Revenue Analysis – Puerto Rico Tax Incentive Bill

Section One
Background and Proposal Overview

Background – Income derived from operations of US corporations in Puerto Rico and other US possessions has received special tax benefits since the Revenue Act of 1921. The special tax benefits were intended to increase employment and investment in Puerto Rico and other US possessions.[1]

Until the early 1980's, many believed that these special tax benefits stimulated investment and helped to transform Puerto Rico's economy from an agricultural economy to one based on manufacturing. However, during the past twenty years, the Congress questioned more and more the efficacy of these tax provisions and consequently, modified many of these special tax benefits and, in some cases, repealed such provisions.

Present law phases out the tax credits available to Puerto Rico and the Virgin Islands. For taxable years beginning after 2006 and thereafter, the credit with respect to all possessions is repealed.

Proposal Overview – HR 2550 would amend the Internal Revenue Code (IRC) by providing special tax treatment for US-based companies operating in Puerto Rico and US possessions.[2] The bill would apply only to controlled foreign corporations (CFC's) that are incorporated or doing business in Puerto Rico and the possessions, but not to CFCs in other countries.[3] The bill has three major provisions that would:

- Exclude from worldwide income otherwise taxable income
- Provide generous transition rules for the transfer of intangibles
- Allow interest-free loans between the CFC and the domestic operations

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[1] While provisions contained in the Internal Revenue Code apply to all US possessions, the vast majority of the tax benefits accrue to US corporations doing business in Puerto Rico. More than 99 percent of all tax credits apply to corporations in Puerto Rico, with the remaining credits being attributable to Guam, American Samoa, the Virgin Islands, and the Northern Mariana Islands. Manufacturing claimed more than 95 percent of the tax credits, with drug manufacturers claiming 53 percent of all manufacturing credits. See "US Possession corporations," Miller, Randy, IRS – Statistics of Income, Fall 1999 Bulletin.

[2] S 1475 is the Senate version of HR 2550. There are several differences between the two bills, but none that alter the substance of the provisions.

[3] The bill permits corporations to elect annually such tax treatment and would apply to existing possessions corporations as well as newly established CFC.

Income Exclusion – Under HR 2550, a CFC operating in the possession may exclude from income tax 90 percent of otherwise taxable qualified income. Qualified income is defined as income generated in active business operations or in the sale or exchange of substantially all assets used in the business.[4]

Transition rules for intangibles – One barrier thought to deter possession corporations from electing CFC status is the inability to transfer intangible assets. The super royalty provisions in the transfer pricing rules act as a barrier to transferring intangible assets, by imposing a tax on the royalty value of the intangible. Under HR 2550, possessions corporations electing CFC status would be permitted to transfer intangibles without paying this tax.

Interest-free loans from the CFC to the US parent corporation – In addition to the generous tax benefits, HR 2550 allows interest-free loans between the newly created CFC and its US corporate owner. The CFC may loan to the US corporation from its qualified income without paying taxes on the interest income.

Section Two
HR 2550 Revenue Consequences

Possession corporations converting to CFC status could take advantage of existing tax benefits afforded to CFC's under the tax code as well as new tax benefits afforded under HR 2550.[5]

HR 2550 would reduce tax revenues by allowing CFC's to:

- Exclude from tax up to 90 percent of qualified worldwide income
- Use special transition rules to avoid taxes on the transfer of intangibles
- Make interest-free loans to the US corporate parent

Income Exclusion – Newly created possession CFC's could exclude from tax up to 90 percent of qualified income. In the case of Puerto Rican possession corporations, this is comparable to the generous provisions of section 936 (30A) prior to the phase out. This exclusion reduces the amount of income subject to income tax, thereby reducing the associated tax liability. *Allowing this exclusion could* ***reduce Federal fiscal year receipts by $2 – 4 billion per year****. The magnitude of the revenue loss*

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[4] Alternatively, the CFC may elect an 85 percent deduction for dividends received for such dividends paid from qualified income.

[5] The existing tax benefits available to all CFCs include: use of foreign tax credits; indefinite deferral of certain income accumulated in CFC's; and aggressive transfer pricing rules.

depends upon the timing of the conversion to CFC status and the expected growth rate of possession corporation revenues.

Transition rules for intangibles[6]**–** By electing CFC status for a possession corporation, domestic corporations could use these generous transition rules to transfer intangibles to the possession corporation and avoid Federal income taxes on such transfers. *Currently, US corporations hold $1.4 trillion in intangible assets. While it is unclear what percentage are attributable to US corporations doing business in US possessions,* ***estimates of the annual revenue loss attributable to US corporations doing business in US possessions could range between $1 – 2 billion****.*

Interest-free loans – Use of interest-free loans from possessions corporations to their domestic counterpart would provide an additional opportunity to shelter accumulated earnings from income. *The magnitude of this revenue loss depends upon the expected growth rate of possession corporation income, but* ***could reduce annual tax receipts by $100 – 200 million.***

Additional Revenue Consequences – In addition to the direct revenue consequences of HR 2550, there exists the potential for abusive behavior that would create additional revenue losses. Such abusive behavior includes:

- Establishing a possession CFC in Puerto Rico for the sole purpose of diverting income to the possession to take advantage of the generous income exclusion provisions in HR 2550
- Exercising aggressive use of existing transfer pricing practices to further reduce the taxable income of the US corporation

Revenue Consequences – Under HR 2550, estimates of annual revenue losses attributable to US corporations doing business in US possessions could range between $3 – 6 billion per year. This magnitude of this loss depends upon the timing of the possession corporation's conversion to CFC status as well as the growth of new CFC's in Puerto Rico. In any case, the combination of provisions contained in HR 2550 could provide benefits in excess of the section 936 possessions tax credit prior to its phase out.

[6] The transfer of intangible assets benefits primarily the large manufacturing corporations. Such corporations typically have large stocks of intangibles associated with developing their products.