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TAX POLICY

Analysis of Certain Potential Effects of Extending Federal Income Taxation to Puerto Rico



General Government Division

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The Honorable Don Young
Chairman, Committee on Resources
House of Representatives

The Honorable Elton Gallegly
Chairman, Subcommittee on Native
American and Insular Affairs
Committee on Resources
House of Representatives

In response to your request, this report presents information on some potential consequences of extending the income tax provisions of the federal Internal Revenue Code (IRC) to residents of the Commonwealth of Puerto Rico. Specifically, you asked us for estimates of

- (1) the amount of federal income tax that individuals residing in Puerto Rico would pay if they were treated in the same manner as residents of the 50 states, the amount of earned income tax credits (EITC) Puerto Rican residents would receive, the percentage of taxpayers who would have positive federal tax liabilities, and the percentage who would earn EITC;
- (2) the extent to which the Government of Puerto Rico would have to reduce its own income tax if it were to keep the amount of combined income tax (both federal and Commonwealth) on individuals the same as it was without the full imposition of the federal tax;
- (3) how the amount of income taxes paid by the average taxpayer in Puerto Rico compares with the amount of combined federal, state, and local income taxes paid by residents in the 50 states and the District of Columbia; and
- (4) the amount of revenue the U.S. Treasury could obtain by the repeal of the possessions tax credit, which effectively exempts from federal taxation a portion of the income that subsidiaries of U.S. corporations earn in Puerto Rico.

As agreed with your offices, our estimates relating to federal tax liabilities and earned income tax credits are based on the income and demographic characteristics of Puerto Rican taxpayers in 1992, the latest year for which detailed data were available. We did not attempt to adjust these estimates to reflect changes in the Puerto Rican economy, changes in the behavior of

individual taxpayers, or different compliance rates that might result from the imposition of federal income taxes. The data that we used in making our estimates also had some limitations that are explained in the scope and methodology section of this letter and in appendix I.

Estimates of the impact of tax policy changes are inherently imprecise. Data limitations and the necessity to make certain behavioral and economic assumptions limits the precision of the estimates. Despite these limitations, we believe our analysis is adequate to provide general information about the magnitude of the potential revenue effect of extending full federal income taxation to the residents of Puerto Rico.

The discussion of the implications of extending federal income taxes to the Commonwealth of Puerto Rico should also be viewed in the context of the broader debate about the status of the Commonwealth under the Constitution. The broader issue of whether the benefits and obligations of statehood or independence should be sought for or granted to Puerto Rico is outside the scope of this analysis. However, any changes to tax policy as it affects Puerto Rico may have an impact on or be affected by this broader debate.

Background

Under the Jones Act, Puerto Rico is part of the United States for purposes of acquiring citizenship of the United States by place of birth. Thus, a person born in Puerto Rico is typically considered a U.S. person for U.S. tax purposes and thus is subject to the U.S. Internal Revenue Code (IRC). However, IRC has different tax rules for residents of Puerto Rico than it does for residents of the United States. Section 933 of IRC provides that income derived from sources within Puerto Rico by an individual who is a resident of Puerto Rico generally will be excluded from gross income and exempt from U.S. taxation, even if such resident is a U.S. citizen. Section 933 does not exempt residents of Puerto Rico from paying federal taxes on U.S. source income and foreign source income. Nor does section 933 affect the federal payroll taxes that residents of Puerto Rico pay. Federal employment taxes for social security, medicare, and unemployment insurance apply to residents of Puerto Rico on the same basis and for the same sources of income that they are applied to all other U.S. residents.

Income Taxes

Puerto Rico has had authority to enact its own income tax system since 1918. The current individual income tax system of Puerto Rico is broadly similar to the U.S. individual income tax system. The Puerto Rican and the

U.S. corporate income tax rules have many similarities and some differences. The structure of Puerto Rico's income tax system is discussed in appendixes II and III.

The current Puerto Rican income tax system is a significant source of revenue for the Puerto Rican government. In fiscal year 1992,¹ individual and corporate income taxes totaled about 40 percent of Puerto Rico's total revenues, with transfers from the federal government accounting for about 30 percent of revenue and other taxes, such as excise taxes, generating about 18 percent. The balance of the Commonwealth's revenues came mainly from nontax sources. For fiscal year 1992, the Puerto Rico Treasury collected about \$1.1 billion in individual income taxes and about \$1.02 billion in corporate income taxes.² About 42 percent of the corporate tax (about \$426 million) was paid by U.S. subsidiaries covered by the possessions tax credit.³ The remaining 58 percent (about \$594 million) was paid by corporations not covered by the credit. In addition, about \$10 billion of income earned by corporations in Puerto Rico was exempted from the local corporate income tax as a result of Puerto Rico's industrial tax incentive legislation.

Currently IRC has special income tax provisions that extend tax benefits to Puerto Rico that are not available to the states. The United States exempts from income taxation—at the federal, state, and local levels—all bonds issued by the Government of Puerto Rico.⁴ Corporations organized in Puerto Rico are generally treated as foreign corporations for U.S. income tax purposes. Like other foreign corporations, they are taxed on their U.S. source income, but their Puerto Rico source income is not subject to U.S. tax. Foreign corporations pay U.S. tax at two rates—a flat 30-percent tax is withheld on certain forms of income not effectively connected with the conduct of a trade or business within the United States, and tax at progressive rates is imposed on income that is effectively connected with a U.S. trade or business. Much interest income is exempt from the withholding tax. Also, IRC's possessions tax credit effectively exempts from federal taxation a portion of the income qualified subsidiaries of U.S.

¹Puerto Rico's 1992 fiscal year was from July 1991 through June 1992.

²These amounts do not include \$99 million of tollgate tax (tax paid by corporations on income repatriated from Puerto Rico), \$32.1 million of alternative tax withheld on interests and dividends, \$62.1 million of income tax withheld from nonresidents, or \$1.2 million of tax paid on partnership income.

³Section 936 of IRC provides a tax credit to those subsidiaries of U.S. companies with possessions source income. This credit is commonly known as the "possessions tax credit."

⁴48 U.S.C. 745.

corporations (corporations organized in any state of the United States) earn in the possessions. Tax rules related to possessions source income are discussed in more detail in appendix III.

Results in Brief

Our estimates of the potential revenue effect of extending current federal income tax rules to taxpayers in Puerto Rico were derived from our analysis of individual income tax data for tax year 1992 provided by the Government of Puerto Rico. If the characteristics of the Puerto Rican taxpayer population were the same in 1995 as they were in 1992, we estimated that their net aggregate federal tax liability after subtracting EITC would have been about \$49 million under U.S. tax rules that had been adopted as of the end of 1995.⁵ The aggregate tax liability in the absence of EITC would have been about \$623 million, but Puerto Rican taxpayers would have qualified for a total of about \$574 million of EITC.

We estimated that about 59 percent of the taxpayers who filed Puerto Rico individual income tax returns in 1992 would have earned some EITC. The average EITC earned by eligible taxpayers would have been about \$1,494; the median amount would have been about \$1,623. Over half of the taxpayers would have received net transfers from the federal government because their EITC would have been larger than their precredit federal income tax liabilities. We estimated that about 41 percent of the Puerto Rican taxpayers would have had positive federal income tax liabilities including EITC.

Had current federal tax rules been in effect in Puerto Rico at the time, it is probable that some Puerto Rican residents who did not file Puerto Rican tax returns in 1992 would have had an incentive to file federal tax returns because they could have qualified for the refundable EITC. We have no way of knowing with certainty how many of these nonfiler residents would claim EITC. However, we did derive an estimate of the amount of EITC that might have been claimed by residents who were not legally required to file tax returns in 1992. We considered the number of people who had income levels below the income tax threshold and were exempt from withholding as an upper limit on the number of those potential additional filers. If all of

⁵EITC is a refundable tax credit made available to certain low-income workers to offset the impact of Social Security taxes and encourage low-income workers to seek employment rather than welfare. Because there have been significant changes to EITC that do not fully phase in until 1996 and because EITC is an important factor in our results, we used the 1996 rules for the EITC in our analysis.

those residents claimed EITC, we estimated that they would have qualified for about \$64 million.⁶

If the additional EITC that could have been claimed by legal nonfiler residents were about \$64 million, our estimate of the aggregate amount of EITC that would have been earned would have increased from about \$574 million to about \$638 million. This additional EITC would be sufficient to eliminate the \$49 million of aggregate net federal income tax liability that we estimated would exist for the population that did file. Again, it is important to note that our estimates do not reflect other potential behavioral responses to the availability of the credit or the imposition of the federal income tax.

For tax year 1992, Puerto Rican taxpayers reported about \$1.03 billion in individual Puerto Rican income tax. If application of federal income tax resulted in an additional \$49 million in tax liability after subtracting EITC as we estimated, and if the Government of Puerto Rico wanted to keep constant the aggregate amount of combined federal and Puerto Rican individual income tax levied on its residents, then it would have had to reduce its own individual income tax revenue by about 5 percent. If, because of additional EITC for residents who did not file returns in 1992, the estimated aggregate federal tax liability were eliminated, then the Government of Puerto Rico would not have had to change its individual income tax revenue to keep the aggregate combined taxes constant. However, even though the aggregate taxes may not have changed significantly, the taxes paid by certain classes of taxpayers could have changed dramatically.

The per-capita amount of Puerto Rico's individual income tax was lower than the state and local income tax in most states and the District of Columbia in 1992. However, the Puerto Rican income tax as a percentage of total personal income was higher than the state and local income tax as a percentage of total personal income of any state and the District of Columbia. Nevertheless, since residents of Puerto Rico paid only about

⁶There were some additional taxpayers in 1992 who had tax withheld but did not file Puerto Rican tax returns. The potential amount of additional EITC these taxpayers could have qualified for would likely have been relatively low because their earned incomes probably were very low.

\$4.4 million⁷ in federal income tax in 1992 (see discussion of foreign tax credit in app. II), the combined federal and Puerto Rican income tax was lower, in dollars per capita or as a percentage of personal income, than the combined federal, state, and local tax of any state and the District of Columbia. In Puerto Rico, the per-capita combined tax was about \$342, and the tax as a percentage of personal income was about 5.3 percent. In Mississippi, which had the lowest combined income tax of any state, the per-capita tax was about \$1,147 and the tax as a percentage of personal income was about 8.2 percent. If the federal income tax had been extended fully to Puerto Rico, and the Government of Puerto Rico did not adjust its own tax, we estimated that the per-capita combined individual income tax in Puerto Rico would have increased slightly to about \$355—equivalent to about 5.5 percent as a percentage of personal income.

The Joint Committee on Taxation's most recent estimates indicate that the federal tax expenditure for the possessions tax credit would be \$3.4 billion in 1996, growing to \$4.4 billion by 2000. The U.S. Department of the Treasury's most recent estimates are that the tax expenditure would be \$2.8 billion in 1996, growing to \$3.4 billion by 2000.⁸ Tax expenditure estimates are computed to indicate how much revenue the U.S. Treasury would forgo due to the existence of a tax benefit. The Joint Committee and the Treasury both use a different methodology to estimate tax expenditures than they use to estimate the amounts of revenue that would be saved if specific tax preferences were eliminated. Estimates of revenue savings take into account expected tax avoidance behavior by taxpayers in response to the elimination of preferences; tax expenditure estimates do not reflect these responses.

Given the differences in behavioral assumptions, if either the Joint Committee or the Treasury were to make both a tax expenditure estimate for a tax credit and a revenue gain estimate for the elimination of the credit, using the same set of economic forecasts and the same data, the revenue gain estimate could very well be smaller than the tax expenditure estimate. However, imprecisions in other assumptions, or in the economic

⁷The Government of Puerto Rico does not compile data on the amount of federal income tax paid by individuals residing in Puerto Rico, and although the Internal Revenue Service (IRS) compiles data, the individual income tax is not segregated from other taxes paid by residents of Puerto Rico to the United States. In 1992, individuals claimed a total of \$4.4 million in foreign tax credits on their Puerto Rican income tax returns. Officials from the Puerto Rico Treasury told us that a very large percentage of these credits are attributable to income taxes paid to the U.S. federal government. Therefore, for purposes of determining the combined federal and Puerto Rican income tax, we assumed this amount was all for U.S. federal income taxes.

⁸Differences in the estimating methodologies and databases used by each set of estimators account for the differences in the estimates.

forecasts that the Joint Committee or the Treasury uses, could cause both the tax expenditure estimate and the revenue gain estimate to either overstate or understate the true amount of revenue that would flow into the Treasury if the credit were eliminated. The last publicly available revenue savings estimates, made by either the Joint Committee or the Treasury, for the immediate elimination of the possessions tax credit do not reflect the significant limitations that were placed on the credit by the Omnibus Budget Reconciliation Act of 1993.

Estimated Total Federal Tax Would Have Been Substantially Reduced by EITC

As of July 1995, 651,201 individual income tax returns for tax year 1992 had been filed with the Government of Puerto Rico. Some of the individuals filing those returns paid federal income tax because they had income from sources within the United States. However, due to section 933 of IRC, which excludes Puerto Rico source income from federal taxation, the vast majority of Puerto Rican taxpayers were not subject to the federal income tax.

If current federal tax rules were applied to residents of Puerto Rico in the same manner as they are applied to residents of the 50 states, and if the income and demographic characteristics of Puerto Rican taxpayers were the same as they reported on their 1992 tax returns, we estimate that the 651,201 filers would have owed about \$623 million in federal income tax before taking EITC into account.⁹ The aggregate amount of EITC earned by these taxpayers would have been about \$574 million, thus the aggregate net federal tax liability would have been about \$49 million (see table 1). We estimate that 384,107 filers, or about 59 percent of the total number, would have earned some EITC. The average amount of EITC earned by the 384,107 filers would have been about \$1,494. The median EITC would have been about \$1,623 (see table 2).

⁹By "current" federal tax rules, we mean rules adopted as of the end of 1995. For the most part these are the rules that were effective for tax year 1995. The one exception is that we used the rules for the EITC that did not become fully phased in until tax year 1996.

