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General Government Division

B-280505

July 8, 1998

The Honorable Don Nickles  
United States Senate

Subject: Puerto Rico: Potential Federal Income Tax Revenues Resulting From Statehood

Dear Senator Nickles:

At your request, this letter provides estimates of revenue impacts on the U.S. Treasury if federal individual and corporate income taxes were to apply in Puerto Rico in the same manner as they apply in the 50 states. It also provides a separate estimate of the cost of extending the new child tax credit to residents of Puerto Rico.<sup>1</sup>

Considerable uncertainty exists over future growth in personal and corporate income in Puerto Rico after the 10-year phaseout of the Puerto Rican economic activity credit<sup>2</sup> and after a possible transition to statehood. This uncertainty carries over to projections of the impacts that statehood would have on federal income tax revenues and spending for social programs. The Congressional Budget Office (CBO) has been working on projecting these revenue and spending impacts. To provide you with some information on possible revenue impacts before CBO completes its projections, you asked us to make rough estimates of the federal income taxes that individuals and corporations in Puerto Rico would pay if (1) the termination of the Puerto Rican economic activity credit and the change in political status occurred today and (2) the

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<sup>1</sup>The Taxpayer Relief Act of 1997 established a tax credit equal to \$500 (for tax years after 1998) for each qualified child under 17. The amounts of child tax credits that taxpayers can claim are subject to limitations related to the taxpayers' adjusted gross incomes and tax liabilities. For taxpayers with three or more qualifying children, the credit is refundable within certain limits.

<sup>2</sup>The Puerto Rican economic activity credit replaces the possessions tax credit, which was repealed by the Small Business Job Protection Act of 1996. That act makes existing claimants of the possessions tax credit eligible for the new credit if they meet certain conditions. The new credit is to be eliminated for taxable years beginning in 2006 and thereafter.

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amount and distribution of individual and corporate incomes in Puerto Rico remain similar to what they have been in recent years.

You also asked us to estimate how much federal spending would increase if Puerto Rico were treated as a state and if the existing caps on certain types of federal spending were removed. As agreed with your office, we did not make those estimates because we have not done any recent work that would allow us to do so quickly, and because CBO will likely produce its own estimates in the near future.

## RESULTS

In a 1996 study, we estimated that, under 1995 federal tax law, the net impact of Puerto Rican statehood on federal individual income tax revenue would have been approximately zero.<sup>3</sup> We determined that the taxes paid by some residents would have been completely offset by the earned income credit (EIC)<sup>4</sup> refunds received by other residents. We assume that, if Puerto Rico were a state in 1998, the aggregate federal individual income tax payments and tax credits of Puerto Rican residents would still roughly offset each other, before taking the new child tax credit into account. We estimate that the potential cost of that credit in Puerto Rico likely would be less than \$200 million in 1998. Therefore, we estimate that the net impact of Puerto Rican statehood likely would be to reduce federal individual income tax revenue, but by less than \$200 million.

The effect of Puerto Rican statehood on federal corporate income tax revenue depends on a number of factors relating to how corporations will modify their operations and investments. To illustrate how sensitive the federal revenue impact is to unknown factors, we computed estimates using two alternative assumptions for some of these factors. Even if aggregate corporate income in Puerto Rico remains approximately equal to what it was in 1995, the immediate impact of statehood on federal corporate income tax revenues could be as little as a \$1 billion gain or as large as a \$4.6 billion gain, depending on decisions made by corporations. Future changes in aggregate corporate income in Puerto Rico could result in either larger or smaller revenue impacts than the range we present here.

## SCOPE AND METHODOLOGY

To estimate the impact of Puerto Rican statehood on federal individual income tax revenue, we updated estimates from our 1996 study that was based on (1) U.S. tax rules that had been adopted as of the end of 1995 and (2) income data for individuals who filed

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<sup>3</sup>Tax Policy: Analysis of Certain Potential Effects of Extending Federal Income Taxation to Puerto Rico (GAO/GGD-96-127, Aug. 15, 1996).

