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Federal Tax Reform and the Impact on the Territories

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Chairman Baucus, Ranking Member Hatch, and Members of the Committee–on behalf of the Congressional Research Service, I thank you for the opportunity to appear before you today.

I have been invited here today to discuss how tax reform could affect the territories. In this testimony, I will briefly summarize the U.S. tax treatment of the territories.[1] I will then discuss a selected number of expiring provisions (commonly referred to as tax extenders) pertinent to the territories. Finally, I will outline how tax reform may affect the territories.

Federal tax reform will have an impact on the territories in two ways. First, American Samoa, Guam, the Commonwealth of the Northern Marianas, and the U.S. Virgin Islands each mirror the U.S. federal tax code. Simply put, this means the territories use the United States tax code as it is written, replacing the words "United States" with the territory name "U.S. Virgin Islands," for example. As a result, when the U.S. tax code changes so does their tax code in these territories. Puerto Rico, in contrast, has an independent tax regime, though it is modeled on the U.S. tax code. Secondly, there are specific provisions in the U.S. tax code that directly benefit one or more of the territories. This group of provisions is often found in so-called "extenders" legislation; three extenders are examined in this testimony.

Territories and Taxation

The U.S. taxes residents and corporations located in the territories differently than if they resided in the United States. For individuals residing in the territories, their tax treatment is most similar to the tax treatment of foreign citizens. Generally, territorial residents are exempt from federal taxes on territory-sourced income but are—with some exceptions—taxed on income sourced in the U.S. In contrast, U.S. residents are subject to federal taxes on their territory-source income as if it were foreign-source income. However, territorial taxes can generally be claimed as foreign tax credits to offset U.S. tax liability. Thus, as with foreign-source income, the United States concedes primary tax jurisdiction to the territory where the income is earned. With some exceptions, it retains primary tax jurisdiction over U.S. sourced income earned by territorial residents.

Corporations chartered in the territories are treated like foreign-chartered corporations under the Internal Revenue Code (IRC). In principle, they are exempt from federal taxes on territorial income; U.S. firms that invest in the territories through subsidiaries can—at least potentially—defer federal taxes on territory earnings. Generally, U.S. taxes are paid only when earnings are repatriated to the domestic parent, with the U.S. tax reduce by the foreign tax credit. In the past, most U.S. firms that operated in the territories, however, chose instead to use the now expired possessions tax credit (IRC Sec. 936).

The impact of United States tax reform on the territories would depend in large part on the specifics of U.S. tax reform and how the territories responded to the changes. One option would be for these territories to decouple from the mirror system. American Samoa, Guam, and the Commonwealth of the Northern Marianas each have pending negotiations with the U.S. about ending the mirror system and coordinating with the United States on a new territory tax system. This option would allow the territories to be largely unaffected by U.S. tax reform, unless they choose to enact similar reforms. Alternatively, continuing with the mirror system the territories would incorporate the federal changes.[2] If the changes focus on increasing the progressivity of the federal tax code with higher rates for higher income

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[1] These are the five major territories. American Samoa, Guam, and the U.S.V.I. are "possessions" whereas the Northern Marianas and Puerto Rico are "commonwealths."

[2] The U.S. Virgin Islands does not have the option of implementing an independent tax structure.

earners, the impact on the territories would likely be muted as average income is significantly lower in the territories. In any case, this option would effectively cede control of the territories' tax systems to the U.S.

Puerto Rico

Puerto Rico (PR) levies separate individual and corporate income taxes under the Puerto Rico Internal Revenue Code. The U.S. Internal Revenue Code, section 933, deems that income earned by a bona fide PR resident from sources inside PR is excluded from U.S. income. The Puerto Rican income tax is structured with generally lower statutory rates, compressed bracket ranges, and lower exemption amounts.[3] Rates range from 7% to 33% for taxable income in excess of $61,300 in 2012. (In comparison, U.S. individual income tax rates range from 10% to 35%.) Also in 2012, a 5% surtax is applied to taxable incomes above $200,000 and taxpayers must also calculate an alternative minimum tax (AMT), which is similar in operation to the U.S. version of the individual AMT. PR employers and employees are subject to the payroll taxes, FICA (Federal Insurance Contributions Act) and FUTA (Federal Unemployment Tax Act).

