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The Puerto Rican Economic Activity Tax Credit: Current Proposals and Scheduled Phaseout

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Summary

U.S. firms have long received a tax benefit for operations in Puerto Rico and other U.S. possessions; the benefit's purpose is to generate employment-creating investment in the possessions. Prior to 1996, the provision was known as the Possessions Tax Credit and was provided under section 936 of the Internal Revenue Code. In the years following World War II, the government of Puerto Rico depended on the 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 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 modifications culminated with the Small Business Job Creation Act of 1996, which scheduled the credit for phaseout and ultimate repeal in 2005. The tax credit–renamed the Puerto Rican Economic Activity Credit (EAC)–is now authorized by section 30A of the tax code. (A separate phase-out schedule and rules apply to the possessions other than Puerto Rico.) The Clinton Administration for several years has proposed extending a modified version of the credit beyond its expiration date, and several proposals in Congress would also modify and extend the credit. This report will be updated as legislative developments occur.

The Possessions Tax Credit Prior to 1993

While the tax benefit for possessions[1] investment is technically a tax credit that reduces taxes rather than taxable income, prior to 1993 the credit was equal to a firm's full federal tax liability on possessions-source income. The effect of the credit, then, was that

[1] American Samoa, Guam, Northern Marianas, Puerto Rico, and the U.S. Virgin Islands.

of a full tax exemption for income U.S. firms could attribute to operations in the possessions. To qualify for the credit, a corporation was required to earn at least 80% of its income in a possession and at least 75% of its income was required to be from the active conduct of a trade or business in the possessions.

Most firms that used the possessions tax credit did so by establishing subsidiary corporations that met the section 936 requirements; it was the qualifying subsidiaries (called possessions corporations) that earned tax-favored possessions-source income. Further, since the possessions corporations were U.S.-chartered corporations, their mainland parents could generally qualify for the dividends-received deduction the tax code provides for payments between related U.S. corporations. This removed the possibility that taxes might apply when the exempt possessions income was remitted to the mainland parent corporations as intra-firm dividends.

While the tax credit is scheduled to expire in 2006, it should be noted that even without the tax credit full federal taxation would not necessarily apply to U.S. firms in Puerto Rico. Corporations chartered in the possessions are considered "foreign" corporations, for tax purposes, and so can use an alternative tax benefit known as "deferral" that is available for the operations of U.S. firms in foreign countries. Under deferral, U.S. firms can postpone U.S. tax on foreign income as long as the foreign income is reinvested abroad. Still, the possessions tax credit (and the current EAC) is a permanent exemption, while for some firms, deferral is only temporary. In addition (notwithstanding restrictions imposed in 1982 and 1986), relatively generous income-allocation rules apply under the possessions tax credit that potentially make it easier for firms to shift income from various sources to the possessions, where the income is protected from taxation by the tax credit.

Legislation, 1976–1993: Issues of Targeting and Revenue Cost

Legislation aimed at limiting the benefit's revenue cost and targeting it more tightly to the possessions began with the Tax Reform Act of 1976 (P.L. 94-455), which restricted the tax exemption to income earned in the possessions themselves.[2] Prior to the Act, as long as a corporation qualified as a possessions corporation, all its income–from the possessions and other sources alike–was exempt from tax. Legislation with the same cost and targeting concerns was again considered in 1982, but now focused on income shifting. The possessions tax credit was heavily used by firms that invest intensively in intangible assets – the credit's use by pharmaceutical firms and electronics companies, for example, was especially high. Prior to 1982, there were concerns that firms were using transfers of intangibles at unrealistic prices to shift large amounts of what was really mainland-source income to possessions subsidiaries that qualified for the exemption and that could shelter the mainland income from tax. In response to these concerns, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA; P.L. 97-248) provided a set of rules governing the allocation of income from intangibles in the case of possessions corporations and their mainland parents.