<sup>4</sup>The EIC is a refundable tax credit made available to certain low-income workers to offset the impact of Social Security taxes and encourage unemployed individuals to seek employment.

Puerto Rican tax returns for tax year 1992. As we noted in our 1996 study, our estimates did not reflect changes in the Puerto Rican economy since 1992, changes in the behavior of individual taxpayers, or different compliance rates that might result from the imposition of federal income taxes. In this letter, we update those previous estimates by showing what the revenue implications would be in 1998 if one assumed that tax payments and tax credits grew at the same rate in recent years. We have also adjusted our previous estimate of the net revenue impact of statehood by taking into account the child tax credit, which was created by the Taxpayer Relief Act of 1997.

To estimate the aggregate amount of child tax credit that residents of Puerto Rico would be able to claim, we used tabulations produced during the course of our 1996 study relating to (1) the number of children claimed as dependents on Puerto Rican tax returns and (2) the potential federal tax liabilities of Puerto Rican taxpayers before taking the EIC into account. Given the time available for our work, we were not able to make child credit computations for individual taxpayers. Instead, we used data that were aggregated according to income class, tax filing status, family size, and/or the size of pre-EIC tax liability. Consequently, we were required to make a number of assumptions to derive all of the information needed to estimate the aggregate amount of child tax credit that Puerto Rican taxpayers would be able to claim.<sup>5</sup> We met with officials from the U.S. Department of the Treasury to confirm our understanding of how the child tax credit is intended to work.

To compute our range of estimates for the impact of Puerto Rican statehood on federal corporate tax revenue, we used 1995 aggregate data for the total Puerto Rican corporate

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<sup>5</sup>Our data included the number of taxpayers with zero, one, two, or three or more children, by income class. On the basis of U.S. Bureau of the Census data, we assumed that families with three or more dependent children had four children on average. Because we did not have data on the ages of dependent children, we assumed, on the basis of Census data on the age distribution of Puerto Rican children, that 78 percent of the children claimed as dependents would qualify for the child credit. We also had data on the distribution of pre-EIC income tax liability (by broad dollar ranges) within each income class. However, we could not directly relate the number of children to income tax liability for individual taxpayers. We tested alternative assumptions regarding the relationship between family size and tax liability within each income class. Our results were sensitive to changes in the assumptions; therefore, we could not present a more precise estimate. The maximum amount of credit per child is temporarily set at \$400 for tax year 1998. For our computations, we used the fully phased-in maximum amount of \$500.

taxes paid, Puerto Rican taxes paid by possessions corporations,<sup>6</sup> the total income of possessions corporations, the exempt income of possessions corporations, and the total exempt income in Puerto Rico, as provided by Puerto Rico's Department of the Treasury. Although these were the best data available to us, they did not provide us with all of the information needed to make an estimate. Nor did we have sufficient time to interview corporate managers about their likely responses to the tax and political changes in Puerto Rico. Consequently, we needed to make a number of simplifying assumptions relating to the future Puerto Rican and federal tax liabilities of corporations operating in Puerto Rico.<sup>7</sup>

### IMPACT OF STATEHOOD ON FEDERAL INDIVIDUAL INCOME TAX REVENUE

In our previous study, which was based on 1992 income data for Puerto Rico and 1995 federal tax law, we estimated that, under statehood, Puerto Rican residents would have had a net aggregate federal income tax liability of approximately zero. The taxes paid by some residents would have been offset by the EIC refunds received by other residents. We have no way of making precise adjustments to our estimates to reflect the growth of incomes in Puerto Rico since 1992. If we assume that both tax payments and tax credits have increased by roughly the same rate in recent years, then the aggregate federal

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<sup>6</sup>A possessions corporation is one that formerly elected to be taxed under section 936 of the Internal Revenue Code (governing the possessions tax credit) and met the following two requirements: over a 3-year period preceding a taxable year, 80 percent or more of its income must have been derived from sources within a possession; and 75 percent or more of its income must have been derived from the active conduct of a trade or business within a possession. We use the term to refer to corporations that were possessions corporations in 1995, the latest year for which we have data.