Table 1: Estimated Potential U.S. Tax Liabilities and EITC for Residents of Puerto Rico

Dollars in millions

U.S. adjusted gross income (AGI) classes	Number of Puerto Rican returns	U.S. tax liability before EITC ^a	U.S. EITC	U.S. tax liability after EITC ^b
Less than \$0	922	\$0	\$0	\$0
\$0 to \$2,999	34,906	0	7	-7
\$3,000 to \$5,999	50,719	0	40	-40
\$6,000 to \$9,999	133,266	8	200	-192
\$10,000 to \$14,999	152,916	33	226	-193
\$15,000 to \$24,999	151,122	118	101	17
\$25,000 to \$49,999	103,758	261	0	261
\$50,000 to \$99,999	20,493	128	0	128
\$100,000 and over	3,099	75	0	75
Total	651,201	\$623	\$574	\$49

^aU.S. tax liabilities before EITC are reduced by estimated child and dependent care tax credits totaling about \$15 million.

^bPuerto Rican residents and nonresidents claimed as a tax credit on their Puerto Rican tax returns about \$4.4 million in U.S. individual taxes in 1992. Estimated U.S. tax liabilities of \$49 million under state-like taxation is gross of this amount.

Source: GAO simulation of U.S. tax law applied to 1992 Puerto Rican individual income tax returns.

Table 2: Estimates of Potential Puerto Rican Total, Average, and Median EITCs

Earned income range	Number of credit filers	Percentage of credit returns	Estimate of total credits (in millions)	Average credit	Median credit
Phase-in	59,721	16%	\$71	\$1,192	\$1,026
Maximum	90,759	24	193	2,126	1,920
Phase-out	233,627	61	310	1,326	1,346
Total	384,107	100%	\$574	\$1,494	\$1,623

Note: Totals may not add because of rounding.

Source: GAO simulation of U.S. tax law applied to 1992 Puerto Rican individual income tax returns.

Our estimates indicate that, before taking the federal child and dependent care tax credit (DCTC) into account, about 41 percent of the 651,201 households that filed Puerto Rican income tax returns in 1992 would have had positive federal income tax liabilities, about 53 percent would have

received net transfers from the federal government because their EITC would have more than offset their precredit liabilities, and the remaining 6 percent would have had no federal tax liability. The lack of adequate information on the child and dependent care expenses of Puerto Rican taxpayers made it impossible for us to estimate the amount of DCTC that each taxpayer in our Puerto Rico database would have earned.¹⁰ The nonrefundable DCTC could only have reduced the number of households having positive tax liabilities and increased the numbers with zero liabilities or net transfers. However, it seems unlikely that the DCTC would have caused a large number of taxpayers to shift from one status to another because our estimates indicate that the average credit earned by those claiming the credit would likely be less than \$500. Taxpayers would only move from having a positive tax liability to having a zero tax liability, or receiving a net transfer, if they claimed the credit and if their precredit tax liability were less than the amount of credit claimed.¹¹

If the federal income tax had been fully extended to residents of Puerto Rico in 1992, it seems likely that additional individuals and married couples who had not filed Puerto Rican tax returns would have filed federal tax returns in order to take advantage of EITC. Individuals with AGIS less than or equal to \$3,300 and married couples with AGIS less than or equal to \$6,000 were not required to file Commonwealth tax returns in 1992. However, some of these individuals filed in order to claim refunds of taxes that had been withheld on their wages, dividends, or interest. Others did not file, for example, because they were not subject to withholding taxes on their wages or salaries, as is the case for domestic workers and farm laborers, or because the amount withheld was small.

We have no way of knowing with certainty how many of these residents who currently are not required to file would file in order to claim EITC. However, to derive an estimate of what this number might be, we considered the number of people who had income levels below the income tax threshold and also were exempt from withholding as an upper limit of

¹⁰We did use the experience of U.S. taxpayers as a basis for estimating the aggregate amount of the federal DCTC that Puerto Rican taxpayers might earn (see app. I for details.) This aggregate amount of DCTC is factored into our estimate of the aggregate federal tax liability in table 1. However, we were unable to assign DCTC to specific taxpayers and, consequently, were unable to determine how those credits affected the net federal tax liability of each individual taxpayer.

¹¹We estimate that between 30,000 and 40,000 Puerto Rican taxpayers would have qualified for DCTC in 1992—roughly 5 to 6 percent of the taxfiling population. (See app. I for the estimating methodology.) The number who would have moved from a positive tax liability to a zero or negative one simply by the addition of this credit probably would have been small, since the average amount of credit earned by DCTC recipients in the United States in 1992 was about \$427.

the number of these potential additional filers.¹² If all of those residents claimed EITC, we estimated that they would have qualified for about \$64 million.¹³

If the additional EITC that could have been claimed by nonfiler residents were about \$64 million, our estimate of the aggregate amount of EITC that would have been earned would have increased from about \$574 million to about \$638 million. This additional EITC would be sufficient to eliminate the \$49 million of aggregate net federal income tax liability that we estimated would exist for the population that did file.

Our estimates do not reflect other potential behavioral responses to the availability of the credit or the imposition of the federal income tax. For example, we were not able to estimate the number of potential EITC claimants who currently are not filing, even though they are legally obligated to file.

Puerto Rico Would Have Had to Reduce Its Own Tax to Keep the Average Combined Income Tax at Its Current Level

For tax year 1992, Puerto Rican taxpayers reported about \$1.03 billion in individual income tax. We estimated that, if current federal tax rules had been fully applied to residents of Puerto Rico and, if there were no behavioral responses to this new taxation, then the aggregate federal income tax liability of Puerto Rican taxpayers in 1992 would have been about \$49 million. If the Government of Puerto Rico had wanted to keep the amount of combined federal and commonwealth individual income tax the same as it was without the imposition of full federal income tax, then it would have had to reduce the aggregate liability imposed by its own individual income tax by about 5 percent. If we allowed for the potential expansion of the filing population in response to the availability of EITC (to include residents who had no withholding), then the estimated aggregate federal income tax liability would have been essentially eliminated. In that case, the Government of Puerto Rico would not have to change its own income tax to keep the aggregate combined income tax constant. There are, however, other reasons why the Government of Puerto Rico may have adjusted its own income tax under these circumstances.

¹²There were some additional taxpayers in 1992 who had tax withheld but did not file Puerto Rican tax returns. The potential amount of additional EITC these taxpayers could have qualified for would likely have been relatively low because their earned incomes probably were very low.

¹³According to officials from the Puerto Rican Treasury, the number of domestic workers and farm laborers who were exempt from income tax withholding in Puerto Rico in 1992 was approximately 43,000. We estimated the upper bound for the amount of EITC that these individuals would have earned by assuming that (1) none of the 43,000 workers actually filed a return in 1992; (2) none of these workers were from the same family; (3) all of these workers were qualified for EITC; and (4) they each earned the average EITC which we estimated to be about \$1,494.

In comments on a draft of this report, the Secretary of the Treasury of Puerto Rico stated that his government would adjust the island's fiscal system to provide relief to taxpayers who would have positive federal income tax liabilities if the federal income tax were fully extended to residents of Puerto Rico.

Average Combined Individual Income Tax in Puerto Rico Was Low Relative to That in the 50 States

There are several ways to compare individual income tax across jurisdictions. A comparison of per-capita tax shows how much, in dollars, the average resident in each jurisdiction bears. Personal income provides a better indication of a jurisdiction's tax capacity than does population because a person's ability to pay taxes rises as his or her income rises. A comparison of taxes paid as a percentage of total state or commonwealth personal income shows, approximately, the relative extent to which each jurisdiction draws upon its residents' ability to pay. When comparing individual income taxes paid, however, it is important to recognize that some jurisdictions may have relatively low individual income taxes because they rely more heavily on other revenue sources. It is also important to note that comparisons of average taxes paid across jurisdictions do not show the comparative taxes paid by specific classes of taxpayers in each jurisdiction.

In per-capita terms, Puerto Rico's individual income tax is relatively low. In 1992, the per-capita tax burden of Puerto Rico's individual income tax was about \$341. The state and local income taxes in 33 states, and the District of Columbia, were higher per capita. Moreover, since residents of Puerto Rico currently pay a relatively small amount of federal income tax, the combined federal and Commonwealth per-capita income taxes in Puerto Rico are lower than those in any of the 50 states and the District of Columbia. If residents of Puerto Rico had been fully subject to the federal income tax in the same manner as residents of the 50 states were, we estimate that the per-capita federal income tax in Puerto Rico would have been about \$14 in 1992.¹⁴ In this case, if the Government of Puerto Rico did not adjust its own income tax in response to the imposition of the federal tax, the combined federal and Commonwealth income tax in Puerto Rico would have been about \$355 per capita. This amount is about a third of the per-capita combined federal, state, and local income taxes in Mississippi, which has the lowest per-capita income taxes of any state. (See app. IV.)

One reason why Puerto Rico's per-capita income tax is relatively low is that per-capita personal income in Puerto Rico is significantly lower than

¹⁴This estimate of the per-capita burden is based on the estimated aggregate burden of \$49 million.

that in any of the 50 states and the District of Columbia. In 1992, Puerto Rico's per-capita personal income was \$6,428, compared to \$14,083 in Mississippi, the state with the lowest per-capita personal income.

Puerto Rico's individual income tax collections amounted to 5.3 percent of the Commonwealth's personal income in 1992. This percentage is higher than that of the state and local income tax collections in any of the states and the District of Columbia. New York state, where state and local income taxes amounted to 4.2 percent of state personal income, ranked closest to Puerto Rico. (See app. IV).

One reason why Puerto Rico's income tax as a percentage of personal income is high, relative to those of the 50 states and the District of Columbia, is because Puerto Rico relies more heavily on income taxes as a source of revenue than do most of those other jurisdictions. In 1992, only two states, Maryland and Massachusetts, relied more heavily on their state and local individual income taxes than Puerto Rico did. Puerto Rico's reliance on its corporate income tax was also much higher than that of any state or the District of Columbia. Puerto Rico does not levy a general sales tax and received only 5.8 percent of its general revenues from property taxes. In contrast, in the vast majority of states, general sales taxes and property taxes account for at least 25 percent of general revenues. (See app. IV).

Despite Puerto Rico's heavy reliance on its individual income tax, the combined federal, state, and local individual income taxes, as a percentage of personal income, were significantly lower in Puerto Rico than in any of the states or the District of Columbia because residents of Puerto Rico paid little federal income tax. If residents of Puerto Rico had been fully subject to the federal income tax in 1992, and Puerto Rico did not alter its own income tax, we estimate that the combined income taxes would have amounted to about 5.5 percent of Commonwealth personal income. Combined income taxes in Mississippi amounted to 8.2 percent of state personal income in 1992. In no other state or the District of Columbia did combined income taxes amount to less than 9 percent of personal income. (See app. IV).

Although the combined average income tax rates paid by residents of Puerto Rico would not have changed substantially, unless the Government of Puerto Rico adjusted its own income tax rate schedule, higher income residents of Puerto Rico would face substantial increases in their combined marginal income tax rates if they were fully subject to the

federal income tax. These individuals would face much higher combined marginal income tax rates than similar individuals residing in any of the 50 states or the District of Columbia face. Under Puerto Rico's current income tax law, marginal tax rates can reach as high as 38 percent over certain ranges of income. Rates for single taxpayers and married taxpayers filing joint returns in Puerto Rico reach 31 percent when taxable income is as little as \$30,001. Rates for married taxpayers filing separately reach 31 percent when taxable income is as little as \$15,001.¹⁵ In contrast, as of 1994, in no state or the District of Columbia did state and local marginal tax rates exceed 12 percent for any taxpayers at any income level. With the full imposition of the federal income tax, some residents of Puerto Rico could face combined marginal income tax rates of over 70 percent, unless the Government of Puerto Rico adjusted its own tax.

Revenue Estimates for the Elimination or Phase-Out of the Possessions Tax Credit

Neither the Joint Committee on Taxation nor the U.S. Department of the Treasury has made public any recent estimates of the amount of revenue that would be saved if the possessions tax credit were eliminated immediately. The last publicly available revenue estimate that the Joint Committee made for an immediate repeal of the possessions tax credit, without any phase out, was in February 1993. At that time, it estimated that the repeal of the credit would increase revenues by \$4.1 billion in 1996. That estimate did not reflect the significant limitations that the Omnibus Budget Reconciliation Act (OBRA) of 1993 subsequently placed on the use of the credit. Since the 1993 changes reduced the benefits provided by the credit, the February 1993 estimate was higher than it would have been if the Joint Committee had known about the changes.¹⁶ The U.S. Department of the Treasury also has not publicly released a revenue estimate for the immediate repeal of the credit since the OBRA 1993 changes.

The Seven-Year Balanced Budget Reconciliation Act of 1995 (H.R. 2491) would have repealed the possessions tax credit after December 31, 1995, had it not been vetoed by the President. The act contained a grandfather rule that would have gradually phased out the credit for existing credit claimants over a period of up to 10 years. The Joint Committee on Taxation estimated that this phasing out of the credit would

¹⁵These current rates became effective for tax years beginning after June 30, 1995. For tax year 1992 the comparable rates would have been 41, 36, and 36 percent. See app. II for further details on the changes made to Puerto Rico's income tax since 1992.

¹⁶The economic assumptions that the Joint Committee would use when making an estimate now are also likely to be different from the ones used in 1993. We do not know the effect that the change in assumptions would have on the estimate.

save the Treasury \$255 million in 1996 and a total of \$2.5 billion from 1996 through 2000. This revenue estimate is relevant only to the very specific phase-out rules contained in the act. Other phase-out schemes could have much different revenue consequences.

The Joint Committee on Taxation and the Treasury Department have made “tax expenditure” estimates for the possessions tax credit as recently as September 1995 and March 1996, respectively. The latest Joint Committee estimates indicated that the tax expenditure would be \$3.4 billion in 1996, growing to \$4.4 billion by 2000. The Treasury Department estimated that the tax expenditure would be \$2.8 billion in 1996, rising to \$3.4 billion by 2000. The Joint Committee and Treasury both use a different approach for making tax expenditure estimates for specific tax preferences than they use for estimating the revenue gains that would occur if those preferences were eliminated. A revenue gain estimate reflects expected behavioral changes on the part of taxpayers in response to the elimination of a particular preference; a tax expenditure estimate, which represents the amount of tax benefit that taxpayers would receive if the preference were not repealed, does not reflect any behavioral changes.

