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DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE
WASHINGTON, D.C.
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Mr. Chairman and Members of the Committee:

It is a pleasure to be here today on behalf of the Administration, to discuss S. 712, a bill "To Provide for a Referendum on the Political Status of Puerto Rico." This bill would give the people of Puerto Rico an historic opportunity to vote upon the status of that island. The bill would provide for a referendum, to be held in 1991, in which the Puerto Rican people could decide among the options of statehood, independence, or commonwealth status.

The Administration strongly supports the right of the people of Puerto Rico to decide for themselves on the status of the island. Further, as the President has noted a number of times, he favors the admission of Puerto Rico to the Union as a state, thereby assuring the people of Puerto Rico an equal standing with other United States citizens. However, by providing for a status referendum, the United States Government would be assisting the Puerto Rican people to exercise the basic political right to determine the nature of their government.

The choice facing the people of Puerto Rico is fundamentally a political one, with long-term implications for their rights and obligations as citizens. Each voter must determine for himself or herself the type of political relationship that should exist between Puerto Rico and the United States. By its very nature, a status referendum determines a people's political future. Individual voters must weigh the implications of their vote not only for themselves but also for future generations.

The Administration firmly believes that the Puerto Rican people should be given an opportunity to express their will in a manner that recognizes the historic and fundamentally political nature of their decision of self-determination. The importance of the decision they face as a people transcends any narrow concern about specific aspects of economic or fiscal structures.

For this reason, the Administration believes that the discussion of Puerto Rico's future status should not be

encumbered at this stage by the tax and financial provisions in the current bill. The selection among the possible status options should be a choice made by the people of Puerto Rico unaffected by the bias which specific economic costs and benefits could bring to the process. After that choice has been made, appropriate tax and financial relationships between Puerto Rico and the United States could be formed consistent with the choice of the Puerto Rican people.

The Administration recognizes the difficulty of isolating the impact of tax and financial issues from the question of Puerto Rico's future status. Appropriate transition mechanisms will ultimately have to be developed to minimize economic disruption to Puerto Rico resulting from any change from the current commonwealth status. In addition, we believe that a transition to statehood can be structured so that the Puerto Rican government, after making appropriate use of its own resources, would not be forced to incur a net revenue loss during this transition. The Administration would support a "transition grant" to Puerto Rico to assist in achieving that result. The budgetary treatment of a transition to statehood should be consistent with sound budget discipline. Finally, we believe that there should be a level economic playing field among options.

The development of provisions which will properly achieve these goals will require a careful cooperative analysis by the Administration, Congress, and the government of Puerto Rico. The resulting package would probably consist of interrelated provisions affecting Puerto Rico's own tax system, the Federal tax system, and direct Federal grants. Accordingly, depending on the specific alternatives chosen, many will be involved in the process, including, for example, the tax-writing committees of the Congress.

The Administration looks forward to working with your committee at the appropriate time in fashioning an integrated economic package which meets the Administration's commitments to Puerto Rico and which is fully acceptable to both Congress and the Puerto Rican government. To lay a foundation for that process, I would like to review with you today some of the technical issues which are presented by the provisions in the current bill. While not intended as either an endorsement or rejection of these provisions, my comments will hopefully highlight particular problems which the current language raises.

Each of the political options covered by the bill -- statehood, independence, and commonwealth status -- raises special issues that affect the tax systems of both Puerto Rico and the United States. The following comments are limited to those issues. They are not intended to reflect any views on the desirability of any of the status options.

Regardless of the status option under consideration, we believe that a primary goal of the bill in question should be to ensure that the tax implications of the option are clearly defined. Certainty in the application of the tax law is always a goal of tax policy, and we believe that it is especially important to strive for that certainty in these circumstances, where the Puerto Rican people are facing the possibility of fundamental changes to their government's structure. The focus of my testimony, therefore, will be to identify the tax results of this bill's provisions as drafted, to note those ambiguities which the bill raises, and to highlight those issues which the bill's tax provisions do not currently address.

I. GENERAL REVENUE EFFECTS OF S. 712

It is difficult to present very precise estimates of the Federal revenue consequences of the various options described in the bill, but it may be helpful for purposes of this discussion to consider some rough guidelines.

Both the independence and the statehood options assume some form of reduction of the tax incentives currently provided under Internal Revenue Code ("Code") section 936. It should be noted that even under the commonwealth option, Congress can continue to review and revise section 936 and other tax benefits as necessary.

We estimate that in FY 1989 the tax benefits received by section 936 corporations amount to about $1.9 billion. If section 936 benefits are phased out, some section 936 corporations may choose to leave Puerto Rico. However, the nature of most section 936 company operations makes it unlikely that they could find a good substitute for Puerto Rico in some low-tax foreign location. Thus, if companies do leave the island, it is most likely that they would move back to the mainland where they would be subject to U.S. tax.

A phase-out of section 936 benefits would cause economic dislocation on Puerto Rico, at least in the short run. Employment in 936 companies now accounts for about 12 percent of total Puerto Rican employment. However, it is very difficult to project the extent to which Federal tax collections would be affected by this dislocation. Under the statehood option, collections of personal income tax may be somewhat reduced for a time; but as discussed below, fully phased-in Federal personal income tax collections from Puerto Rico can be expected to be relatively modest.

