverage taxes.[81] Most of these penalties and additions to tax are found in Subtitle F, Administrative Provisions, Procedures, Interests, Penalties, and Additions to Taxes. There are civil penalties that result in monetary fines and also loss of tax benefits,[82] and there are criminal penalties (misdemeanor and felony) that can result in monetary fines and imprisonment. The more frequent penalties that are associated with income taxes, estate and gift, excise taxes, and sales and use tax are highlighted below.

With respect to income taxes, the failure to file penalty is 5% for the first 30-day period and 10 percent for each 30-day period or fraction thereof not to exceed 25 percent;[83] the failure to timely pay penalty is 5% if made during the 30-60 day period after due date and 10% if made after 60 days;[84] the accuracy-related penalties for negligence, substantial undervaluation of income, substantial overvaluation of property, substantial overvaluation of contributions to pension plans, and transactions lacking financial substance are 20% of the deficiency but increased to 40% for grossly overvalued property or contributions to pension plans;[85] and the failure to pay estimated tax for both individuals and corporations (and partnerships) is 10% for each due and unpaid installment.[86] Any deficiency as a result of fraud with intent to evade taxes is subject to a penalty of 100% of the assessed amount.[87]

With respect to estate and gift tax, the failure to file required returns and failure to timely pay are subject to the same penalties discussed above. However, the accuracy-related provisions contain a penalty not to exceed double the deficiency for an undervaluation of property included in an estate as a gift for less than its value.[88]

With respect to excise taxes, the failure to file required returns and failure to timely pay as discussed above would be applicable. In addition, the Secretary of the Treasury of Puerto Rico (Secretary) may administratively impose a fine not greater than $20,000 for each violation of the excise tax provisions based on the magnitude of the violation. No penalty is to exceed $2,000 unless it involves fraud, tort, or systemic evasion. However, for repeat offenders, an additional penalty of 50 to 100% of the tax may be imposed.[89] In addition, any person who fails to file required excise statements and monthly returns is subject to a $100 penalty for each failure.[90]

[80] All section references in this memorandum refer to Title 11 of the Puerto Rico Tax Law unless otherwise denoted.
[81] Section 6010.01.
[82] Section 1052.01(g) – 10-year denial period for fraudulently claiming the Earned Income Credit.
[83] Section 6030.11.
[84] Section 6030.02.
[85] Section 6030.03.
[86] Section 6030.09 for individuals and Section 6030.10 for corporations and partnerships.
[87] Section 6030.03(b).
[88] Section 6030.03(c).
[89] Section 6042.01.
[90] Section 6042.15.

With respect to sales and use tax provisions there are also substantial penalties. The failure by a merchant that is required to register is subject to a penalty of up to $10,000; selling or transferring a registration without authorization is subject to a penalty of $5,000; providing false information is subject to a penalty of $5,000; forgery of a registration certificate or knowing use of a fraudulent registration is subject to a $10,000 penalty.[91] The failure to remit the sales and use tax timely and in the required manner is subject to a penalty of not less than 25% and not more than 50% of the unremitted amount with a 100% penalty for repeat offenders.[92] Any person required to file the monthly sales and use tax return timely and in the manner required is subject to the greater of $100 or 10 percent of the tax liability on the tax return (failure to file electronically when required is considered a failure.)[93] Any merchant that fails to keep documents is subject to a penalty of up to $20,000 for each violation.[94]

With respect to real property taxes, there is an addition to tax of 5% if payment is made after 30 days but within 60 days from the due date, the penalty is increased to 10% for a delay of more than 60 days.[95] Any owner of property that willfully fails to report assets that have not been appraised for the levy of taxes to the Collection Center is subject to a misdemeanor and a fine of $500 and/or imprisonment for six months.[96]

With respect to personal property tax, if there is a delay in making a timely payment, there is a surcharge of 5% for a payment after 30 days but before 60 days, 10% penalty for a payment made after 60 days but before 90 days, and 15% for a payment after 90 days. In addition, if there is a failure to file the return timely, there is a penalty of 5% if the delay is not more than 30 days and an additional 5% per for each 30-day period or fraction thereof not to exceed 25%. In case of a deficiency, there is a 10% penalty for negligence or intentional disregard of the rules or regulations, and a 100% penalty if due to fraud. The interest on delinquent taxes is 10%.[97]

The interest rate for tax due on nonpayment and deficiencies is 10%[98] while the interest paid to the taxpayer on a credit or refund is 6%.[99] Thus, although not a penalty, the interest rate at 10 percent may be an incentive for taxpayers to make their tax payments on time.

2.7.2 Description of Options

Section 6030.02 provides for additions to tax for failure to pay. In general, there is no penalty if the payment is made within 30 days of the required payment date; 5% if the payment is made after 30 days but before 60 days, and 10% if made after 60 days. Although the date for payment may be extended, there is no general reasonable cause exception for failure to pay. However, there is a special rule for excise taxes and sales and use taxes. Section 6030.07 provides that the Secretary may release a taxpayer from the surcharges and interest established in section 6030.02 at his or her judgment and discretion. Also, the Secretary may fix a new date for payment under four stated conditions.[100] The conditions appear to be very limited. Moreover, there does not

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[91] Section 6043.03.
[92] Section 6043.04.
[93] Section 6043.05.
[94] Section 6043.06.
[95] 21 L.P.R.A. §5091.
[96] 21 L.P.R.A. §5069.
[97] 21 L.P.R.A. §5221.
[98] Sections 6030.01 and 6030.02.
[99] Section 6025.03.
[100] 1) When, within six (6) months of the effectiveness of a new provision of law or a regulation, a taxpayer submits a written consultation to the Secretary concerning a construction of such legal or regulatory provision due to the complexity of the matter involved, and the Secretary takes over ninety (90) days from the date of receipt of such consultation at his/her office to issue his/her answer.

appear to be a clear reason why this exception should only be applied to excise and sales and use taxes and not the other taxes.