<sup>7</sup>In addition to the two alternative assumptions described later in this letter, we made the following significant assumptions: (1) Corporations pay the top marginal income tax rates (Puerto Rican and federal, when applicable) on all of their taxable income. (2) Possessions corporations and their U.S. parent corporations earn the same amount of total income in Puerto Rico that they did in 1995. (3) Corporations that are not possessions corporations pay the same proportion of total Puerto Rican corporate income tax they did in 1995. (4) Except for the exemption of the income of certain corporations under Puerto Rico's tax incentive laws, the definition of taxable income is approximately the same under both Puerto Rican and federal corporate income taxes. (5) The amount of Puerto Rican income tax that possessions corporations will pay is approximately equal to the sum of what they paid in 1995 for the corporate income tax, special additional tax, and tollgate tax. We assume that this Puerto Rican tax would qualify as a creditable foreign tax (if Puerto Rico remains a commonwealth) or as a deductible state tax (if Puerto Rico becomes a state). (6) All nonpossessions corporations operating in Puerto Rico are incorporated in Puerto Rico and owned by Puerto Rican residents.

individual income tax payments and tax credits of Puerto Rican residents would still roughly offset each other, before taking the new child tax credit into account.

Using data developed for that previous study and making rough adjustments for income growth, we estimate that the cost to the federal government of providing the child tax credit to residents of Puerto Rico would be less than \$200 million this year. By adding this cost to the preceding estimate of zero, we estimate that the net impact of Puerto Rican statehood would be to reduce federal individual income tax revenue by less than \$200 million.

The potential federal tax liabilities of Puerto Rican residents would vary considerably across income groups. We estimate that fewer than half of the households in the tax filing population (primarily those with incomes over \$25,000 in 1992) would have positive federal income tax liabilities, after taking the EIC and child tax credit into account. More than half of all tax filing households would receive net transfers from the federal government because their EICs and child tax credits would more than offset their precredit liabilities, resulting in refunds.

#### IMPACT OF STATEHOOD ON FEDERAL CORPORATE TAX REVENUE

The effect of Puerto Rican statehood on federal corporate income tax revenue depends upon a number of factors,<sup>8</sup> including

- how many possessions corporations will remain in the commonwealth (and how much income they will earn there) after the phaseout of the Puerto Rican economic activity tax credit;
- the extent to which the investment behavior of the possessions corporations would be affected if Puerto Rico decided to become a state;
- whether, after the phaseout of the Puerto Rican economic activity tax credit, these possessions corporations would operate as branches of U.S. corporations or as U.S.-owned subsidiaries chartered in Puerto Rico, if the latter remained a commonwealth;
- the extent to which those corporations that choose to incorporate in Puerto Rico earn passive income that would be subject to federal income tax immediately; and
- the extent to which those corporations that choose to incorporate in Puerto Rico repatriate the active business income that they earn in Puerto Rico.

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<sup>8</sup>Some of these factors relate to the baseline situation, that is, what the federal corporate income tax base would be in Puerto Rico after the phaseout of the credit, but with no change in political status. Other factors relate to how that tax base would change, relative to that baseline, as a result of statehood.

CBO plans to make projections that take into account the future growth in corporate investment and income. However, even without considering the uncertainty relating to income growth, the last three factors listed above, by themselves, make it difficult to provide precise estimates of the impact statehood would have on federal corporate tax revenue.

To illustrate this point, we provide estimates of the additional federal tax that would have been paid on 1995 corporate income under two alternative assumptions. First, we assume that all of the possessions corporations will either operate as branches of U.S. corporations or, if they incorporate in Puerto Rico, will repatriate all of the income they earn in the year that they earn it. Under this set of assumptions, all of the income earned by these corporations would be subject to immediate federal taxation if Puerto Rico remained a commonwealth. The principal difference in federal taxation under commonwealth status and statehood would be that, under the former, the corporations or their parent corporations would receive a foreign tax credit for most of the income taxes they pay to Puerto Rico, while under the latter, they would be able to deduct their Puerto Rican income taxes from their federal taxable income.<sup>9</sup>

Our alternative set of assumptions is that all of the possessions corporations would incorporate in Puerto Rico, earn only active business income, and not repatriate any of their earnings to the United States. Under this set of assumptions, these corporations would pay no federal income tax immediately under commonwealth status, but all of their income would be subject to immediate federal taxation under statehood. Our results are presented in table 1.

