S. HRG. 114–462

PUERTO RICO: ECONOMY, DEBT, AND OPTIONS FOR CONGRESS

HEARING

BEFORE THE

COMMITTEE ON ENERGY AND NATURAL RESOURCES UNITED STATES SENATE

ONE HUNDRED FOURTEENTH CONGRESS

FIRST SESSION

OCTOBER 22, 2015

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PUERTO RICO: ECONOMY, DEBT, AND OPTIONS FOR CONGRESS

THURSDAY, OCTOBER 22, 2015

U.S. SENATE,
COMMITTEE ON ENERGY AND NATURAL RESOURCES,
Washington, DC.

The Committee met, pursuant to notice, at 10:07 a.m. in Room SD–366, Dirksen Senate Office Building, Hon. Lisa Murkowski, Chairman of the Committee, presiding.

OPENING STATEMENT OF HON. LISA MURKOWSKI, U.S. SENATOR FROM ALASKA

The CHAIRMAN. Good morning. The committee will come to order.

Today we are here to look at the current state of Puerto Rico's economy, its short-term liquidity issues, and options for Congress to address what has become a financial crisis for the island.

In looking over the fiscal data that is available on Puerto Rico, I would like to reiterate Chairman Hatch's remarks at his Finance Committee hearing on Puerto Rico last month. We do want to be helpful, but in order to be helpful, we need verifiable data.

As an example, the FY 2016 budget approved by the Puerto Rico Legislature sets aside $1.5 billion for debt service costs, yet the Krueger Report states that the official FY 2015 $850 million surplus is "a far cry from interest and amortization costs of $2.8 billion." The report further states that there is spending by entities other than the General Fund that is draining cash balances.

That is a fairly significant gap of over $1 billion. With no independent audited financial report of Puerto Rico's Government Development Bank—the island's fiscal agent and financial adviser—since 2013 it leads to uncertainty over the true level of Puerto Rico's financial situation. I would ask our witnesses this morning to share their views on the accuracy of the data that is available to us.

What we do know is that a number of reports suggest that even with the emergency actions taken by the government of Puerto Rico, the government will run out of cash in November, just a few short weeks away. If the current course of action is continued, an even bigger cash crunch will take place in June 2016, with a negative cash balance of over $500 million.

Barclays reports that the government may need to invade COFINA's tax revenue in order to pay its general obligation debt over the next five years and even that might not be enough. In short, Puerto Rico's short-term liquidity crunch is real, and action is needed.

A number of ideas have been floated to help address Puerto Rico's fiscal challenges, both short-term and long-term. We are going to use today's hearing to take a much closer look at what the reality on the ground is, what actions—both locally and at the Federal level—could have the most positive impact, and what structural reforms can be made to make for a more effective and efficient government.

I also intend for this hearing to take a closer look at Puerto Rico's Electric Power Authority (PREPA) and what is happening in Puerto Rico's energy sector. In my opinion, energy and the economy cannot be separated. They are too intrinsically interlinked, and Puerto Rico's economic health cannot be solved without also addressing its energy issues.

I had a meeting just yesterday with some small-business owners in Puerto Rico. They tell me that some 30 percent of their business expenses go to energy costs. This is extraordinary. If one of the pillars for solving Puerto Rico's long-term financial situation is private sector economic growth, that level of energy expense is simply not sustainable. As the various options are considered, we must keep that pillar in mind to ensure that any means implemented do not drive business away from the island or make it too difficult for them to remain in operation.

With that, we have a very distinguished panel before us this morning. After Senator Cantwell's remarks, I will introduce each of you, but we are very pleased to have the panel that we have.

With that, I will turn to Senator Cantwell for her remarks this morning.

STATEMENT OF HON. MARIA CANTWELL, U.S. SENATOR FROM WASHINGTON

Senator CANTWELL. Thank you, Madam Chair, and thank you for holding this important hearing. I, too, look forward to the witnesses' testimony this morning and working with you and other Members of the Senate on this issue.

At the outset, I would note that many observers may be wondering why, exactly, the Senate Committee on Energy and Natural Resources is having a hearing on the Puerto Rico debt crisis. It is important to remember that, until the Senate reorganized its committee structure in 1977, this committee was actually known as the Committee on Interior and Insular Affairs. We have jurisdiction over measures relating generally to the insular provisions of the United States except those affecting their revenues and appropriations.

So today, we retain jurisdiction over territorial possessions of the United States, including the former Trusteeship and matters related to the territory of Puerto Rico.

It is because of our general responsibilities in oversight that the Energy Committee has a key role to play in convening a responsible discussion about economic solutions that Puerto Rico now faces. However, it is also clear that fashioning these solutions will require partnerships with other Senate committees—the Chair mentioned the Finance Committee hearing, which I attended, and the Judiciary Committee, along with many others in the Puerto Rican Government and the Administration.

The Finance Committee has convened a hearing on this topic to date. Today we will hear for the first time what the Administration would do to try to address the crisis more specifically, and I certainly look forward to that testimony.

I would also like to make a few key points to put the current situation in context. First, it is very important to remember that 3.5 million residents of Puerto Rico today are U.S. citizens and have been citizens since 1917.

As we look at the ways that our U.S. economy has recovered, it is very important to understand that Puerto Rico has not rebounded. The continuing decline in productivity is felt there every day. Incomes are falling. Puerto Rico is already well below the poorest state, about $18,000 per person in Puerto Rico, about half the $37,000 in Mississippi. Tuition is up. Hospitals are closing. Everywhere, families are facing these challenges.

Puerto Rico is currently experiencing one of the largest migrations in U.S. history, having lost about eight percent of their population, over 300,000 people, in the past ten years. These individuals are many of Puerto Rico's most-skilled and highest-paid workers. This migration to the U.S. will continue, and I think it is one of the challenges we face.

Debt has accumulated to an estimated $72 billion. In fact, the government and the electric utility have failed to make their required debt payments. I know, Madam Chair, you know a lot about high-cost utility costs, but the fact that these energy rates are at 29 cents a kilowatt obviously presents an incredible challenge to any manufacturing in the future. Also, credit is either unavailable or prohibitively expensive, and cash reserves are expected to be exhausted in the coming weeks.

It is clear that the current situation is not acceptable. It is clear that we do not want to see the situation unfold in which the government of Puerto Rico faces a binary choice of either paying teachers or reimbursing healthcare costs versus paying the debt, much of which has been bought up by Wall Street for pennies on the dollar, under the assumption that Congress would not act.

I think it is very important that we meet our responsibilities here, that congressional authority over Puerto Rico and the territories that stems from the Territorial Clause of the Constitution—which, just to remind people, say Congress shall have the power to dispose and to make all necessary rules and regulations respecting territories—I think is very important.

We have done this in the past. Congress has acted. The constitution of Puerto Rico was authorized and approved by Congress. The Organic Acts of Guam and the U.S. Virgin Islands are Federal statutes. All of these have been reported by the Senate committee, and so I think it is very important that we realize that we do have the power and authority to act here.

It was first President Bush in 1992 who said that Federal agencies should "treat Puerto Rico administratively as if it were a state," unless doing so otherwise would "increase or decrease Federal receipts or expenditures or seriously disrupt" Federal programs.

I know there are a lot of ancillary debates here about how we help Puerto Rico, but we do have the ability to give them the key tools to financial restructuring without doing another thing, without costing us anything. We have the ability to give them that power.

If we are, in fact, to enact new laws in this area, we do need to have a partnership. Obviously, as I said, there are other committees that would have to be consulted in how we move forward on this issue. So I look forward to hearing from all the witnesses and the discussion about how we best move forward for Puerto Rico's future.

I should just note, getting through this financial crisis is one step of the process. Clearly I have a lot of questions in my own mind about a flat world and how an island economy can best proceed in the future, but we will save that discussion for another day and instead focus on how we give Puerto Rico the best tools possible to get through this financial crisis.

I thank the Chair, and I look forward to the witnesses' statements.

The CHAIRMAN. Thank you, Senator Cantwell, I appreciate your comments this morning.

With that, let us turn to our panel that has been assembled here this morning. We will lead off the panel this morning with Mr. Antonio Weiss. Mr. Weiss serves as the Counselor to the Secretary of the Treasury. He has been leading the Obama Administration's efforts to provide technical assistance to Puerto Rico on financial matters. We appreciate you being here this morning and assume that you will fill us in on the details of the proposal by the Administration.

Next we have the Honorable Governor Padilla. Governor Padilla has been Governor of Puerto Rico since 2013, and he has been head of the Popular Democratic Party since 2012. Governor Padilla, it is nice to have you back before the committee. Welcome.

Next to the Governor we have Mr. Pedro Pierluisi. Mr. Pierluisi has been Puerto Rico's Resident Commissioner in the U.S. House of Representatives since 2009. He is a member of the House Judiciary and Natural Resources Committee. Mr. Pierluisi has also been before the committee on several occasions, so we are pleased to have you back as well. Good morning.

Next to Mr. Pierluisi we have Mr. Sergio Marxuach. I hope I am pronouncing that correctly. He is the Public Policy Director at the Center for a New Economy in Puerto Rico. He has previously served as Deputy Secretary of Commerce and Economic Development for the Government of Puerto Rico and as a Special Assistant in the Commonwealth's Office of Management and Budget. Good morning.

Finally we have Mr. Steven Fetter. Mr. Fetter is President of the advisory firm Regulation UnFettered. He served as Chair of the Michigan Public Service Commission. He has also been Group Head and Managing Director at Fitch Ratings with a focus on global energy issues. So we also welcome you before the committee.

I will ask that each of you try to keep your comments this morning to about five minutes or less. Your full statements will be included as part of the record.

I will alert you to the fact that we are scheduled to have one, if not two, votes commencing at 11 o'clock this morning, so my hope would be that we would be able to get the testimony from each of you, and if we need to take a short break to run and do votes, we will do so. But hopefully we will be able to get all the comments in under that 11 o'clock time, and we will be able to proceed. There is a lot that is before the committee this morning, and we want to give you every opportunity.

Mr. Weiss, if you would like to lead off. Welcome.

STATEMENT OF ANTONIO WEISS, COUNSELOR TO THE SECRETARY, U.S. DEPARTMENT OF THE TREASURY

Mr. WEISS. Chairman Murkowski, Ranking Member Cantwell, and members of the committee, thank you for inviting Treasury to participate in today's hearing. We welcome the opportunity to have a constructive dialog with you and with your colleagues on this important and very urgent matter. The economic security and well-being of 3.5 million Americans living in the Commonwealth is at stake. I would also like to acknowledge our ongoing collaboration with Governor Garcia Padilla and Resident Commissioner Pierluisi, both of whom are here today.

Through our daily contact with local leadership and frequent meetings with stakeholders in San Juan and Washington, I can tell you with total confidence that Puerto Rico's fiscal crisis is escalating and it is very real, and that without Federal action, it could easily become a humanitarian crisis as well.

Let me be clear: there is no substitute for legislative action. Administrative authorities are simply insufficient to put an end to the crisis. Without Federal action, this crisis will escalate and result in further economic contraction, outmigration, and suffering of American citizens in Puerto Rico.

In the very near future, Puerto Rico will face impossible choices among providing essential public services, delivering promised pension benefits, and making payments on its debt. Now my written testimony describes the gravity of Puerto Rico's fiscal challenges, but I would like to highlight a few of the more salient facts.

First, Puerto Rico's decline started before the U.S. financial crisis, but unlike the U.S. as a whole, the Commonwealth never recovered and remains in recession today.

Second, these economic challenges have sparked the largest wave of outmigration from Puerto Rico since the 1950s, and that pace continues to accelerate. Eighty-four thousand Puerto Ricans left the island last year.

Third, the Commonwealth has already run out of operating cash. Government services and debt payments have only continued because Puerto Rico is deploying unsustainable emergency liquidity actions, such as delaying tax refunds to its citizens and borrowing from workers' compensation funds. But even with these steps, the Commonwealth projects it still will completely exhaust its liquidity before year end.

Now the strain created from these actions is already evident. The pensions are underfunded severely, hospitals have reduced services—one has even closed—and invoices to small businesses are going unpaid. Against this backdrop, additional fiscal adjustment, while absolutely necessary, must be measured against its negative impact on Puerto Rico's economy and people.

In our judgment, austerity alone is not a solution. Most fundamentally, the debt is unsustainable, and the market knows this, which is why Puerto Rico's debt has traded for some time between 30 and 70 cents on the dollar.

Now there is plenty of blame to go around for the mistakes of the past, but we must now focus on the path forward. The Administration believes that Federal actions, executed alongside measures taken in the Commonwealth, are now required to allow Puerto Rico to address its fiscal crisis and for the economy to return to growth. We are presenting these policies as principles to the committee and stand ready to work with you on specific legislation. There are four interrelated elements to our plan.

First, Puerto Rico needs tools to comprehensively restructure its financial liabilities. Congress should pass legislation already introduced that provides Chapter 9 protection to Puerto Rico's municipalities and public corporations, but Congress should also authorize a broader legal framework that allows for a comprehensive restructuring of all of Puerto Rico's outstanding debt.

Second, Congress should require that Puerto Rico implement strong fiscal governance and oversight as part of any comprehensive legislative package. The oversight should provide sufficient safeguards to ensure Puerto Rico adheres to its recovery plan and fully implements proposed reforms, but care must also be taken to structure fiscal oversight in a way that respects Puerto Rico's autonomy and unique heritage.

Third, Congress must provide a long-term solution to Puerto Rico's inadequate Medicaid treatment to raise the standard of care. We should also remove the Medicaid cap and increase support through the Federal Medicaid match.

And finally, Congress must help Puerto Rico boost economic growth. The decade-long recession has taken its toll on Puerto Rico's finances, its economy, and its people. To break this vicious cycle and help those hardest hit, Congress should extend the earned income tax credit (EITC) to citizens in Puerto Rico. The EITC is one of the strongest, most powerful policies for rewarding work and supporting economic growth.

We look forward to a constructive, bipartisan dialog that identifies ways to execute the Administration's proposals and provide Puerto Rico with the tools it needs to manage through this crisis and restore growth.

You have kindly invited us today to discuss Puerto Rico's economy, debt, and options for Congress. We believe this discussion is timely and the issue must be addressed.

Thank you.

[The prepared statement of Mr. Weiss follows:]

EMBARGOED FOR DELIVERY

Testimony of Antonio Weiss
Counselor to the Secretary, U.S. Department of the Treasury
Written Testimony
Senate Committee on Energy and Natural Resources
"Hearing on Puerto Rico: economy, debt, and options for Congress"
October 22, 2015

As Prepared for Delivery

Chairman Murkowski, Ranking Member Cantwell, and Members of the Committee:

Thank you for the invitation to participate in today's hearing on Puerto Rico's economy, debt, and options for Congress moving forward. On behalf of the U.S. Department of the Treasury and the Obama Administration, we welcome the opportunity to have a constructive dialogue with you and your colleagues on this important and urgent matter. The well-being of 3.5 million Americans living in the Commonwealth of Puerto Rico is at stake.

I would also like to acknowledge our collaboration with Governor Alejandro Garcia Padilla and Resident Commissioner Pedro Pierluisi, both of whom are here today.

We also appreciate the growing interest in this urgent issue by a wide range of Members of Congress on both sides of the aisle, and other Committees who have been engaged and have held hearings.

