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U.S. FEDERAL TAXES IN PUERTO RICO

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U.S. Federal Taxes in Puerto Rico

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Summary

U.S. federal taxes generally do not apply to individuals in Puerto Rico, with the exception of Social Security taxes. Instead, Puerto Rico levies its own taxes, at a level higher than those of most U.S. states, but lower than that of the federal government. For businesses, a partial federal tax exemption is provided by the Puerto Rican economic activities credit and the possessions tax credit under sections 30A and 936 of the Internal Revenue Code. Puerto Rico itself provides a set of partial tax exemptions that are designed to complement the special federal corporate tax benefit. However, under federal legislation enacted in 1996, the credits are currently being phased out and will expire entirely in 2006. Congress has frequently considered the tax treatment of Puerto Rico in the context of several different policy issues. For example, is the current partial application of federal taxes to Puerto Rico equitable, given the partial application of federal transfer programs to Puerto Rico? And, is the federal corporate tax benefit effective in promoting investment and employment in Puerto Rico? Also, because statehood or independence would each alter the federal tax treatment of Puerto Rico, federal tax policy has been an issue in deliberations over Puerto Rico's political status. This report will be updated as major legislative developments occur.

Individual Income Taxes

Normally, the United States taxes its citizens on their worldwide income, regardless of its geographic source, and Puerto Ricans are U.S. citizens. But while this would ordinarily mean that Puerto Ricans would be subject to full federal taxation, section 933 of the U.S. Internal Revenue Code (IRC) exempts residents of Puerto Rico from federal income tax on that part of their income that has its source in Puerto Rico. Thus, Puerto Ricans pay federal income tax only on income they receive from the United States or other non-Puerto Rican sources. For example, wage and salary income of a person living and working in Puerto Rico is normally exempt from federal tax.[1]

[1] Section 933 makes an exception for federal employees in Puerto Rico, and subjects them to federal tax. However, U.S. citizens who pay tax to Puerto Rico – including, for example, mainland residents with Puerto Rican income and U.S. federal employees in Puerto Rico – are permitted to (continued...)

Puerto Rico's own tax system is distinct from that of the other U.S. possessions in that Puerto Rico is not required to "mirror" the federal IRC and adopt federal tax rules and rates as its own.[2] Puerto Rico's rate structure is slightly lower than the federal structure, but its brackets are substantially narrower so that the higher rates apply at much lower levels of taxable income. Also, while Puerto Rico's tax system provides for personal exemption amounts and a standard deduction, they are smaller than those of the federal system. Nonetheless, the level of Puerto Rico's individual income tax revenue is roughly half that of the federal government: Puerto Rican taxes are 6.0% of Puerto Rican personal income; federal taxes are 11.3% of mainland personal income. The reason is doubtlessly that Puerto Rico's lower per capita income places more individuals in lower tax brackets compared to residents of the 50 states. At the same time, Puerto Rico's taxes apply at a higher rate than do those of most U.S. states.[3]

Corporate Income Taxes

Just as U.S. citizens are ordinarily subject to federal tax on their worldwide income, corporations chartered in the 50 states or the District of Columbia likewise pay corporate income tax on their worldwide income. But as with individual income taxes, a special exemption exists with Puerto Rico, in this case provided by two alternative tax credits: the possessions tax credit and the Puerto Rican economic activity credit, respectively provided by sections 936 and 30A of the U.S. Internal Revenue Code. Under either credit, a U.S. firm can exempt part of its Puerto Rico-source income from federal corporate income taxes. The possessions tax credit generally enables qualifying firms to exempt 40% of their income from federal tax. (Prior to 1993, firms could use the possessions tax credit to exempt all their Puerto Rican income from tax.) The essential elements of the economic activity credit were enacted in 1993, and provide an exemption linked with employment and investment in Puerto Rico: the more wages and depreciation a firm claims in Puerto Rico, the larger the exemption delivered by the credit.

In the years following World War II, the government of Puerto Rico depended on the possessions tax credit and its own set of tax benefits to attract investment to Puerto Rico from the U.S. mainland. The tax benefit and the inflow of investment it stimulated helped

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[1] (...continued)
credit Puerto Rican taxes they pay against their federal tax liability.