The statehood option presents the issue of how a newly-imposed Federal income tax will interact with a Puerto Rican state tax system. The effects of this change must be considered for both individual and business tax revenues.

The extension of Federal income tax to individuals in Puerto Rico would perhaps raise some $500 million per year. In comparison, the Puerto Rican government collected about $900 million in personal income taxes in their fiscal year ending June 30, 1989, or about 30 percent of total Puerto Rican revenue from local sources. This amounted to only about 5 percent of personal income in Puerto Rico.

As a state, Puerto Rico could design an income tax which would maintain combined revenue levels. Under either the commonwealth or independence options, Puerto Rico could continue a system similar to the current Puerto Rican tax.

With respect to business taxation, the Puerto Rican government now collects about $1.0 billion a year in taxes from business, which represents about 10 percent of business income. Since about 40 percent of this revenue is collected from exempt section 936 corporations, Puerto Rico may experience some loss of revenue if a phase-out of section 936 benefits causes any of these companies to reduce their Puerto Rican operations.

Under statehood, Federal corporate tax would also apply to Puerto Rican business that does not now benefit from section 936. This includes locally incorporated, or foreign, companies as well as section 936 corporations that do not receive a full or partial exemption from Puerto Rican tax. This would increase Federal revenues by about $300 million per year at 1989 levels.

Puerto Rico does not now pay Federal excise taxes. Assuming that by virtue of its becoming a state, U.S. excise taxes became applicable within Puerto Rico, this change would result in an increase in revenues of approximately $150 million. In addition, the Federal Government would gain approximately $100 million per year in customs duties which are now collected and segregated for the benefit of Puerto Rico.

Finally, Puerto Rico may choose to make adjustments on the expenditure side instead of, or in addition to, adjustments on the revenue side. Government employment now accounts for 23 percent of total employment in Puerto Rico. In addition, Puerto Rican government enterprises play a very important role in the Puerto Rican economy. A reduction of these expenditures, either to reduce taxes or to provide incentives to business may, therefore, be one of the consequences of any phase-out of current provisions.

Under the independence option, a phase-out of section 936 benefits would increase Federal tax collections if 936 corporations remained in Puerto Rico as U.S. corporations or if they moved back to the United States. However, some Puerto Rico-oriented companies in routine industries, such as apparel or food processing, may choose to reincorporate as Puerto Rican companies. The Federal revenue gain may therefore not be quite as large as under statehood. Under the independence option,

Federal excise taxes would only apply, as they do now, on imports from Puerto Rico; and the Federal Government would not collect any customs duties on goods imported into Puerto Rico. However, this would be offset somewhat by increased customs collections on imports from Puerto Rico. In addition, there might be a modest revenue pickup from withholding taxes on dividends paid to Puerto Rican residents, etc.

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With the above rough estimates in mind, I would now like to turn to a technical review of bill as drafted. Before discussing the bill's specific provisions, however, it may be useful to briefly summarize the tax relationship that currently exists between Puerto Rico and the United States.

II. SUMMARY OF EXISTING TAX LAWS

Generally speaking, the Commonwealth of Puerto Rico is not considered part of the "United States", as that term is used in the Internal Revenue Code ("Code") (see section 7701(a)(9) and (d)). Thus, Puerto Rico has its own tax laws, and the U.S. internal revenue laws do not extend fully to Puerto Rico. Depending upon the nature of the tax involved, different methods have been used to allocate taxing jurisdiction between the two governments.

A. Income taxes

United States income tax. The United States generally taxes the worldwide income of U.S. citizens, resident alien individuals, and domestic corporations. It also taxes the U.S. income of foreign corporations and nonresident alien individuals. Two important provisions affect the U.S. taxation of U.S. persons with Puerto Rican income.

First, under section 933 of the Code, the United States exempts the Puerto Rican source income of individuals who are bona fide residents of Puerto Rico. Consistent with section 933, U.S. citizens resident in Puerto Rico may be exempted from the withholding of Federal tax on their Puerto Rican source earnings (see section 3401(a)(8)).

Second, section 936 provides an effective exemption for certain Puerto Rican income of qualifying U.S. corporations that elect its benefits and that are engaged in business in Puerto Rico. The exemption is granted in the form of a "tax sparing" credit, under which the company's U.S. tax liability on its qualifying Puerto Rican income is reduced by a credit for a hypothetical Puerto Rican tax equal to the amount of U.S. tax due on that income. Because Puerto Rican tax law provides generous exemptions to certain business operations there, section 936 corporations enjoy a very low aggregate effective tax rate.

Puerto Rican income tax. Puerto Rico is authorized by Congress to enact its own income tax system. In 1954, the Puerto Rican legislature adopted its present income tax system, which is based on the U.S. Internal Revenue Code of 1939. In the absence of a tax exemption grant, Puerto Rico taxes all Puerto Rican source income earned by U.S. and foreign persons (including corporations) and taxes the worldwide income of all Puerto Rican resident individuals and Puerto Rican corporations.