If a tax credit were eliminated, taxpayers would be likely to seek ways to avoid paying the full amount of tax that the credit had previously offset. For example, if the possessions tax credit were repealed, U.S. corporations might shift some of their investment out of Puerto Rico to operations in foreign countries, where some of the income might not be immediately subject to U.S. taxation. Due to the differences in behavioral assumptions, if either the Joint Committee or Treasury were to make both a tax expenditure estimate for a tax credit and a revenue gain estimate for the elimination of the credit, using the same set of economic forecasts and the same data, the revenue gain estimate could very well be smaller than the tax expenditure estimate. On the other hand, imprecisions in other assumptions and in the economic forecasts that the Joint Committee or Treasury uses could cause both the tax expenditure estimate and the revenue gain estimate to either overstate or understate the true amount of revenue that would flow into the treasury if the credit were eliminated.

Scope and Methodology

To calculate an estimate of the amount of personal income taxes the United States would collect from residents of Puerto Rico and to analyze issues related to EITC, we obtained individual income tax data from the Government of Puerto Rico. The data included selected items from each individual income tax return filed with the Department of the Treasury of

Puerto Rico in 1992, the last year for which detailed information was available.

The data we used were the best available. However, they were taken from an administrative database that had not been cleaned of all errors or inconsistencies. We did our own consistency checks and, with the assistance of the Department of the Treasury of Puerto Rico, corrected the significant errors we detected. Some inconsistencies remain in the data, but we determined that the data is adequate to provide general information about the magnitude of the potential revenue effect of extending full federal income taxation to the residents of Puerto Rico.

We documented the structure of the Puerto Rican individual income tax system and compared it to the U.S. tax system. On the basis of the tax law summary table in appendix II and the data provided by the Commonwealth, we prepared a computer program to estimate the federal income tax that would have been paid if each Puerto Rican 1992 individual filer had filed a U.S. individual tax return according to U.S. tax rules that had been adopted as of December 31, 1995. With one exception, we used U.S. tax rules that were effective for tax year 1995. The one exception was that we used the rules governing EITC that became fully phased in for tax year 1996.

We did not attempt to predict how taxpayers would respond to the new incentives and disincentives they would face under U.S. tax law. Behavioral responses of corporate taxpayers to the elimination of the possessions tax credit would be of particular importance to the aggregate amount of income earned in Puerto Rico. According to officials from the Department of the Treasury of Puerto Rico, corporations covered by the credit directly employed about 109,000 Puerto Rican residents in 1995. As we concluded in our earlier report on the possessions tax credit, reliable estimates of the impact that the elimination of the credit would have on Puerto Rico's economy cannot be made.¹⁷

A second important limitation of our estimate of federal individual income tax liabilities results from deficiencies of the data available for our estimate. The Puerto Rican tax returns do not contain all of the information that we would need to accurately simulate certain aspects of the federal tax code. For example, under Puerto Rico tax rules, interest from U.S. federal securities is exempt from taxation. No information about

¹⁷Tax Policy: Puerto Rico and the Section 936 Tax Credit, (GAO/GGD-93-109, June 8, 1993).

this type of interest is reported on the return, and accordingly, we do not have the data to estimate its effect on a possible U.S. tax liability.

To compare the combined income tax burden of the Commonwealth of Puerto Rico to the combined income tax burden of the 50 states and the District of Columbia, we analyzed federal, state, and local individual income taxes in per-capita terms and as a percentage of personal income using published data from the Advisory Commission on Intergovernmental Relations (ACIR), the Commonwealth of Puerto Rico, and IRS statistics of income. Further details on our methodology are contained in appendix I.

As agreed with your staff, we did not produce our own estimate of the amount of revenue the U.S. Treasury could obtain by eliminating the possessions tax credit. We have simply presented the Joint Committee on Taxation's and the U.S. Treasury's estimates of the tax expenditure for the credit.

The Puerto Rico Treasury was unable to provide us with detailed data relating to corporations operating in Puerto Rico that are not covered by the possessions tax credit. There are differences between Puerto Rico's corporate income tax and the federal corporate income tax. In the absence of detailed data relating to the incomes and deductions reported by corporations not covered by the possessions tax credit, we cannot say whether federal income taxation of these corporations would have yielded significantly more or significantly less revenue than the approximately \$594 million of income tax actually collected from these corporations by Puerto Rico in 1992. Marginal tax rates for corporations are generally higher in Puerto Rico than in the United States, but Puerto Rico provides significant tax exemptions for income earned from certain designated activities. Appendix III provides a description of the principal differences in the treatment of corporate and partnership income under the Puerto Rican and federal tax codes.

We did our work in Washington, D.C., between August 1995 and June 1996 in accordance with generally accepted government auditing standards.

Agency Comments

We requested comments on a draft of this report from the Secretary of the Treasury of the Commonwealth of Puerto Rico, from officials of the U.S. Treasury, and from the Internal Revenue Service. We discussed the draft on June 7, 1996, with responsible officials from the Office of the Assistant Secretary of the Treasury for Tax Policy. We discussed the draft on

June 11, 1996, with the Secretary of the Treasury of Puerto Rico and members of his staff. The Secretary also provided us with written comments, the full text of which, excluding an attachment of technical comments, is presented in appendix V. IRS' Office of the Associate Chief Counsel provided us with written comments relating to our descriptions of sections of IRC. Most of the comments that the various officials made brought to our attention corrected and updated information. There were also suggestions that parts of our presentation needed to be clarified. We considered their comments and modified the report where appropriate.

The U.S. and Puerto Rican officials made several comments that merit special attention. First, officials from both the U.S. and Puerto Rican Departments of the Treasury pointed out that we did not address the distributional effects that a full imposition of the federal income tax would have in Puerto Rico. An official from the U.S. Treasury noted that the combined marginal income tax rates of higher income individuals in Puerto Rico would be significantly higher than the combined marginal rates on similar individuals in any of the 50 states or the District of Columbia. He suggested that the Government of Puerto Rico would be compelled to modify its own tax system to avoid these extremely high rates. The Secretary of the Treasury of Puerto Rico noted that his government would have to make significant adjustments to the island's fiscal system to provide relief for those who would have positive federal income tax liabilities. IRS' Associate Chief Counsel noted that U.S. persons who currently pay Puerto Rican income tax as well as federal income tax, such as U.S. military personnel stationed on the island, can claim a foreign tax credit against their federal income tax liability. If the Puerto Rican income tax were to be treated as a state income tax, these individuals would only be allowed to claim a deduction for that tax, not a credit. As a result, their U.S. income tax liabilities could increase significantly if Puerto Rico did not adjust its income tax.

We agree that the full imposition of the federal income tax could have significant impacts on specific groups of taxpayers in Puerto Rico, even though the impact on aggregate federal revenue might be negligible. However, the data and our estimating methodology did not support a detailed distributional analysis. We did not mention possible policy responses by the Government of Puerto Rico because that was beyond the scope of this study. In the section of our report that compares the combined individual income taxes in Puerto Rico with those in the 50 states and the District of Columbia, we have added a comparison of the marginal tax rates for Puerto Rico's income tax with the marginal income

tax rates for other U.S. jurisdictions. The top marginal income tax rate in Puerto Rico is significantly higher than the rates in the other jurisdictions.

Officials from both the U.S. and Puerto Rican Treasuries were concerned about our discussion of local corporations operating in Puerto Rico that are not covered by the possessions tax credit. The officials felt that we improperly implied that the amount of income tax revenue that the Government of Puerto Rico currently collects from these corporations indicates roughly the amount of revenue that the federal government might collect if the corporations were subject to the full federal income tax. We tried to make clear in our draft that there are differences between Puerto Rico's corporate income tax and the federal corporate income tax and that potential federal revenues could be greater or less than the amount that the Government of Puerto Rico currently collects. In response to the comments, we moved some of the discussion of differences between the two corporate income taxes forward from an appendix to the body of the letter.

Finally, the Secretary of the Treasury of Puerto Rico noted that our report does not address all of the consequences that are likely to follow from a major change in the fiscal relations between Puerto Rico and the federal government. He said that, in particular, we do not address potential changes in federal transfers to Puerto Rico. We agree that there are important considerations relating to potential changes in fiscal relations that are beyond the scope of this report.

Unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this report. At that time, we will send copies of this report to the Ranking Minority Members of the House Committee on Resources, and the Subcommittee on Native Americans and Insular Affairs, and to other appropriate congressional committees. We will also send copies to the Commissioner of the IRS, Secretary of the Treasury, representatives of the government of Puerto Rico, and other interested parties. Copies will also be made available to others upon request.

This work was performed under the direction of James Wozny, Assistant Director, Tax Policy and Administration Issues. Major contributors to this report are listed in appendix VI. If you have any questions please contact me on (202) 512-9044.

A handwritten signature in black ink, appearing to read 'Natwar M. Gandhi'. The signature is stylized with large loops and a long horizontal stroke.

Natwar M. Gandhi
Associate Director, Tax Policy
and Administration Issues

Contents

Letter		1
Appendix I		22
Objectives, Scope, and Methodology	EITC Estimate	24
	Child and Dependent Care Tax Credit Estimate	26
	Combined Individual Income Taxes	27
Appendix II		29
Comparison of U.S. and Puerto Rico Individual Income Tax Rules	EITC Rules	40
Appendix III		44
Comparison of U.S. and Puerto Rico's Taxation of Corporate and Partnership Income	Corporate Taxation	44
	Possessions Tax Credit	45
	Partnership Taxation	46
Appendix IV		47
Combined Individual Income Taxes: Puerto Rico, the 50 States, and the District of Columbia		
Appendix V		56
Comments From the Secretary of the Treasury of Puerto Rico		

Appendix VI	58
Major Contributors to This Report	

Tables		
	Table 1: Estimated Potential U.S. Tax Liabilities and EITC for Residents of Puerto Rico	8
	Table 2: Estimates of Potential Puerto Rican Total, Average, and Median EITCs	8
	Table II.1: Conversion of Puerto Rican 1992 Individual Income Tax Return Items to U.S. 1995 Individual Income Tax Return Items	29
	Table II.2: Analysis of the Principal EITC Requirements For Tax Year 1996	42
	Table IV.1: Actual Federal, State, and Local Individual Income Tax Per Capita, 1992	47
	Table IV.2: Actual Federal, State, and Local Individual Income Tax as a Percentage of Personal Income, 1992	49
	Table IV.3: Puerto Rico, State, and District of Columbia General Revenue Sources, Percentage Distribution, Fiscal Year 1992	52

Abbreviations

ACIR	Advisory Commission on Intergovernmental Relations
AGI	Adjusted Gross Income
AMT	Alternative Minimum Tax
DCTC	Child and Dependent Care Tax Credit
EITC	Earned Income Tax Credit
IRA	Individual Retirement Account
IRC	Internal Revenue Code
IRS	Internal Revenue Service
OBRA	Omnibus Budget Reconciliation Act
SEP	Simplified Employee Pension
SOI	Statistics of Income

Objectives, Scope, and Methodology

The Chairman, House Committee on Resources, and the Chairman, House Subcommittee on Native American and Insular Affairs, Committee on Resources, requested that we provide certain data regarding the potential effects of extending federal income taxation to Puerto Rico. Specifically, they asked that we provide estimates of

(1) the amount of federal income tax that individuals residing in Puerto Rico would pay if they were treated in the same manner as residents of the 50 states, the amount of earned income tax credits (EITC) Puerto Rican residents would receive, the percentage of taxpayers who would have positive federal tax liabilities, and the percentage who would earn EITC;

(2) the extent to which the Government of Puerto Rico would have to reduce its own income tax if it were to keep the amount of combined income tax (both federal and Commonwealth) on individuals the same as it was without the full imposition of the federal tax;

(3) how the amount of income taxes paid by the average taxpayer in Puerto Rico compares with the amount of combined federal, state, and local income taxes paid by residents in the 50 states and the District of Columbia; and

(4) the amount of revenue the U.S. Treasury could obtain by the repeal of the possessions tax credit, which effectively exempts from federal taxation a portion of the income that subsidiaries of U.S. corporations earn in Puerto Rico.

To calculate the amount of personal income taxes the United States would collect from residents of Puerto Rico and analyze issues related to EITC, we obtained individual income tax data from the Government of Puerto Rico. These data included selected items from each individual income tax return filed with the Department of the Treasury of Puerto Rico in 1992, the last year for which detailed information was available.

The data we used were the best available. However, they were taken from an administrative database that had not been cleaned of all errors or inconsistencies. We did our own consistency checks and, with the assistance of the Department of the Treasury of Puerto Rico, corrected the significant errors we detected. Some inconsistencies remain in the data, but we determined that the data is adequate to provide general information about the magnitude of the potential revenue effect of extending full federal income taxation to the residents of Puerto Rico.

To estimate the total U.S. federal income tax related to extending the federal income tax to Puerto Rico, we documented the elements that made up Puerto Rico's taxable income, deductions, exemptions, and credits and compared them to the U.S. federal income tax. To aid that process, we have prepared a summary table tracing each line item from the U.S. 1040 return and schedule of itemized deductions to a comparable item in the 1992 Puerto Rican individual income tax return. On the basis of the tax law summary table in appendix II and the data provided by the Commonwealth, we prepared a computer program to estimate the federal income tax that would have been paid if (1) each Puerto Rican 1992 individual filer had filed a U.S. individual tax return according to U.S. tax rules that had been adopted as of the end of 1995 and (2) his or her filing behavior had not changed as a result of the imposition of U.S. income taxes. U.S. tax law was used to determine U.S. tax treatment of Puerto Rican tax return income, exemption, and deduction items.¹ We assumed that the taxpayers took advantage of any U.S. credits or deductions that were not available under Puerto Rico law, if we had sufficient data to presume their eligibility for those credits and deductions.

The estimate of U.S. federal tax liabilities that we produced in this manner differs in several important ways from an estimate of the amount of revenue that the United States would actually receive if the federal income tax were actually imposed on Puerto Rico residents for tax year 1995. We have not attempted to estimate how the extension of individual and corporate income taxes or any federal aid programs would affect the pretax incomes of Puerto Rican taxpayers.