[2] Federal law requires the U.S. Virgin Islands, Guam, and the Commonwealth of the Northern Marianas to mirror the federal tax code. American Samoa is not required to mirror the federal system, but has nonetheless adopted the federal tax code as its own territorial system, with some modifications.

[3] Total state individual income taxes, though varying significantly by state, are 3.2% of U.S. personal income. The data for Puerto Rico are from: Puerto Rican Planning Board, *Economic Report of the Governor, 1998* (San Juan, 1999), p. A-32. Data for the United States are from: U.S. Executive Office of the President. *Economic Report of the President* (Washington: GPO, 2000), pp. 399, 404 . A more general comparison contrasts the level of all taxes(not just individual income taxes) collected in by each jurisdiction as a percentage of gross national product (GNP). In 1998, federal taxes were 21.5% of U.S. GNP, Puerto Rican taxes were 15.4% of the Commonwealth's GNP, and state taxes were 10.1% of U.S. GNP. (We use GNP rather than gross domestic product in the comparison because of the large outflow of factor payments from Puerto Rico.)

transform the Puerto Rican economy from one based on agriculture to one based on manufacturing, services, and trade. However, the credit was criticized on several grounds: that it had a high revenue cost compared to its employment effect; that a large share of the benefit did not accrue to residents of Puerto Rico; and that it distorted deliberations over Puerto Rico's political status. As a result, over the past 20 years the credit has been subject to a series of modifications designed to limit its revenue cost and tie the credit's benefit and effects more tightly to Puerto Rico–the 1993 revisions that capped the possessions tax credit at 40% and that linked the alternative credit to wages and depreciation were two such revisions. The modifications culminated with the Small Business Job Creation Act of 1996, which scheduled the credit for phaseout and ultimate repeal after 2005.[4]

An alternative tax benefit known as "deferral" is also available for mainland firms in Puerto Rico, although most U.S. firms in Puerto Rico currently use the tax credits rather than deferral. Deferral is available for U.S. firms operating through foreign subsidiaries in foreign countries as well as the U.S. possessions, and works like this: the United States taxes the income of corporations chartered in the United States on their worldwide income. At the same time, however, corporations chartered abroad or in the U.S. possessions are not subject to U.S. tax on foreign-source income or income earned in the possessions. Thus, U.S. firms can avoid federal taxes on their foreign or possessions income by arranging to earn that income through subsidiary corporations chartered in the possessions or abroad; the income the subsidiaries earn is generally not subject to federal taxes until it is repatriated to the mainland U.S. parent corporation as dividends or other income.

For many firms, the possessions tax credit and economic activity credit provide a larger tax benefit than deferral because possessions income that is exempt under the possessions tax credit is not subject to federal taxes when it is remitted to mainland parents. The deferral benefit, in other words, provides a postponement of tax while the exemptions afforded by the tax credits are permanent. Also, the tax code's rules governing allocation of income between tax-favored possessions subsidiaries and their mainland parents are more generous under the tax credit regimes.

In theory, Puerto Rico's own corporate income tax could nullify any corporate tax benefit provided under the federal tax if Puerto Rico were to tax what the federal government does not. However, Puerto Rico has enacted a set of its own tax benefits for businesses that complement the federal tax benefits.

Excise Taxes

In general, federal excise taxes apply in Puerto Rico only where the Internal Revenue Code explicitly extends them to Puerto Rico.[5] By this standard, most federal excise taxes

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[4] For further information on the tax credits, see CRS Report RS20695, *The Puerto Rican Economic Activity Tax Credit: Current Proposals and Scheduled Phaseout,* by David L. Brumbaugh.

[5] This point is made in: U.S. Congress, General Accounting Office, *U.S. Insular Areas: Information on Fiscal Relations with the Federal Government,* GAO/T-GGD-95-71 (Washington:
(continued...)

do not apply in Puerto Rico, including, for example, the federal gasoline tax, the tax on local telephone calls, and the tax on tobacco consumed in Puerto Rico. However, there are exceptions – notably the environmental taxes imposed under chapter 38 of the tax code on petroleum and certain chemicals.