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[2] For a history of the possessions tax credit to 1985, see: U.S. Congress. Congressional Research Service. *Puerto Rico and Federal Taxes under Section 936: History and Proposed Changes*. Report No. 85-196 E, by David L. Brumbaugh. Washington, 1985. 37 p. Copies can be obtained by contacting the author at CRS.

Proposals for change continued after TEFRA. With its 1985 proposals for broad tax reform, the Reagan Administration pointed out that the possessions tax credit provided no direct incentive for firms to boost their employment in the possessions. (Indeed, since the corporate income tax is a tax on the return to capital, an exemption is an incentive to employ capital, not labor.) The Reagan Administration proposed replacing the possessions tax credit with a tax credit equal to a specified portion of a firm's wages paid in the possessions.[3] However, Congress did not include the Administration's proposals for section 936 reform when it passed the landmark Tax Reform Act of 1986 (TRA86; P.L. 99-514). The 1986 Act did, however, include rules designed to further limit income-shifting to possessions corporations.

A modified version of the wage credit proposal was ultimately adopted in 1993 with the Omnibus Budget Reconciliation Act (OBRA93; P.L. 103-66). The measure was initially proposed by the Clinton Administration, which stated that a disproportionate share of the provision's benefit was realized by intangible-intensive industries "that create relatively few jobs in the possessions" and that "while section 936 has created employment in Puerto Rico, the number of jobs created is too small in relation to the tax expenditure."[4]

OBRA93's provisions remain essentially intact under current law (subject to new phase-out rules), so they are worth describing in some detail. The new law altered section 936 by imposing a cap on the existing full tax exemption. A firm calculated its possessions tax credit as under prior law, but the maximum credit it could claim was limited by the cap. The cap was equal to one of two alternative limitations; which applied was up to the taxpayer. Under the first – known as the "percentage limitation" – a firm's possessions tax credit was equal to a specified percentage of the credit the firm could have claimed under prior law; after a phase-in period, the percentage was set at 40%.

Under the second alternative – known as the "economic-activity" limitation–a firm's maximum credit was limited to an amount equal to the sum of three factors. One factor was 60% of a possessions corporations' wages paid in the possessions; qualified wages, however, were limited for each employee to 85% of the amount subject to Social Security taxes. The second factor was a specified percentage of the possessions corporation's depreciation deductions for the taxable year. The applicable percentage depended on the type of property: 15% for property with a relatively short recovery period; 40% for property with a medium-length recovery period; and 65% for long-lived property.[5] For firms whose tax credit was constrained by the limitations, the caps functioned in a manner similar to a wage credit and a credit for investment. For example, a firm subject to the constraint could reduce its tax bill by 60 cents for each additional dollar spent on wages.[6]

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[3] U.S. President (Reagan). *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity*. Washington, 1985. P. 309.

[4] U.S. Department of the Treasury. *Summary of the Administration's Revenue Proposals*. Washington, 1993. P. 51.

[5] Short-life recovery property is property having a 3- or 5-year recovery period; medium-life recovery property is 7- or 10-year property; long-life property is that with a recovery period exceeding 10 years.

[6] For additional analysis of the credit as enacted, see: U.S. Library of Congress. Congressional

(continued...)

The Small Business Job Creation Act of 1996

Congress continued to focus on the possessions tax credit after OBRA93. In November, 1995, Congress passed the Balanced Budget Act (H.R. 2491), and included a provision phasing out the credit over 10 years. President Clinton vetoed the bill, and the tax credit's phaseout was one provision the Administration singled out for criticism. The President proposed to instead restrict the credit's calculation to OBRA93's economic activity limitation that links the benefit with wages and tangible possessions investment. The Administration viewed its proposal as a further movement in the direction begun in 1993.