Another important limitation of our estimate results from deficiencies of the data available for our estimate. The Puerto Rican tax returns do not contain all of the information that we would need to accurately simulate certain aspects of the federal tax code. For example, under Puerto Rico's tax rules, interest from federal securities is exempt from taxation. Also, for example, unemployment compensation is not included in Puerto Rico's definition of gross income, whereas it is in U.S. tax law. Information about this interest and unemployment compensation is not reported on the return, and accordingly, we did not have the data to estimate its effect on a possible U.S. tax liability. The analysis in appendix II describes the extent

¹We followed U.S. tax laws that were in place as of October 1, 1995. All relevant dollar amounts that are included in the U.S. tax code, such as the amounts for exemptions, standard deductions, and boundaries for tax rate brackets, were deflated into 1992 dollar equivalents. Also, prospective changes in the calculation of the earned income tax credit scheduled to be in place in tax year 1996 were incorporated in the simulation exercise.

to which we could or could not estimate amounts for each line item on the federal tax return from data on Puerto Rican returns.

Finally, a study of compliance with Puerto Rico's income tax prepared for the Puerto Rico Treasury revealed that noncompliance with Puerto Rico income tax laws is significantly more extensive than noncompliance with federal income tax laws. This study indicated that the total income gap (the amount of adjusted gross income (AGI) that went unreported) in 1991 for Puerto Rico was about \$3.71 billion, or 26 percent of total income, while for the United States the income gap was about \$447.1 billion, or 12 percent. Our estimates reflect the compliance behavior of Puerto Rican taxpayers in 1992. They do not take into account any change in compliance rates in Puerto Rico that have occurred since 1992 or that might occur if full federal income taxation were imposed. Since the completion of that study, the Department of the Treasury of Puerto Rico has implemented new compliance initiatives that, according to Puerto Rico Treasury officials, have increased the number of individual income tax returns filed from 651,201 in 1992 to 720,000 in 1994 and increased their collections of all taxes by about \$430 million in fiscal years 1994 and 1995.

EITC Estimate

EITC is a major feature of the U.S. income tax system that would significantly affect estimates of federal tax revenues obtained from Puerto Rico if the federal income tax were extended to Puerto Rico. EITC is a refundable credit that is awarded to tax filers who meet certain earned income requirements and have qualified children residing in their households. A smaller credit is awarded tax filers who have earned incomes but no qualifying children—the so-called “childless” credit. Qualification requirements for the credit are discussed in table II.2. Because the credit is targeted to tax filers with relatively low earned incomes, a tax filing population with a high proportion of low-income earners, such as Puerto Rico's, would be entitled to a substantial amount of EITC in the aggregate.

Our EITC simulation methodology relied on available information contained in Puerto Rican tax returns for 1992 to estimate proxies for earned income, unearned income, AGI, and qualifying children, as defined under federal tax law. We restated all dollar values, such as income thresholds and maximum credits, contained in the EITC computation rules as 1992 dollars. We then applied the restated rules to the estimated proxies in

order to compute an EITC for each Puerto Rican taxfiler in 1992 that met the necessary conditions.

A limitation of the simulation described above, apart from the necessity to approximate the value of certain tax elements, is the risk of significantly undercounting the potential EITC-qualified population of tax filers. The 1992 Puerto Rican tax filing population may omit potential filers either because their incomes fell below the filing threshold for the Puerto Rico income tax or because they evaded their filing obligations in 1992.² Because the number of these potential filers may be substantial at the lower earned income levels, and thus cause our simulated estimate of EITC to be understated, we examined Census data in an attempt to estimate the number of nonfilers that would file if EITC were available.

The decennial 1990 Census of Puerto Rico contains information on the incomes and family composition of households during the sample period 1989. From the family relationships contained on the Census file we constructed a data file of simulated tax filers, e.g., single, head-of-household, and married joint returns. Information about the age and incomes of nonfiling family members was used to estimate the number of EITC-qualified children. Income elements, although not complete for computing taxable incomes, seemed reasonably adequate for estimating approximations of AGI and earned income.

From the simulated tax filing data set, we estimated the number of potential filers who would qualify for EITC by AGI classes. These counts of potential filers were compared to the count of simulated EITC filers obtained from the 1992 Puerto Rican tax return file. As expected, the number of potential filers in the Census data set in low-AGI groups, roughly those AGIs below tax filing thresholds, exceeded the number from the tax file data set. Many of the simulated filers from the Census data set, in these income groups, could be agricultural workers or domestic service workers who are exempt from tax withholding and thus need not file tax returns. However, in the higher AGI classes, the number of simulated EITC tax filers from the Census data set was lower than the number of simulated EITC filers from the 1992 tax return data set. This result is not plausible because the number of potential EITC recipients in the full Puerto Rican population

²In Puerto Rico, the requirements for filing a return for tax year 1992 were \$3,300 in gross income for single persons or married individuals not living together, and \$6,000 in gross income for married persons living together. Individuals below these tax thresholds may have filed, however, to claim refunds of taxes withheld by employers. Some taxpayers may not have filed for a refund if the amounts withheld were small.

cannot be lower than the number of potential recipients in the tax filing population.

We have more confidence in our simulations based on the tax return data than those based on the Census data. The translation of Puerto Rican filing units into federal filing units is relatively straightforward from the tax data, although there is considerable uncertainty as to how households in the Census database should be translated into filing units. In addition, income amounts reported on the Census survey may differ from the amounts that the same individuals would report for tax purposes. For these reasons we concluded that we could not use the Census data to estimate the total number of nonfilers who might claim EITC if it became available to them.³ However, as explained in the letter, we did make an upper-bound estimate for the amount of EITC that might be claimed by taxpayers who had legitimate reasons for not filing tax returns in 1992.

Potential noncompliance with the EITC provisions and behavioral responses to the availability of the credit could result in a larger aggregate amount of EITC being earned than we have estimated. A previous GAO report and studies by IRS have raised concerns regarding the vulnerability of EITC to noncompliance including fraud.⁴ Also, the introduction of the earned income credit could induce some welfare recipients to forego welfare and obtain employment in order to claim the tax credit. We did not adjust our estimate for these factors because there was insufficient information available to quantify their effect on EITC.

Child and Dependent Care Tax Credit Estimate

Differences between U.S. and Puerto Rican tax rules relating to child and dependent care expenses made it impossible for us to estimate the amount of federal child and dependent care tax credit (DCTC) that each taxpayer in our Puerto Rico database would earn. The federal credit, which is nonrefundable, is equal to a percentage of the expenses that a taxpayer pays for child or dependent care in order to be able to obtain gainful

³We examined the possibility that the difference in the years between the two data sets—the Census data were based on information in 1989, whereas the tax return data set were for the year 1992—might have caused the inconsistency in counts between AGI groups. We obtained from the Treasury Department of Puerto Rico a table of tax filers by AGI groups for the same year as the Census data—1989. In order to estimate the number of EITC filers in each AGI group in 1989, we used our 1992 data to compute the proportions of all tax filers that qualified for the EITC by AGI class and then applied these proportions to the 1989 tax filer counts for the respective AGI groups. A comparison of the count of Census simulated EITC tax filers to the imputed EITC tax return simulated filers again led to a statistical inconsistency across AGI groups.

⁴Tax Administration: Earned Income Credit—Data on Noncompliance and Illegal Alien Recipients, (GAO/GGD-95-27, Oct. 25, 1994).

employment. The maximum credit for taxpayers with AGIS of \$10,000 or less is \$1,440 for two or more dependents, and \$720 for one dependent. The maximum credit for taxpayers with AGIS over \$28,000 is \$960 for two or more dependents, and \$480 for one dependent. Puerto Rico allows an itemized deduction for child-care expenses but not for expenses to care for other dependents. The maximum deduction is \$800 for two or more children, and \$400 for one child. A large majority of Puerto Rican taxpayers do not itemize, so we were unable to determine whether they had any expenses for child care.

In the absence of complete information on the child and dependent care expenses of Puerto Rican taxpayers, we had to rely upon the experience of U.S. taxpayers as a basis for estimating the aggregate amount of federal DCTC that Puerto Rican taxpayers might claim. Using a sample of individual tax returns compiled by IRS for tax year 1991, the latest data available, we classified U.S. returns by nine AGI categories and by the number of children claimed as qualifying for the DCTC. We classified Puerto Rican returns according to estimated U.S. AGI and the number of children claimed as dependents. We computed an average credit amount per U.S. return for each class of return. We assumed that the average credit per Puerto Rican return in a given class would be the same as the average credit for the comparable class of U.S. returns⁵ Thus, we multiplied the number of Puerto Rican returns in each class by the appropriate U.S. average credit to obtain the amount of credit earned by each class of Puerto Rican returns. We obtained our overall estimate of about \$15 million by summing the estimates for the individual classes.

We were unable to allocate the aggregate amount of DCTC across individual taxpayers. Consequently, we do not know precisely how many taxpayers might have had their federal tax liabilities completely offset by this credit. For this reason, we could not estimate precisely the number of Puerto Rican taxpayers who would have had positive federal tax liabilities.

Combined Individual Income Taxes

Determining the magnitude of the income tax reductions the Government of Puerto Rico would have to make in order to maintain the same level of combined income tax paid by individuals resident in Puerto Rico if they were subject to the federal income tax was a two-step process. First, we

⁵Dependent-care expenses are likely to be lower in Puerto Rico than in the rest of the United States because labor costs are significantly lower in Puerto Rico than in the United States. However, the amount of expenses that qualify for the credit is capped at \$2,400 per dependent and at \$4,800 in total. These caps should reduce differences between the average amounts of credit that would be claimed in Puerto Rico, by income group, and the average amounts claimed in the rest of the United States.

determined the total amount of 1992 Puerto Rican tax from the income tax return data provided by the Commonwealth. Then, we compared this amount to the total estimated potential U.S. tax liability as calculated in the first objective.

To compare the combined federal and Puerto Rican income tax to the combined federal, state, and local income tax of the 50 states and the District of Columbia, we analyzed federal, state, and local individual income taxes in per-capita terms and as a percentage of personal income. In addition, to understand the results of our analysis of Puerto Rico's income tax, we analyzed the general revenue sources of Puerto Rico and the states. We used published data from the Advisory Commission on Intergovernmental Relations (ACIR), IRS' Statistics of Income Bulletin, and Puerto Rico's Informe Económico al Gobernador, an annual report to the Governor on the economy of the Commonwealth.⁶ Generally, ACIR based its calculations on state and local general revenue data collected by the Bureau of the Census.⁷ We followed the Census Bureau's Classification Manual definitions of government and finance data.

⁶ACIR was created by Congress to monitor the operation of the American federal system and to recommend improvements.

⁷General revenue, as defined by the Census, includes all revenue except that classified as liquor store, utility, or insurance trust revenue. For purposes of this analysis, the general revenue data we included for the government of Puerto Rico excludes its public corporations.

Comparison of U.S. and Puerto Rico Individual Income Tax Rules

The following tables summarize our comparison of United States and Puerto Rican individual income tax rules relevant to our simulation for each item on the U.S. individual income tax return. These tables provide comments on issues related to the conversion of the Puerto Rican income tax return items to the U.S. individual income tax return items. Our conversion is based on 1992 Puerto Rican income tax rules because that was the latest year for which return information necessary for our simulation was available on computer tape. Since 1992, the Puerto Rican tax system has been changed. In October 1994, Puerto Rico enacted tax reform legislation that according to the government of Puerto Rico, was intended to achieve several objectives. These objectives include (1) establishing a more equitable tax structure, (2) encouraging equal and consistent application of tax laws, and (3) simplifying the tax structure. Generally, the 1994 tax reform lowered individual tax rates and corporate tax rates. Effective for tax years commencing after June 30, 1995, the act lowered all statutory individual income tax rates and increased the level of taxable income subject to the maximum tax rate, from \$30,000 to \$50,000 for married filing jointly. Tax rates were lowered from 1 to 7 percentage points, depending on the tax bracket and filing status of the taxpayer. We noted some of the significant provisions of the Puerto Rico Tax Reform Act of 1994 in table II.1.

Table II.1: Conversion of Puerto Rican 1992 Individual Income Tax Return Items to U.S. 1995 Individual Income Tax Return Items

U.S. individual income tax item	Issues/comments on conversion to U.S. return
Filing status	<p data-bbox="586 1318 1511 1373">U.S. reporting: The United States has four filing statuses: single, married filing jointly or surviving spouse, married filing separately, and head-of-household.</p> <p data-bbox="586 1398 1511 1478">Puerto Rico reporting: Puerto Rico has five filing statuses: married and living with spouse, head-of-household, married not living with spouse, single, and married filing separately.</p> <p data-bbox="586 1503 1511 1688">Conversion to the U.S. return: The United States does not have a married not living with spouse status. For the married not living with spouse status, taxpayers would have to file as married filing jointly or married filing separately status. For the married not living with spouse status, we classified returns filed under this status as head-of-household filing status if the Puerto Rican return reports a dependent child, since that status has more favorable tax rates. If the return did not report a dependent child, then the return was classified as single.</p>

(continued)