But while growing bipartisan interest is appreciated, Congress will need to take action. The Commonwealth of Puerto Rico is in the midst of an economic and fiscal crisis, and, without federal action, the situation could become a humanitarian crisis as well. Puerto Rico's government is out of cash and running out of options. Over the past year, we have met regularly with key stakeholders, including members of Puerto Rico's legislature and local business and labor leaders. We also remain in daily contact with the officials managing Puerto Rico's fiscal response. The sense of crisis is escalating and very real.

My testimony today will describe the magnitude of Puerto Rico's challenges and offer a comprehensive set of specific policies the Administration believes are needed to fix the problem. Let me be clear: there is no substitute for legislative action. No administrative authority can put an end to this crisis. A very wide gap exists between the proposals the Administration has put forth and any non-legislative alternatives.

We remain deeply committed to doing what we can to help, but Congressional action is required to avert further crisis and put Puerto Rico's economy on a path toward sustainable growth. All stakeholders, including bondholders, need to contribute to the solution. Puerto Rico must also do its part by implementing a comprehensive fiscal plan.

As the Administration has made clear, our policy proposals are not a bailout. On the contrary, they are the critical reforms we believe Puerto Rico requires to manage through this crisis. Only

Congress can provide the tools Puerto Rico needs to restructure its debt, enhance its fiscal governance, fix its healthcare system, and help jumpstart its economy.

Without action by Congress, the Commonwealth's crisis will escalate and result in further economic contraction, further outmigration, and further suffering of the American citizens in Puerto Rico. In the very near future, Puerto Rico will face impossible choices among providing essential public services, delivering promised pension benefits, and paying its debt.

This Could Become a Humanitarian Crisis, Not Just an Economic and Fiscal Crisis

Puerto Rico was once referred to, and emulated, as a beacon for economic growth and democracy around the world. The Commonwealth has substantial strengths with a stable rule of law and currency as well as a highly-skilled workforce. For more than a century, Puerto Ricans have fought courageously to defend our nation. In 2014, the 65th Infantry Regiment, known as the Borinqueneers, was awarded the Congressional Gold Medal, and tens of thousands of Puerto Ricans proudly serve in our armed forces.

Today, however, the Island is suffocating from a decade of economic decline and expanding deficits. Important efforts to increase revenues and reduce outlays have been insufficient to reverse the trend. As a result, Puerto Rico is experiencing a prolonged, downward spiral in economic performance, investment, employment and income flows, intensified by a sharp cutback in business and consumer lending.

Puerto Rico's decline started before the U.S. financial crisis, but unlike the rest of our country, the Commonwealth never recovered and remains in recession today. Since 2006, Puerto Rico's economy has shrunk by more than 10 percent and has shed more than 250,000 jobs. More than 45 percent of the Commonwealth's residents live in poverty – the highest poverty rate of any state or territory – and its 11.6 percent unemployment rate is more than twice the national average. Median household income in Puerto Rico is less than $19,000, approximately one-third of the U.S. median.

These economic challenges have sparked the largest wave of outmigration from Puerto Rico since the 1950's, and that pace continues to accelerate. More than 300,000 people have left Puerto Rico in the past decade; a record 84,000 people left in 2014. Citizens are leaving from across the socioeconomic spectrum. More than 40 percent leave for job-related reasons. They range from highly educated doctors, who are leaving at a rate of more than one a day, to young adults unable to find work in the local economy. As they depart, the population ages and the revenue base shrinks. Seniors already represent more than 23 percent of Puerto Rico's population, one of the highest in the United States, and the number of children under five years of age has decreased 37 percent to 187,000 since 2000. Only a return to growth can end this vicious cycle.

The Commonwealth is already taking significant revenue and expense actions that, while necessary, are creating further economic headwinds. Nearly $2.0 billion in tax increases are reducing household income spending, and reductions in pay and benefits are having a contractionary effect. The wholesale petroleum tax quintupled to $15.50 per barrel, and the sales tax recently increased to 11.5 percent, the highest in our nation. A strict fiscal sustainability law was enacted to reduce government expenses and cap public wages. Government spending, net of debt service, is now at its lowest level since 2005, both in nominal terms and as a share of Gross National Product.

However, austerity alone is not a path to recovery. After ten years of recession, there are limits to the scale and pace of additional fiscal adjustment that can be achieved.

Puerto Rico's Current Liquidity Situation

Puerto Rico lost access to the traditional municipal bond market in February 2013 after ratings agencies downgraded its bond rating to below investment grade status. In March 2014, the Commonwealth raised $3.5 billion at an 8.5 percent yield entirely from hedge funds, but they too are no longer available as a sustainable funding source. Even short-term financing, such as tax revenue anticipation notes, has proved impossible to obtain on an affordable basis.

Given the lack of market access, the Commonwealth ran out of the cash needed for normal operations earlier this year. Government services and debt payments have only continued because Puerto Rico is deploying onerous and unsustainable emergency liquidity actions. These measures include delaying payment of tax refunds to residents, borrowing from Puerto Rico's workers compensation funds, liquidating pension assets early to provide working capital, failing to pay certain appropriation debts, withholding monthly set aside funds for debt service, and stretching payment of accounts payables to vendors and other third parties. Despite these actions, the Commonwealth projects it will completely run out of emergency liquidity before year-end.

The strain created from these actions is already evident. For example, delays in healthcare reimbursements have forced many medical centers to close floors and eliminate specialized services, and at least one hospital shut down temporarily because of a failure to pay its bills. Puerto Rico's Federation of Mayors estimates that forty-five of Puerto Rico's seventy-eight municipalities will not have enough cash for payroll expenses as early as this November. Fuel services at six municipalities could be cutoff within weeks as well. Against this backdrop, any additional fiscal adjustment must be measured against its potentially adverse effects on the Puerto Rican economy and people.

The central government's ongoing structural deficits also put Puerto Rico's pension systems at risk. Monthly pension payments are the only source of steady income for many of the pension system's 163,000 retirees. An additional 167,000 workers, who represent nearly 20 percent of Puerto Rico's workforce, are also counting on the pension systems for future retirement income.

For much of the past decade, while workers paid into the system, Puerto Rico failed to pay its annual required contributions. As a result, system administrators are currently being forced to sell pension assets to pay current benefits. Once those assets are depleted – likely by 2019 – all future pension benefits will need to be paid directly from the Commonwealth's General Fund. This will require an additional $700 million to $1 billion of outlays per year.

Longer-term, absent policy changes, Puerto Rico projects it will confront a $28 billion budget shortfall over the next five years. The Commonwealth has identified additional tough revenue and expense measures to narrow that gap. However, full implementation of Puerto Rico's proposed actions, including the generation of economic growth, only reduces the estimated five-year fiscal deficit to $14 billion. The remaining $14 billion shortfall must be closed, in part, through the restructuring of Puerto Rico's large and complex debt burden.

The Administration's Proposed Plan

The Administration believes federal actions, executed alongside measures taken in the Commonwealth, are now required to allow Puerto Rico to address its fiscal crisis and restore economic growth. The Administration is presenting these concepts as principles and stands ready to work with Congress to advance comprehensive legislation that achieves our collective objective.

There are four interrelated elements to the Administration's proposal:

First, Congress should provide tools for Puerto Rico to comprehensively restructure its financial liabilities. Puerto Rico's debt load is unsustainable. Tax-supported debt service is projected to consume over 35 percent of government receipts in coming years. In contrast, debt service for the fifty states is, on average, only 5 percent of revenues. Additionally, total liabilities exceed 160 percent of GNP – a greater burden than can likely be supported by Puerto Rico even if economic growth resumes. The bond market also knows this, which is, in part, why Puerto Rico's uninsured debt trades between 30 and 70 cents on the dollar, and rating agencies have determined there is a high probability of default.

For that reason, a central element of any Congressional response must include a fair and orderly restructuring mechanism built on the tested principles of the federal bankruptcy code. Puerto Rico does not have access to the federal bankruptcy courts to restructure its financial obligations. Puerto Rico's officials tried to address this shortfall on their own by passing a law to provide a bankruptcy-like process, but the United States Court of Appeals for the First Circuit held that federal law preempts the local legislation. Further, the Court held that only Congress may grant Puerto Rico access to bankruptcy protection.

Puerto Rico's debt stock is highly complex. More than 20 creditor committees have already formed around Puerto Rico's 18 different debt issuers, each with its own competing interests. This will make it very difficult for Puerto Rico to negotiate a voluntary restructuring on a timely basis. A court-supervised process would help ensure fair treatment to all parties. Absent an orderly process, all stakeholders stand to lose in the face of continued deterioration of Puerto Rico's economic and financial conditions.

Bankruptcy is not a bailout. Allowing Puerto Rico to resolve its liabilities under the supervision of a bankruptcy court involves no federal financial assistance whatsoever. Instead, bankruptcy requires shared sacrifice from both Puerto Rico and its creditors. The alternative – an untested and potentially disorderly process with numerous creditor lawsuits and years of litigation – would depress the local economy, increase costs, and make long-term recovery harder to achieve.

Congress should move swiftly to pass pending legislation that provides Chapter 9 protection to Puerto Rico's municipalities in the same manner it already provides bankruptcy protection to municipalities in the fifty states. This legislation would cover approximately one-third of Puerto Rico's bonded debt.

Congress should also authorize a broader legal framework that goes beyond the scope of Chapter 9 to allow for a comprehensive restructuring of all of Puerto Rico's outstanding debt. The restructuring regime should be reserved exclusively for U.S. territories. As under current law, states would remain ineligible to file for bankruptcy under this or any other bankruptcy regime.

The restructuring regime should provide the basic protections of bankruptcy: a stay on creditor collection actions, priority for new private short-term cash flow financing, and voting by creditor classes on any proposed restructuring.

The restructuring regime should fairly balance the interests of Puerto Rico and all its creditors. It should safeguard Puerto Rico's capacity to fund its public pensions and pay retiree benefits. Such an approach would, among other things, provide breathing space for consensual negotiations and ensure the uninterrupted provision of essential public services.

Second, Congress should require that Puerto Rico implement strong fiscal governance and oversight as part of a comprehensive legislative package. Puerto Rico's efforts have been hampered by a lack of fiscal oversight and transparency. Historically, Puerto Rico's budgets relied on unrealistic revenue estimates, and, as a result, annual budgets masked recurring structural deficits. Moreover, proposed revenue and expense measures have fallen short because Puerto Rico lacks important fiscal controls to ensure discipline.

Consequently, independent and credible fiscal oversight is needed. Congress should enact that oversight as part of a comprehensive approach to the crisis. Care must be taken to structure the fiscal oversight in a way that respects Puerto Rico's autonomy. At the same time, the oversight should provide sufficient safeguards to ensure Puerto Rico adheres to its recovery plan and fully implements proposed reforms. This would help restore confidence among all stakeholders. Access to the broader restructuring regime should be conditioned on this oversight. The Administration is ready to work with Congress to identify the powers of this oversight body and its proposed membership.

Any fiscal oversight should also work to improve Puerto Rico's fiscal accounting and reporting systems. While the historical inadequacies of Puerto Rico's financial systems are undeniable, there is little doubt about the realities of the current fiscal crisis. The Commonwealth recently commissioned an independent and exhaustive forensic accounting of their financial books that for the first time revealed the true extent of Puerto Rico's fiscal crisis. This rigorous and thorough accounting is available on the website of the Government Development Bank.

Congress should provide funding and authorization for technical assistance to help Puerto Rico make the critical investments needed to bring its accounting and disclosure practices into the 21st century. This includes taking action to fund information technology upgrades, improve economic forecasting capabilities and provide Federal technical assistance around budgeting, cash management and spending controls. Agencies in Puerto Rico use different financial systems that are incompatible with one another, making it difficult to provide consistent, timely financial reporting and visibility into expenses. The funding amounts involved would be small, but the benefits would be great.

Third, Congress must provide a long-term solution to Puerto Rico's inadequate Medicaid treatment. Given the current treatment of Puerto Rico and the other territories under federal law, the 3.5 million Americans in Puerto Rico do not have access to healthcare services considered standard in the rest of the nation. There are currently more than 1.6 million Medicaid enrollees in Puerto Rico's healthcare system, representing nearly half of the Commonwealth's population. Insufficient and unstable funding for Medicaid has contributed to Puerto Rico's fiscal challenges and endangered access to coverage. When one-time funds from the Affordable Care Act for Puerto Rico's Medicaid system are exhausted, as many as 600,000 Americans living in Puerto Rico could lose coverage.

Puerto Rico's Medicaid program is fundamentally different from the Medicaid program that serves Americans in the 50 states and the District of Columbia. Medicaid funding in Puerto Rico is capped; U.S. citizens in Puerto Rico are offered fewer benefits; and the federal government contributes less on a per capita basis in Puerto Rico than in the states.

As a result, Congress should reform Puerto Rico's Medicaid program to raise the standard of care and prevent Medicaid's unstable financing from exacerbating Puerto Rico's fiscal crisis. Americans in Puerto Rico should be provided with access to Medicaid and key healthcare services that better align with what people receive on the mainland.

Congress should also remove the cap on Puerto Rico's Medicaid program and increase the Federal support Puerto Rico receives through the Federal Medicaid match, after a sufficient transition period. A transition period is required so Puerto Rico can develop the more robust infrastructure required to offer new benefits and strengthen its internal accountability, financial management, and program integrity controls to prevent fraud, waste, and abuse. Because the transition may take years, Congress should avoid a drop in coverage when one-time funds from the Affordable Care Act expire.

Finally, Puerto Rico desperately needs measures to boost economic growth. The decade-long recession has taken its toll on Puerto Rico's finances, its economy, and its people. To break this vicious cycle and help those hardest hit, Congress should extend some of the most proven, bipartisan tools for stimulating growth and rewarding work to the citizens of Puerto Rico.

At forty percent, Puerto Rico has the lowest labor market participation in the United States and the territories – participation rates are about two-thirds the U.S. average. Low participation in the formal economy stunts economic growth and undermines Puerto Rico's economic reform.

Puerto Rico does not currently have an Earned Income Tax Credit (EITC). A large body of economic research has found that the EITC is one of the strongest, most powerful policy tools for rewarding work and supporting economic growth. The existence of an EITC should also increase employment in the official sector relative to the informal economy by providing higher wages to workers who file taxes. As a result, Congress should grant Puerto Rico access to an EITC.

The EITC is a proven job creation policy that has long garnered broad bipartisan support in Washington. President Reagan proposed a major EITC expansion in his 1986 Tax Reform Act, which he argued was "the best antipoverty, the best pro-family, the best job creation measure to come out of Congress." Several studies demonstrate that the large expansions to the EITC enacted in the 1980s and 1990s induced more than half a million people to enter the labor force.

Congress should also consider other proven measures, in addition to an EITC, that reward work and support growth, such as the Child Tax Credit.

The Administration's Ongoing Engagement

Although there is no substitute for legislative action, the Administration has been actively working for many months, within existing authorities, to help the residents of Puerto Rico.

Treasury started monitoring Puerto Rico's fiscal situation several years ago. As the Commonwealth's financial challenges worsened, Secretary Lew intensified the Department's effort. He created a dedicated team within Treasury to evaluate Puerto Rico's fiscal outlook more closely and begin sharing our expertise with the officials that oversee the Commonwealth's economic policies.

Since its formation, the team has visited Puerto Rico regularly to review Puerto Rico's financial data, offer our perspectives on how other entities have managed through similar crises, and recommend steps Puerto Rico could take to restore economic growth. We meet frequently with the Governor, members of Puerto Rico's legislature, and local business and labor leaders. We also remain in daily communication with the officials managing Puerto Rico's fiscal response.