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<sup>9</sup>Foreign tax credit protection generally would not be available for income derived from marketing intangibles related to the U.S. domestic market. The U.S. Treasury Department considered this to be an important factor in 1990, when it was estimating the revenue effects of statehood. We do not have data that would allow us to incorporate this factor into our estimates. If we had been able to do so, the estimates we present in table 1 would have been lower.

Table 1: Additional Federal Corporate Income Tax That Would Be Paid Under Alternative Assumptions

Alternative assumptions concerning the baseline situation	Additional federal corporate income tax that would be paid under statehood if incomes remained as they were in 1995
All corporate income subject to federal tax immediately under commonwealth status	\$1.0 billion
No corporate income subject to federal tax immediately under commonwealth status	\$4.6 billion

Source: Computations based on data provided by Puerto Rico's Treasury Department and on our assumptions.

This range of estimates shows how sensitive the federal revenue impact of statehood is to factors such as corporate organization and repatriation behavior. However, these two estimates do not represent the full range of possible revenue impacts because they do not take account of possible changes in corporate investment and income. Projections for corporate income, if available, could have produced an even wider range of revenue estimates. For example, if we had assumed that many of these corporations would reduce their income-producing physical and/or intangible assets in Puerto Rico after the phaseout of the tax credit, both of our estimates would be lower.<sup>10</sup> In contrast, if we had assumed that corporate investment and income would continue to grow in Puerto Rico despite the phaseout of the tax credit, both of our estimates would be higher.

### SUMMARY

Given the uncertainty over income growth in Puerto Rico after both the phaseout of the economic activity credit and the potential change to statehood, it is difficult to project the impact statehood would have on future combined federal individual and corporate income tax revenues. We have roughly estimated the impact that statehood would have on individual income tax revenue if personal incomes remain similar to what they have been in recent years. There is more uncertainty over the impact of statehood on corporate tax

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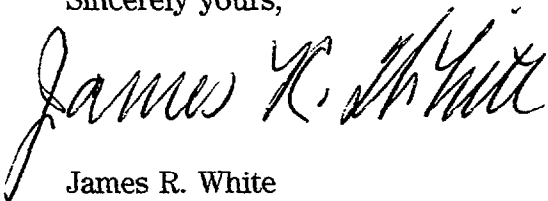
<sup>10</sup>A significant amount of the income of possessions corporations is attributable to intangible assets, such as research patents, which are relatively mobile. We have not analyzed the circumstances under which there might be tax advantages to relocating such assets.

revenue because, even if corporate incomes remain close to their current levels, the revenue impact would be sensitive to decisions that corporations made regarding their organizational form and repatriation of profits. While we are able to roughly illustrate the extent to which the corporate tax revenue impact could vary, depending on the decisions corporations make, we have no basis for predicting what the actual corporate decisions would be.

We did our work in June and July 1998 in accordance with generally accepted government auditing standards. This letter was prepared under the direction of James A. Wozny, Assistant Director. Other major contributors were Edward J. Nannenhorn, Senior Economist, and Elwood D. White, Evaluator. Copies of this letter are being sent to the Secretary of the Treasury, the Chairmen and Ranking Minority Members of the Senate Committee on Energy and Natural Resources, the Senate Committee on Finance, the House Committee on Resources, the House Committee on Ways and Means, and the Joint Committee on Taxation. We will also make copies available to others upon request.

If you or your staff have any questions about the information contained in the letter, please contact me or Mr. Wozny at (202) 512-9110.

Sincerely yours,



James R. White  
Associate Director, Tax Policy  
and Administration Issues

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