The Puerto Rican individual income tax rates are somewhat higher than corresponding U.S. rates, and the Puerto Rican personal exemptions are somewhat lower than the U.S. exemptions. This will remain true even after tax law changes enacted by the Puerto Rican legislature in 1987 are fully phased in.

Under a series of industrial incentives laws, Puerto Rico has granted generous exemptions to certain business and investment income of qualifying businesses. Thus, while Puerto Rico's nominal corporate tax rate is slightly higher than the U.S. corporate tax rate, the exemption grants significantly reduce the effective Puerto Rican corporate tax rate.

B. Estate and gift taxes

United States estate and gift taxes. The United States taxes the worldwide estates of U.S. citizens and noncitizen decedents domiciled in the United States, as well as the U.S. situs estates of nondomiciliary aliens. The United States allows a foreign tax credit for Puerto Rican estate taxes imposed on the Puerto Rican situs estate of U.S. decedents (see section 2014(g)). Similarly, the U.S. gift tax applies to all gifts by U.S. citizens and noncitizen domiciliaries, and to gifts of U.S. situs property by nondomiciliary aliens. For purposes of the U.S. estate and gift taxes, U.S. citizens resident in Puerto Rico who are citizens solely because of being citizens of Puerto Rico or because of their birth or residence in Puerto Rico are treated as nondomiciliary aliens, taxable only on transfers of U.S. situs property (see sections 2208, 2209, 2501(b), and 2501(K)).

Puerto Rican estate and gift taxes. Puerto Rico generally taxes the worldwide estate of Puerto Rican resident decedents and the Puerto Rican situs estate of nonresident decedents. The amount of Puerto Rican estate tax on the Puerto Rican situs estate of a U.S. citizen resident in Puerto Rico can depend upon whether the United States includes that property in the U.S. gross estate. Puerto Rico allows a credit for U.S. estate taxes paid on the U.S. situs property of a Puerto Rican resident decedent. Similarly, Puerto Rico taxes all gifts by Puerto Rican resident donors and gifts of Puerto Rican situs property by nonresident donors.

C. Employment taxes

The various Federal employment taxes, including the self-employment tax (section 1401), the social security or FICA taxes (sections 3101 and 3111), and the unemployment insurance or FUTA tax (section 3301), are fully applicable within Puerto Rico as in the United States. (See sections 1402(b), 3121(e), and 3306(j)).

D. Excise/sales taxes

U.S. excise taxes. The United States does not impose a broad-based Federal sales tax. The Code does, however, impose a wide variety of excise taxes, including retail taxes, manufacturer taxes, services taxes, environmental taxes, alcohol taxes, etc. Generally, these taxes do not apply within Puerto Rico because of an exemption in the Puerto Rico Federal Relations Act (48 U.S.C. sec. 734).

Code sections 7652 and 7653 provide special rules with respect to taxes on articles manufactured in Puerto Rico and shipped into the United States, and *vice versa*. Basically, these rules treat such shipments as if they were imports from or exports to a foreign country. Under section 7652, articles of Puerto Rican manufacture shipped into the United States are subjected to a Federal tax equal to the amount of the Federal tax that would apply to similar articles manufactured in or imported into the United States. For example, by virtue of section 7652, the United States imposes a tax at the rate of $12.50 per proof gallon on distilled spirits produced in Puerto Rico and shipped into the United States, because that is the tax imposed on U.S.-produced distilled spirits.

The special feature about these rules, however, is that they call for a rebate or "cover-over" of these equalization taxes to Puerto Rico. Section 7652(a) generally requires the United States to cover over to the Puerto Rican Treasury the amount of these Federal equalization taxes imposed on Puerto Rican articles shipped into the United States. In addition, section 7652(e) generally requires the United States to cover over to Puerto Rico (and, under a sharing arrangement, to the Virgin Islands) the Federal tax collected on all rum imported into the United States. By virtue of section 7652(f), however, the amount of these alcohol taxes to be covered over to Puerto Rico cannot exceed $10.50 per gallon.

Section 7653(b) provides that articles otherwise subject to Federal taxes will be exempt from the normal taxes if they are shipped into Puerto Rico. Instead, section 7653(a) imposes a tax on such items equal to the amount of Puerto Rican tax applicable to similar items manufactured in Puerto Rico.

Puerto Rican excise taxes. Pursuant to excise tax amendments enacted in 1987, Puerto Rico imposes a 5 percent excise tax on a broad range of commodities, transactions, and occupations.

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I would now like to turn to a review of the issues presented by the tax provisions under each of the three political options described in the bill.

III. COMMENTS ON STATEHOOD OPTION

A. In General

Status of pre-existing laws. Title II of S. 712, relating to the statehood option, contains three sections which are particularly relevant to the application of both the U.S. and Puerto Rican tax laws. These sections are:

- Section 9 (Laws in Effect), which provides that Puerto Rico's territorial laws remain in force after statehood until amended or repealed by Puerto Rico, and that all Federal laws will have the same force and effect within Puerto Rico as elsewhere in the United States.

- Section 14 (Repeal and Amendment of Inconsistent Laws), which provides that all Puerto Rican or Federal laws or parts thereof which are in conflict with S. 712 are repealed or amended to conform with S. 712.