Appendix II
Comparison of U.S. and Puerto Rico
Individual Income Tax Rules

U.S. individual income tax item	Issues/comments on conversion to U.S. return
Exemptions	<p><u>U.S. reporting:</u> The United States allows a deduction amount based on the number of exemptions claimed. Exemptions can be claimed for the taxpayer, the spouse, and the dependents.</p> <p><u>Puerto Rico reporting:</u> Puerto Rico allows a deduction amount based on the number of personal exemptions and dependents claimed. However, Puerto Rico allows only one personal exemption for married taxpayers and does not allow a head-of-household taxpayer an exemption for the dependent that qualifies him or her as head-of-household.</p> <p><u>Conversion to the U.S. return:</u> The number of exemptions was included in the U.S. return as reported on the Puerto Rican return except that married filing jointly taxpayers were considered two exemptions instead of one, and head-of-household taxpayers had an additional dependent added.</p>
Wages, salaries, and tips	<p><u>U.S. reporting:</u> This includes all compensation for personal services as an employee unless specifically excluded.</p> <p><u>Puerto Rico reporting:</u> Includes all amounts paid to employees that constitute compensation.</p> <p><u>Conversion to the U.S. return:</u> Wages, salaries, and tips on the Puerto Rican return were used as reported.</p>
Taxable interest and tax-exempt interest	<p><u>U.S. reporting:</u> All interest is taxable, except for interest on certain state and local bonds and certain other exceptions.</p> <p><u>Puerto Rico reporting:</u> Income from federal, state, and local government bonds is exempt in Puerto Rico and is not reported. Also the first \$2,000 of interest income from Puerto Rican banking institutions is exempt. However, the exempt amount is reported on the income tax return, but it is excluded from gross income.</p> <p><u>Conversion to the U.S. return:</u> Only those interest earnings reported on the Puerto Rican income tax return were included in our simulation. Interest earnings included the exempt amount for interest in Puerto Rican banking institutions but not interest from federal, state, and local government bonds because it was not reported on the Puerto Rican return.</p>
Dividend income	<p>The amount of dividend income was included in the U.S. return as reported on the Puerto Rican return.</p>
Taxable refunds, credits or other offsets	<p><u>U.S. reporting:</u> This item is an accounting entry in the federal income tax return used only by taxpayers who, during the tax year, received a refund, credit, or offset of state or local income taxes that they paid and deducted in any prior year.</p> <p><u>Puerto Rico reporting:</u> There is no equivalent line item on the Puerto Rican tax return.</p> <p><u>Conversion to the U.S. return:</u> This entry was not necessary for our simulation because no prior year deductions would have been made.</p>
Alimony received	<p>The amount for alimony received was included in the U.S. return as reported on the Puerto Rican return.</p>

(continued)

Appendix II
Comparison of U.S. and Puerto Rico
Individual Income Tax Rules

U.S. individual income tax item	Issues/comments on conversion to U.S. return
Business income or loss	<p>U.S. reporting: Sole proprietor income after related expenses is included on the U.S. individual income tax return with certain limits. However, U.S. passive losses generally can only be deducted against passive income. Related expenses include those that are ordinary and necessary such as depreciation. The U.S. tax rules allow straight line and some accelerated depreciation. The United States also allows an immediate write-off of business assets up to \$17,500. This amount is reduced if the total cost of the property placed in service during the year exceeds \$200,000.</p> <p>Puerto Rico reporting: Sole proprietor income after related expenses is also included on the Puerto Rican return. Puerto Rico also limits the extent to which business losses can offset salary income. Deductions rules, like depreciation, may differ. For example, in 1992, Puerto Rico allowed certain taxpayers to use "flexible depreciation." This depreciation method allows a depreciation deduction up to the full cost of the asset in the year it is first used. However, the deduction was not to exceed the net benefit of the business or commercial activity in which the property was used. This flexible depreciation method was repealed in the Tax Reform Act of 1994 for assets acquired after June 30, 1995.</p> <p><u>Conversion to the U.S. return:</u> The amount reported on the Puerto Rican return was used as reported.</p>
Capital gain or loss	<p>U.S. reporting: Net capital gains are fully included in income with an alternative 28-percent tax rate for long-term gains net of long- and short-term losses. Capital losses are deductible to the extent of capital gains; up to a \$3,000 loss is allowed against other income. Capital losses can be carried forward and deducted in succeeding years. Long-term capital gain or loss means gain or loss from the sale or exchange of a capital asset held for more than 1 year.</p> <p>Puerto Rico reporting: Gains are fully taxable; capital losses are limited to capital gains plus net income or \$1,000, whichever is lower, with the excess losses carried forward for 5 years. Also, there is an alternative tax on net long-term capital gains, which is either the regular tax or a "special 20-percent tax on capital gains," whichever is more advantageous to the taxpayer. Long-term capital gain or loss means gain or loss from the sale or exchange of a capital asset held for more than 6 months.</p> <p>Puerto Rico also has sale or exchange of principal residence rules that are somewhat similar to those of the United States. In general, if the Puerto Rican taxpayer buys another residence within 1 year before or 1 year after the sale of the old residence (18 months after sale is allowed if a new residence is constructed), the gain is not recognized to the extent the selling price does not exceed the cost of the new residence. A one-time exclusion of \$50,000 is provided for taxpayers 60 years old or older at the time of the sale, if the taxpayer lived in the old residence for at least 3 years of the last 5 years prior to the sale.</p> <p><u>Conversion to the U.S. return:</u> The amount of capital gains and losses was included in the U.S. return as reported on the Puerto Rican return.</p>

(continued)

Appendix II
Comparison of U.S. and Puerto Rico
Individual Income Tax Rules

U.S. individual income tax item	Issues/comments on conversion to U.S. return
Other gains or losses	<p><u>U.S. reporting:</u> This line item is used for gains and losses reported on U.S. Form 4797. Generally, this form is used to report sales or exchanges and involuntary conversions from other than casualty or theft of property used in a trade or business; disposition of noncapital assets other than inventory or property held primarily for sale to customers; and recapture of IRC section 179 expense deductions for partners and S-corporation shareholders. Business real estate and any depreciable property is excluded from the definition of capital asset. However, if the business property qualifies as IRC section 1231 property, capital gain treatment may apply. Under IRC section 1231, if there is a net gain during the tax year from (1) sales of property used in a trade or business, (2) involuntary conversion of property used in a trade or business, or (3) sales of capital assets held for more than one year, the gain is treated as a long-term capital gain. A net loss is treated as an ordinary loss.</p> <p><u>Puerto Rico reporting:</u> Net gains on the involuntary conversion, or on the sale or disposition of property used in a trade or business, held for more than 6 months, are treated as "long-term capital gain." This long-term capital gain is reported together with other long-term capital gains and is taxed as explained in the capital gains section. Except for (1) the holding period of 6 months; (2) the inclusion of involuntary conversion from casualty or theft; and (3) the replacement period of 1 year for involuntary conversions, Puerto Rico's capital gains treatment of the property described in this paragraph is consistent with the U.S. tax treatment.</p> <p>Net gains or net losses on the involuntary conversion or on the sale or disposition of property used in a trade or business, held for less than 6 months, are not considered capital gains or losses. These gains or losses are reported as "ordinary income or loss."</p> <p><u>Conversion to the U.S. return:</u> Other gains and losses were included in the U.S. return as reported on the Puerto Rican return.</p>
Individual Retirement Account (IRA) distributions	<p><u>U.S. reporting:</u> IRA distributions are taxed as ordinary income in the year received. Distributions are fully taxable unless nondeductible contributions have been made. In the United States, a penalty applies if the taxpayer is not 59 1/2 years or older.</p> <p><u>Puerto Rico reporting:</u> Similar rules apply; nondeductible contributions are not permitted. In Puerto Rico, the penalty applies if the taxpayer is not 60 years or older, with certain exceptions. Puerto Rico has a penalty provision that is similar to that of the United States for early withdrawals.</p> <p><u>Conversion to the U.S. return:</u> This line item was used as reported on the Puerto Rican return.</p>

(continued)

Appendix II
Comparison of U.S. and Puerto Rico
Individual Income Tax Rules

U.S. individual income tax item	Issues/comments on conversion to U.S. return
Pensions and annuities	<p>U.S. reporting: The United States taxes each annuity payment as if composed pro rata of taxable income and recovery of cost, projected over the life expectancy of the annuitant. An alternative method is provided for qualified plans; under this method, the total number of payments is determined based on the annuitant's age at the starting date.</p> <p>Puerto Rico reporting: In the case of government pensions, Puerto Rico excludes either \$5,000 or \$8,000 based on age. If the taxpayer paid part or the total cost of the pension, he/she can recover that amount tax free. The excess of the amount received over 3 percent of the aggregate premiums paid is excluded from income until the amount excluded equals the aggregate premiums paid for the annuity. Taxpayers with government pensions are not required to submit Schedule H (Income from Annuities or Pensions) if their pension or annuity income is less than the exclusion amount. Since 1992, the \$5,000 or \$8,000 exclusion has been applied to both government and private sector pensions.</p> <p>Conversion to the U.S. return: This line item was included in the U.S. return as reported on the Puerto Rican return, although the cost recovery rules are different in the United States, and government pensions in the United States are taxed on the same basis as are all other pensions.</p>
Rents, royalties, partnerships, estates, and trusts	<p>U.S. reporting: The United States has complex passive loss rules, limiting the use of losses from passive activities to shelter income from other types of activities. Although a passive activity is defined as one involving the conduct of a trade or business in which the taxpayer does not materially participate, the passive loss rules treat rental activities as passive.</p> <p>Puerto Rico reporting: Passive activity losses may not be used to offset income from another activity. Also, excess losses may be carried forward indefinitely to offset any future income from the same activity. Partnerships that derive at least 70 percent of their gross income from Puerto Rican sources, and at least 70 percent of such income is produced in a specific enterprise, can elect to be treated as special partnerships. However, distributed losses from Special Partnerships can offset up to 50 percent of net income from any source. Puerto Rico's regular partnerships are treated like corporations in the United States. Special partnerships and corporations of individuals (similar to S corporations) are treated like United States partnerships (pass-through entities).</p> <p>Conversion to the U.S. return: These income items were included in the U.S. return as reported on the Puerto Rican return.</p>
Farm income	<p>U.S. reporting: Farm income is reported and taxed in the same way as income from any other business. However, there are inventory and expense deduction rules that recognize the unique issues related to operating a farm. For example, there are special rules for the involuntary conversion of livestock or crop disaster payments.</p> <p>Puerto Rico reporting: Ninety percent of net farm income is exempted from reporting. Puerto Rico also includes some income and expense recognition rules that are specific to farmers.</p> <p>Conversion to the U.S. return: Farm income was included as reported on the Puerto Rican return with the 90-percent exclusion added back to income.</p>

(continued)

Appendix II
Comparison of U.S. and Puerto Rico
Individual Income Tax Rules

U.S. individual income tax item	Issues/comments on conversion to U.S. return
Unemployment compensation	<p><u>U.S. reporting:</u> Unemployment compensation is included in gross income.</p> <p><u>Puerto Rico reporting:</u> Unemployment compensation is not included in gross income and, therefore, not reported on the income tax return. According to data provided by the Department of the Treasury of Puerto Rico, unemployment compensation totaled \$336.5 million in 1994.</p> <p><u>Conversion to the U.S. return:</u> We were not able to simulate this income item because we did not know how the total unemployment compensation was distributed among Puerto Rican taxpayers.</p>
Social Security benefits	<p><u>U.S. reporting:</u> A portion of a taxpayer's Social Security benefits may be taxable.</p> <p><u>Puerto Rico reporting:</u> Social Security payments are not included as income and, therefore, not reported on the income tax return.</p> <p><u>Conversion to the U.S. return:</u> We were not able to simulate this income item.</p>
IRA deductions	<p><u>U.S. reporting:</u> A deduction of up to \$2,000 per taxpayer is allowed for IRA contributions for employees who cannot participate in certain employer-sponsored pension plans. Taxpayers who are participants in employer-sponsored plans can deduct a limited amount of IRA contributions, depending on their income. Total contributions of up to \$2,250 can be made per taxpayer each year to the taxpayer's IRA and a spousal IRA.</p> <p><u>Puerto Rico reporting:</u> A \$2,000 deduction per taxpayer is allowed, or \$4,000 for married taxpayers. Limitations apply when the individual participates in cash or deferred accounts. In 1994, the IRA deduction was increased to \$2,500 per taxpayer or \$5,000 for married taxpayers.</p> <p><u>Conversion to the U.S. return:</u> The IRA deduction amount was included in the U.S. return as reported on the Puerto Rican return.</p>
Moving expenses	<p><u>U.S. reporting:</u> Certain moving expenses are deductible as an adjustment to gross income if the move is related to starting work in a new location.</p> <p><u>Puerto Rico reporting:</u> Moving expenses are deductible as ordinary and necessary expenses within certain limitations.</p> <p><u>Conversion to the U.S. return:</u> Because moving expenses are reported with other ordinary and necessary expenses, they were included in our simulation of miscellaneous deductions.</p>

(continued)

Appendix II
Comparison of U.S. and Puerto Rico
Individual Income Tax Rules

U.S. individual income tax item	Issues/comments on conversion to U.S. return
One-half self-employment tax	<p><u>U.S. reporting:</u> One half of self-employment tax is deductible as an adjustment to income. Dividends typically are not included as earnings for self-employment income. However, a taxpayer's distributed share of ordinary income from a trade or business carried on by a partnership is included in self-employment income.</p> <p><u>Puerto Rico reporting:</u> Residents of Puerto Rico are subject to federal self-employment tax under IRC section 1402(b). Self-employed residents of Puerto Rico are to file a U.S. Internal Revenue Form 1040PR to compute self-employment tax. This return follows the same employment tax rules applicable to residents of the United States.</p> <p><u>Conversion to the U.S. return:</u> The tax was computed by multiplying the self-employment tax rate (15.3 percent) times the amount of self-employment income. The Puerto Rican individual income tax return includes corporation dividends and distributions from regular partnerships on the same line of the return. Accordingly, we could not determine the regular partnership distribution amount that would be included as U.S. self-employment income. So that we would not overstate self-employed income and the related tax, we excluded any items from the Puerto Rican return that would not be entirely included as U.S. self-employment income.</p>
Self-employed health insurance deduction	<p><u>U.S. reporting:</u> Up to 30 percent of health insurance premiums for self-employed persons are deductible as an adjustment to gross income.</p> <p><u>Puerto Rico reporting:</u> There is no similar provision in the Puerto Rican return. Health insurance premiums for self-employed persons are deductible as an itemized deduction.</p> <p><u>Conversion to the U.S. return:</u> Self-employed health insurance deduction was not simulated because self-employed insurance premiums and other business adjustments are offset against self-employment income in the Puerto Rican return, and our Puerto Rican individual income tax data file showed only the net self-employment income amount.</p>
Keogh retirement or Simplified Employee Pension (SEP) plans deduction	<p><u>U.S. reporting:</u> Keogh retirement or SEP payments are deductible as an adjustment to gross income.</p> <p><u>Puerto Rico reporting:</u> Keogh retirement or SEP payments are deductible as an adjustment to self-employment income.</p> <p><u>Conversion to the U.S. return:</u> A Keogh retirement or SEP deduction was not simulated because Keogh retirement or SEP payments and other business adjustments are offset against self-employment income in the Puerto Rican return, and our Puerto Rican individual income tax data file showed only the net self-employment income amount.</p>
Penalty on early withdrawal of savings	<p><u>U.S. reporting:</u> Penalties paid on early withdrawal of savings are deductible.</p> <p><u>Puerto Rico reporting:</u> There is no similar line item in the Puerto Rican tax return.</p> <p><u>Conversion to the U.S. return:</u> We were not able to simulate this income adjustment.</p>
Alimony paid	<p><u>U.S. reporting:</u> Alimony paid is deductible as an adjustment to income.</p> <p><u>Puerto Rico reporting:</u> Alimony paid is deductible as an adjustment to income.</p> <p><u>Conversion to the U.S. return:</u> Alimony paid was included in the U.S. return as reported on the Puerto Rican tax return.</p>