The National Economic Council and Treasury are also leading a broad, Administration-wide effort on Puerto Rico. This broader, Administration-wide effort includes the support of the White House Task Force on Puerto Rico, the Office of Management and Budget, the Department of Health and Human Services, the Department of Justice, and all other agencies needed to construct the legislative priorities proposed in this testimony.

The effort has three primary objectives. First, to ensure the Administration brings our full capabilities to bear, within the limit of our authorities, to guarantee Puerto Rico has access to all available federal programs. Second, to encourage federal agencies to pursue all possible administrative options for assistance. And, finally, it established the legislative priorities proposed today.

The inter-agency effort has already produced results. These are some salient examples:

- As part of our effort to ensure Puerto Rico has access to all available federal resources, the **Department of Health and Human Services** worked with the Administración de Seguros de Salud (ASES) to implement an accelerated reimbursement timeline for eligible healthcare expenses. Rather than reimbursing ASES on a periodic basis, reimbursements now occur weekly, substantially reducing the friction between the time funds are outlaid and subsequently repaid. This helps to ease the burden on Puerto Rico as it manages through its limited liquidity. The **Department of Health and Human Services** also convened a working group between the Secretary's office and the Puerto Rico Healthcare Coalition to exchange information and identify any administrative flexibility that might exist. This working group is considering data proxies to improve Medicare payments to hospitals in Puerto Rico and adjustments to Medicare measures that would benefit high-poverty areas across the United States, including Puerto Rico.

- The **Department of Transportation** (DOT) is working closely with Puerto Rico's Highways & Transportation Authority to spur infrastructure investment. As a result, the Federal Highway Administration identified more than $750 million in toll credits Puerto Rico can use to fund new and potentially existing infrastructure projects. DOT is also working with Puerto Rico to add PR-22 to the Presidential Dashboard and is accelerating the design of a congestion pricing system to improve traffic flow on PR-52. The Build America Transportation Infrastructure Center is also in conversation with Puerto Rico about lending its expertise on possible public private partnership opportunities.

- The **Department of Commerce**, led by SelectUSA and through direct engagement from the Vice President of the United States, supported efforts to attract significant new investment to develop the Lufthansa Maintenance, Repair, and Overhaul facility in Aguadilla. SelectUSA continues to partner with Puerto Rico on a pipeline of potential investment deals to help attract jobs and boost economic growth on the Island.

- The **General Services Administration** is helping create opportunities for local and small businesses by spending $85 million to construct a new FBI headquarters in San Juan. This will create both jobs and procurement opportunities for local businesses. As part of their Big Building Projects, the GSA also recently hosted a networking event for local contractors interested in being shortlisted for the FBI project. Separately, the Department of Commerce's **Economic Development Administration** provided $800,000 to the Puerto Rico Trade and Export Company (PRTE) and the Puerto Rico Investment Development Corporation (PRIDCO) to host a Small and Medium Enterprises conference focused on business to business matching and procurement processes.

- The Administration continues to partner with Puerto Rico to improve the structural competitiveness of its economy. **Department of Agriculture** is working with Puerto Rico to modernize and reform the Island's Nutrition Assistance Program to help remove significant benefits cliffs that can potentially discourage individuals from seeking work in the formal economy. The **Department of Justice** recently signed a Memorandum of Understanding to help reduce violent crimes. And, the **Department of Energy** signed a Memorandum of Understanding to develop a long-term energy plan that will provide Puerto Rico with safe, reliable, and clean energy. The Department of Energy's efforts could help to lower electricity costs on the Island, which at twice the levels of the mainland, decrease the Commonwealth's competitiveness for business investment and raise costs faced by its residents.

The Administration remains committed to supporting Puerto Rico as it addresses its fiscal crisis and seeks to restore economic growth. However, while these achievements represent tangible progress, they are insufficient to meet the magnitude of Puerto Rico's fiscal challenges. That is why Congressional action is essential to provide Puerto Rico with the tools it needs to manage through this crisis and restore growth.

Conclusion

There is plenty of blame to go around for the mistakes of the past. But we must now focus on the path forward. Puerto Rico can and will emerge from the current crisis and return to growth. The fundamental question is when and at what cost to its residents and economy. By implementing the Administration's four-part plan, Congress can help put Puerto Rico on the best path to a sustained recovery.

If we do not act collectively and quickly, Puerto Rico will face a long, difficult, and uncertain process. The federal government will also pay a price if a comprehensive solution is not enacted. More residents of Puerto Rico would need to turn to federal safety nets including unemployment insurance, low-income housing grants, nutrition assistance grants, and temporary assistance for needy families, among other federal assistance programs.

We look forward to a constructive, bipartisan dialogue to identify ways to execute the Administration's proposals and provide Puerto Rico with the tools it needs to manage through this crisis and restore growth. You have kindly invited us today to discuss Puerto Rico's economy, debt, and options for Congress. We believe this discussion is timely and the issue must be addressed.

The CHAIRMAN. Thank you, Mr. Weiss.

Governor Padilla, your comments, please? Thank you.

STATEMENT OF HON. ALEJANDRO J. GARCIA PADILLA, GOVERNOR OF THE COMMONWEALTH OF PUERTO RICO

Governor PADILLA. Thank you, Chairwoman Murkowski, for your leadership and for holding this hearing. I appreciate our collaboration and look forward to a bipartisan solution to this crisis, working with Ranking Member Cantwell, members of the committee, Congress, the Treasury, and the Resident Commissioner of Puerto Rico.

We are facing a crisis in Puerto Rico, a crisis decades in the making. We did not create it, but we need to solve it. To address it, my administration has reduced expenses by 20 percent and increased revenues by another 20 percent in the last three years.

Despite these efforts, by the end of this year, Puerto Rico may have to choose between paying its creditors and providing essential services to the island's 3.5 million American citizens. Police and fire protection, healthcare, and social services are all in jeopardy.

Puerto Rico is running out of cash and will soon exhaust the emergency measures we are using to keep the government operating. When faced with the prospect of either making payments on debt obligation or paying for essential services, Puerto Rico will have no choice but to default. With no bankruptcy options, creditors will sue, dragging us into complex and costly legal battles that will only aggravate the crisis.

I urge you to read Dr. Anne Krueger's report, which reinforces this reality. Her debt sustainability study, the first ever done by any administration in Puerto Rico, describes a vicious cycle of economic recession, public borrowing, and fiscal adjustment that began to accelerate in 2005 following congressional repeal of Section 936 of the Internal Revenue Code and the resulting downturn into our manufacturing base.

From 2005 to 2012, Puerto Ricans shouldered the burden of a new sales tax, employee layoffs—thousands, a surtax on real property, and other expenditures and revenue measures while our debt burden nearly doubled from $39 billion to more than $70 billion.

Upon taking office in 2013, I began to implement additional fiscal adjustment measures: reduce expenditures and froze collective bargaining agreements, reform our largest pension fund from defined benefits to defined contribution, and increased revenues. Most notably, throughout attrition, we now have 66 public employees per 1,000 persons, lower than the U.S. average of 68, and have begun to reduce our debt, a historic first.

Other actions my administration has taken are detailed in my written testimony. However, independent experts tell us, and we agree, that even if we implement all of the measures in my working group's Fiscal and Economic Growth Plan, large financing gaps and unfunded pension obligations will persist.

We have never asked Congress for a bailout, and we are not seeking one today. We ask for access to a legal framework to restructure our liabilities. We ask for fair treatment in Medicare and Medicaid funding, for reforms that stimulate labor force participation and job creation such as the earned income tax credit. We ask for exemption of the Jones Act like that of the United States Virgin Islands, our closest neighbors. Treasury's recommendations address many of my administration's requests and are an essential step forward.

Chairwoman and members of this committee, inaction is not an option. By moving forward on these measures now, you can help prevent the situation from getting worse. Your action will have a dramatic impact on the people of Puerto Rico and will have little or no effect on the serious national budget issues confronting Congress.

Working—I am sorry—waiting will only allow the situation to grow worse, more expensive, and difficult for you to address down the road. Give us the tools, and we will finish the job.

Thank you for your time and attention.

[The prepared statement of Governor Padilla follows:]

Alejandro J. García Padilla
Governor of the Commonwealth of Puerto Rico
Written Statement
Senate Committee on Energy and Natural Resources
Hearing on Puerto Rico: economy, debt, and options for Congress
October 22, 2015

Chairman Murkowski, Ranking Member Cantwell, and Members of the Committee:

I want to thank the Committee for giving the Commonwealth of Puerto Rico ("Commonwealth" or "Puerto Rico") the opportunity to participate in this hearing.

Introduction

The plain and simple truth is that, notwithstanding the unprecedented emergency liquidity measures that Puerto Rico has implemented over the last year, the Government of Puerto Rico may run out of sufficient money to meet all of its obligations in the ordinary course before the end of the year and will inevitably have to choose between paying its creditors on time and providing essential government services to the island's 3.5 million American citizens.

As many of you know, in early 2015 we commissioned a team of world-renowned economists led by Dr. Anne Krueger, the former Chief Economist at the World Bank and First Deputy Managing Director of the International Monetary Fund (IMF), to undertake a comprehensive analysis of Puerto Rico's fiscal and economic challenges as well as a debt sustainability analysis, the first ever by any administration.

Dr. Krueger's findings – detailed in a report often referred to as the "Krueger Report" – described that a number of economic shocks have contributed to Puerto Rico's economic stagnation and that, even with significant and painful reforms to reverse Puerto Rico's economic trends, large residual financing gaps would persist well into the next decade, implying a critical need for debt relief from a significant proportion of the principal and interest falling due in Puerto Rico in the next several years.

After the release of the Krueger Report I constituted the Working Group for the Fiscal and Economic Recovery of Puerto Rico (often referred to as the "Working Group") and tasked it with developing the Fiscal and Economic Growth Plan for Puerto Rico. The Fiscal and Economic Growth Plan, which was released on September 9, 2015, reviews the historical measures taken to increase taxes and reduce expenses; analyzes the current liquidity and fiscal position of Puerto Rico; recommends certain fiscal and economic reform and growth measures, including critical measures that require action by the U.S. Government; proposes to create a financial control board appointed by the governor upon the recommendation of a nationally recognized executive search firm or other independent third party; and identifies significant projected financing gaps (even assuming the implementation of the recommended fiscal reform and economic growth measures) that requires widespread debt relief.

The bottom-line is that Puerto Rico faces a $28 billion funding gap over the next five (5) years, and serious action must be taken both by the Government of Puerto Rico and the U.S. Government to close that gap. But even if serious action is taken (notwithstanding all the implementation risks of doing so), Puerto Rico will still face a funding gap of approximately $14 billion over the next five (5) years, which will require substantial debt relief.

Today, however, I would like to focus on three topics. *First*, and most critically, I will discuss the debt crisis that Puerto Rico faces right now, which, if not addressed, threatens 3.5 million Americans with the disruption of essential government services. *Second*, I will address a misconception raised in the Finance Committee hearing on the Financial and Economic Challenges in Puerto Rico related to the availability of current and reliable financial information, which availability should not be used as a justification for failing to take action to solve this imminent crisis. *Finally*, I will provide an update regarding PREPA's ongoing restructuring efforts and the progress it has made and challenges it continues to face.

Debt Crisis

Based on current information, the Commonwealth will have a negative cash balance of $29.8 million in November 2015. The Commonwealth's illiquidity will only grow worse when a $355 million debt service payment on bonds of the Government Development Bank for Puerto Rico ("GDB") comes due on December 1, 2015. These GDB bonds are supported by a guarantee from the Commonwealth, and the GDB, which faces its own liquidity crisis, is not expected to be able to make the payment on its own based on current information. Accordingly, Puerto Rico's negative cash balance will swell to $205 million by year end. And by the end of Puerto Rico's current fiscal year (June 2016), Puerto Rico's cash balance will be further deteriorate to *negative* $512 million. These numbers are optimistic in that they assume the Commonwealth will be successful in implementing a number of "one-time" liquidity measures (such as continuing to defer payments to suppliers (the past due amount of which already exceeds $1.6 billion) and $291 million of refunds due to taxpayers), measures that simply cannot be sustained without having a material adverse effect on the local economy. As we cannot pay debt service out of a negative cash balance, a default on some of our debt obligations is inevitable.

I stress that, while these sums may seem small in comparison to Puerto Rico's overall indebtedness of $73 billion plus approximately $45 billion in unfunded pension liabilities (notwithstanding that we reformed our largest pension system from a defined benefit to a defined contribution plan), a negative cash balance poses an immediate and grave danger to the American citizens living in Puerto Rico. If Puerto Rico is unable to provide adequate assurance of future payment to its suppliers, service providers, and employees, the Commonwealth's ability to provide essential government services to its citizens will be put in severe jeopardy. Police and fire protection, medical services, social services and every other government service on which Puerto Rico's 3.5 million American citizens rely will be at risk. A disruption of essential government services will only exacerbate the massive outmigration of Puerto Ricans to the mainland, which last year reached almost 100,000 persons. The Government's cash crunch has already affected taxpayers, which will see their tax refunds delayed for almost a year, and individuals and businesses who provide essential services to the government, which have not been paid in months. This is and should be unacceptable.

Additionally, while Puerto Rico has done everything in its power to avoid defaulting on its obligations (including reducing its public employee headcount to the 66 public employees per 1,000 persons, which is lower that the U.S. average), when faced with the prospect of either making payments on debt obligations or paying for essential public services, Puerto Rico will have no choice but to default. Nobody wants this, but it is a reality, and the consequences will be grave. With no insolvency regime in place, Puerto Rico's creditors will engage in a classic "race to the courthouse." The Government will be embroiled in countless complex and crippling legal battles that will further drain Puerto Rico of critical resources and prevent it from implementing many of the measures designed to achieve fiscal and economic sustainability. Much of this litigation is likely to be "intercreditor," that is, litigation between and among different groups of creditors seeking to establish the relative priority of their claims, which will have potentially devastating effects on Puerto Rico's access to its tax revenues and therefore on its ability to continue to provide essential services to its citizens.

Notwithstanding this crisis, we have never asked Congress for a bailout, and we are not seeking one today. We ask for (i) access to a legal regime that would allow to restructure Puerto Rico's liabilities in an orderly manner; (ii) equitable treatment in Medicaid and Medicare funding, incentives to grow Puerto Rico's economy; (iii) reforms that stimulate employment and labor force participation; and (iv) an exemption from the Jones Act (like that of the U.S. Virgin Islands).[1]

By taking action on these measures now, you can help prevent the situation from spiraling further out of control.[2] Waiting will only allow the situation to grow worse and more expensive and difficult for Congress to address down the road. The window to take action to avert an imminent crisis is rapidly closing. The time is now.

Financial Information

It became apparent after the Finance Committee hearing that a misconception about the availability of reliable and up-to-date financial information regarding Puerto Rico's finances and its financial crisis is being used by some commentators as "justification" for not taking action to prevent this humanitarian crisis. The unavailability of reliable and up to date financial information is a "red herring" resulting from disinformation being propagated by

[1] Congress should not allow short-term distress investors who have amassed significant financial stakes speculating that Puerto Rico will be forced to default in the absence of a restructuring regime to drive national policy, particularly at the cost of the futures of 3.5 million Americans. While some of these investors have argued that extending bankruptcy protections would represent a bailout, it in fact does not require the expenditure of a single Federal tax dollar. Nor can distress investors suggest that providing a legal framework would be unfair because they purchased debt with the expectation that Chapter 9 would be unavailable. Instead, Congress already effectively dealt with this argument when it adopted Chapter 9's predecessor provision and made it applicable to both future and existing obligations. Indeed, every purchaser of Puerto Rico bonds was well aware that Congress has the right and authority to make Chapter 9 available to Puerto Rico.