- Section 16 (Economic Adjustment from Territory to State), which provides a number of special rules relating to the adjustment of Puerto Rico's tax status.

We are not at all sure how these three provisions are intended to interact in the tax area. The ambiguity affects the status of pre-existing laws of both Puerto Rico and the United States.

For example, section 16(a) provides that Puerto Rico's income tax laws shall stand repealed upon admission of the state. Section 16 is silent about the remainder of Puerto Rico's tax laws. This could mean that all of Puerto Rico's tax laws, other than the income tax laws explicitly mentioned in section 16, remain in effect as state taxes until amended, by virtue of section 9. In other words, section 14 might be read narrowly to repeal or amend only those Puerto Rican tax laws which are manifestly inconsistent with S. 712 by virtue of being explicitly repealed or amended by some other specific provision of S. 712. Alternatively, one might read section 14 broadly to repeal or amend those Puerto Rican tax provisions, in addition to the

income tax provisions explicitly mentioned in section 16, which are inconsistent with the general structure of a state tax system (e.g., the provision granting a credit against Puerto Rican estate tax liability for Federal estate taxes imposed on the U.S. situs property of a Puerto Rican resident decedent).

Similarly, section 9 provides that Federal laws shall have the same force and effect within Puerto Rico as elsewhere in the United States. Section 16(a) generally reaffirms this approach with respect to Federal income tax laws by providing that "Federal Income Taxes" shall immediately apply to Puerto Rico. However, section 16(b) requires Congress to make provision so that "economic and fiscal exceptions of the Internal Revenue Code, already granted, such as those allowed under Section 936 of said code" shall remain in full effect for an unspecified number of years. Section 16(b) does not provide further guidance on the scope of the Federal tax exceptions that are to continue to apply to Puerto Rico. It is therefore impossible to tell which exceptions other than Code section 936 are intended to continue to apply to Puerto Rico.

Thus, S. 712 as currently drafted does not provide clear guidance as to the types of provisions of pre-existing Puerto Rican or U.S. tax law that are intended either to continue or to be repealed upon admission of the state. The draft bill indicates that detailed additional provisions are expected to be added to section 16 of Title II of the bill. Such additional provisions could undoubtedly help to provide greater certainty to both taxpayers and the revenue authorities on the tax implications of the statehood option.

Each of the special tax arrangements which would apply to Puerto Rico under the statehood option of S. 712 could be subject to challenge under the uniformity clause of the Constitution (Art. I, sec. 8, cl. 1), which broadly requires taxes to be uniform throughout the United States. We recognize that the tax committees would have to address the specific issues that could be presented with respect to each particular tax arrangement. Nevertheless, these issues must be fully addressed with respect to such tax provisions before a definitive position on their inclusion and effect can be developed.

Bearing in mind the fact that certain key provisions in the bill's tax provisions remain incomplete at this time, I would like to discuss certain implications of those provisions.

B. Specific Provisions of Section 16

1. Section 16(a)

Basic approach. Paragraph (a) of section 16 describes the basic structure of the income tax changes that would take place upon Puerto Rico's admission as a state. First, it provides that Puerto Rico's income tax laws would stand repealed immediately.

Second, subject to certain exceptions to be discussed later, it provides that Federal income tax laws would apply immediately to Puerto Rico. Third, it provides that there would be some cover-over of Federal income tax revenues to Puerto Rico for an unspecified transitional period.

Repeal of Puerto Rican income tax laws. There are a few points worth noting about the repeal of Puerto Rico's income tax laws. First, as already noted, section 16(a) repeals only the income tax laws of the Commonwealth of Puerto Rico. Accordingly, the bill would apparently leave in place other Puerto Rican tax laws (e.g., estate and gift taxes, excise taxes, property taxes, etc.). Second, the repeal of the income tax laws would reduce annual Puerto Rican tax collections by about $2 billion (based upon the Governor's proposed fiscal 1989 budget). Finally, as a technical matter, the bill seems to tie the effective date of the repeal of the income tax laws to the date of admission of Puerto Rico as a state, rather than to the beginning or end of a taxable year. The bill does not indicate whether administrative provisions of the Puerto Rican income tax law would remain in effect to allow the Puerto Rican tax authorities to complete processing of pre-admission taxable years. If Federal income taxes were to become applicable on the January 1 following admission, tax administration would be facilitated. The Puerto Rican income tax law could be continued thereafter for the limited purpose of allowing Puerto Rican authorities to continue to process and collect liabilities under prior law. Moreover, any such provision would explicitly acknowledge the power of the Puerto Rican Commonwealth Legislature to provide an interim state income tax should it choose to do so, pending enactment of a permanent income tax system by the state legislature after statehood.

Extension of Federal income taxes to Puerto Rico. There are also several points worth noting about the immediate extension of Federal income taxes to Puerto Rico. Again, as already noted, the bill does not clearly indicate whether other Federal taxes are meant to be extended fully to Puerto Rico.

With respect to U.S. citizens resident in Puerto Rico, the extension of the income tax laws presumably means that they will become subject to Federal taxes, rather than Puerto Rican taxes, on their Puerto Rican source income. This will be the result as long as the exclusion of Puerto Rican source income formerly provided by Code section 933 is not preserved under section 16(b) of the bill. The bill would also seem to require that these individuals become subject to the withholding of Federal income taxes on their Puerto Rican earnings.