A different type of exception is provided by section 7652 of the tax code, which applies a special "equalization" excise tax to items produced in Puerto Rico or the U.S. Virgin Islands and shipped to the U.S. mainland. The tax is equal to any excise tax that would apply to an identical item produced on the mainland, and was first imposed to ensure that producers in the possessions would not have a tax advantage over mainland-produced goods that are subject to excise taxes. All revenue from this so-called "equalization" tax, however, is returned ("covered over," or rebated) by the federal government to the treasuries of Puerto Rico and the Virgin Islands. In addition the Caribbean Basin Initiative of 1983 provides that all revenue from federal excise taxes on rum imported into the mainland from any source – including any foreign country – is remitted to the treasuries of Puerto Rico and the Virgin Islands.[6] In 1998, the rebates to Puerto Rico amounted to $200.3 million – 3.4% of the Puerto Rican government's revenue.[7]

A special limitation applies to the cover over of the tax on distilled spirits, which ordinarily applies at the rate of $13.50 per proof gallon. In general, the tax code limits the amount of this tax that is covered over to $10.50 per proof gallon. However, in 1999 Public Law 106-170 temporarily increased the cover-over rate to $13.25 per proof gallon during the period June 30, 1999 to January 1, 2002.

Other Taxes

Federal estate and gift taxes essentially do not apply to residents of the possessions, including Puerto Rico. In general, federal estate taxes apply to the estates of decedents who were U.S. citizens; they apply to estates of nonresident aliens only in the case of tangible property located in the United States. While residents of the possessions are generally U.S. citizens, a special provision exempts them in the same manner as nonresident aliens if their U.S. citizenship is derived solely from their birth or residence in a possession. Thus, for example, the estate of a person born on the mainland but who

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[5] (...continued)
1995), p. 20. In her definitive article on federal taxes and the possessions, Karla Hoff appears to link this principle to a 1901 Supreme Court Case (*Downes v. Bidwell*), which held that the U.S. Constitution is fully applicable only to those territories incorporated into the United States. Puerto Rico is not so incorporated. See Karla Hoff, "U.S. Federal Tax Policy Towards the Territories: Past, Present, and Future," *Tax Law Review*, vol. 37, Fall 1981, p. 56.

[6] The Caribbean Basin Initiative reduced customs duties on imported rum. This introduced the possibility that mainland sales of rum shipped from the possessions would fall, and so too would payments to the possessions of federal excise taxes from rum manufactured in the possessions. The additional payments were enacted to offset the expected loss of revenue. U.S. Congress, House, Committee on Ways and Means, *Caribbean Basin Economic Recovery Act*, 98th Cong., 1st Sess, H. Rpt. 98-266 (Washington: GPO, 1983), p. 26.

[7] Puerto Rican Planning Board, *Economic Report of the Governor, 1998*, p. A-33.

moves to Puerto Rico would generally be subject to the tax, while the estate of a life-long Puerto Rico resident would not.[8]

Federal Social Security and Medicare taxes apply in Puerto Rico, as do Federal Unemployment Tax Act (FUTA) taxes.

Puerto Rico is within the United States customs jurisdiction; U.S. customs duties apply to goods imported into Puerto Rico. However, as with excise taxes, revenue from the customs duties is rebated to Puerto Rico. In 1998 the rebates were $72.2 million.[9]

Financial Flows Between the Federal Government and Puerto Rico

One policy issue with respect to federal taxes is whether their current partial applicability is equitable: as U.S. citizens, should Puerto Ricans be fully subject to federal taxes? This, in turn, is an issue that cannot be addressed by looking at taxes alone. The manner in which federal transfer programs apply to the possessions also has a bearing, and some federal programs do not apply fully in Puerto Rico. The equity issue regarding taxes is thus whether the partial application of federal taxes to Puerto Rico is fair, given that not all federal spending programs extend fully to Puerto Rico.