[2] The costs of not having access to a restructuring regime are already weighing on the island. Specifically, despite reaching a consensual restructuring agreement with holders of nearly $4 billion of PREPA's debt, PREPA has been prevented from consummating the restructuring transaction by 3 institutions that are holding out. With no debt-adjustment regime in place, PREPA has no mechanism by which to bind these hold-outs to the will of the majority. Failure to consummate this transaction will not only mean that PREPA is unable to restructure its overwhelming debt burden, but will also prevent PREPA from going forward with plans to modernize its antiquated and unreliable infrastructure, forcing millions of Americans to wonder whether they will have power each day – a fear to which I can personally attest. While the availability of a legal mechanism to adjust Puerto Rico's debts may seem theoretical, the consequences of not having such a framework in place are very real for PREPA, for PREPA's employees and for the 3.5 million Americans who depend on PREPA for electricity. There are 18 other entities on the island facing this same issue.

those with vested interests in seeing Congress defer taking action so as to force Puerto Rico into a disorderly default. As you are no doubt aware, a number of institutions, many of whom have made a short-term bet on the outcome of Puerto Rico's dire financial situation, have literally spent millions of dollars on a coordinated lobbying campaign to propagate disinformation of this type. To be perfectly clear, in the last six months, Puerto Rico has been more transparent about its financial situation than at any point in its history, and it has engaged some of the best professionals in the world to provide up-to-date financial information to key stakeholders, all of which has been made publicly available.

For example, over the last four months, Puerto Rico has commissioned – and made publicly available – the Krueger Report, which includes a comprehensive and up-to-date debt sustainability analysis, the first ever commissioned by the Government, prepared by independent and internationally recognized experts. The Krueger Report is also unprecedented in presenting, for the first time, a consolidated long-term revenue and expense projection for the Commonwealth. In addition, at the request of our creditors, we commissioned a comprehensive liquidity analysis prepared by Conway MacKenzie (the "Conway Report"), the same financial management and consulting firm that the City of Detroit hired to assist it during its bankruptcy proceedings.[3] As discussed above, the Conway Report concluded that Puerto Rico's liquidity is running extremely low and the Commonwealth will face a major cash crunch during the months of November and December of 2015. We also published on our website the Puerto Rico Fiscal and Economic Growth Plan ("FEGP"), which contains our plan to stabilize our finances by increasing revenues and reducing expenses, and to grow our economy. Furthermore, note that the Puerto Rico Treasury Department publishes revenue results on a monthly basis.

Both of the Krueger Report and the Conway Report were commissioned to provide independent third-party expert reports on the sustainability of the Commonwealth's debt, long-term revenue and expense projections and the current liquidity position of the Commonwealth. In addition, creditors and their advisors that are willing to sign confidentiality agreements may access additional material non-public information, including certain data supporting the reports that were released publicly. The fact that the Commonwealth has shared more detailed background information on the Krueger and Conway reports with creditors and advisors is standard practice in debt restructuring negotiations and should not be used to suggest the Commonwealth has not been forthcoming and

[3] All of the reports commissioned by Puerto Rico and the GDB have been made public on GDB's website at http://www.bgfpr.com/.

transparent with respect to its current financial crisis. Finally, in the coming days, we will be issuing the Commonwealth Report, a quarterly document that provides updated information on all the various aspects of the Government finances, including up-to-date revenue, expense, debt, pension and litigation information, along with relevant risk factors and descriptions of recent material events. This too will be publicly available on the GDB website. In fact, during the past two years, the Commonwealth has sought to publish this report on a quarterly basis, which had previously been published only once a year or in connection with a public bond offering.

The Government has kept the market updated with recent and relevant information, such as the Krueger Report, the FEGP, the Conway Report, monthly revenue and economic data, as well as May and June updates to the Commonwealth Report, among others. The issuance of our financial statements has taken longer than expected in large part due to the Government's fiscal condition, and the additional tests that our auditors are conducting regarding liquidity and other variables. Delays in the release of audited information is common in corporate and municipal distressed situations such as the one faced by Puerto Rico, as auditor demands become more searching and time-consuming. However, all the information necessary to make a proper evaluation of the Commonwealth's finances and liquidity position is public and has been vetted by third parties.

In addition, as part of the FEGP, the Commonwealth is conducting an overhaul of its financial, accounting and payroll system in order to unify the patchwork of existing Governmental platforms, improve the Government's ability to monitor its fiscal situation on a real time basis and eliminate unnecessary delays in the preparation of financial information. Furthermore, the FEGP also requires the implementation of an ambitious 5-year plan to strengthen the Commonwealth's economic statistical systems and analysis by modernizing national accounts with an estimated investment of $3 million per year. Federal assistance in modernizing our financial systems would help improve the fiscal and economic decision making.

Finally, as I mentioned earlier, the Puerto Rico legislature is considering legislation that provides for a control board (the "Board") to oversee the financial affairs of Puerto Rico's Government and each of its public corporations. The Board will be responsible for generating 5-year Commonwealth-wide budgets and certifying that the budgets of each public corporation conform to the Commonwealth budget. The Board will have broad information gathering powers and the ability to sanction public corporations and the Commonwealth itself for non-compliance. Sanctions will include, automatic budget cuts, hiring freezes, approval requirements for large contracts and publication of a notice of non-compliance. To facilitate this process and ensure transparency across the Government, all Government entities will be required to conform their accounting systems to that of the Department of Treasury by no later than July 1, 2018, among other steps to simplify and coordinate financial practices and reporting. These steps necessarily take time, but the foundation for their implementation is being laid and the results will be greater transparency, accountability and controls across the Government.

In short, any suggestion that Puerto Rico is not doing everything it can to provide up-to-date and accurate information to creditors, this Congress or the general public is simply not true. The breadth and depth of the fiscal and financial information published by the Commonwealth during the past six months is simply unprecedented. The situation is too dire to allow this fabricated misconception to delay immediate and necessary legislative action.

PREPA

As discussed above, while PREPA continues to face significant hurdles to implementing a consensual debt restructuring, namely, its inability to bind minority holdout creditors to the will of the majority without a restructuring regime in place, it has made significant progress in its efforts to do so, including reaching agreement on the terms of such a restructuring with the holders of nearly $4 billion of its debt. Like many other entities in Puerto Rico, however, a restructuring of its debt is only one piece, albeit a significant piece, of PREPA's turnaround efforts. In addition to its debt burden, PREPA suffers from an outdated rate structure, aging and technologically obsolete generating facilities and infrastructure, and significant operational inefficiencies.

We have worked tirelessly to turnaround PREPA. In May 2014, I signed Act 57-2014 into law, pursuant to which an energy commission was established to exercise oversight over PREPA. The commission required PREPA to improve its services to the people and businesses of the Commonwealth, including by pursuing public-private partnerships to assist in the construction and operation of new generation facilities. Following the passage of Act 57-2014, PREPA initiated discussions with its key creditors and negotiated forbearance agreements in connection with which it retained a chief restructuring officer to implement operational reforms and lead its restructuring efforts. In addition to the more than $600 million in sinking fund payments that these agreements relieved PREPA from making, and the access they provided to various trust accounts during the forbearance period, PREPA's chief restructuring officer identified and implemented steps to achieve between $245 and $390 million in annual operational savings and up to $260 million in one-time liquidity measures. The sources of these savings have ranged from day-to-day operational changes such as inventory tracking, purchasing controls, limiting cash payments and other industry-standard practices, to prevention of theft, enhanced collection efforts and a consolidation of PREPA's vendor relationships. PREPA is also actively examining its business to reduce and eliminate its operating deficit. Significantly, notwithstanding the cost cutting associated with these efficiencies, PREPA has managed to instill a culture of safety and accountability in its workforce during this time.

These measures have enabled PREPA to continue to operate over the last 18 months in spite of its severe liquidity crisis. Unfortunately, with no restructuring regime in place, PREPA's breathing room may soon be exhausted. In the first half of 2016 nearly $1.5 billion of debt will come due, an amount that PREPA will be likely unable repay. The consequences of a disorderly default of the island's only electricity provider could be catastrophic for the people of Puerto Rico. I urge you in the strongest of terms not to let that happen.

Conclusion

In conclusion, I thank the Committee for recognizing the urgency of these matters by holding this hearing, and for giving Puerto Rico the opportunity to participate. I look forward to working with all of the members of the Committee to ensure the health, safety and well-being of the 3.5 million Americans that call Puerto Rico home. And I urge you to maintain your focus on Puerto Rico's fiscal emergency; the future of 3.5 million Americans depends on what you do next.

The CHAIRMAN. Thank you, Governor.

Mr. Pierluisi, welcome.

STATEMENT OF HON. PEDRO PIERLUISI, RESIDENT COMMISSIONER FOR PUERTO RICO, U.S. HOUSE OF REPRESENTATIVES

Mr. PIERLUISI. Chairman Murkowski, Ranking Member Cantwell, and members of the committee, for Puerto Rico to overcome its challenges, leaders in San Juan and Washington, D.C. must take swift and serious steps. The main economic problem in Puerto Rico is lack of growth. This is the result of low private investment, which is due to the lack of investor confidence in the economic and fiscal policies of the Puerto Rico government.

The territory government has an outdated economic model that relies on government-owned enterprises, tax preferences, and subsidies. The government must streamline operations, expand public-private partnerships, and empower the private sector.

There are no silver bullets or shortcuts. Progress requires smart, steadfast work. The Puerto Rico government must break its entrenched spending habits, which have not adjusted to changing economic and demographic realities. Our government must be a better steward of funds received from taxpayers and lenders, accounting for every dollar it spends.

The local taxes require reform because it is complicated and unfair. Some taxpayers owe too little, while others owe too much, and the government does a poor job of collecting what it levies.

With improved economic and fiscal policy, Puerto Rico can eliminate deficits and be in a better position to meet its obligations to creditors. In short, the Puerto Rico government must be transformed. We owe this to our constituents, no excuses.

Let me turn to the Federal Government now. I am a proud American citizen, but I am also a Puerto Rican patriot. I have spoken forcefully about the need for the Puerto Rico government to chart a new path forward. The Federal Government should now speak with equal force about the need to correct its immoral and illogical policy toward Puerto Rico.

Because Puerto Rico is a territory, it can be and is treated worse than the states under programs like Medicaid, Medicare, refundable tax credits, SSI, and Chapter 9 of the Bankruptcy Code. You cannot treat the people of Puerto Rico like second-class citizens and then profess to be surprised when we do not have a first-class economy, nor can you claim to be shocked that in the last decade over 300,000 island residents have relocated to the States in search of equal opportunity. This was easily foreseeable, but only if your eyes are open.

I join the Treasury Department, the National Economic Council, and HHS in urging Congress to enact a legislative package for Puerto Rico that contains provisions that give Puerto Rico more equitable treatment under spending and tax credit programs, and to grant Puerto Rico access to a fair and orderly legal process to restructure a meaningful portion of its debt.

The package could also contain language authorizing Treasury to guarantee repayment of principal and interest on future Puerto Rico bonds. Puerto Rico is currently locked out of the capital markets, and this provision would ensure that the government has the cash necessary to meet its immediate obligations.

Finally, the package could provide for enhanced Federal oversight of the Puerto Rico government's financial management practices with the goal of helping the territory to budget, spend, and tax in a more responsible and transparent fashion. I believe such assistance would be welcomed by citizens and creditors alike.

While I am open to Federal oversight, I oppose Federal control. If Puerto Rico is better governed at the local level and receives fair treatment at the Federal level, we can overcome our challenges. My constituents already endured the indignity of not being able to vote for their national leaders. Further eroding democracy in Puerto Rico is not the answer.

Finally, let me address the fundamental problem from which nearly all of Puerto Rico's other problems emanate: our undemocratic and unequal political status. No Senator would accept territory status for their constituents, and I do not accept it for mine.

Puerto Rico's status is not an abstract or theoretical problem. It is a moral, social, and political wrong with the crushing practical consequences for the American citizens I represent. One day soon my constituents, including hundreds of thousands of military veterans, will have the same rights and responsibilities as your constituents.

In 2012, there was a local referendum in Puerto Rico, and voters rejected territory status and expressed the preference for statehood. In 2017, it is very likely that voters in the territory will confirm their desire for statehood in the first Federally-sponsored vote in our history. The government of Puerto Rico will then use all appropriate means to petition Congress to enact legislation making the territory a state.

For Puerto Rico to prosper, it must be treated equally, and to be treated equally, it must become a state. Until then, there is much the Puerto Rico government and the Federal Government can do to help the territory.

There has been enough discussion. It is time for action.

Thank you.

[The prepared statement of Mr. Pierluisi follows:]

The Hon. Pedro R. Pierluisi
Written Testimony
"Puerto Rico: Economy, Debt, and Options for Congress"
Senate Committee on Energy and Natural Resources
October 22, 2015

Chairman Murkowski, Ranking Member Cantwell, and Members of the Committee:

The Senate Committee on Finance held a hearing on the financial and economic challenges in Puerto Rico on September 29th, and I was a witness at that hearing. The House Committee on Natural Resources, Subcommittee on Indian, Insular and Alaska Native Affairs held a hearing on Puerto Rico's political status and economic outlook on June 24th, and I was a witness at that hearing. This Committee held a hearing on Puerto Rico's political status on August 1, 2013, and I was a witness at that hearing. The accompanying footnote contains links to my written testimony at these three hearings, because each is relevant to the issues that the Committee is examining today.[1]

Rather than reiterating the specific points I made in these previous statements, I will use this opportunity to make three broad points about how local and federal policymakers can help resolve the economic, fiscal and demographic crisis in Puerto Rico.

The Puerto Rico Government

First, at the risk of stating the obvious, the government of Puerto Rico must do a far better job of actually *governing* the U.S. territory. Puerto Rico confronts a complex array of challenges that have accumulated over the course of many years, as a result of policy errors of both commission and omission. On balance, the actions taken by the current administration since January 2013 have made Puerto Rico's problems immeasurably worse. Puerto Rico's government is not regarded as credible, because it is not viewed as capable or consistent. Puerto Rico's challenges must be confronted with candor and competence; there are no shortcuts, silver bullets or gimmicks. In this effort, there is no substitute for good, effective, ethical leadership at the local level. In our democratic system, if such leadership is not being furnished, the remedy lies at the ballot box. Anyone who claims that Puerto Rico cannot govern itself, and requires unelected and unaccountable individuals from outside of Puerto Rico to administer the territory, underestimates the capacity of my constituents.

As I detailed in my testimony before the Senate Finance Committee, the Puerto Rico government must elevate its performance. Most fundamentally, it needs to implement a comprehensive strategy to

[1] See September 29, 2015 Senate Finance Committee testimony here; June 24, 2015 House Subcommittee on Indian, Insular and Alaska Native Affairs Subcommittee testimony here; and August 1, 2013 Senate Energy and Natural Resources Committee testimony here.

generate economic growth in the private sector by attracting job-creating investment from external and internal sources. To execute this strategy, the government must become more competitive in a range of areas, such as reducing bureaucracy, streamlining the permitting process, lowering the cost of electricity, improving infrastructure, and making the local tax code more simple and more fair. If my constituents cannot find decent employment that pays them a living wage, they will continue to relocate to the states in massive numbers, making it virtually impossible to achieve economic growth. (Since 2004, over 300,000 island residents have exercised their right as American citizens and moved to the U.S. mainland. Puerto Rico's population has declined by 9 percent, from 3.8 million to 3.5 million, in this time period.)