With respect to non-U.S. citizens resident in Puerto Rico, their U.S. income tax status would depend upon their classification as either resident aliens or nonresident aliens,

taking into account the inclusion of Puerto Rico as part of the United States for purposes of applying the resident alien definition of Code section 7701(b).

The substitution of the Federal income tax regime for the Puerto Rican income tax regime also raises a number of issues for Puerto Rican corporations. Because of the inclusion of Puerto Rico as part of the United States after admission, these corporations, which are now treated as foreign corporations for U.S. income tax purposes, would be treated as domestic corporations. This would generally mean that Puerto Rican corporations would become subject to full U.S. income tax on their worldwide income.

If the section 936 credit become available to these corporations under the statehood option -- because they would become U.S. corporations -- they might thereby preserve their exemption from U.S. tax on their Puerto Rican income. The availability of the section 936 exemption, combined with the repeal of the Puerto Rican income tax, could result in a decrease in the income tax liability of Puerto Rican corporations that pay partial or full Puerto Rican income tax now (because they do not qualify for full exemption under the Puerto Rican incentives tax legislation). The section 936 benefit is potentially available to a broader, or at least a different, class of companies than the Puerto Rican incentives tax exemptions. In addition, Puerto Rican locally incorporated companies that had been fully exempt under the Puerto Rican tax system might become subject to tax (for example, if they failed to qualify for exemption under section 936).

The recharacterization of Puerto Rican corporations as domestic corporations could have a number of corollary effects on those corporations, their affiliates, shareholders, and lenders, none of which are explicitly addressed by the draft bill. For example, the change might or might not be treated as an inbound reorganization triggering the provisions of Code section 367, which could result in a taxable event. The change would raise the question of whether various corporate tax attributes from the Puerto Rican system would carry over for Federal income tax purposes (e.g., net operating losses, earnings and profits, method of accounting, etc.). The change could result in a Puerto Rican corporation becoming eligible for the first time to join in the consolidated return of its U.S. affiliated group, with corresponding questions about its ability to use accumulated losses against the income of such a group.

The Puerto Rican corporation could become eligible for the first time to be treated as a small business ("S") corporation as defined in Code section 1361, with the effect of eliminating its corporate tax liability altogether. (This effect would be independent of section 936 and would provide an alternative exemption for qualifying corporations if section 936 also remained in effect.) If the Puerto Rican corporation had been a

controlled foreign corporation under Subpart F of the Code, it would presumably shed that status, although the impact of such a change on matters such as its section 959 "previously taxed income" account would have to be addressed. Interest and dividends paid by the Puerto Rican corporation would become U.S. source income, potentially ineligible for the section 936 exemption in the hands of recipient section 936 companies, but eligible for the 70% or 100% deduction of dividends received under Code section 243.

As indicated by the issues just discussed, the extension of the Federal income tax law to the state of Puerto Rico would raise a myriad of highly complex tax questions. Accordingly, careful consideration should be given to ensuring that there would be a flexible mechanism for resolving such issues.

Cover-over of Federal income taxes to Puerto Rico. Section 16(a) also provides for the cover-over to the Puerto Rican Treasury of certain Federal income taxes. The bill's language raises a number of issues.

First, the bill does not clearly indicate how to measure the amount of Federal income taxes that would be covered over to Puerto Rico. A number of different measurement approaches and combinations thereof are conceivable. For example, the cover-over could be equal to the amount of Federal income taxes collected on Puerto Rican source income of all U.S. taxpayers. This would require all U.S. taxpayers to report separately the amount of their Puerto Rican source income and their other income, and to allocate an appropriate amount of deductions to their Puerto Rican source income in order to determine the amount of their Federal tax liability attributable to that income.

Alternatively, or in combination with that approach, the cover-over could include the amount of Federal income taxes collected on the worldwide income of Puerto Rican residents. For purposes of this alternative, Puerto Rican residents could be deemed to mean individuals resident in Puerto Rico and Puerto Rican corporations. This alternative would require individuals to report their status as residents of Puerto Rico under whatever residency standard would be established for that purpose. The calculation of the separate Federal tax liability of a Puerto Rican corporation could be difficult where, for example, that corporation is part of a U.S. consolidated group.

If the cover-over measure is intended to be linked to the amount of income tax Puerto Rico would have collected if its income tax law had remained in effect, the cover-over measures just described could be limited by imposing as a cap the amount of Puerto Rican tax that would have been collected from the taxpayer on the affected income if Puerto Rico's tax laws were still in effect. Such an approach would require the additional computation and reporting of the hypothetical Puerto Rican tax liability under the principles of pre-statehood Puerto Rican law,

or some rough estimate based on actual Puerto Rican collections in the last pre-statehood years.