(continued)

Appendix II
Comparison of U.S. and Puerto Rico
Individual Income Tax Rules

U.S. individual income tax item	Issues/comments on conversion to U.S. return
Medical and dental expenses	<p><u>U.S. reporting:</u> Unreimbursed medical and dental expenses are deductible as itemized deductions to the extent they exceed 7.5 percent of AGI.</p> <p><u>Puerto Rico reporting:</u> Under Puerto Rico's rules, generally, the same kind of medical and dental expenses, except drug expenses, are deductible, but only 50 percent of total medical expenses paid are deductible in the year paid and to the extent they exceed 3 percent of AGI.</p> <p><u>Conversion to the U.S. return:</u> The gross medical and dental expense amount and any orthopedic equipment expenses (see miscellaneous deductions) were included in the U.S. return as reported on the Puerto Rican tax return and adjusted for U.S. income limitation rules.</p>
Taxes	<p><u>U.S. reporting:</u> Under U.S. tax rules, certain state, local, and foreign government taxes—such as real property and income taxes—are deductible as an itemized deduction. Personal property taxes are deductible only if paid or accrued to state or local governments.</p> <p><u>Puerto Rico reporting:</u> Puerto Rico allows as an itemized deduction property taxes paid on the taxpayer's principal residence. Puerto Rico has no personal property or local individual income taxes (below the Commonwealth level).</p> <p><u>Conversion to the U.S. return:</u> We used the amount of property taxes as reported on the Puerto Rican tax return. No amount was simulated for personal property or local income taxes because they do not exist. We used the actual Puerto Rican tax liability after credits except for the foreign tax credit, which is largely a credit for U.S. income taxes (see foreign tax credit).</p>
Interest	<p><u>U.S. reporting:</u> The U.S. itemized deduction includes home mortgage interest and points, home equity loans, and refinanced mortgages for a qualified residence. The deduction is limited to principal amounts of \$1 million for mortgages and \$100,000 for home equity loans. These limits apply to mortgage or home equity loans taken out after October 1987. Additional limits apply if the mortgage exceeds the fair market value of the residence.</p> <p><u>Puerto Rico reporting:</u> The Puerto Rican deduction includes many of the U.S. provisions, except that there are no limitation amounts and no deduction is allowed if the mortgage exceeds the fair market value of the residence at the time the debt was incurred.</p> <p><u>Conversion to the U.S. return:</u> The Puerto Rican tax return item was used. The Puerto Rican deduction could be limited under U.S. rules. However, we did not know whether the principal amount exceeded the U.S. limits because that information is not reported on the Puerto Rican income tax return.</p>

(continued)

Appendix II
Comparison of U.S. and Puerto Rico
Individual Income Tax Rules

U.S. individual income tax item	Issues/comments on conversion to U.S. return
Gifts to charity	<p><u>U.S. reporting:</u> U.S. tax rules generally allow as an itemized deduction total contributions to governmental entities, charitable organizations, cemetery companies, war veterans groups, and certain domestic fraternal societies, which are usually limited to 50 percent of AGI. Certain contributions are also limited to 30 percent or 20 percent of AGI, depending on the type of contribution. A carryover is allowed for any excess up to 5 years.</p> <p><u>Puerto Rico reporting:</u> The Puerto Rican allowable deduction is the total amount of contributions in excess of 3 percent of AGI. The actual deduction taken must not exceed 15 percent of AGI, except an additional deduction of up to 15 percent of AGI is allowed for contributions to accredited university-level educational institutions established in Puerto Rico. Under certain circumstances an unlimited deduction for charitable contributions is allowed. After 1994, a carryover for excess charitable contributions up to 5 years was allowed.</p> <p><u>Conversion to the U.S. return:</u> The Puerto Rican tax return line item was used. However, because of the differences stated above, the U.S. deduction may be understated.</p>
Casualty and theft losses	<p><u>U.S. reporting:</u> U.S. rules allow an itemized deduction for theft, vandalism, fire, storm, or similar causes; car, boat, and other accidents; and money lost due to insolvency or bankruptcy of financial institutions. Each separate casualty or theft loss must be \$100 or more. Only losses that total more than 10 percent of AGI are deductible.</p> <p><u>Puerto Rico reporting:</u> Puerto Rico limits losses of personal property to \$5,000 for the year in which the loss was incurred. The carryover of excess losses is allowed for 2 years. Puerto Rico has no limit for casualty loss on a principal residence.</p> <p><u>Conversion to the U.S. return:</u> The amount reported on the Puerto Rican return was included in the U.S. return as reported, but the U.S. limits were applied.</p>
Miscellaneous deductions	<p><u>U.S. reporting:</u> The United States allows itemized deductions for unreimbursed employee expenses such as job travel, union dues, and job education. Other expenses are also deductible such as for investing, preparing tax returns, and renting a safe deposit box. Only amounts in excess of 2 percent of AGI are deductible. All itemized deductions are reduced by 3 percent of the amount that AGI exceeds a threshold amount.</p> <p><u>Puerto Rico reporting:</u> Puerto Rican job expenses are deductible from AGI as "ordinary and necessary expenses" instead of as an itemized deduction. Taxpayers can deduct ordinary and necessary expenses whether or not they itemize. Generally, the expenses deductible are the same as in the United States. The amount deductible is limited to \$1,500, or 3 percent of gross income from salaries, whichever is less. In 1994, the deduction of meals and entertainment expenses was reduced from 80 percent to 50 percent of the amount incurred.</p> <p><u>Conversion to the U.S. return:</u> The amount reported on the Puerto Rican return was included in the U.S. return as a miscellaneous deduction but limited by the U.S. rules. In 1992, the rules on the deduction of meals and entertainment expenses were more restrictive in the United States.</p>

(continued)

Appendix II
Comparison of U.S. and Puerto Rico
Individual Income Tax Rules

U.S. individual income tax item	Issues/comments on conversion to U.S. return
Other miscellaneous deductions	<p>U.S. reporting: Several expenses are deductible as miscellaneous itemized deductions. However, they are not subject to the 2-percent limit. Examples of deductible items include the following:</p> <p>Amortizable premium on taxable bonds: Bond premiums are deductible for a bond purchased before October 23, 1986.</p> <p>Gambling losses to the extent of gambling winnings: The taxpayer cannot offset the losses against the winnings. He/she must report the full amount of the winnings and claim the losses as an itemized deduction.</p> <p>Impairment-related work expense of persons with disabilities: These are allowable business expenses incurred for the taxpayer to be able to work.</p> <p>Puerto Rico reporting: Bond premium amortization is allowed as an offset against interest income, and the net amount is reported as miscellaneous income; however, no deduction is allowed for interest-exempt bonds. Gambling losses are deducted from gambling winnings, and net gambling winnings are reported as miscellaneous income. Net gambling losses are not deductible. An itemized deduction is allowed for "orthopedic equipment expenses for the handicapped." However, this deduction does not have to be directly related to the employment of the taxpayer.</p> <p>Conversion to the U.S. return: Since bond premium amortization is offset against interest income and gambling losses are offset against gambling winnings, we were not able to simulate a miscellaneous deduction for these items.</p> <p>Also, we were not able to simulate a miscellaneous deduction for orthopedic equipment expenses because under Puerto Rico's tax law the orthopedic equipment expense deduction is not required to be work related to be deductible. However, orthopedic equipment expenses were included as medical and dental expenses (see medical and dental expenses).</p>

(continued)

Appendix II
Comparison of U.S. and Puerto Rico
Individual Income Tax Rules

U.S. individual income tax item	Issues/comments on conversion to U.S. return
Child and dependent care tax credit (DCTC)	<p><u>U.S. reporting:</u> Under U.S. tax rules, the DCTC allows a portion of the child and dependent care expenses for the taxpayer to obtain gainful employment, as a nonrefundable tax credit. A child must be under the age of 13 to qualify. The credit is computed on the basis of maximum allowable related expenses of \$2,400 for one child, or \$4,800 for two or more children. Then, depending on the AGI of the taxpayer, a credit is computed on a sliding scale from 20 percent to 30 percent of the allowable expenses.</p> <p><u>Puerto Rico reporting:</u> Puerto Rico allows a child-care, but not dependent-care, itemized deduction of \$400 for one child and \$800 for two children. The expenses must be for work or a profitable activity. The child must not be over 14 years of age to qualify. The Puerto Rican return lists the expenses, but up to the limitation amount.</p> <p><u>Conversion to the U.S. return:</u> Because Puerto Rican taxpayers that do not itemize cannot claim the child-care deduction and because the expense limits are low in comparison to the United States, simulating the credit on the basis of the information reported on the Puerto Rican return would significantly understate the potential use of the credit. Because the DCTC could be an important feature of the federal income tax system extended to Puerto Rico, we imputed the potential value of the credit on the basis of available 1991 IRS Statistics of Income data (SOI).</p> <p>From the SOI data, we identified the dollar value of the credit claimed by all taxpayers categorized by the number of dependent children reported and by AGI class. We then calculated the average credit claimed for each number of dependents in each AGI class. This average credit was given to each Puerto Rican taxpayer with the same number of dependents in the same AGI group.</p>
Credit for the elderly	<p><u>U.S. reporting:</u> U.S. rules allow the credit for taxpayers who are 65 or older or who have a permanent and total disability. The amount of the credit depends on the taxpayer's filing status, age, and level of pension, disability, or annuity income.</p> <p><u>Puerto Rico reporting:</u> There is no similar credit in Puerto Rico.</p> <p><u>Conversion to the U.S. return:</u> We were not able to calculate the credit because the necessary data were not available.</p>
EITC	<p><u>U.S. reporting:</u> See table II.2.</p> <p><u>Puerto Rico reporting:</u> Puerto Rico does not have a similar credit.</p> <p><u>Conversion to the U.S. return:</u> EITC was computed using information reported on the Puerto Rican tax return.</p>

(continued)

Appendix II
Comparison of U.S. and Puerto Rico
Individual Income Tax Rules

U.S. individual income tax item	Issues/comments on conversion to U.S. return
Foreign tax credit	<p><u>U.S. reporting:</u> The United States allows a credit or a deduction for any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States.</p> <p><u>Puerto Rico reporting:</u> Puerto Rico allows a credit for the amount of income, war profits, and excess profits taxes imposed by the United States, possessions of the United States, and foreign countries.</p> <p><u>Conversion to the U.S. return:</u> Officials from the Department of the Treasury of Puerto Rico told us that almost all of the foreign tax credits claimed by Puerto Rican residents (about \$4.4 million) on Puerto Rican individual income tax returns was from income taxes paid to the United States. (Puerto Rican residents with income from sources outside Puerto Rico are subject to federal income taxes.) Because these amounts would be the equivalent of federal tax paid, they would not be deductible on a federal income tax return.</p>
Miscellaneous credits	<p><u>U.S. reporting:</u> The United States has several targeted credits such as the general business credit, jobs credit, alcohol fuels credit, etc.</p> <p><u>Puerto Rico reporting:</u> Data were not available from the Puerto Rican return to calculate any of these credits.</p> <p><u>Conversion to the U.S. return:</u> These credits were not included in our simulation.</p>
Alternative minimum tax (AMT)	<p><u>U.S. reporting:</u> AMT was developed to ensure that high-income taxpayers who make extensive use of certain tax deductions and exemptions pay a minimum amount of tax. AMT is computed by adding back certain tax preference items, such as certain itemized deductions, investment interest, depletion, and certain tax-exempt interest to taxable income. Certain tax preference items may have to be recomputed under special AMT rules before they are added back. After deducting an exemption amount, a tentative AMT amount is computed by multiplying the remaining income by either a 26-percent or 28-percent tax rate. The difference between the tentative AMT and the regular tax is the amount of AMT actually owed. The tentative AMT is then added to the regular income tax if it is greater than the regular tax.</p> <p><u>Puerto Rico reporting:</u> Puerto Rico has an alternate basic tax that will be assessed if it is greater than the regular tax. The tax is computed by subtracting ordinary and necessary expenses and capital gains from AGI. Then an additional tax of 10 percent to 20 percent is calculated on alternative AGIs of over \$75,000. The regular tax or the alternate basic tax is paid, whichever is larger.</p> <p><u>Conversion to the U.S. return:</u> Since computing the U.S. AMT requires the application of complex rules for several income and deduction items, it requires a substantial amount of data to be accurately applied. Some of the data needed to apply these rules is not available on the Puerto Rican return, such as certain types of tax-exempt interest income. Accordingly, the AMT tax was not computed for our simulation.</p>

Source: GAO analysis of U.S. and Puerto Rican income tax laws.

EITC Rules

EITC is a refundable tax credit available to low-income working taxpayers. The credit was established in 1975 to achieve two long-term objectives:

(1) to offset the impact of Social Security taxes on low-income workers with families and (2) to encourage low-income individuals with families to seek employment rather than welfare.

EITC amounts generally are determined according to the amount of the taxpayers' earned income and whether they have qualifying children who meet certain age, relationship, and residency tests, which are described in table II.2. The credit gradually phases in, plateaus at a maximum amount, and then phases out until it reaches zero. If the taxpayers' earned income or AGI exceeds the maximum qualifying income level, they are not eligible for the credit. When the taxpayers' AGI falls in the credit's phase-out range, they receive the lesser amount resulting from using either their earned income or AGI in calculating the credit.