Additionally, in order to regain the trust of the Puerto Rico public and the investment community, the government must manage its public finances in a smart, disciplined and transparent way. The current administration has failed this test, and it is no excuse for local political leaders to insist that prior administrations failed it too. As I will explain in the following section, I believe there is an important oversight role that the federal government—namely, the Comptroller General of the United States, the chief executive officer of the Government Accountability Office (GAO), the investigative arm of Congress—can fulfill in this respect.[2]

Finally, Puerto Rico has a sizeable and complicated debt burden—$72 billion spread across approximately 18 distinct bond-issuing public entities. However, if the Puerto Rico government takes serious steps to cut unnecessary spending, implement a fair tax system and collect the taxes it is owed, and execute a strategy focused on economic growth, the debt situation can be made far more manageable. It is also important to emphasize that the solvency of each bond issuer and the strength of the legal protections governing each class of bonds are different. The current administration's strategy is essentially to treat the territory's debt as if it were a single monolithic sum, which I believe is ill-advised. Puerto Rico is a United States jurisdiction and, in the U.S., the facts and the law *matter*. Each credit should be considered on a case-by-case basis in light of its particular financial and legal attributes. In general, the current administration—steered by outside advisors to whom the administration has yielded far too much power—has used confrontational tactics that have created adversaries out of many creditors who should be allies of the government or, at least, should be more inclined to find common ground with the government. The current administration should interact in a more constructive manner with the institutions and individuals, hundreds of thousands of whom live and work in Puerto Rico, that have loaned the government money. Picking fights that you are unlikely to win, whether in a court of law or in the court of public opinion, is not a wise or winning strategy.

This Congress is right to expect more from the government of Puerto Rico. More importantly, the people of Puerto Rico deserve—and they should demand—far better from their elected leaders.

The Federal Government

Second, while I am the first to offer constructive criticism of the Puerto Rico government, I will not silently accept such criticism from Members of Congress of either party unless that criticism is accompanied by a forthright acknowledgment that the federal government has shared responsibility for

[2] The Comptroller General is appointed by the President with the advice and consent of the Senate to a 15-year term. In the event of a vacancy, Congress establishes a bipartisan, bicameral commission to recommend individuals to the President.

this crisis. Instead of piously lecturing Puerto Rico about its shortcomings, Congress and the administration ought to correct the errors in their own policy towards the territory. Action in San Juan without corresponding action in Washington, D.C. will be insufficient, just as action in Washington, D.C. without accompanying action in San Juan will be inadequate. This is an American problem, not just a Puerto Rico problem, and it requires an American solution.

Because Puerto Rico is a territory, the federal government has a license to treat the island worse than the states under federal programs. Congress does not have to use this license, but it does so with dismaying frequency. Puerto Rico is treated in discriminatory fashion, or excluded entirely from, programs like Medicaid, Medicare, the federally-subsidized health insurance exchanges established by the *Affordable Care Act*, Chapter 9 of the federal bankruptcy code, the earned income tax credit, the child tax credit, Supplemental Security Income (SSI), Temporary Assistance for Needy Families (TANF), the Supplemental Nutrition Assistance Program (SNAP), and the Low Income Home Energy Assistance Program (LIHEAP). When it comes to programs within this Committee's jurisdiction, Puerto Rico is treated unfairly under the Land and Water Conservation Fund (LWCF), through which the federal government provides grants to states and territories to safeguard natural areas, preserve the habitat of endangered species, and provide outdoor recreational opportunities.

I have introduced bills to eliminate or mitigate these various disparities, the cumulative impact of which has been devastating for Puerto Rico. I also recently filed legislation—H.R. 3725—that would authorize the U.S. Department of the Treasury to guarantee repayment of principal and interest on future bonds issued by government entities in Puerto Rico, but only if the Treasury Department first makes a determination that the government of Puerto Rico has demonstrated meaningful improvement in managing its public finances. The legislation is modeled on a 1975 federal law that authorized the Treasury Department to make short-term loans to New York City, which was unable to obtain loans from its customary sources. Because the Puerto Rico government has lost the trust of investors, the government is effectively locked out of the capital markets. My bill would ensure that the government has the liquid assets—cash—necessary to meet its short-term obligations, like providing essential services, paying workers and repaying loans.

I urge Congress, acting on a bipartisan basis, to swiftly enact a legislative package that includes a number of the bills I have introduced to provide more equitable treatment for Puerto Rico under federal spending and tax credit programs. Congressional action is essential, and absolutely justified. According to the U.S. Census Bureau's Consolidated Federal Funds Report, which was last published in Fiscal Year 2010, federal spending on both direct payments to individuals and grants is far higher in the 50 states than in Puerto Rico as a result of the territory's disparate treatment under federal programs. In the case of direct payments, federal spending per capita is $5,569 in the states, versus $3,465 in Puerto Rico. In the case of grants, federal spending per capita is $2,187 in the states, versus $1,695 in Puerto Rico.[3] Naturally, the gap is even wider when you compare federal spending per capita in the poorer states to federal spending per capita in Puerto Rico.

Parenthetically, I have heard it suggested—including by a witness at the September 29th Senate Finance Committee hearing—that residents of Puerto Rico do not pay federal taxes and therefore

[3] These statistics are contained in Food and Nutrition Service, U.S. Department of Agriculture, "Examination of Cash Nutrition Assistance Program Benefits in Puerto Rico," at page 6 (August 17, 2015), available at http://www.fns.usda.gov/examination-cash-nutrition-assistance-program-benefits-puerto-rico.

should receive less federal support than their counterparts in the states. This argument deserves careful scrutiny because the truth is more complex. Congress—acting on its own volition—has chosen to exempt most residents of Puerto Rico from paying federal taxes on income they earn in the territory. Nevertheless, in Fiscal Year 2014, the U.S. Internal Revenue Service collected nearly $3.6 billion in federal taxes from individuals and businesses in Puerto Rico, which is nearly as much as the IRS collected from several states.[4] Residents of Puerto Rico are required to pay federal taxes on any income that they earn in the states or in foreign countries, and employers and employees in the territory are responsible for all federal payroll taxes. Notably, nearly half of all individuals living in the states do not owe federal income taxes, and yet are treated equally under all federal programs. Finally, the reality is that federal law—through the application of refundable tax credits like the earned income tax credit and the child tax credit—provides a substantial benefit to working-class families in the states that it denies to working-class families in Puerto Rico. To illustrate, consider a married couple with two children living in a state that earns $25,000 a year, and then consider an identical family living in Puerto Rico. Both families owe the same federal payroll taxes. But the stateside family would receive over $6,000 in federal tax credits, for an income of over $30,000 after all federal taxes and credits. The Puerto Rico family, because it is ineligible for these credits, takes home less than $24,000.[5] This is a useful example to bear in mind when the supposed "tax advantages" of living in Puerto Rico are cited as a justification for treating residents of the territory unequally under federal programs.

With respect to a potential legislative package, I recognize that there may be a desire on the part of certain Members of Congress of good faith to couple language that provides for better treatment of the territory under specific federal programs with language that provides for some degree of federal oversight of the Puerto Rico government's financial management practices. Although I do not believe equality for U.S. citizens should be conditioned in such a manner, I am open to this concept. However, as noted above, I would oppose any legislative provision that removes authority over taxing and spending decisions from Puerto Rico's elected leaders and places this authority in the hands of individuals who are not accountable to voters in the territory. Such a step would be perfectly legal, but profoundly unwise. Congress treats Puerto Rico poorly, and this is the principal reason why Puerto Rico's economic and fiscal performance has been consistently poor. The logical solution is also the moral solution: Congress should treat Puerto Rico equitably. If Puerto Rico receives fair treatment from the federal government and has more capable local leadership, I am confident we can overcome our challenges. My constituents already endure the indignity of not being able to vote for their president and commander-in-chief, U.S. senators, or voting members of the U.S. House. Further eroding democracy in the territory cannot be the answer.

With respect to federal *oversight* (which I regard as potentially appropriate), as distinct from federal *control* (which I regard as inappropriate), let me make two points. First, on July 11, 2013, I testified at a hearing held by this Committee regarding S. 1237, the *Omnibus Territories Act*. One provision in that bill as introduced—Section 8—would have required the U.S. Comptroller General to evaluate the annual estimates of revenues and expenditures of the five territory governments, including the

[4] See 2014 Internal Revenue Service Data Book, at page 12, available at https://www.irs.gov/pub/irs-soi/14databk.pdf. In Fiscal Year 2010, the Internal Revenue Service collected more federal taxes from individuals and businesses in Puerto Rico than in Vermont. See 2010 Internal Revenue Service Data Book, at page 12, available at https://www.irs.gov/pub/irs-soi/10databk.pdf.

[5] This example is based on the federal rules for Tax Year 2013.

government of Puerto Rico, and to make recommendations for improving the process by which those estimates are developed. I testified in strong support of this provision, noting that the Puerto Rico government had a history of overestimating the amount of revenue that would be collected and underestimating the amount of expenditures that would be made in the coming fiscal year. I pointed out that when a government makes inaccurate budget projections, it has a negative cascading effect—resulting in larger-than-expected deficits, excess borrowing, loss of market confidence, credit downgrades, higher interest payments, and the diminished ability to meet pension obligations and make other important investments. I expressed the view that GAO assistance could help the government of Puerto Rico better manage its finances.[6]

Following that hearing, however, representatives of the Governor of Puerto Rico contacted the Committee and urged it to remove Puerto Rico from Section 8, making the argument that this provision would interfere with "the government of Puerto Rico's fiscal autonomy." (To clarify, under the U.S. Constitution, Congress has nearly absolute power over the territory of Puerto Rico. Over time, Congress has delegated to Puerto Rico about the same authority over local matters that the states possess. What Congress has given, Congress can take away or modify as it sees fit.) When the Committee subsequently approved S. 1237, the bill contained a revised section that covered the four other territories, but not Puerto Rico.[7] It is fine for this Committee to criticize the Puerto Rico government for its poor budgeting practices, just as Members of the Senate Finance Committee recently did. But a dose of humility is in order. This Committee, by acceding to the Governor's self-interested desire to shield Puerto Rico's budget forecasting from GAO scrutiny, has contributed to the problem it now complains about. As part of any legislative package for Puerto Rico that Congress crafts, Congress could authorize the Comptroller General to evaluate the annual estimates of revenues and expenditures made by the Puerto Rico government and to make recommendations for how those estimates can be improved. If the Governor again opposes such a provision, his objections should be duly noted and ignored.

Second, I believe there is an additional role that the Comptroller General could fulfill in Puerto Rico, and a provision to this effect could be included in any forthcoming legislative package. Specifically, in 1973, Congress enacted a law—Section 715 of Title 31 of the U.S. Code—requiring the Comptroller General to audit "the accounts and operations" of the District of Columbia government on an annual basis. Although this provision is still technically on the books, it has effectively been superseded by subsequent federal statutes, and the GAO no longer conducts such audits as a matter of practice. Under the law, the GAO was required to submit each audit report to the Mayor of the District of Columbia, the Council of the District of Columbia, and Congress. The audit report could include any recommendations that the GAO considered appropriate. Within 90 days of receiving the audit report, the Mayor was required to inform the Council and Congress of the measures the District of Columbia government was taking to comply with the GAO's recommendations. The law provided that the District of Columbia government had to make all relevant financial and other records available to the GAO, and to provide the GAO with the facilities to conduct the audit.

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[6] See http://www.energy.senate.gov/public/index.cfm/files/serve?File_id=672238c6-3204-49c0-82f9-d63614fc4ac4.pdf.

[7] S. 1237 was reported by the Committee on Energy and Natural Resources on April 8, 2014 and approved by the full Senate on June 18, 2014. The Committee converted Section 8 to Section 5 at its markup session on December 19, 2013. As noted, at the Governor's request, the Committee amended this section to exclude Puerto Rico.

Although the District of Columbia and Puerto Rico are different in important respects, I believe this statute could serve as a suitable template for the territory. A legitimate criticism leveled against the Puerto Rico government by the Puerto Rico public, the investment community and federal officials is that the government is unable or unwilling to produce timely, accurate, audited financial statements that depict the true financial condition of the territory government, including its public corporations. A federal law tasking the Comptroller General with audit responsibilities for Puerto Rico could serve a valuable purpose for all stakeholders and help the territory government rebuild its damaged credibility.

In summary, I am open to exploring different ways to fashion a legislative package that combines provisions to give Puerto Rico more equitable treatment under federal law with provisions to provide for enhanced oversight of the Puerto Rico government's financial management practices by the federal government. But I would oppose any provision that crosses the line from federal oversight to federal control.

Puerto Rico's Political Status

Third, the American public and their elected representatives must come to terms with a fundamental fact, which is that the main cause of Puerto Rico's multi-faceted problems is its undemocratic and unequal political status. As then-Chairman Wyden and then-Ranking Member Murkowski both recognized during their opening statements at this Committee's August 1, 2013 hearing, a clear majority of voters in Puerto Rico rejected this status in a locally-sponsored referendum in November 2012.[8] My constituents are now being governed under an arrangement to which they do not consent.

Notwithstanding the mass exodus of Puerto Rico residents to the states, I still represent 3.5 million American citizens—more than 12 of the 22 Senators that serve on this Committee and more than 42 of the 100 Senators that serve in this chamber. Not a single Senator would accept territory status for his or her constituents. So why should I accept territory status for *my* constituents? I do not accept it. To the contrary, I oppose it with every fiber of my being. Puerto Rico's status as a territory is not an abstract or theoretical problem. It is a moral, social and political wrong with crushing practical consequences for the men, women and children I represent.

There will always be some people and politicians who assert, despite overwhelming evidence to the contrary, that Puerto Rico's consistent underperformance relative to the 50 states over the course of many decades has nothing to do with the unequal treatment that Puerto Rico receives as a territory. There are even people and politicians who claim that Puerto Rico's status is an advantage rather than a disadvantage, though their voices have mostly gone silent in recent years. These people and politicians can always be counted on to find some reason why *now* is not the moment to address the issue of status. They are wrong on the merits, and they are on the wrong side of history. The time has come for my constituents to have equality in this union or to have independence outside of it. If Puerto Rico

[8] See opening statement of Chairman Wyden here ("[T]here is no disputing that a majority of the voters in Puerto Rico—54 percent—have clearly expressed their opposition to continuing the current territorial status."). See opening statement of Ranking Member Murkowski here ("Now that the plebiscite has been held, it is clear to me that the majority of Puerto Ricans do not favor the current territorial status as evidenced by the first question on the ballot.")

can be compared to a weak and fragile body, then territory status is its depleted heart. Puerto Rico has the potential to be strong and stable, but it needs a powerful new heart.

I look forward to the day when the U.S. citizens that reside in Puerto Rico, especially the hundreds of thousands of men and women who have served this nation in the armed forces, can vote for their national leaders and fully participate in debates over national policy that affect every aspect of their lives. I look forward to the day when Puerto Rico will be treated equally as a matter of right, and does not have to beg this Congress for fair treatment. I look forward to the day when *my* constituents have the exact same rights and responsibilities as *your* constituents—not better treatment, not worse treatment and not "special" treatment.