The bill calls for a phase-down of the cover-over during an unspecified number of years ("the proceeds of said taxes shall be transferred to the Treasury of Puerto Rico in an amount to be diminished by ____% of the monies collected each year for a ____year period"). Apparently, this language is intended to result in a straight-line reduction of the cover-over during the transitional period. The bill does not mention any other adjustment to the cover-over amount. For example, the cover-over amount apparently would not be adjusted to reflect in any way the amount of state income tax revenues that Puerto Rico might collect during the transition period by enacting state income tax laws. In addition, the bill does not mention any adjustment that might be made to the cover-over amount to reflect rebates or other subsidies that Puerto Rico might grant to taxpayers whose Federal income tax payments are being covered over to Puerto Rico. The bill does not provide the rule enacted in 1984 (in Code section 7652(c) and (d)) to limit certain Federal excise tax cover-overs in cases where the Federal tax revenues attributable to Puerto Rico are liable to be artificially inflated or otherwise manipulated.

2. Section 16(b)

Section 16(b) calls upon Congress to make provision so that "economic and fiscal exceptions of the Internal Revenue Code, already granted, such as those allowed under Section 936" shall be continued in full for an unspecified period after statehood, to be phased out gradually thereafter. This provision raises a number of questions. For example, it does not indicate which "exceptions", other than section 936, are intended to be retained during the transitional period. Thus, the provision does not specify whether it is intended to cover section 243(b)(1)(C) (relating to the 100 percent dividends received deduction for certain dividends from section 936 companies) or section 933 (relating to the exemption from Federal tax for the Puerto Rican source income of bona fide residents of Puerto Rico).

In addition, the bill does not clearly indicate when or how Congress would make provision to continue section 936 or other exceptions, nor does it indicate how long such exceptions would continue. Moreover, the bill provides no guidance on whether section 936, if it were to continue for Puerto Rico, would be frozen in its current form, or whether Puerto Rico's version of section 936 would be subject either to whatever amendments Congress might subsequently make to section 936 as it applies to other possessions, or to subsequent amendments specifically applicable to Puerto Rico.

The bill appears to envision that section 936 would remain in effect not only for corporations which had elected its benefits

prior to statehood, but also those which might elect its benefits after Puerto Rico becomes a state.

While most section 936 companies currently benefit from Puerto Rican income tax exemptions under the industrial incentives legislation, thereby paying very little income tax, the effect of continuing section 936 while simultaneously repealing Puerto Rico's income tax laws could mean that all section 936 companies would enjoy a total elimination of their income tax liability as a result of statehood.

The section 936 exemption applies not only to Puerto Rican business profits of U.S. corporations, but also to their Puerto Rican source investment income derived from qualifying investments of those profits. The latter category of investment income, known as QPSII ("qualified possession source investment income"), can include income from lending section 936 funds through a Puerto Rican financial institution to qualifying borrowers in beneficiary countries of the Caribbean Basin Initiative (CBI). The bill does not indicate whether the transitional period during which section 936 would remain in effect would be the same for both operating profits and the income from investing those profits in QPSII investments.

3. Section 16(c)

Section 16(c) calls for Congress to enact an omnibus act to, among other things, "assure appropriate continuity in the treatment...of alcohol excise taxes". It is not clear whether this provision contemplates a permanent continuation of the cover-over of U.S. alcohol excise taxes that occurs under Code section 7652 or a gradual phase-out similar to those mentioned in sections 16(a) and 16(b).

The Federal excise tax cover-over method of providing funding to the Puerto Rican Government has given rise to concerns about equity relative to state governments. For example, the Senate Finance Committee in 1984 expressed the view that the practice should not be expanded without a thorough examination of that issue. S. Rep. 98-169, I-1000. Additional concerns have arisen from the provision by Puerto Rico of subsidies to producers of articles subject to the Federal excise tax.

IV. COMMENTS ON INDEPENDENCE OPTION

A. In General

Title III of S. 712 deals with the independence option, and section 5.4 of Title III specifically addresses a number of tax issues. More generally, however, section 4.1(a) deals with the status of pre-existing law upon proclamation of independence. Section 5.3 commits the United States not to impose trade barriers or quotas on merchandise coming into the United States

from Puerto Rico until proclamation of independence and for twenty years thereafter.

Status of pre-existing laws. Under section 4.1(a)(2), all U.S. laws applicable to Puerto Rico immediately prior to independence shall no longer apply in the Republic of Puerto Rico. For purposes of U.S. tax laws, this provision presumably means that those Federal tax laws that treat Puerto Rico either as part of the United States or as a possession of the United States shall no longer apply, and that Puerto Rico shall instead be treated exclusively as a foreign country for U.S. tax purposes. Thus, for example, U.S. citizens living and working in Puerto Rico could become eligible for the foreign earned income exclusion under Code section 911. Generally, except for the section 911 exclusion, income derived by U.S. citizens and residents from foreign sources is subject to U.S. tax with a credit for foreign income taxes. However, this system would be substantially modified with respect to Puerto Rico by the bill's proposal to continue section 936.

Under section 4.1(a)(3),

> all laws and regulations of the Commonwealth of Puerto Rico in force immediately before the proclamation of independence shall continue in force and shall be read with such modifications, adaptions, qualifications, and exceptions as may be necessary to bring them into conformity with the Constitution of the Republic of Puerto Rico, until such time as they shall be replaced with new legislation . . . .

In other words, Puerto Rico's tax laws would generally remain in effect as national tax laws in an independent Puerto Rico, until changed by new legislation.