When changes made in the 1993 Omnibus Budget Reconciliation Act are fully in effect in tax year 1996, taxpayers with two children and whose earned income ranges from \$1 to \$8,890 are to receive \$0.40 for each dollar earned. Taxpayers with two children and whose incomes range from \$8,890 to \$11,610 are to receive the maximum credit amount of \$3,556. The credit will gradually phase out, declining at a rate of about \$0.21 for each additional dollar of income, for taxpayers with two children and incomes ranging from \$11,610 to \$28,495. Taxpayers with one qualifying child or no children receive EITC at a lower rate, with different plateau amounts and phase-out rates.

Beginning in 1996, taxpayers will be disqualified for EITC if their unearned income exceeds \$2,350. Unearned income is defined as the combined amount of taxable and tax-exempt interest income, dividends, and the net income from rents and royalties not received from a trade or business.

The following table summarizes the principal EITC qualification rules and details the extent to which the Puerto Rican tax return provides data for determining eligibility for the credit.

Appendix II
Comparison of U.S. and Puerto Rico
Individual Income Tax Rules

Table II.2: Analysis of the Principal EITC Requirements for Tax Year 1996

EITC requirements	Issues/comments on conversion to U.S. return
Eligible individuals	
(1) Must have a qualifying child; must have had earned income; must not be a qualifying child of another person; if married persons, must file jointly or qualify for head-of-household status; or	See qualifying child definition below.
(2) Must have been a resident of the United States for more than one-half of the tax year; must have had earned income; must not be a dependent of another person; must not be a qualifying child of another person; if married persons, must file jointly or qualify for head-of-household status; must be at least 25 but not 65 years of age at the close of the tax year; and	<p>Puerto Rico reporting: The Puerto Rican tax return reports residency in Puerto Rico at the end of the tax year, not residency for more than one-half of the tax year. Though age information is reported on the Puerto Rican return, this information was not made available for our simulation. The return does not ask whether the taxpayer is taken as a dependent on another taxpayer's return.</p> <p>EITC estimate: We assumed that the taxpayer had been a resident for more than one-half of the tax year, was not taken as a dependent on another taxpayer's return, and met the age requirements.</p>
(3) Must not have disqualified income of more than \$2,350. Disqualified income includes interest, dividends, and net income from rents and royalties not received from a trade or business.	<p>Puerto Rico reporting: Specific income items can be identified on the Puerto Rican tax return. However, the Puerto Rican return includes royalties as part of miscellaneous income.</p> <p>EITC estimate: Since royalties and net rental income derived from nonbusiness or trade activity can not be specifically identified, they were not included in our simulation of the U.S. tax return.</p>
Qualifying child	
(1) Relationship test: must be son, daughter, adopted child, or descendant of the son, daughter, or adopted child; stepson or stepdaughter; or foster child. Married child is not eligible unless he or she is a dependent.	<p>Puerto Rico reporting: The Puerto Rican return identifies some relationships between the taxpayer and a dependent. The identified relationships include child, parent, in-laws, and "closely related." However, the return does not identify the specific relationships needed to comply with the EITC requirements.</p> <p>Qualifying child definition: We only included as qualifying children those dependents identified on the Puerto Rican return as "children." We were unable to include other eligible dependents in our simulation, such as "stepson or stepdaughter," because they are identified on the Puerto Rican return as "closely related," which includes other ineligible dependents.</p>
(2) Age Test: must be under age 19, a full-time student under age 24, or permanently and totally disabled.	<p>Puerto Rico reporting: Age and dependent status information is on the Puerto Rican tax return. Disabled persons also qualify as dependents.</p> <p>Qualifying child definition: Dependents listed on the Puerto Rican return as a nonuniversity student or university student and who met the age and relationship tests were counted as qualifying children. In the special case of head-of-household filers, when one dependent is selected as qualifying the filer for head-of-household status and included in a special dependent section, we assumed this dependent to have met the qualifying child requirements (age and relationship).</p>

(continued)

Appendix II
Comparison of U.S. and Puerto Rico
Individual Income Tax Rules

EITC requirements

(3) Residence test: child's principal place of residence is with the taxpayer in the United States for more than one-half year (the entire year, in the case of an eligible foster child). There are special rules for members of the U.S. armed services.

Issues/comments on conversion to U.S. return

Puerto Rico reporting: Under Puerto Rican tax rules, a child's residence does not have to be with the taxpayer to qualify as a dependent. Also, the Puerto Rican return requests information on residency in Puerto Rico at the end of the tax year. It does not request information about whether more than one-half of the year was spent in the United States or Puerto Rico.

Qualifying child definition: We assumed that the child had been a resident for more than one-half of the tax year.

Earned income

Includes wages, salaries, tips and self-employment income, and certain nontaxable earned income items such as voluntary salary deferrals.

Puerto Rico reporting: Many earned income items can be identified on the Puerto Rican tax returns, including wages, salaries, tips, and self-employment income. These self-employment income items may vary from those which would have been reported on U.S. returns because of differences in tax accounting rules, such as those related to depreciation of assets.

Earned income definition: We used data elements for wage, salaries, and tips as shown on the Puerto Rican return. Items included in our approximation to U.S. self-employment income were (1) profits or losses from special partnerships, (2) profits or losses from commissions, (3) profits or losses from agriculture, (4) profits or losses from professions, and (5) profits or losses from rental businesses.

Source: GAO analysis of EITC's principal tax requirements.

Comparison of U.S. and Puerto Rico's Taxation of Corporate and Partnership Income

Corporate Taxation

Puerto Rican tax rules for corporations have many similarities to and some differences from U.S. tax rules. Both the United States and Puerto Rico require corporations to report their worldwide income. Also, both Puerto Rico and the United States allow the deduction of “ordinary and necessary” business expenses and have similar rules on accounting for inventories and cost of goods sold. Prior to June 30, 1995, Puerto Rico allowed, under certain circumstances, businesses to expense up to 100 percent of the basis of business assets in the year of acquisition and thereafter. This provision was repealed in Puerto Rico's Tax Reform Act of 1994 for assets acquired after June 30, 1995.

Puerto Rico has generally higher marginal corporate tax rates than does the United States. In 1995, corporate taxes in the United States started at 15 percent for incomes of up to \$50,000, with a maximum corporate tax rate of 35 percent.¹ In 1992, Puerto Rico's regular corporation tax rate started at 22 percent. Also, a sliding scale surtax was added to the regular tax, starting at a marginal rate of 6 percent for incomes up to \$75,000 with an allowance of a special credit. The maximum surtax marginal rate was 20 percent for incomes over \$275,000. Puerto Rico also has an alternative corporate capital gains tax rate of 25 percent and an alternative dividend rate of 20 percent. The Puerto Rico Tax Reform Act of 1994 lowered the regular corporate tax rate to 20 percent, the maximum surtax rate to 19 percent, and the alternative dividend rate to 10 percent.

Both the United States and Puerto Rico offer corporations special tax incentives to meet a variety of economic goals. In the United States these incentives can be either additional deductions from income or tax credits. Some examples of these incentives include accelerated depreciation of buildings, credits for low-income housing, expensing of research and experimentation expenditures, or the possessions tax credit.

Puerto Rico's tax code also includes various deductions and tax credits as incentives. However, since 1947, Puerto Rico has offered a tax incentive program to encourage the establishment and growth of manufacturing and certain other businesses. Most recently, the Puerto Rico Industrial Incentive Act of 1987 provided several tax reductions to industrial units that, for example, manufacture products that had not previously been made in Puerto Rico, produce products designated for export, develop specific types of real estate, or produce energy from recycling or renewable sources. In general, these businesses are exempted from

¹A corporation with taxable income in excess of \$100,000 is required to increase its tax liability by the lesser of 5 percent of the excess or \$11,750. A corporation with taxable income in excess of \$15 million must increase its tax liability by the lesser of 3 percent of the excess or \$100,000.

taxation on 90 percent of the net income derived from these sources; and the same percentage for eligible interest and dividends; currency exchange; and patents, royalties, and other rights. The act also includes a package of municipal, personal property, and real property tax reductions.

The rate reductions are not permanent. The duration of the rate reductions depends on the location of the exempt business and varies from 10 to 25 years. However, the exempted businesses are allowed the option of selecting the specific years they will be exempt from taxation under the Industrial Development Act.

According to statistics provided by the Commonwealth, in 1993, 1,111 corporations were qualified under the Industrial Tax Exemption laws, with about \$10.7 billion of exempted income.

Possessions Tax Credit

One U.S. tax policy significantly affecting Puerto Rico is the possessions tax credit defined in section 936 of the federal Internal Revenue Code (IRC). Under this section of the IRC, a portion of income derived from operations of qualified subsidiaries of U.S. corporations in U.S. possessions is effectively exempted from U.S. income tax.

Firms are qualified for the credit if, over the 3-year period preceding the close of a taxable year, 80 percent or more of their income was derived from sources within a possession, and 75 percent or more of their income was derived from the active conduct of a trade or business within a possession.

The 1993 Budget Reconciliation Act limited the possessions tax credit.² For tax years beginning after 1993, taxpayers are to calculate the credit as under prior law, but the credit would be capped under one of two alternative options selected by the taxpayer:

- The “percentage limitation” option provides for a decreasing credit equal to a decreasing percentage of the amount computed under prior law. The percentages are set by law at 60 percent for 1994, 55 percent for 1995, 50 percent for 1996, and 45 percent for 1997. The percentage will be 40 percent for 1998 and thereafter.
- The “economic activity limitation” option provides a cap on the credit equal to the sum of three factors:

²Omnibus Budget Reconciliation Act of 1993, Pub.L. No. 103-66, S13227, 107 Stat. 312, 489 (1993).

- The first factor is 60 percent of the firm's wages plus allocable employee fringe benefits paid in the possession, with wages limited for each employee to 85 percent of the maximum wage base under the old age survivor and disability insurance portion of Social Security.
- The second factor is a specific percentage of the firm's depreciation deductions for qualified tangible property for each taxable year. The type of property defines the applicable percentage, with factors ranging from 15 percent for property with a relatively short recovery period to 65 percent for assets with a long recovery period.
- The third factor, which applies only to firms that do not use the 50-percent profit-split method of income allocation³ is a portion of the income taxes paid to the possession government. Included taxes, however, cannot exceed a 9-percent effective tax rate.

Partnership Taxation

U.S. and Puerto Rico's tax laws for partnerships have several significant differences. With a few exceptions, U.S. partnerships are not taxable entities. Distributions of partnership profits are included on the partner's individual income tax return and are taxed at personal income tax rates.

In contrast, Puerto Rico taxes regular partnerships on their net income at corporate tax rates and also requires partners to include distributed partnership profits as taxable income on their individual income tax returns.

"Special partnerships" in Puerto Rico are not taxed at the entity level. Instead, as is the case with U.S. partnerships, partners include on their individual income tax returns their distributable shares of partnership net income. To qualify as a special partnership, 70 percent of the partnership's gross income must come from Puerto Rican sources. Further, not less than 70 percent of such income must be generated from one of several activities including construction, land development, or manufacturing when it generates substantial employment.

³This method generally permits allocation to the possession corporation of 50 percent of the affiliated group of U.S. corporations' combined taxable income derived from sales of products that are manufactured in a possession.

Combined Individual Income Taxes: Puerto Rico, the 50 States, and the District of Columbia

The following tables compare the actual federal, state, local, and combined individual income taxes of the 50 states, the District of Columbia, and Puerto Rico. The income tax is measured in per-capita terms (table IV.1) and as percentage of total personal income (table IV.2.) In addition, table IV.3 shows the distribution of general revenue sources for Puerto Rico, the 50 States, and the District of Columbia.

Table IV.1: Actual Federal, State, and Local Individual Income Tax Per Capita, 1992

Puerto Rico/ fifty states/D.C.	Federal income tax	State and local income tax	Combined federal, state, and local income tax
Puerto Rico	\$1	\$341	\$342
Mississippi	979	168	1,147
Louisiana	1,315	203	1,518
West Virginia	1,203	339	1,542
New Mexico	1,264	281	1,545
South Dakota	1,546	N.T.	1,546
Arkansas	1,213	355	1,568
North Dakota	1,480	189	1,669
Tennessee	1,669	19	1,688
South Carolina	1,311	392	1,703
Alabama	1,391	312	1,703
Oklahoma	1,363	380	1,743
Montana	1,368	391	1,759
Texas	1,781	N.T.	1,781
Utah	1,354	431	1,785
Arizona	1,532	324	1,856
Wyoming	1,880	N.T.	1,880
Kentucky	1,358	547	1,905
Maine	1,446	479	1,925
Idaho	1,430	502	1,932
Florida	1,997	N.T.	1,997
Nebraska	1,639	408	2,047
Iowa	1,569	505	2,074
North Carolina	1,558	524	2,082
Missouri	1,692	397	2,089
Vermont	1,623	475	2,098
Kansas	1,778	332	2,110
Georgia	1,680	455	2,135
Indiana	1,735	451	2,186

(continued)

**Appendix IV
 Combined Individual Income Taxes: Puerto
 Rico, the 50 States, and the District of
 Columbia**

Puerto Rico/ fifty states/D.C.	Federal income tax	State and local income tax	Combined federal, state, and local income tax
Michigan	1,856	385	2,241
New Hampshire	2,235	31	2,266
Washington	2,287	N.T.	2,287
Rhode Island	1,846	478	2,324
Ohio	1,753	581	2,334
Wisconsin	1,798	629	2,427
Oregon	1,688	747	2,435
Pennsylvania	1,909	545	2,454
California	1,957	551	2,508
Alaska	2,534	N.T.	2,534
Nevada	2,536	N.T.	2,536
Colorado	2,083	465	2,548
Virginia	2,039	519	2,558
Illinois	2,256	395	2,651
Minnesota	2,019	671	2,690
Delaware	2,129	759	2,888
Hawaii	2,111	785	2,896
Maryland	2,276	873	3,149
Massachusetts	2,404	891	3,295
New Jersey	2,816	525	3,341
New York	2,341	1,005	3,346
District of Columbia	2,587	1,073	3,660
Connecticut	3,288	569	3,857

N.T. = No Tax

Note: Puerto Rico's federal income tax per-capita amount is based on the foreign income tax credit (about \$4.4 million) claimed on the Puerto Rican tax returns, which is almost all for federal taxes paid to the United States (see app. II, foreign tax credit). However, if residents of Puerto Rico had been subject to the federal income tax in the same manner as residents of the states were, we estimate that the federal individual income tax per-capita in Puerto Rico would have been about \$14 in 1992, and the combined federal and Puerto Rican individual income tax per-capita would have been about \$355 in 1992.