PR's corporate income tax consists of a normal tax and surtax whose rates combine to a top corporate tax rate of 39%. At the same time, however, certain types of firms may qualify for substantially reduced taxes under PR's industrial incentives program.[4]

U.S. Virgin Islands[5]

The U.S. Virgin Islands (USVI) imposes a mirror tax system. Any changes to U.S. tax law are automatically incorporated into the USVI code. For individual income tax filers, bona fide residents of the USVI without U.S. sourced income need only to file with the USVI government. USVI residents with U.S. sourced income file U.S. returns, but can claim a foreign tax credit for the taxes paid to the U.S. on their USVI returns.

Corporations formed in the USVI pay taxes to the USVI based on worldwide income. These USVI corporations can claim foreign tax credits for taxes paid to jurisdictions other than the USVI including the United States. IRC Section 934 allows for the USVI to provide special income exclusions for entities operating in the USVI. The intent of this section of the U.S. Code is to allow the USVI to offer economic development incentives for certain types of businesses.

American Samoa

American Samoa (AS) has what operates as a "mirror" tax system, though technically the AS tax is a local tax and AS residents are still responsible for U.S. taxes. They file in both the U.S. and AS, but all AS source income is excluded for purposes of U.S. income taxes.[6] Unlike the other territories, the AS tax structure does not "replace" the U.S. federal tax. The AS tax, however, is a territorial tax that is modeled after the U.S. federal tax.

Corporations in AS calculate taxes for the AS corporate tax just as U.S. corporations calculate taxes for U.S. corporate taxes and claim foreign tax credits for taxes paid to other countries, including the U.S.

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[3] Puerto Rico has a "0%" bracket amount which is similar in effect to an exemption. In 2012, the first $6,500 of taxable income is taxed at the 0% rate.

[4] A description of Puerto Rico's industrial incentives tax program is located at http://www.puertoricodoesitbetter.com/en/how-to-invest/incentives/Pages/default.aspx.

[5] See 48 U.S.C. 1397 and 48 U.S.C. 1642 for the legal background the USVI tax structure.

[6] Section 931 of the U.S. tax code.

Guam

Guam employs a mirror tax system that is outlined in IRC Section 935. This section, however, was repealed by the Tax Reform Act of 1986, (TRA86, P.L. 99-514), conditioned on the U.S. and Guam agreeing to an implementation agreement for future tax coordination. That agreement has not been reached, thus IRC Section 935 still applies for Guamanian residents. The U.S. Treasury in some instances does collect taxes on Guam-sourced income and from withholding on U.S. Federal personnel employed or stationed in Guam. Generally, the U.S. Treasury returns (or "covers over") tax collected on Guamanian-sourced income to the Treasury of Guam.[7] Guam returns the favor and sends to the U.S. Treasury tax revenue collected on U.S. sourced income. In FY2012 the U.S. Treasury will cover over approximately $53 million to the Guam Treasury for the so-called "Guam Section 30 Income Taxes."[8]

Corporations formed in Guam pay the Guam corporate income tax, which mirrors the U.S. corporate income tax.

Commonwealth of the Northern Mariana Islands

The Commonwealth of the Northern Mariana Islands (CNMI) also employs a mirror tax system. The CNMI mirror code is linked to Guam's mirror code with the important exception that if Guam does develop its own independent tax code, CNMI is not required to follow suit. The CNMI, like Guam, is authorized to implement its own tax regime (or non-mirror system) if an implementation agreement can be reached between the CNMI and the U.S. Internal Revenue Service (IRS). CNMI has also been authorized to rebate a significant portion of taxes paid on CNMI sourced income. According to the Joint Committee on Taxation (JCT), these rebates can range from 50 to 90 percent for individuals.[9]

Corporations formed in CNMI pay the CNMI corporate income tax, which mirrors the U.S. corporate income tax. As with CNMI individual taxpayers, corporations are also eligible for rebates on their CNMI taxes that range from 50 to 90 percent.

Provisions in U.S. Tax Code Benefitting the Territories

The U.S. tax code includes at least three provisions that directly benefit taxpayers that have income from activities in the territories or that are resident in the territories. If tax reform were to include scaling back tax expenditures generally, one or all of these may be curtailed or eliminated.