Both of these general conclusions are subject to the special provisions of section 5.4, to which we now turn.

B. Section 5.4(a)

Continuation of section 936. Section 5.4(a) provides that the section 936 credit currently allowed under the Code shall remain in full force for 15 years after independence with respect to corporations which now or at any time during that period meet the requirements of section 936. There are several points to note about this provision.

First, this language indicates that it is the present intention of Congress that section 936 benefits, as currently provided in the Code, would continue to apply without change to companies doing business in Puerto Rico. Pursuant to this language, this would seem to be the case regardless of whether the basic 936 credit, as it applies to the remaining U.S.

possessions, might be changed by Congress after Puerto Rico's independence. This feature of the bill is problematic in light of the numerous amendments that have been made to section 936 in recent years.

Second, the bill would not only preserve 936 benefits for those companies which are currently receiving them, but would also provide them to U.S. companies which might set up operations in Puerto Rico at any time during the transition period. Moreover, the proposed continuation of section 936 is not tied to any continuation of the industrial incentives tax legislation of Puerto Rico. In other words, the bill as drafted would require the United States to continue to exempt the Puerto Rican income of section 936 companies even if Puerto Rico substantially increased its level of taxation on those companies.

Third, the proposed continuation of section 936 raises a significant question about the bill's impact on understandings reached with a number of U.S. income tax treaty partners (including China, Korea, Barbados, Cyprus, Jamaica, Malta, and Morocco) to the effect that those treaties would be renegotiated or amended to include tax sparing provisions if the United States ever gave tax sparing to any other foreign country. We have not attempted to quantify the revenue cost of implementing those changes in the event this provision triggers such changes. However, it should be noted that it has been a cornerstone of U.S. tax treaty policy, supported by both Congress and the Executive Branch, that tax sparing credits (such as those provided under section 936) will not be included in U.S. tax treaties with other countries.

Finally, the bill is unclear with respect to the scope of the U.S. tax benefits that are intended to be preserved along with section 936. For example, section 5.4(a) does not mention the 100 percent dividends received deduction applicable to certain dividends from 936 companies under section 243. However, the language of section 5.4(b), to which we now turn, implies that the dividends received deduction is intended to be preserved.

C. Section 5.4(b)

Phase-out of section 936. Section 5.4(b) contains a number of provisions relating to the phase-out of the section 936 benefit after the initial 15-year period.

First, the section provides that in the tenth year after independence, an joint Puerto Rican-U.S. commission shall be established to recommend changes to the section 936 benefit to take place at the end of the 15-year period. If this group cannot agree on changing the credit, the bill provides that the basic exemption shall remain in full force through the 25th year after independence. In other words, Puerto Rico would have to agree to give up the section 936 credit in order for it to disappear before the expiration of 25 years after independence.

In the absence of an agreement by the joint commission, the only change that would be made during the period that is 15-25 years after independence would be to begin to subject "earnings repatriations" (presumably referring to dividends) by section 936 companies to U.S. tax on a phased-in basis. This proposal seems to assume that the section 243 one hundred percent dividends received deduction had remained in effect after independence. Even the U.S. taxation on the dividends is subjected to the requirement that the United States grant a credit for Puerto Rican taxes on the dividends. It is not clear how the drafters intended this proposal to interact with the provisions of the U.S. corporate alternative minimum tax, which include some portion of section 936 dividends in the alternative minimum taxable income base.

D. Section 5.4(c)

Business profits/permanent establishment. Section 5.4(c) contains a provision, commonly found in much more expanded form in income tax treaties, which would exempt enterprises resident in either Puerto Rico or the United States from taxation by the other country on their business profits, unless those profits are attributable to a permanent establishment in that other country. This provision differs, however, from comparable provisions in U.S. income tax treaties. For example, it does not define either "business profits" or "permanent establishment", both of which are commonly defined in tax treaties. It is not accompanied by the kind of "anti-treaty-shopping" provision that would prevent third country residents from abusing the relationship between Puerto Rico and the United States by setting up a Puerto Rican company to enjoy the U.S. tax benefit. It is not accompanied by other provisions (e.g., nondiscrimination, exchange of information, competent authority procedures, etc.) which typically form part of the overall bargain in a treaty relationship. Moreover, like the other treaty-type provisions in section 5.4, this provision does not clearly indicate whether its drafters intended it to create an obligation under international law, which neither jurisdiction could change unilaterally.

We have asked the State Department for its views on this question, and defer to its conclusions. We would also defer to the State Department on the issue of whether these provisions, including the part of section 5.4(f) which calls for a tax treaty to be negotiated between Puerto Rico and the United States, infringes in any way on the constitutional allocation of treaty-making power to the President with the advice and consent of the Senate.