Instead, in 1996 Congress passed – and the President signed – the Small Business Job Protection Act (P.L. 104-188), which contained among its various tax provisions the essential elements of the 1995 phase-out proposal. Under its terms the credit is phased out over a 10-year period, and is scheduled for repeal beginning in 2006. In providing for the phaseout and repeal, Congress cited reasons of fairness and revenue concerns, stating that it:

> understood that the tax benefits provided by the Puerto Rico and possession tax credit are enjoyed by only the relatively small number of U.S. corporations that operate in the possessions. Moreover, the Congress was concerned about the tax cost of the benefits provided to these possession corporations that is borne by all U.S. taxpayers.[7]

The repeal of the tax credit was effective immediately for firms not already using the benefit. For other firms ("existing claimants," in the Act's language), the credit's phase-out rules depended on whether they use the economic activity limitation or the alternative 40% exemption. For economic activity firms, the amount of the credit is determined as under OBRA93 through 2001. Beginning in 2002, the credit for these firms is subject to an additional cap. The cap restricts income eligible for the credit to the firm's average profits during a base period prior to 1996, increased for inflation and a proxy for economic growth. For firms using OBRA93's alternative 40% exemption, the 1996 Act applied the base-period income cap beginning in 1999. (Firms were permitted to change the particular limitation they had chosen under OBRA93's rules.)

While the repeal of the credit applies to all possessions, existing claimants in possessions other than Puerto Rico and the U.S. Virgin Islands (i.e., Guam, American Samoa, and the Northern Marianas) were exempted from the base-period cap. In addition, for firms in Puerto Rico using the economic activities limitation, the 1996 Act moved the credit's authorizing provisions to new section 30A of the Internal Revenue Code and renamed the credit the Puerto Rican economic activities credit.

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[6] (...continued)
Research Service. *The Possessions Tax Credit: Economic Analysis of the 1993 Revisions*. CRS Report No. 94-650 E, by David L. Brumbaugh. Washington, 1994. 18 p.

[7] U.S. Congress. Joint Committee on Taxation. *General Explanation of Tax Legislation Enacted in the 104th Congress*. Joint Committee Print, 104th Cong., 2d Sess. Washington, U.S. Govt. Print. Off. 1996. P. 207-13.

To recap, in 2000 the state of the phaseout in Puerto Rico is this: only existing claimants can now claim the tax credit. For firms who have elected OBRA93's 40% exemption, the credit is now restricted by an added limitation linked to base-period earnings. Firms using the EAC are not currently subject to the base-period cap, but will be, beginning in 2002. The credit will expire completely on January 1, 2006.

Current Proposals and Issues

In each of the four budgets the Clinton Administration has submitted since 1996, it has proposed extending a modified version of the Puerto Rican tax credit. The Administration stated that the proposals' purpose is to provide a "more efficient and effective tax incentive for the economic development of Puerto Rico and to continue the shift from an income-based credit to an economic-activity credit that was begun in OBRA93."[8] The first three of the proposals would have disallowed the optional 40% exemption, but extended the EAC indefinitely. The proposals also would have allowed new claimants to use the credit, and would have repealed the base-period earnings limitation that is scheduled to begin in 2002. The most recent Administration budget proposal (for FY2001) would remove the "existing claimant" restriction on the credit, and would extend the EAC version of the credit. In contrast to the preceding budgets, however, the present proposal would extend the credit only through 2008.[9]

Two bills to extend the EAC have been proposed in Congress. Like the Administration's latest proposal, S. 212 (Sen. Moynihan) would extend the credit through 2008, but would restrict its use to firms using the EAC version of the credit. The bill would relax but not eliminate the existing claimant rules and would repeal the base-period cap. H.R. 2138 (Rep. Crane) would also restrict the credit to the EAC and would repeal the base-period cap. In contrast to the Senate bill, however, H.R. 2138 would replace the extension through 2008 with a flexible extension. Under its provisions, the credit would be extended indefinitely, but only if certain economic indicators for the possession are not exceeded. (Stated differently, if a possession's economy meets certain performance standards, the credit would expire.) If a possession's unemployment for a particular year does not exceed 150% of mainland unemployment; the possession's per capita income is at least 60% of that of the mainland; and the possession's poverty level does not exceed 30%, the tax credit for that possession would be repealed in the fourth year following the year in which the performance indicators are met.