That new day is just over the horizon. As noted, in a 2012 local referendum, Puerto Rico voters rejected territory status. In that same referendum, more voters expressed a preference for statehood than for any other status option. In 2017, it is likely that voters in the territory will confirm their desire for statehood in a *federally-sponsored* yes-or-no referendum on admission, pursuant to an historic law—P.L. 113-76—enacted by Congress in 2014 at my initiative. The government of Puerto Rico will then use any and all appropriate means to petition Congress to enact legislation making the territory a state. In the immediate term, there is much that the Puerto Rico government and the federal government can and should do to help the territory manage its economic, fiscal and demographic crisis. However, for Puerto Rico to truly prosper, it must be treated equally. And to be treated equally, the territory must become a state.

The CHAIRMAN. Thank you, Commissioner.
Mr. Marxuach, welcome.

STATEMENT OF SERGIO MARXUACH, POLICY DIRECTOR, CENTER FOR A NEW ECONOMY

Mr. MARXUACH. Good morning, Chairman Murkowski, Ranking Member Cantwell, and members of the U.S. Senate Committee on Energy and Natural Resources. I thank you for the opportunity to appear today before this committee to discuss Puerto Rico's financial and economic challenges.

Puerto Rico currently faces two distinct yet related crises. The first and most urgent arises out of the government's weak financial situation. The second is the product of the chronic stagnation of its economy over the last ten years.

Decades of fiscal and economic mismanagement have engendered an economy characterized by chronic primary deficits, high debt-to-GNP ratios, low employment levels in the formal economy, a large informal economy encompassing both legal and illegal activities, significant government corruption and predatory rent-seeking behavior in both the public and private sectors, substantial tax evasion, a hollow productive base, and high levels of private consumption and indebtedness enabled by having access to a stronger currency than its economic fundamentals will warrant. In our opinion, the parallels with Greece are quite evident for all to see and none to misunderstand.

Notwithstanding this dismal economic situation, the island managed to triple its public debt from $24 billion in 2000 to $72 billion in 2015. Indeed, during this period, Puerto Rico's public indebtedness grew at a compound annual rate of 7.6 percent while its income measured by GNP grew at a nominal rate of only 3.6 percent.

To be fair, for decades the borrowed money was put to good use: to finance the construction of public schools, hospitals, highways, and other essential infrastructure. The problem is that during the last 20 years or so, a large portion of the money borrowed by issuing long-term debt was used to finance budget deficits, operating expenses, and classic pork barrel spending.

Given the magnitude and multiplicity of challenges facing Puerto Rico, it should be obvious that there are no quick fixes to solve the island's fiscal and economic problems. Congress needs to implement a comprehensive program to remove some of the disadvantages imposed on Puerto Rico under the current political arrangement and eliminate some long-standing inequitable and discriminatory policies. The current situation simply does not allow for piecemeal action by Washington. A wide-ranging plan is needed.

In the short-term, the most pressing issue is Puerto Rico's deteriorating liquidity situation. If the cash-flow projections made by Conway MacKenzie are accurate, Puerto Rico will not have enough cash on hand to meet all its obligations as soon as December of this year. In that event, and the absence of either (1) access to an emergency liquidity facility, or (2) forbearance from bondholders, the probability of a disorderly default is quite high because the current administration has already stated its firm intention to keep essential government operations running, and Puerto Rico cannot avail itself of relief under Chapter 9 of the U.S. Bankruptcy Code. Given the short time window, the policy options at the Federal level boil down to providing short-term financing to Puerto Rico to avoid a default or enacting legislation extending the application of Chapter 9 to the island.

Another significant problem on the fiscal side is the cost of the government health plan, which is one of the principal drivers of Puerto Rico's non-interest expenditures. Providing Puerto Rico equal treatment under Federal healthcare programs such as Medicare, Medicaid, and the Affordable Care Act will provide the Commonwealth with some much-needed fiscal space and address a long-standing injustice inflicted on Puerto Ricans. For the truth of the matter is that Puerto Rican workers and employers pay the same payroll taxes as workers and employers in each of the 50 states of the mainland, yet benefits to Puerto Rico are unfairly rationed by Federal legislation.

On the economic growth side of the equation, we recommend extending the Federal earned income tax credit to Puerto Rico. The Federal EITC is the most effective anti-poverty program in the United States. It has been shown to promote savings. It helps poor families smooth out the effect of unexpected financial shocks and builds a strong sense of future orientation among recipients. Extending this program to Puerto Rico, which would provide a significant wage supplement to low-income Puerto Rican working families, could be expected to stimulate aggregate demand in the short run.

Sustaining economic growth over the long-term, however, is a more complicated issue involving the interplay of many factors and variables, including the capability to accumulate and increase capital in all its forms: physical, financial, and human.

The efficiency with which inputs are utilized in the production process, what economists refer to as total factor productivity, the degree of openness to the world, and the adaptable institutional structures that provide the right incentives to innovate and develop new technologies to reorganize production in order to exploit new opportunities.

In this context, we recommend—we strongly recommend that any savings derived from a reduction in debt service be dedicated exclusively to develop and implement a new industrial policy for Puerto Rico based on a set of coherent horizontal policies such as reforming a complicated permitting and licensing system that stifles innovation; lowering energy and other costs of doing business in the island; substantially improving educational standards; discovering new sectorial opportunities through a process of dialog and consultation with key stakeholders in the private and civic spheres; and identifying spillovers, externalities, and other areas where Puerto Rican society could learn more.

This new learning, in turn, would lead to new investment in research and development, increased productivity, identifying new areas of comparative advantage for Puerto Rican firms, higher economic growth, and the creation of high-quality jobs, which is what will in the end categorically terminate Puerto Rico's economic stagnation.

We at the Center for a New Economy are currently working with experts from Columbia, Brown, MIT, and Brookings, among other institutions, to develop this medium- to long-term industrial policy.

Finally, any new economic strategy for Puerto Rico, no matter how nuanced, sophisticated, or brilliantly conceived, is bound to fail if it ignores the fact that Puerto Rico has reached the limits of its development within the constraints imposed by its subordinate political status, which is both humiliating to Puerto Ricans and unworthy of a nation like the United States.

In conclusion, Chairman Murkowski, I thank you and the committee for once again participating in this important public policy debate and look forward to answering any questions you may have.

[The prepared statement of Mr. Marxuach follows:]

TESTIMONY BEFORE THE UNITED STATES SENATE COMMITTEE ON ENERGY AND NATURAL RESOURCES PUBLIC HEARING ON PUERTO RICO'S ECONOMY, DEBT, AND OPTIONS FOR CONGRESS

Sergio M. Marxuach
Policy Director
Center for a New Economy
October 22, 2015
Washington, DC

Good morning, Chairman Murkowski, Ranking Member Cantwell, and Members of the United States Senate Committee on Energy and Natural Resources. I thank you for the opportunity to appear today before this Committee to discuss Puerto Rico's financial and economic challenges.

Puerto Rico currently faces two distinct, yet related, crises. The first, and most urgent, arises out of the government's weak financial situation. The second is the product of the chronic stagnation of its economy over the last ten years.

Decades of fiscal and economic mismanagement have engendered an economy characterized by: (1) chronic primary deficits; (2) high debt-to-GNP ratios; (3) low employment levels in the formal economy; (4) a large informal economy, encompassing both legal and illegal activities; (5) significant government corruption and predatory rent-seeking behavior in both the public and private sectors [1]; (6) substantial tax evasion; (7) a hollow productive base; and (8) high levels of private consumption and indebtedness enabled by having access to a stronger currency than its economic fundamentals would warrant. In our opinion, the parallels with Greece are quite evident for all to see and none to misunderstand.

Notwithstanding this dismal economic situation, the island managed to *triple* its public debt from $24 billion in 2000 to $72 billion in 2015. Indeed, during this period Puerto Rico's public indebtedness grew at a compound annual rate of 7.6%, while its income (GNP) grew at a nominal rate of only 3.6%.[2]

Given that Puerto Rico's indebtedness grew at an average annual rate two times faster than the growth rate of its GNP during the past fifteen years, it should not be surprising that Puerto Rico's public debt currently exceeds its GNP. To be fair, however, for decades the borrowed money was put to good use to finance the construction of public schools, hospitals, highways, and other essential infrastructure. The problem is that during the last twenty years or so, a large portion of the money borrowed by issuing long-term debt was used to finance budget deficits, operating expenses, and classic pork-barrel spending.

In February 2014, the three principal rating agencies downgraded the Commonwealth's debt, as well as debt issued by several of its agencies and instrumentalities, to speculative or non-investment grade.

The rating downgrades had a material adverse effect on the Commonwealth's finances because they essentially shutdown its access to the capital markets, at least at reasonable rates. This, at a time when the central government is still running a sizeable budget deficit, several of the Commonwealth's agencies and instrumentalities face

[1] "Rent-seeking" can be defined as the pursuit of uncompensated value from other economic agents; in contrast with profit seeking, where economic agents seek to create value through mutually beneficial economic activity.

[2] In Puerto Rico, GNP, which measures income earned by residents or by locally-owned production factors, is a more accurate measure of economic activity than GDP due to distortions induced by the transfer pricing practices of multinational companies operating in the island. For a technical analysis of the GNP/GDP gap in Puerto Rico see "Economic Growth" by Barry P. Bosworth and Susan M. Collins in *The Economy of Puerto Rico: Restoring Growth*, (Brookings Institution Press: Washington, DC, 2006), p. 17-81.

significant maturities in the near term, the economy is contracting at an estimated annual rate of 1.2%, liquidity is running extremely tight, and net outmigration has increased to levels not seen since the 1960s.

Given the magnitude and multiplicity of challenges faced by Puerto Rico it should be obvious that there are no quick fixes to solve the island's fiscal and economic problems. Congress needs to implement a comprehensive program, remove some of the disadvantages imposed on Puerto Rico under the current political arrangement, and eliminate some long-standing inequitable and discriminatory policies. The current situation simply does not allow for piecemeal action by Washington, a wide-ranging plan is needed.

In the short-term the most pressing issue is Puerto Rico's deteriorating liquidity situation. If the cash flow projections made by Conway MacKenzie are accurate, then Puerto Rico will not have enough cash on hand to meet all its obligations as soon as December of this year.[3]

In that event, in the absence of either (1) access to an emergency liquidity facility or (2) forbearance from bondholders, the probability of a disorderly default is quite high, because the current administration has already stated its firm intention to keep essential government operations running and Puerto Rico cannot avail itself of relief under Chapter 9 of the U.S. Bankruptcy Code.

Given the short time window, the policy options at the federal level boil down to (1) providing short-term financing to Puerto Rico to avoid a default or (2) enacting legislation extending the application of Chapter 9 to Puerto Rico.

With respect to Chapter 9, the first thing to notice is that Puerto Rico's debt is spread across of variety of debtors (18 issuers in total) representing a complex web of claims in an uncertain regulatory and legal framework. This situation makes it very difficult for creditors to work as a class because one set of creditors will worry that any relief they provide the island will simply make it easier for a different set of creditors to recover a larger amount of their claims.

In game theory terms, Puerto Rico faces a game in which there are multiple players, which sometimes have common and sometimes-opposing interests, and not making a deal leaves everyone worse off. In this type of game the final outcome could be one of any number of possible "Nash equilibria", which would generate sub-optimal results for all parties involved.

Congress could help Puerto Rico figure a way out of this conundrum by approving legislation to authorize the Puerto Rican government to allow its distressed agencies, instrumentalities, and municipalities to file for bankruptcy under Chapter 9 of the U.S. Bankruptcy Code.

However, while we support allowing Puerto Rico to avail itself of Chapter 9 procedures to adjust its debt and believe it would provide a helpful framework for addressing existing coordination and information failures, we also stress that it is by no means a complete or perfect solution to all of Puerto Rico's troubles.

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[3] Conway MacKenzie, *Commonwealth of Puerto Rico Liquidity Update*, August 25, 2015.

Another significant problem on the fiscal side is the cost of the Government Health Plan, which is one of the principal drivers of Puerto Rico's non-interest expenditures.[4] Providing Puerto Rico equal treatment under federal healthcare programs, such as Medicare, Medicaid, and the Affordable Care Act would provide the Commonwealth with some much-needed fiscal space and address a long-standing injustice inflicted on Puerto Ricans. For the truth of the matter is that Puerto Rican workers and employers pay the same payroll taxes as workers and employers in the mainland, yet benefits to Puerto Rico are unfairly rationed by federal legislation.[5]

On the economic growth side of the equation, we recommend extending the federal Earned Income Tax Credit ("EITC") program to Puerto Rico. The federal EITC is the most effective anti-poverty program in the United States. Recent research also shows that it encourages work, promotes savings, helps poor families smooth out the effect of unexpected financial shocks, and builds a strong sense of future orientation among recipients.[6] Extending this program to Puerto Rico, which would provide a significant wage supplement to low-income Puerto Rican working families, could be expected to stimulate aggregate demand in the short-run.

Sustaining economic growth over the long-term, however, is a more complicated issue, involving the interplay of many factors and variables, including: the capability to accumulate and increase capital in all its forms—financial, physical and human; the efficiency with which inputs are utilized in the production process, what economists refer to as total factor productivity; the degree of openness to the world, which has become increasingly important as knowledge flows across national borders and foreign trade and investment influence the incentives to innovate, imitate, and use new technologies; and finally, adaptable institutional structures that provide the right incentives to innovate and develop new technologies, reorganize production in order to exploit new opportunities, and accumulate physical and human capital.

In this context we strongly recommend that any savings derived from a reduction in debt service be dedicated *exclusively* to develop and implement a new industrial policy for Puerto Rico based on (1) a set of coherent horizontal policies such as reforming an unnecessarily complicated permitting and licensing system that stifles innovation, lowering energy and other costs of doing business in the island, and substantially improving educational standards; (2) discovering new sectorial opportunities through a process of dialogue and consultation with key stakeholders in the private and civic

[4] *Commonwealth of Puerto Rico Quarterly Report,* dated May 7, 2015, p. 20-21 and 37-40.
[5] See United States Government Accountability Office, *U.S. Insular Areas: Multiple Factors Affect Federal Health Care Funding,* GAO-06-75, (October 2005), and *Puerto Rico: Information on How Statehood Would Potentially Affect Selected Federal Programs and Revenue Sources,* GAO-14-31, (March 2014).
[6] See Bruce D. Meyer, "The Effects of the Earned Income Tax Credit and Recent Reforms" in *Tax Policy and the Economy*, Volume 24, Jeffrey R. Brown, ed., (University of Chicago Press, 2010); Sara Sternberg Greene, *The Broken Safety Net: A Study of Earned Income Tax Credit Recipients and a Proposal for Repair*, New York University Law Review, Vol. 88, No. 2, May 2013; V. Joseph Hotz, Charles H. Mullin, and John Karl Scholz, *Examining the Effect of the Earned Income Tax Credit on the Labor Market Participation of Families on Welfare*, NBER Working Paper 11968, (National Bureau of Economic Research: Cambridge, MA, 2006); and Chuck Marr, Chye-Ching Huang, and Arloc Sherman, *Earned Income Tax Credit Promotes Work, Encourages Children at School, Research Finds*, (Center on Budget and Policy Priorities: Washington, DC, 2014), among others.

spheres; and (3) "identifying spillovers, externalities, and other areas where [Puerto Rican] society could learn more."[7]

This new learning, in turn, would lead to: new investment in R & D, increased productivity, identifying new areas of comparative advantage for Puerto Rican firms, higher economic growth and the creation of high-quality jobs, which is what will categorically end Puerto Rico's economic stagnation. We at the Center for a New Economy are currently working with experts from Columbia, Brown, MIT, and Brookings, among other institutions, to develop this medium to long-term industrial policy.