E. Section 5.4(d)

Source/situs taxing jurisdiction. Section 5.4(d) provides that both the United States and Puerto Rico shall have taxing jurisdiction over income sourced within its territory and

earned by individuals resident in the other jurisdiction, over property situated within its territory (including transfers of such property by gift or at death), and over products consumed in its territory. This provision seems designed to allocate taxing jurisdiction between the United States and Puerto Rico for purposes of income, estate, gift, and excise taxes. It is unclear whether the provision is intended to allocate exclusive (as opposed to merely primary) taxing jurisdiction to the source or situs country. For example, it is unclear whether the provision is suggesting that only Puerto Rico can tax the income earned in Puerto Rico by U.S. resident individuals. We note that section 5.4(f) provides that sourcing determinations shall be made according to the terms of a tax treaty to be entered into promptly upon Puerto Rico's independence, and meanwhile by the laws of each country.

F. Section 5.4(e)

Foreign tax credit and tax sparing. Section 5.4(e) contains two provisions. First, it guarantees taxpayers resident in either the United States or Puerto Rico that they may take a foreign tax credit for taxes payable to the other country in accordance with the various provisions of section 5.4 In the case of Puerto Rican taxes, the bill appears to guarantee a credit without regard to the normal Code rules relating to the creditability of foreign taxes.

Section 5.4(e) also gives Puerto Rico most favored nation status in the event that the United States grants tax sparing credits to any other country. It does this by saying that such credits shall be available "ipso facto" to Puerto Rico in the event that the United States amends its laws on the provision of tax sparing credits or reaches an agreement on the provisions of a tax sparing credit with any other nation. By contrast, most understandings between the United States and its developing country treaty partners referring to tax sparing would say that tax sparing will be granted to them only by amendment of their treaty in the event their most favored nation understanding on tax sparing is triggered.

G. Section 5.4(f)

Treaty relationship. Section 5.4(f) provides that the various source, situs, and other definitional determinations required under section 5.4 shall be made according to the terms of a tax treaty to be entered into promptly between the United States and Puerto Rico. As indicated above, the provision indicates that such determinations would be made, in the meantime, under the "current" domestic laws of the two jurisdictions. Here again, it is unclear whether the relevant domestic laws could be unilaterally amended without violating some international law agreement that might be deemed to arise from this type of provision.

H. Section 5.6(b)

Continuation of exemption for interest on Puerto Rican government obligations. Section 5.6 of the independence option contains a provision which would require the United States to continue to provide an exemption for 25 years after independence for interest payments made on debt obligations issued by the government of Puerto Rico, whether issued before or after independence. This provision would be unique; the United States does not provide such exemptions to U.S. taxpayers holding foreign government obligations even in the context of income tax treaties. Moreover, the exemption would apparently have to be equivalent to that "currently provided by law" on Puerto Rican bonds, raising the question whether any subsequent amendments to the domestic tax exempt bond provisions would apply to Puerto Rican bonds if this provision were enacted.

I. Section 5.3

Duty-free trade. While I defer to my USTR colleague to comment on the trade aspects of this bill, I do want to underscore an area of particular Treasury concern. Section 5.3 provides that the United States will not impose trade barriers or quotas on articles coming into the United States from Puerto Rico until proclamation of independence and for twenty years thereafter.

This provision does not distinguish between (1) products of Puerto Rico, that is, products that are either wholly obtained or substantially processed in Puerto Rico, and (2) third-country goods shipped through Puerto Rico. The consequences are far-reaching, going beyond our bilateral trade relationship with Puerto Rico, since third-country textiles and other goods could circumvent U.S. quotas and tariffs.

A more effective and typical formulation is to specify that duty-free treatment be accorded to "products of" Puerto Rico. This narrows eligibility, excluding third-country goods in which Puerto Rico does not have a significant economic stake.

V. COMMENTS ON THE COMMONWEALTH OPTION

Subpart 4 of the commonwealth option provides for an amendment to section 9 of the Puerto Rico Federal Relations Act. One part of that amendment would render Federal statutes inapplicable in Puerto Rico unless they are consistent with the policy established under subpart 3 of that option (i.e., to enable the people of Puerto Rico, among other things, to accelerate their economic and social development), and unless they have proper regard for the economic, cultural, ecological, geographic, demographic, and other local conditions of the Commonwealth of Puerto Rico. It is not clear to us how that part of the amendment would affect U.S. tax statutes currently

applicable in Puerto Rico, if at all. Indeed, it would seem appropriate for the Congress to clarify that these provisions would not be applicable to tax, customs, or similar revenue measures.

In addition, we believe Congress should make clear that tax benefits such as section 936 cannot be regarded as benefits that will last indefinitely under commonwealth status, but rather as incentives which Congress will continue to review and revise as necessary.

A further part of the amendment to section 9 would provide that the Commonwealth of Puerto Rico may "continue" to enter in its own right into international cultural, commercial, educational, and sports agreements, and other agreements of like nature. In addition, the same amendment would authorize the Governor of Puerto Rico to take "any official action" to promote the international interests of Puerto Rico that requires the consent of the United States Government and is not expressly prohibited by law. The amendment appears to contemplate that U.S. consent would be implicit unless the President objected to the action on foreign relations or national defense grounds, after being notified of the proposed action by the Governor. Currently, Puerto Rico does not have the authority to negotiate or enter into international double taxation or similar agreements in its own right, and it is unclear how the proposed amendment would affect that issue. It is certain, however, that the grant of independent tax treaty authority to Puerto Rico would significantly complicate the negotiations of United States treaties and quite possibly undermine several existing conventions.