In addition to these two bills, Chairman Roth of the Senate Finance Committee included a proposal to liberalize the credit's phase-out rules in his "chairman's mark" of the Community Renewal and New Markets Act. While the proposal would not extend the ability of firms to earn the credit beyond 2005, it would liberalize the "existing claimant" rules, remove the base-period limitation, and increase the economic activity limitation for firms that increase their employment.

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[8] Office of Management and Budget. *Budget of the United States Government. Fiscal Year 1998. Analytical Perspectives.* Washington, U.S. Govt. Print. Off. 1997. P. 48.

[9] The budget does not explicitly mention the base-period limitation, while the previous budgets' proposals stated that the limit would be removed. We thus assume the limitation would remain under the current proposal. It is not clear, however, how the limit would apply to new claimants.

Economic Considerations

As noted above, the purpose of the Puerto Rico tax credit is to stimulate employment-generating investment in Puerto Rico. For policy purposes, a crucial economic question is therefore: what is the effect of the tax credit and its modifications on employment in Puerto Rico? What will be the impact of its repeal?

Employment and compensation by firms that use the tax credit are an important part of Puerto Rico's manufacturing sector, and the manufacturing sector, in turn, is an important part of Puerto Rico's economy.[10] Thus, any impact that may result or has resulted from the 1993 redesign of the credit could potentially be important for Puerto Rico's economy. Likewise, the impact of the provision's scheduled repeal is potentially important. The most recent rigorous study of the tax credit was published by Grubert and Slemrod in 1998, and assessed the effect of the provision in its pre-1993 form. It found that the ability of firms to use the credit to shelter non-possessions income from tax is "the predominant reason for U.S. investment in Puerto Rico," and that without the ability to shift taxable income to Puerto Rico, the operating capital and payroll of U.S. firms in Puerto Rico would be more than two-thirds lower.[11] But this result does not rule out the possibility that linking the tax benefit more directly with tangible investment and employment (as with OBRA93) will or already has produced a larger impact on U.S. firms' employment in Puerto Rico than did prior law's version of the credit. Indeed, an earlier study by the same authors found that adoption of a wage credit would increase U.S. firms' Puerto Rican payroll substantially.[12]

Presumably, evidence of any large effect by OBRA93's changes could be visible by now. We can note that Puerto Rico's economy has registered real growth of between 2.5% and 4.2% in each of the years since 1993.[13] Beyond this most general observation, however, a thorough analysis of the evidence is beyond the scope of this report.

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[10] Based on 1995 data, the U.S. Internal Revenue Service (IRS) estimated that manufacturing firms using the credit employed 113,444 workers and paid $2,703,933 thousand in employee compensation. (U.S. Internal Revenue Service. *Statistics of Income Bulletin*. V. 19. Summer, 1999. P. 184.) For the same year, the Puerto Rico Planning Board reported employment of 172,000 persons in the entire manufacturing sector and total employee compensation in manufacturing of $3,561,800 thousand. (Puerto Rico Planning Board. *Economic Report of the Governor, 1998.* San Juan, 1999. P. A-38; A-12. The IRS figures are 66% of the Planning Board's total for employment and 76% for compensation. While the two data sets are not necessarily strictly compatible, they support the general point that tax-favored firms from the mainland make up a substantial part of employment and compensation in Puerto Rico's manufacturing sector.

[11] Grubert, Harry, and Joel Slemrod. The Effect of Taxes on Investment and Income Shifting to Puerto Rico. *Review of Economics and Statistics*. V. 80. August, 1998. P. 365.

[12] Cited in *Ibid*., p. 372.

[13] Posted by the Government Development Bank of Puerto Rico on its web site at [http://www.gdb-pur.com].