Finally, any new economic strategy for Puerto Rico, no matter how nuanced, sophisticated, or brilliantly conceived, is bound to fail if it ignores the fact that Puerto Rico has reached the limits of its development within the constraints imposed by its subordinate political status, which is both humiliating to Puerto Ricans and unworthy of the United States.[8]

In conclusion, Chairman Murkowski, I thank you and the Committee once again for the opportunity to participate in this important public policy debate and look forward to answering any questions that you or Committee Members may deem appropriate to ask.

[7] Joseph E. Stiglitz and Bruce C. Greenwald, *Creating a Learning Society: A New Approach to Growth, Development, and Social Progress*, (Columbia University Press: New York, 2014), p. 489.
[8] Neither a sovereign country nor a state of the union, Puerto Rico has no authority to negotiate international treaties, no access to emergency financing from multilateral institutions, no monetary policy instruments, limited fiscal policy tools, nominal representation in Congress, and the U.S. Supreme Court has determined it is constitutionally permissible for Congress to discriminate against Puerto Rico in the application of federal programs as long as there exists a "rational basis" for doing so.

The CHAIRMAN. Thank you, Mr. Marxuach.

Mr. Fetter, welcome.

STATEMENT OF STEVEN FETTER, PRESIDENT, REGULATION UNFETTERED

Mr. FETTER. Thank you. Chairman Murkowski, Ranking Member Cantwell, and members of the committee, I appreciate the opportunity to testify on the fiscal issues affecting the Commonwealth of Puerto Rico.

With my background as a utility regulator and utility bond rater, I have been asked to discuss Puerto Rico's electric utility known as PREPA.

I should say with the comments from my colleagues on the panel, the fiscal issues are extremely serious, but I believe, at least on the energy side, with a few changes it potentially has a brighter outlook, including the possibility of a consensual settlement agreement with investors short of a filing for bankruptcy.

Initially, I wish to emphasize that I come at the PREPA issues with the hope that the ultimate resolution will create an environment in which investors will be willing to continue providing funds to the Commonwealth for the wide range of public services they now support and that that goes on well into the future. I believe the best way of achieving that is if stakeholders can reach a consensual settlement agreement under which necessary sacrifices can be shared across the board.

This is consistent with the approach I took at the Michigan Commission, where I continually urged our staff and adversarial parties to attempt to reach agreement on points of difference through settlement because no matter how thorough a litigated case record is developed, the parties are always in a better position to weigh their areas of dispute and strike a fair balance as to how they wish them to be resolved. Basically, then, each party chooses the end result for themselves.

Toward this ultimate goal, I offer the following thoughts:

The new Energy Commission should expedite PREPA's current base rate case as much as it possibly can, a point that I believe Congress could help emphasize. My understanding is that rate levels have long been inadequate to meet operating expenses and debt obligations, thus leading to PREPA's financial crisis.

Adding to the problem, when oil-reliant PREPA received a major positive break with oil prices plummeting down during the past year, those saved funds were immediately flowed back to customers rather than keeping rate levels the same and using the additional revenues to support operations and required investor payments. My back-of-the-envelope calculation puts those lost revenues during the past year as approaching $1 billion on a total base of $9 billion of debt at PREPA.

I admit I am not sure if the Energy Commission had the authority to so direct these fuel savings, but my experience tells me that they could have done what I did at the Michigan Commission. I went to the Michigan legislature. Actually, your colleague, Senator Stabenow, was serving in the legislature at that time.

I explained to policymakers why the law needed to be changed and why the public interest would be furthered if they did it immediately. Such a proactive step would have helped PREPA respect the interests of debt investors while mitigating the financial pain its customers will likely have to face as this crisis proceeds.

Similarly, PREPA should immediately endeavor to operate with substantially increased efficiencies, especially with regard to rate-collection practices. I think if I were serving at the commission or at PREPA, I would seek the advice of individuals and institutions that have faced similar difficulties in the past.

For example, almost every U.S. utility regulator serves at NARUC, their longstanding national association, and utility executives belong to a range of electric and natural gas associations. I expect that any of these organizations would be willing to assist PREPA or the Energy Commission.

And of course, relevant experience exists in utility consulting firms across the U.S. Expertise is there to be tapped, and I believe Congress could play a role in facilitating a connection between PREPA, the commission, and these experts.

In addition, I understand that outside investors are willing to assist PREPA in a range of ways, from new investment aimed at asset modernization, all the way up to privatization. At this point, no option should be off the table.

Finally, let me briefly discuss the potential for Chapter 9 bankruptcy filings being permitted for PREPA or other Commonwealth entities. At least with regard to the energy sector, the potential for a Chapter 9 filing was not a risk that investors considered at the time they decided they would lend money to PREPA.

Undoubtedly, that means that if Chapter 9 were permitted for review of debt investors' return of funds, there would be legal challenges to such an authorization that would go on for years. I think a consensual settlement agreement is potentially there and would be a far superior path.

Finally, let me tell you just my concern about the Chapter 9. Debt investors lent money to the Commonwealth and its public agencies with the expectation that they would receive their funds back with interest. They are not equity holders or co-owners of PREPA, subject to the ups and downs of utility performance. Thus, in my mind, for any resolution of this crisis to succeed going forward, it must keep faith with the debt investment community because those are the individuals and institutions, along with possible future equity investors, that will be needed to support Puerto Rico's continuing recovery well into the future.

Thank you, Madam Chairman.

[The prepared statement of Mr. Fetter follows:]

U.S. SENATE COMMITTEE ON
ENERGY & NATURAL RESOURCES

HEARING ON PUERTO RICO:

ECONOMY, DEBT, AND OPTIONS FOR CONGRESS

Testimony of Steven M. Fetter

President, Regulation UnFettered

October 22, 2015

Steven M. Fetter, President
Regulation UnFettered

Chairman Murkowski, Ranking Member Cantwell, and Members of the Committee:

My name is Steven M. Fetter and I am President of an energy advisory firm called Regulation UnFettered. I appreciate the opportunity to testify on the economic issues affecting the Commonwealth of Puerto Rico. Based upon my past experience of serving as Chairman of the Michigan Public Service Commission and head of the utility credit ratings practice at Fitch Ratings, I will direct my comments toward the situation facing the Puerto Rico Electric Power Authority, known as PREPA, though I expect my views will have some relevance on other fiscal issues Puerto Rico is currently facing.

Initially I wish to emphasize that I come at the PREPA issues with the hope that the ultimate resolution will create an environment in which investors will be willing to continue providing funds to the Commonwealth for the wide range of public services they now support well into the future. I believe the best way of achieving that is if stakeholders can reach a consensual settlement agreement under which necessary sacrifices can be shared. This is consistent with my approach at the Michigan Commission where I continually urged our Staff and adversarial parties to attempt to reach agreement on points of difference through settlement, because no matter how thorough a litigated case record is developed, the parties are always in a better position to weigh their areas of dispute and strike a fair balance as to how they wish them to be resolved. Simply put, through settlement, each party is able to dictate the type and extent of sacrifices they feel they can accept.

Toward this ultimate goal, I offer the following thoughts:

The new Energy Commission should expedite PREPA's current base rate case as much as it possibly can, a point that I encourage Congress to emphasize to their counterparts in Puerto Rico as well. My understanding is that rate levels have been inadequate to meet operating expenses and debt obligations, thus leading to PREPA's financial crisis. Adding to the problem, when oil-reliant PREPA received a major positive break with oil prices plummeting down during the past year, those saved funds were flowed back to customers, rather than keeping rate levels the same and using the additional revenues to support operations and required investor payments. My back-of-the-envelope calculation puts those lost revenues during the past year as approaching one billion dollars. I admit, I'm not sure if the Energy Commission had the authority to so direct these fuel savings, but my experience tells me that they could have done what I did at the Michigan Commission: go to the Michigan Legislature – actually Senator Stabenow was in the legislature back then – and explain to the policymakers why the law needed to change, and that the public interest would be furthered if that change could be made immediately. Such a proactive step would have helped PREPA respect the interests of debt investors while mitigating the financial pain its customers will likely have to face as this crisis proceeds.

Similarly, PREPA should immediately endeavor to operate with substantially increased efficiencies, especially with regard to rate collection practices. I think if I were serving at the Commission or in PREPA management, I would seek the advice of individuals and institutions that have faced similar difficulties in the past. For example, almost every US utility regulator serves in NARUC, their longstanding national association, and utility executives belong to a range of electric and natural gas associations – I expect any of those organizations would be willing to assist PREPA or the Energy Commission. And, of course, relevant experience exists in utility consulting firms across the United States. Expertise is there to be tapped, and I believe Congress could play a role in facilitating such interaction.

In addition, I understand that outside investors are willing to assist PREPA in a range of ways: from new investment aimed at asset modernization all the way up to privatization. At this point, no option should be off the table.

Let me briefly discuss the potential for Chapter 9 bankruptcy filings being permitted for PREPA or other Commonwealth entities, and caution Congress about becoming involved with the issue. Undoubtedly, legal challenges to such an authorization would go on for years with all the uncertainly that such a delay would engender. But, more importantly, if such proceedings were intended to take from debt investors, including insurers of such bond investors, more than they are willing to give, in my opinion the end result might be that the current crisis will morph into a Commonwealth catastrophe.

Let me explain why: debt investors ***lent*** money to the Commonwealth and its public agencies with the expectation that they would receive their funds back with interest. They are not equity holders, or co-owners of PREPA, subject to making or losing a bunch of money depending upon the ups and downs of the utility's performance. Thus, in my mind, for any resolution of this crisis to succeed going forward, it must keep faith with the debt investment community, because those are the individuals and institutions, along with possible new equity investors, that will be needed to support Puerto Rico's continuing recovery well into the future.

Thank you for your attention.

The CHAIRMAN. Thank you, Mr. Fetter, I appreciate your comments, and you gave some specific proposals there that I think will be good for the committee to look at.

Let me begin my questioning first directed to you, Governor. Again, thank you for being here.

As we have come to this hearing today, we have heard a great deal of discussion about the numbers and where Puerto Rico is and their clear inability to pay, but there has been a lot of concern about the fact that we have not seen the financial reports that have been hoped for. There have been a number of financial reports. You mentioned one, and several of you also mentioned the Krueger report. There is also the Conway MacKenzie report to the working group report, which I think is helpful.

But there is concern, clearly, about the verifiability of Puerto Rico's financial data, and this goes back to the fact that we have not seen a comprehensive independent audit since July 2013. I know that this was an issue that was raised before the Finance Committee as well.

Can you tell the committee this morning whether or not there are plans to complete independent audits of the Government Development Bank for Fiscal Years 2014 and '15 and then, of course, going into the future? What is the status of that?

Governor PADILLA. Thank you, Chairwoman.

It is a historical problem in Puerto Rico. We inherited such a mess there, too, and it was part of the different governments in the past to hide information to the market so they were able to have more access to the market. We have been dealing with that. Now we are just one audited financial statement behind. That should be released in the next weeks or months.

The CHAIRMAN. Excuse me. Would that be '14 or '15 that would be——

Governor PADILLA. It will be '14 and then '15, but when I was sworn in, the delay was huge. We have been able to go forward and being now a little bit more accurate. The Conway MacKenzie and Krueger reports are part of that effort of the Commonwealth and my administration to bring you and to the world the right numbers about Puerto Rico through commission-independent experts to evaluate Puerto Rico numbers.

So on the audited financial statement, it is a historical problem that we are just now getting up to date. But to supplement that lack of information, that is why we commissioned the same company that did the research in Detroit, this Conway MacKenzie, and the best one in the world from the IMF is the Krueger report.

The CHAIRMAN. But what you are telling the committee is we should anticipate the 2014 independent audit sometime within the next several weeks?

Governor PADILLA. Weeks or months, yes. I will tell you why. As you know, it is an independent contractor that is requesting every day information, so to put a burden on them to be faster, I need to ask them to address the issue in a more responsible way so you will have the better numbers. But, yes, we are putting a lot of pressure on them to accelerate that process.

The CHAIRMAN. I think you understand the need and of course——

Governor PADILLA. Of course.

The CHAIRMAN.—concern for very clear numbers.

Let me ask you, Mr. Weiss, given your close interaction with the Puerto Rico government over the last year, are you comfortable with the financial data that is available and has the Treasury Department considered sending a team from Treasury to help them produce some of these auditable financial statements?

Mr. WEISS. Thank you for posing the question, Chairman Murkowski.

An essential part of the plan that we are proposing, not covered in my oral testimony but contained in the written proposal, is that it is absolutely the case that Puerto Rico needs to make an investment in its financial reporting systems and cannot be in a position where audited financials are not released on a timely and transparent basis to all stakeholders.

It is equally the case that we have analyzed all available data, including the Conway MacKenzie report and other analyses, and there can be no doubt—there can be no doubt in our judgment that there is a fiscal crisis and that it is imminent. There is a liquidity crisis as well as a long-run fiscal crisis.

And this is why we have proposed not just a broader restructuring authority but also enhanced fiscal oversight, and as part of that fiscal oversight, an investment in IT infrastructure and also the authorizations, as you suggest, to allow Treasury and the other agencies within the Federal administration to provide real on-the-ground technical assistance to make sure that that IT infrastructure is built out quickly and effectively.

The CHAIRMAN. So that technical assistance that you are speaking to will be a team from Treasury that will go to Puerto Rico to try to get a better handle on what we are talking about with the numbers? The reason I ask, you mentioned assisting with the system. You and I both know that that is going to cost money. You and I both know that there is a lot of uncertainty right now in terms of what is going on with just the budget and appropriations as we move forward.

As we look at the proposals you have outlined, one of the concerns that has been expressed is that there does not appear to be any kind of an estimate as to what the overall cost may be, whether it is for the proposals that have been discussed with the EITC, removing the Medicaid cap, or, as you have just mentioned, assistance with helping build out what is very necessary, I would agree. But do we have any kind of an estimate out there in terms of the costs of the Administration's proposals?

Mr. WEISS. As to the cost of the build-out of the IT infrastructure, it is our judgment that the cost is low but that the benefits are great, and that, in fact, the technical assistance we could provide, not just out of Treasury but other agencies, would help to ensure that it is effective and quickly implemented.

But I need to underline that there can be no doubt that there is a fiscal and liquidity crisis in Puerto Rico. The debt is consuming \$3.5 billion to \$4 billion annually out of a \$10 billion budget. That is 35 to 40 percent of government receipts. This compares to figures more in the area of five to ten percent in states and municipalities. The debt trades at prices between 30 cents and 70 cents and has traded there for the past two years since Puerto Rico lost access to traditional municipal bond investors. So the investment needs to be made, but it cannot be an excuse in our judgment for a failure to act.

The CHAIRMAN. Okay. Mr. Weiss, I am well out of time but know that I am going to come back to you with this question in the next round to try to understand what it is that we are dealing with because, as I would agree, we have to work with Puerto Rico here. We must address this.

We also recognize that we have issues as they relate to just dealing with the costs, so I am trying to get some kind of an understanding as to what we are dealing with with the Administration's proposal and whether or not they have got a back-of-the-envelope number that we can be looking to. So know that I am going to be coming back to you.

Mr. WEISS. Thank you.

The CHAIRMAN. Senator Cantwell.

Senator CANTWELL. Thank you, Madam Chair, and thank you to the panelists.

I think having seen some of the discussion in the Finance Committee—at the end, it got kind of heated—I think it is safe to say that you all do not hang out together. [Laughter.]

So if I could just get an answer to this question, a yes or no. Which of you support this Chapter 9 authority, creating Chapter 9 authority for Puerto Rico?