1. Deduction allowable with respect to income attributable to domestic production activities in Puerto Rico (sec. 199(d)(8))

U.S. based entities, either individuals or corporations, are allowed to deduct 9% of taxable income that was earned in Puerto Rico. The deduction lowers the marginal effective tax rates of taxpayers in the highest bracket amounts to just under 32%. This confers a tax advantage

[7] 26 U.S.C. 7654.

[8] U.S. Department of the Interior, Office of Insular Affairs, "Budget Justifications and Performance Information: FY2013," p. 7.

[9] U.S. Congress, Joint Committee on Taxation, "An Overview of the Special Tax Rules Related to Puerto Rico and an Analysis of the Tax and Economic Policy Implications of Recent Legislative Options," JCX-24-06, June 23, 2006.

for these entities because like situated entities without Puerto Rican or U.S. sourced income cannot claim the same deduction and thus are taxed at a higher marginal rate.

This special provision expired on December 31, 2011. The President's FY2013 Budget proposes extending this provision through 2013. The expected revenue impact would be a reduction in federal revenues of $312 million over the three year window of FY2012 through FY2014.[10]

Impact of tax reform

If Congress chooses to broaden the base of both the individual and corporate income tax, they may choose to eliminate this special provision for entities with Puerto Rico-sourced income. The result may be some shifting of activity away from Puerto Rico, though the magnitude of this shift would seem minimal, especially in the short term, as much of the activity generating the income may not be easily or quickly shifted out of Puerto Rico.

If Congress chooses additional structural reforms, such as lower overall rates, the value of the deduction to taxpayers would decline. If, for example, the top rate for the U.S. corporate income tax were to drop from 35% to 25%, the after deduction marginal tax rate would be 9% of a smaller number (a 3.15 percentage point reduction compared to a 2.25 percentage point reduction). The size of this change would seem unlikely to significantly influence capital flow to and from Puerto Rico.

2. Temporary increase in limit on cover over of rum excise tax revenue (from $10.50 to $13.25 per proof gallon) to Puerto Rico and the Virgin Islands.

The United States levies a $13.50 per proof gallon excise tax on distilled spirits produced in or imported into the United States. Through 2011, $13.25 per proof gallon of *all* imported rum is transferred or "covered over" to the Treasuries of Puerto Rico (PR) and the United States Virgin Islands (USVI). The Caribbean Basin Economic Recovery Act of 1983 (P.L. 98-67) provides that all revenue from federal excise taxes on rum imported into the United States from any source—including any foreign country—is remitted to the treasuries of PR and the USVI.

In FY2011, PR received over $449.1 million in revenue and the USVI received $155.1 million.[11] The law does not impose any restrictions on how PR and USVI can use the transferred revenues. Both territories use some portion of the revenue to promote and assist the rum industry. Reports of the size of the subsidy vary considerably, though the amount ranges from roughly 6% of the covered over revenue in PR up to 18.5% in the USVI as of 2009.[12]

Beginning on January 1, 2012, the amount covered over to PR and the USVI reverted to $10.50 per proof gallon. The President's FY2013 Budget proposes extending the $13.25 rate retroactively through 2013. The expected revenue impact of extending the proposal will be a reduction in federal revenues of $222 million over the three-year budget window of FY2012 through FY2014.[13]

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[10] U.S. Congress, Joint Committee on Taxation, "Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal," JCX-27-12, March 14, 2012.

[11] The data for Puerto Rico are from an e-mail correspondence with Carol Coy, Alcohol and Tobacco Tax and Trade Bureau, National Revenue Center, April 26, 2012. The USVI data are from: U.S. Department of the Interior, Office of Insular Affairs, "Budget Justifications and Performance Information: FY2013," p. 7.

[12] For more on the cover over, see: CRS Report R41028, *The Rum Excise Tax Cover-Over: Legislative History and Current Issues*, by Steven Maguire.

[13] U.S. Congress, Joint Committee on Taxation, "Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal," JCX-27-12, March 14, 2012.