Sources: Significant Features to Fiscal Federalism, Vol. 2, Advisory Commission on Intergovernmental Relations, 1994; Statistics of Income Bulletin, IRS, Spring 1994; Informe Económico al Gobernador, Puerto Rico Planning Board, 1994; and GAO computations using Puerto Rico's taxpayer data provided by the Department of the Treasury of Puerto Rico.

Appendix IV
Combined Individual Income Taxes: Puerto
Rico, the 50 States, and the District of
Columbia

Table IV.2: Actual Federal, State, and Local Individual Income Tax as a Percentage of Personal Income, 1992

Puerto Rico/ fifty states/D.C.	Federal income tax	State and local income tax	Combined federal, state, and local income tax
Puerto Rico	0.0%	5.3%	5.3%
Mississippi	7.0	1.2	8.2
South Dakota	9.0	N.T.	9.0
Tennessee	9.4	0.1	9.5
Louisiana	8.3	1.3	9.6
Texas	9.7	N.T.	9.7
North Dakota	8.7	1.1	9.8
West Virginia	7.7	2.2	9.9
New Mexico	8.2	1.8	10.0
Arkansas	7.8	2.3	10.1
Wyoming	10.1	N.T.	10.1
Florida	10.1	N.T.	10.1
New Hampshire	10.2	0.1	10.3
Alabama	8.4	1.9	10.3
South Carolina	8.1	2.4	10.5
Maine	8.0	2.6	10.6
Oklahoma	8.3	2.3	10.6
Arizona	8.8	1.9	10.7
Washington	10.7	N.T.	10.7
Nebraska	8.6	2.1	10.7
Montana	8.4	2.4	10.8
Kansas	9.2	1.7	10.9
Missouri	8.9	2.1	11.0
Vermont	8.6	2.5	11.1
Iowa	8.6	2.8	11.4
Michigan	9.5	2.0	11.5
Alaska	11.5	N.T.	11.5
Utah	8.7	2.8	11.5
Rhode Island	9.1	2.4	11.5
Kentucky	8.2	3.3	11.5
Georgia	9.1	2.5	11.6
Idaho	8.6	3.0	11.6
North Carolina	8.7	2.9	11.6
California	9.2	2.6	11.8
Nevada	11.7	N.T.	11.7

(continued)

**Appendix IV
 Combined Individual Income Taxes: Puerto
 Rico, the 50 States, and the District of
 Columbia**

Puerto Rico/ fifty states/D.C.	Federal income tax	State and local income tax	Combined federal, state, and local income tax
Pennsylvania	9.2	2.6	11.8
Indiana	9.4	2.5	11.9
Illinois	10.4	1.8	12.2
Virginia	9.8	2.5	12.3
Ohio	9.2	3.1	12.3
Colorado	10.1	2.3	12.4
Wisconsin	9.4	3.3	12.7
New Jersey	10.8	2.0	12.8
Hawaii	9.5	3.5	13.0
District of Columbia	9.3	3.8	13.1
Oregon	9.1	4.0	13.1
Minnesota	9.8	3.3	13.1
Maryland	9.8	3.8	13.6
New York	9.7	4.2	13.9
Massachusetts	10.2	3.8	14.0
Delaware	10.3	3.7	14.0
Connecticut	12.1	2.1	14.2

N.T. = No Tax

Note: Puerto Rico's federal income tax as a percentage of personal income is based on the foreign income tax credit (about \$4.4 million) claimed on the Puerto Rican tax returns, which is almost all for federal taxes paid to the United States (see app. II, foreign tax credit). However, if residents of Puerto Rico had been subject to the federal income tax in the same manner as residents of the states were, we estimate that the federal individual income tax as a percentage of personal income in Puerto Rico would have been about 0.2 percent in 1992, and the combined federal and Puerto Rican individual income tax as a percentage of personal income would have been about 5.5 percent in 1992.

Sources: Significant Features to Fiscal Federalism, Vol. 2, Advisory Commission on Intergovernmental Relations, 1994; Statistics of Income Bulletin, IRS, Spring 1994; Informe Económico al Gobernador, Puerto Rico Planning Board, 1994; and GAO computations using Puerto Rico's taxpayer data provided by the Department of the Treasury of Puerto Rico.

**Appendix IV
Combined Individual Income Taxes: Puerto
Rico, the 50 States, and the District of
Columbia**

**Appendix IV
Combined Individual Income Taxes: Puerto Rico, the 50 States, and the District of Columbia**

Table IV.3: Puerto Rico, State, and District of Columbia General Revenue Sources, Percentage Distribution, Fiscal Year 1992

Puerto Rico/ fifty states/D.C.	Transfer from federal government	Individual income	Corporation income
Alabama	22.8%	10.1%	1.3%
Alaska	12.6	N.T.	3.0
Arizona	16.8	9.7	1.6
Arkansas	25.0	12.3	1.8
California	18.9	13.3	3.5
Colorado	16.3	12.6	1.0
Connecticut	16.4	12.4	3.9
Delaware	14.5	17.4	4.3
District of Columbia	37.7	13.3	1.9
Florida	13.8	N.T.	1.5
Georgia	19.0	13.8	1.7
Hawaii	16.6	16.0	1.2
Idaho	19.4	15.6	2.0
Illinois	16.5	11.2	2.4
Indiana	18.0	13.8	2.1
Iowa	17.1	14.0	1.9
Kansas	16.7	9.8	2.3
Kentucky	22.8	16.8	2.2
Louisiana	25.8	5.6	1.5
Maine	21.3	12.6	1.5
Maryland	16.3	23.4	1.2
Massachusetts	18.9	20.8	2.9
Michigan	17.8	10.1	4.8
Minnesota	15.9	15.3	2.2
Mississippi	28.2	5.7	1.9
Missouri	20.7	13.3	1.5
Montana	25.1	10.4	1.9
Nebraska	17.1	11.3	1.8
Nevada	15.1	N.T.	N.T.
New Hampshire	19.6	0.9	2.4
New Jersey	14.8	11.3	2.3
New Mexico	20.6	7.4	1.3
New York	18.6	17.6	4.3
North Carolina	19.0	16.5	3.0
North Dakota	24.6	4.9	1.6

**Appendix IV
 Combined Individual Income Taxes: Puerto
 Rico, the 50 States, and the District of
 Columbia**

Revenues from own sources

Taxes

	Taxes					Total revenues from own sources
	Property	General sales	Other	Total taxes	Nontax revenues	
	5.6%	14.0 %	15.3 %	46.3 %	30.9 %	77.2 %
	9.4	1.1	20.1	33.6	53.8	87.4
	20.1	19.8	9.1	60.4	22.8	83.2
	9.1	17.8	11.7	52.7	22.3	75.0
	16.1	14.6	8.7	56.3	24.7	81.1
	18.3	14.6	8.4	55.0	28.7	83.7
	26.1	13.9	10.4	66.7	16.8	83.6
	7.6	N.T.	24.4	53.6	31.9	85.5
	19.2	9.4	7.3	51.1	11.2	62.3
	21.6	18.5	14.7	56.4	29.8	86.2
	16.4	15.9	7.6	55.3	25.8	81.0
	9.8	22.8	10.0	59.9	23.6	83.4
	13.9	12.8	11.0	55.2	25.3	80.6
	24.2	13.4	11.5	62.7	20.8	83.5
	17.4	15.1	6.4	54.8	27.1	82.0
	19.7	10.4	10.2	56.1	26.8	82.9
	21.6	13.9	10.6	58.2	25.1	83.3
	9.1	11.2	14.6	53.9	23.3	77.2
	7.6	17.5	13.2	45.4	28.8	74.2
	21.7	12.2	8.7	56.7	22.0	78.7
	17.5	8.6	11.8	62.5	21.2	83.7
	20.5	7.7	7.7	59.6	21.5	81.1
	25.0	10.2	7.0	57.1	25.1	82.2
	17.7	11.3	10.1	56.5	27.5	84.1
	12.1	15.3	9.8	44.7	27.1	71.8
	13.5	16.9	10.8	56.0	23.3	79.3
	18.9	N.T.	16.1	47.3	27.6	74.9
	20.2	13.3	9.4	55.9	27.0	82.9
	13.8	19.0	24.5	57.2	27.7	84.9
	37.5	N.T.	17.7	58.4	22.0	80.4
	27.2	11.1	10.9	62.8	22.4	85.2
	5.7	19.8	12.8	47.0	32.4	79.4
	20.7	10.7	8.7	62.0	19.4	81.4
	11.8	13.7	12.2	57.3	23.7	81.0
	13.8	11.1	14.2	45.6	29.7	75.4

(continued)

**Appendix IV
 Combined Individual Income Taxes: Puerto
 Rico, the 50 States, and the District of
 Columbia**

Puerto Rico/ fifty states/D.C.	Transfer from federal government	Individual income	Corporation income
Ohio	19.0	17.2	1.7
Oklahoma	19.1	12.3	1.5
Oregon	20.1	18.5	1.3
Pennsylvania	19.3	14.3	3.6
Puerto Rico	29.3	19.3	18.0
Rhode Island	25.4	12.0	1.2
South Carolina	22.2	12.4	1.2
South Dakota	26.1	N.T.	1.5
Tennessee	24.3	0.6	1.9
Texas	16.5	N.T.	N.T.
Utah	20.0	13.1	1.3
Vermont	22.1	11.6	1.3
Virginia	13.9	15.6	1.3
Washington	16.5	N.T.	N.T.
West Virginia	25.9	10.3	3.1
Wisconsin	16.8	16.4	2.3
Wyoming	26.7	N.T.	N.T.

**Appendix IV
 Combined Individual Income Taxes: Puerto
 Rico, the 50 States, and the District of
 Columbia**

Revenues from own sources

Taxes

Property	General sales	Other	Total taxes	Nontax revenues	Total revenues from own sources
16.8	11.7	9.8	57.2	23.8	81.0
7.9	15.8	15.4	52.9	28.0	80.9
21.4	N.T.	10.7	51.9	28.0	79.9
16.0	9.9	13.7	57.6	23.2	80.7
5.8	N.T.	18.0	61.2	9.5	70.7
23.7	9.8	9.7	56.3	18.3	74.6
14.3	12.9	9.3	50.1	27.7	77.8
18.9	16.5	11.4	48.2	25.7	73.9
11.5	21.8	12.9	48.7	27.0	75.7
22.8	18.5	16.6	57.9	25.6	83.5
14.0	16.4	6.9	51.8	28.3	80.0
23.2	6.7	12.7	55.5	22.4	77.9
19.5	9.7	13.5	59.7	26.4	86.1
17.3	28.5	13.3	59.1	24.4	83.5
8.9	13.4	14.8	50.5	23.6	74.1
21.5	11.6	9.0	60.7	22.5	83.2
18.2	9.3	15.4	42.9	30.4	73.3

N.T. = No Tax

Note: Totals may not add due to rounding.

Sources: Significant Features to Fiscal Federalism, Vol. 2, Advisory Commission on Intergovernmental Relations, 1994; and Informe Económico al Gobernador, Puerto Rico Planning Board, 1994.

Comments From the Secretary of the Treasury of Puerto Rico



SECRETARY OF
THE TREASURY

MANUEL DIAZ SALDAÑA

June 11, 1996

Ms. Lynda D. Willis
Director
Tax Policy and Administration Issues
U.S. General Accounting Office
Washington, D.C.

Dear Ms. Willis:

Thank you kindly for sending us the draft of your report **Analysis of Certain Potential Effects of Extending Federal Income Taxation to Puerto Rico**, for review and comments. We took great care at the Treasury Department in reading the document, and would like to share with you some general observations. More technical comments are included in a brief attachment to this letter.

The request you received referred to the tax effect of treating individuals residing in Puerto Rico as residents of the 50 states for purposes of federal income taxation. Your report addresses that issue. In our opinion, however, useful information about the total consequences of extending federal taxation to Puerto Rico is not elicited from the questions addressed to you. Said information would have been obtained by studying the consequences of integrating Puerto Rico into the federal fiscal system. To address the entire issue, it would have been necessary to consider the whole expected tax and transfer effects in such scenario on the U.S. and Puerto Rico public finances and economy.

It is difficult indeed to make compatible data reported in different tax bases for federal individual income tax liability estimates. We reviewed the methodology used to convert the data provided to the federal individual income tax base and to estimate the aggregate tax effect of extending federal individual income taxation to Puerto Rico. As you stated in the report, the estimates should be regarded as approximations.

One conclusion in your report is that the aggregate tax liability effect of adding the federal individual income tax system to the local, is practically nil. That conclusion did not consider

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Appendix V
Comments From the Secretary of the
Treasury of Puerto Rico

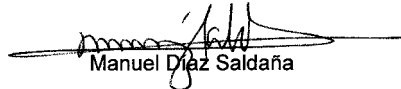
Ms. Lynda D. Willis
June 11, 1996
Page 2

the distributional effects of the additional tax burden. These effects should be carefully evaluated and weighted whenever a major change in a tax system is considered or simulated. From the data in your report it is evident that, if distributional effects are taken into account, then (1) the Puerto Rican working poor would be better off, and (2) the fiscal system would have to undergo more profound transformations than a 5 percent reduction in tax collections. Obviously, in Puerto Rico we will not consider earned income tax credits refunds, as taxable income, and we will provide a relief to the remaining taxpayers in order to avoid any increase in their current tax liability. To implement such local tax reliefs would require adjustments in our fiscal system. As you know, in 1994 we were able to put into effect a tax reform, granting \$400 million in tax reliefs while taking other public measures that resulted in increasing government revenues significantly.

Finally, the draft report comment regarding the amounts that local corporations may pay if federal income taxation is charged to them, does not appear to be pertinent to the inquiry, since those corporations are neither individuals nor corporations subject to Section 936 of the Internal Revenue Code. The assumption that their federal tax liability is going to be equal to their local one is not justified.

We trust you will find our comments useful. Please feel free to contact us for any further assistance.

Cordially yours,


Manuel Díaz Saldaña



SECRETARY OF THE TREASURY

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