Although interest continues to accrue on the nonpayment of tax after the 60th day, no additional penalty for failure pay apples. Perhaps, the penalty should continue to apply until it reaches a maximum, e.g., 5% per month or fraction thereof until it reaches a maximum of 25%.

Section 6030.03 provides for accuracy-related penalties on deficiencies for negligence or intentional disregard for rules and regulations, substantial undervaluation of income taxes, a substantial incorrect valuation of property; substantial overvaluation of contributions to certain pension plans, absence of financial substance in transaction, and estate tax incorrect valuation of a gift. The penalty is 20% of the deficiency except it is increased to 40% for gross valuation errors. Except for the negligence or disregard for rules and regulations, the penalty applies mechanical. There does not appear to be a reasonable cause exception for this penalty. Section 6030.08 provides a limited exception from penalties that would not apply in many cases. 156 Thus, it appears that a taxpayer who in good faith relied on a well-reasoned opinion from a qualified tax adviser with respect to a complex or complicated transaction would be subject to this penalty if the mechanical test applied.

If there is no reasonable cause relief for accuracy-related penalties, a taxpayer may be reluctant to file an amended return correcting an error because it would result in an automatic penalty. Consideration could be given to permitting a "qualified amended return". If a taxpayer files a qualified amended return (a return reporting an increased tax liability), before the taxpayer is contacted by the taxing authority for an examination for that year, the amount reported on the amended return will be deemed to have been reported on the original return and the taxpayer would not be subject to the penalty under section 6030.03 with respect to this increased amount.

Section 6030.09 provides that if taxes are not paid within 10 days of notice and demand after completing bankruptcy or receivership proceedings, interest shall accrue. A surcharge of 5% will if payment is after 30 days but before 60 days and 10% for over 60 days. This provision appears to be duplicative of section 6030.02.

The Code provides for various exceptions from penalties and surcharges if the taxpayer meets certain standards equating reasonable cause. The term "reasonable cause" is used with respect to section 6041.14 (failure to furnish information statement to recipient of income); section 6041.11 (failure to file certain information statements and statements of brokers or stockbrokers); section 6041.12 (failure to deposit taxes withheld); section 6041.13 (failure to furnish reports to special employee-owned corporation members; section 6042.15 (failure to file excise tax statement and monthly return); and section 6043.05 (failure to file monthly sales and use tax return); and section 6043.06 (failure to violating other provisions of sales and use tax).

The Code also uses the term "reasonable cause and not from willful carelessness" or "reasonable cause and not due to willing carelessness" for section 6030.11 (penalty for failure

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(2) When dealing with new items or taxable items that are new in the market of Puerto Rico, which create a reasonable doubt in terms of their taxable status, classification, or extent pursuant to the laws in effect, insofar as.
(3) When the taxpayer files a well-grounded, written allegation concerning his/her status as exempt from paying taxes, and the Secretary, by reason of the legal difficulty or complexity, takes more than ninety (90) days from the date of receipt of such consultation in his/her office to issue his/her answer.
(4) When the Secretary clearly and definitely leads a taxpayer to error when the taxpayer submits a written consultation concerning a contentious issue that until that time has not been clarified by any regulations or promulgation.

to file tax returns); section 6041.09 (individual failure to pay estimated tax; and section 6041.10 (corporation failure to pay estimated tax).

Section 6071.03 provides for administrative sanctions and monetary penalties for Specialists (tax return preparers) for violations such as failure to keep a copy of the return, furnish a copy to the taxpayer, failure to sign the return. However, the penalties are waived if "just cause is proven."

The use of these different standards to establish an exception from a penalty is confusing. A single standard should be considered.

Section 6071.03(a)(5) provides that when an underpayment of tax can be attributed to a deliberate act of a Specialist (tax return preparer), a fine of $1,000 can be imposed on the Specialist for each tax return or refund claim but is limited to $25,000 per year. The $25,000 annual limitation is the same as for a Specialist that acted negligently. For a deliberate act, the annual limitation be increased to a significantly higher.

Section 6071.02(a)(7) provides that the Specialist is required to include the registration number on the prepared return. However, there is no penalty for failure to include the registration number. The monetary penalties under section 6071(a)(3) for failure to sign the return could be modified to include failure to provide a registration number.

2.8 Transition

2.8.1 Issues

2.8.1.1 Cash Flow

Maintaining adequate cash flow is critical. Once alternatives are selected cash flow alternatives must be modeled. These considerations will affect the form and timing of transition relief

2.8.1.2 Time to Implement

A number of proposed changes will take time to implement. Failure to allow sufficient time to implement changes may jeopardize the project. In particular, moving to a GST may require from 18 months to two years to implement. In the interim, the revenue base must be maintained. Once decisions are taken as to the contours of the Governor's proposals appropriate timing and revenue options can be explored.

2.8.1.3 Protecting Economic Expectations

Fundamental fairness requires that tax changes protect the consequences of economic decisions that have been made in reliance on existing law. Thus, effective dates and phase-in provisions have to be considered carefully.

2.8.1.4 Public Education

A robust and comprehensive public education effort should commence as soon as practicable, particularly with respect to the introduction of a GST. The New Zealand program could be a template for the scope of a similar program in Puerto Rico.