Impact of tax reform

Allowing the higher payment to expire permanently as part of tax reform would have a direct impact on the governments of PR and the USVI. In the near term, the reduced payments from the U.S. could adversely impact economic development projects that are tied to the anticipated revenue streams. For example, the USVI has issued debt secured by future cover-over revenue to finance the construction of rum producing facilities. Over the longer term, however, the USVI would incorporate the reduction from $13.25 to $10.50, into future economic development plans.

An even more substantial reform, such as repealing the cover over for rum not produced in PR or USVI (or termination of the cover over completely) would be significantly more disruptive to the island economies.

To the extent the covered over revenues are used to subsidize rum producers in PR and the USVI, the current subsidy may: (1) reduce the price of PR and USVI produced rum relative to other countries' production of rum and distilled spirits; (2) increase the rate of return of capital invested in the subsidized producers; and (3) increase worker earnings in the subsidized production facilities. The relatively competitive market in the United States for distilled spirits and existing labor market characteristics of PR and USVI could lead one to conclude that the subsidy is largely realized in an increased rate of return to capital for investors in the subsidized producers.

From an economic efficiency perspective, this analysis implies that subsidy-receiving rum producers are earning a higher rate of return than would be the case absent the cover over and related government subsidy. Some observers have suggested that this outcome may be at odds with the intent of the cover-over program. However, Congress has indicated that the use of the cover-over revenue is best left to the Territorial Government.

In the Senate report language accompanying the Revised Organic Act of 1954, Congress expressed a desire that the USVI use the covered-over revenue to loosen the dependence of the USVI on periodic appropriations from the U.S. government. According to the report language, under a cover-over system, "the people of the Virgin Islands would have a far greater degree of control over their finances than under the present system."[14] The report continues, recommending that "the people of the Virgin Islands bend their efforts to stimulating and increasing business in every way possible."[15]

3. American Samoa economic development credit

A domestic corporation is allowed a credit for operations in American Samoa (AS) to offset U.S. corporate tax liability. Generally, the credit is limited to the amount of U.S. corporate tax liability generated by AS sourced income. The credit was intended to replace the expired possessions tax credit (sec. 936) and as such is limited by the tax code with language contained in the repealed sec. 936.

The President's FY2013 Budget proposes extending the credit retroactively through 2013. The expected revenue impact of extending the proposal would be a reduction in federal revenues of $21 million over the three-year budget window of FY2012 through FY2014.

Tax Policy in General

Economists typically evaluate tax policy based on three principles: equity, efficiency, and administrative simplicity. The current mirror tax structure in the territories means that federal

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[14] U.S. Congress, Senate Report to Accompany S. 3378, *Revision of the Organic Act of the Virgin Islands*, Report no. 1271, 83rd Congress, 2nd sess., April 29, 1954, p. 5.

[15] Ibid., p. 6.

tax reform would, in most cases, automatically change territorial tax systems. If tax reforms move the U.S. tax code closer to a more equitable, efficient, and administratively simpler tax regime, then the territorial system could move in the same direction as well. If the territories, however, respond by decoupling their tax systems from the U.S. tax code or abandoning the mirror system, there may be negative consequences for the three principles described above.

The intergovernmental tax context has two perspectives to consider: horizontal and vertical. Horizontal equity, efficiency, and administrative simplicity refers to the coordination among governments at the same level. For the 50 states, this could be achieved with tax coordination among states for taxes that are levied on the same base—such as income and sales taxes. For territories, coordination is less important as economic interaction among the five major territories is limited—with the exception of the U.S. Virgin Islands and Puerto Rico. A mirror system would seem to provide such coordination. Within each territory, however, the parameters of the U.S. code, which are geared to the large and dynamic U.S. economy, may not be appropriate for the territorial economies. Thus, decoupling from the U.S. code may create a more equitable and efficient tax regime within a given territory. Among territories, however, potentially different tax regimes may induce taxpayer behavioral changes that can increase the economic burden of taxes generally.

Vertical coordination, in contrast, would be between governments at different levels. The existing mirror structure seems to be a reasonable attempt at coordinating the tax regimes of the U.S. federal government and the territories. Abandoning the mirror system would likely increase compliance and administrative costs for taxpayers with territory and U.S. sourced income.

The possibility of federal tax reform will have an impact on the territories. The magnitude of that impact will depend on the nature of federal reform and how the territories respond.