A comprehensive description of how federal spending programs apply to Puerto Rico is beyond the scope of this report. Nonetheless, we make several general observations. Puerto Rico participates fully in the Social Security and Medicare programs. But at the same time, while they participate in most other federal welfare programs, federal funding for most of the programs is capped at a maximum dollar amount.[10]

Data provide detail on this situation. Tables 1 and 2, below, present numbers on federal spending and federal revenue collections in Puerto Rico. (The data are presented in separate tables because they are from separate sources and are therefore not strictly comparable.)

Table 1. Payments by Residents of Puerto Rico to the Federal Government: Puerto Rican Fiscal Year 1998
(in millions of dollars)

Total	Social Security, Medicare, and Civil Service Retirement Contributions	Unemployment Insurance Contributions	Other
$2,420.3	$2,156.8	$217.2	$46.3

Source: Puerto Rican Planning Board, *Economic Report of the Governor, 1998*, p. A-23. Puerto Rico's fiscal year is July – June.

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[8] Sections 2208 and 2209 of the Internal Revenue Code contain these provisions.

[9] Puerto Rican Planning Board, *Economic Report of the Governor, 1998*, p. A-33.

[10] U.S. Congress, House, Committee on Ways and Means, *2000 Green Book: Background Material and Data on Programs Wthin the Jurisdiction of the Committee on Ways and Means*, committee print, 106th Cong., 2d Sess. (Washington: GPO, 2000), pp. 761-75.

Table 2. Federal Outlays in Puerto Rico: Federal Fiscal Year 1998
(in millions of dollars)

Total	Retirement and Disability Payments	Other Direct Payments	Grants	Salaries and Wages	Procurement
$11,119	$4,031	$2,080	$3,895	$739	$374

Source: U.S. Department of Commerce, Bureau of the Census, *Consolidated Federal Funds Report: 1998, State and County Areas* (Washington: GPO, 1999), pp. 25-30.

While precise comparisons between the two tables cannot be made because of their separate sources, it is nonetheless clear that federal payments to Puerto Rico outstrip Puerto Rico's payments to the federal government by a wide margin. Yet this is not the full story: on a per capita basis, federal spending in Puerto Rico is substantially less than either the United States average or that of the poorest state (Mississippi). In 1998, per capita federal spending in Puerto Rico was $2,880 compared to $5,491 for the United States as a whole and $5,565 for Mississippi.[11] The relationship holds even when procurement and wages and salaries are subtracted out, leaving only transfer payments. This last comparison underlines the point that if Puerto Rico does not bear the full burden of federal taxes, neither does it participate fully in federal transfer programs.

How might the flow of funds to and from Puerto Rico change, if Puerto Rico were to become a state? In the case of taxes, Puerto Rico's low income level would severely limit the amount of additional federal tax that would be collected. A 1998 General Accounting Office study concluded that there would be a small revenue loss (less than $200 million) under the individual income tax, due primarily to payments of the refundable earned income tax credit. The revenue gain under the corporate income tax would depend on how firms react to the repeal of the economic activities credit after 2000 and would amount to $1 billion to $4.6 billion.[12] In the case of spending, the per capita comparisons in the preceding paragraph suggest that if Puerto Rico were treated like states, spending would increase substantially, and the increased outlays would likely be larger than increased revenue collections.[13]

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[11] Data for the United States and Mississippi are from U.S. Bureau of the Census Consolidated Federal Funds Report, 1998, available at the Bureau's web site: [http://www.census.gov/govs/www/cffr98.html#data]. More recent data for the United States are available, but we cite the 1998 figures because the most recent available tax data for Puerto Rico are for 1998.

[12] U.S. Congress, General Accounting Office, *Puerto Rico: Potential Federal Income Tax Revenues Resulting from Statehood*, GAO report GAO/GGD-98-166R (Washington, July 8, 1998), pp. 2, 7.

[13] This is also the conclusion reached by a 1990 Congressional Budget Office report: U.S. Congress, Congressional Budget Office, *Potential Economic Impacts of Changes in Puerto Rico's Status under S. 712* (Washington: April, 1990), p. A-2. However, several factors have changed since 1990: welfare reform and the scheduled repeal of the federal corporate tax credits.