Governor PADILLA. Yes.

Senator CANTWELL. Can we just go down the line?

Governor PADILLA. I am sorry.

Senator CANTWELL. Mr. Weiss?

Mr. WEISS. Yes, Senator.

Governor PADILLA. Yes.

Mr. PIERLUISI. I support Chapter 9—giving access to Puerto Rico to Chapter 9. I introduced a bill for that purpose.

Senator CANTWELL. Okay.

Mr. MARXUACH. Yes, Senator, I support it.

Mr. FETTER. No, I do not.

Senator CANTWELL. Okay. Mr. Fetter, your testimony suggests that you believe that there are assets within the utility, and that is why you do not support Chapter 9, and you want to make sure that those assets—but in a bankruptcy, that is what the bankruptcy discussion is about. It is about what assets are there.

So, Mr. Weiss, how is Puerto Rico—or the Governor—going to be constrained, and all the other sectors trying to reform in bankruptcy going to be constrained by this utility objection?

Mr. WEISS. We need to be clear about bankruptcy as a whole. There are two aspects. One is Chapter 9, which has been introduced by Congressman Pierluisi in the House, and there is a companion bill in the Senate, and that would cover PREPA and the other public corporations and municipalities. That totals approximately one third of the total bonded debt in Puerto Rico.

The Administration is absolutely in favor of moving forward with that legislation immediately. It would help not only finalize the PREPA negotiations, which are ongoing, but also cover the other municipalities in Puerto Rico, which are over-indebted.

At the same time, we are advocating for a broader bankruptcy that would cover the entire bonded debt of Puerto Rico. And the benefits of that are, first, litigation has been made at—various have mentioned litigation that provides a stay on litigation and necessary breathing space for the economy while it is in effect. Second, it provides a mechanism for assuring an agreement with each class of bondholders that is enforceable across the entire debt stock. And third, to the extent needed, it allows for senior financing, which can be brought in from the private sector and come out on a priority basis.

It is our judgment that the time has come to address the entire debt stock of Puerto Rico and not just the Chapter 9 municipalities and public corporations.

Senator CANTWELL. Mr. Fetter, you are definitely holding the utility area sacrosanct under this larger problem. What about what Mr. Weiss just said is not a process and procedure for making sure that this is——

Mr. FETTER. Senator, my——

Senator CANTWELL.—that your investors are going to have a fair day—in a horrible situation, no doubt—but they are going to have their fair day under this?

Mr. FETTER. I guess I come at it a few different ways. It is a risk that they did not envision when they decided to make their investment. I believe with a commitment towards improved operations at PREPA and improved regulatory timeliness, a consensual settlement agreement can be reached.

And so, to me, that is far superior than starting down a path of Chapter 9 restructuring, which, in the end, might be okay to investors or it might not be okay. So since it is that binary okay or not, my expectation is that they would raise legal objections at the outset, as opposed to working toward that settlement agreement that I think is possible.

Senator CANTWELL. Mr. Marxuach.

Mr. MARXUACH. I just want to make a quick remark. I disagree. I respectfully disagree with the remark that bondholders relied expressly on bankruptcy protection in order to make these investments. To my knowledge, looking at every prospectus that is out there, I do not think it was even highlighted, you know, when the debt was issued. The main driver for Puerto Rican bonds was the triple tax exemption they enjoyed under the U.S. Tax Code and in Puerto Rico, and that was really what drove people to invest in Puerto Rico.

It will be very difficult, I think, for any investor to prove in a court that they relied expressly on a representation that bankruptcy was not an option.

Senator CANTWELL. Okay. I see my time is expired. Thank you.

The CHAIRMAN. Thank you, Senator Cantwell.

Senator Barrasso.

Senator BARRASSO. Thank you, Madam Chairman.

Congressman Pierluisi, you mentioned in your written testimony that Puerto Rico is, I think you said, "treated in discriminatory fashion or excluded entirely" from various Federal programs, including Chapter 9 of the Federal Bankruptcy Code. As you know, there is a companion legislative proposal to your bill in the Senate introduced by Senator Blumenthal to grant Chapter 9 Bankruptcy Code protection.

I have concerns about families and retirees in my state and other states who were incentivized by Congress through the Tax Code to invest in the Puerto Rican bonds, including the Puerto Rico Electric Power Authority. I have heard there are many individuals who are invested in these bonds across the State of Wyoming. Some have investments in their 401(k)s, people who may not even know that their 401(k)s are invested in these bonds. Congress explicitly prohibited Puerto Rico from being able to access Chapter 9. Puerto Rico took advantage of the lower cost of capital by doing that. If access to Chapter 9 was granted and the rules under which investments in these bonds were made are retroactively changed, then the value would, I think, be negatively impacted. So my concern is people bought the bonds because they are tax-free, low-interest, Government bonds. So what happens when a retiree in Wyoming goes to their mailbox and opens their financial statement only to find their investment has been negatively impacted because Congress changed the rules of the game after the fact? What do I tell them?

Mr. PIERLUISI. Okay. First of all, Congress has the power to change the bankruptcy laws at any time, and no lawyer worth his or her salt would advise a client that bankruptcy law cannot change. Puerto Rico for 45 years had access to Chapter 9. It did not use it then and did not need it then. For reasons that are not even expressed in the Congressional Record, it was left out. That is the story, the life of a territory.

But I would also add that any investor would be in worse shape if, for any reason, the entity in which the investor invests has no legal structure, no legal remedy to handle its debt obligations. That is the situation in Puerto Rico right now. It is going to end up being chaos. You need a legal framework in which a Bankruptcy Court, a Federal Bankruptcy Court, oversees the reorganization of an entity that becomes insolvent.

By the way, this is not like automatic. The law is clear. You need to show that you are insolvent. You need to show that you are not able to pay your debts when they become due. In addition, creditors have a participation in the process. So, if anything, I say it is much better to have Chapter 9 than not. And all we are asking is the same access as the states have. That is my answer.

Senator BARRASSO. Thank you.

Mr. Weiss, if this Chapter 9 status is granted, would that not cost Puerto Rico the confidence of investors in the future who are a key component of improving the economy of Puerto Rico?

Mr. WEISS. Senator, thank you for the question. And it really leads to the point that Puerto Rico lost confidence of traditional investors two years ago when it lost its investment grade rating. And the only financing it has been able to complete since then has been one $3.5 billion financing at an 8.5 percent rate, which was put together entirely by hedge funds.

More recently, it has also lost its interim financing. It is in a completely shutout situation from financial markets today and——

Senator BARRASSO. So would granting Chapter 9 do anything to address the structural problems and practices that have led to the economic situation in Puerto Rico?

Mr. WEISS. As we have said in our proposal, the Chapter 9, the broader version, which covers the entire debt stock of Puerto Rico, in our judgment, should be coupled with greater fiscal oversight provided by a body that appropriately represents the status and people of the Commonwealth, and investment in IT infrastructure around financial reporting. So we would do the two together.

But we think the quickest way to restore confidence in Puerto Rico in financial markets is to go through a broader, comprehensive restructuring of the Commonwealth's debt such that it emerges in a position where investors have confidence in the oversight and IT systems and that the level of debt itself, which today is totally unsustainable, better matches the size of the economy.

Senator BARRASSO. Thank you, Madam Chairman.

The CHAIRMAN. Thank you, Senator Barrasso.

For the information of the committee members, a vote has just started. There will be two votes. So I think what we will do is go until 25 after, and then we will take a break. That way we can try to hit both votes at one time and then come back.

At this time, we will go to Senator Heinrich.

Senator HEINRICH. Commissioner Pierluisi, Mr. Fetter seemed to suggest that PREPA rates are not adequate, and that may be true from at least the narrow view of some investors. But as you know, PREPA rates are already far higher than mainland electric rates.

If electric rates were higher in Puerto Rico, how would that impact the broader ability to attract additional business investment that is needed to grow out of the current situation?

Mr. PIERLUISI. Excellent question. But of course that PREPA and our energy cost are crucial to Puerto Rico's future. We need to grow. We need to grow our economy, and we are paying over 20 cents per kilowatt hour for energy. PREPA needs to diversify its energy sources. To do so, it needs to attract private capital so we have new LNG plants in Puerto Rico.

But in the current state of affairs in PREPA, it has become such a risk for the investment community that nobody would enter into a power purchase agreement with PREPA as matters are. That is why restructuring at PREPA, reorganizing PREPA under the protection of the Bankruptcy Code, should be an option.

I am the first one, Senator, who supports consensual negotiations with creditors. PREPA has been doing that for more than a year. I have been saying that it has taken too long, but we should always have that option because it is good for the process. It encourages the parties to negotiate in good faith. It gives PREPA, yes, more leverage in the negotiation, but it is the right thing to do.

And of course the solution cannot be raise rates. That cannot be the solution. That is going to harm our economy, and it is going to cause even more migration, and it is going to create more fiscal pressure. So you are absolutely right.

Senator HEINRICH. With regard to Chapter 9, you believe that the certainty that that creates in the long run is better for the investment community than the status quo obviously?

Mr. PIERLUISI. Yes. Definitely, it is a tool we should have. I should say that in Puerto Rico I believe—I, for one—I believe we have 18 different entities issuing bonds in Puerto Rico. Some of those entities are in reasonable financial condition. Some definitely need to be reorganized. PREPA is one. The Water and Sewer Authority is probably the next candidate, and we should have this, too. We should definitely have this, too.

Now, part of our debt, and I should make this point, is it has been issued by the central government and it has been guaranteed by our constitution; and Congress approved our constitution. I believe that that part of the debt, which is about $18 billion worth, is manageable, and we should pay every penny of it because it is our word. It is our constitution, and we should be a jurisdiction of law and order.

So I want to clarify the record there. Even though I agree with having Chapter 9 as—I do not agree with the concept of restructuring or failing to pay all of our debt. We should honor our obligations to the extent we can, and we should have Chapter 9 available.

Senator HEINRICH. Do you think there is a relationship between the uncertainty over Puerto Rico's political status to the current economic crisis? What is the nexus there, Commissioner?

Mr. PIERLUISI. A clear nexus. Let me give you just an example. And by the way, Chairman, you referred to the lack of estimates. Obviously, to the extent we start generating specific bills, we will score them. CBO will score them.

But let me just give you one example. If you improve the treatment of Puerto Rico under the Medicaid program so that at least we can cover the people falling below the Federal poverty level—I am not even asking for Medicaid expansion—the Puerto Rico government would be receiving at the very least roughly about $1.5 billion from the Federal Government that it is not receiving right now.

That accomplishes two things. On the one hand, it helps us fiscally. We would not have the deficits that we are having. We would not have the liquidity problems we are having. On the other hand, we could cover this population, American citizens under the poverty level, as we should. So that is just one example. That is why this is tied to status.

Why are we treated like that? Because we are a territory, and you have license to treat us differently. But I complained because, as American citizens, we should be treated equally. It has an impact on our fiscal health, and it definitely has an impact on our economy.

Senator HEINRICH. Thank you, Madam Chair.

Mr. FETTER. May I add some rebuttal?

The CHAIRMAN. We are going to go to Senator Sanders just because we are running short of time here.

Thank you, Senator.

Senator SANDERS. Thank you, Madam Chair.

I want to raise a couple of issues. First of all, let us be clear about the extent of the human tragedy currently taking place in Puerto Rico. As I understand it, since 2006, Puerto Rico has lost 20 percent of its jobs. About 60 percent of Puerto Rico's adult population are either unemployed or have given up looking for work. Over the last five years alone, more than 150 public schools have been shut down, and the childhood poverty rate has shot up to 56 percent.

That is a human tragedy, and in my view, Wall Street should not be believing that they can get blood from a stone. When people are suffering and hurting, you cannot continue to squeeze them.

I want to get back to that, but I want to say a word now on the energy situation. I have not heard one word—or maybe I missed it—on a phrase called "sustainable energy." As I understand it, Puerto Rico today is producing its electricity 55 percent from oil, 28 percent from natural gas, 16 percent from coal, 1 percent from renewables.

Now, unless Puerto Rico's advertising is incorrect, last I heard you were a sunny island. You are an island. There is wind. I do not understand why you are producing electricity from oil and why we are not investing significantly into sustainable energy. I know there are plans underway, but you have huge potential to lead this part of the world.

All right. Let us get back to my friends on Wall Street here. Mr. Weiss, you indicated that the hedge funds, some of the vulture funds, are buying bonds at 30 to 70 percent. At a time when children in Puerto Rico are going hungry and schools are being shut down, why should the U.S. Government or why should these guys be getting back 100 percent on their investment when they are paying 30 to 70 percent on the dollar for these bonds?

Mr. WEISS. Senator, as we have said, the debt is unsustainable, and the market knows this. The fact that the highest-rated, most senior debt trades at 70 cents is a clear indication that this is no surprise and you want——

Senator SANDERS. What are the interest rates? I do not have a lot of time. What are the interest rates now that these——

Mr. WEISS. A yield on the most highly priced security, debt security in Puerto Rico, is in excess of 11 percent.

Senator SANDERS. Whoa. So they are getting 11 percent, or they want 11 percent?

Mr. WEISS. They are receiving——

Senator SANDERS. They are receiving 11 percent——

Mr. WEISS.—11 percent.

Senator SANDERS.—and children in Puerto Rico are going hungry. Somehow that equation does not make a lot of sense to me. I think this is an issue that has to be dealt with.

So the first point that I would make, in any serious discussion about this issue, the goal cannot be simply to protect high interest rates going to vulture funds on Wall Street. They are going to have to sit down on the table and take a significant haircut. They made risky investments, and when you make a risky investment, you should not expect to get 100 percent back on your dollar.

Mr. MARXUACH. Senator, may I make one point? That 11 percent is tax exempt. I just wanted to make that point.

Senator SANDERS. All right. So I think let us put that on the table, and that has got to end.

My own view is—and I indicated this to the Secretary of the Treasury, Mr. Weiss, I think the Secretary of the Treasury and you should call a meeting with all of the players, including the players in Puerto Rico who are now suffering. Representatives of labor unions, when I hear labor reform, usually what that means to me is lower wages and longer hours, all right? But I would like to see all of the players sit down with the vulture funds and work out an agreement that is satisfactory to both sides.

Now, in terms of transparency, I have heard, and I do not claim to be an expert on this, but that it is possible that some of the debt was incurred in an unconstitutional way, in violation of Puerto Rico's constitution.

Governor PADILLA. Yes.

Senator SANDERS. Who wants to talk to that one? Yes, sir, Governor.

Governor PADILLA. Yes, we need to audit that.

Senator SANDERS. You think that that is a possibility that some of your debt was unconstitutional?

Governor PADILLA. In those words, if that is a possibility, the answer is yes.

Mr. PIERLUISI. And let me clarify that there is an Attorney General opinion in Puerto Rico providing some support for the interpretation that some of the debt could be issued outside the constitutional requirements. So it is a legal issue. But you might be right, and it is something that should be studied.

Senator SANDERS. Should debt be repaid if, in fact, that debt was incurred in an unconstitutional way?

Mr. MARXUACH. No.

Senator SANDERS. Who said no? You both say no? Sir?

Mr. MARXUACH. I said no, and in addition to the opinion from the Attorney General that Congressman Pierluisi mentioned, the constitution specifically says that to balance the budget, you are not allowed to issue debt. You are supposed to either—basically increase taxes. That is what the Puerto Rico constitution——

Senator SANDERS. And we presume that the investors understood that and were familiar with the constitution——

Mr. MARXUACH. Well, it was certainly disclosed in the financial statement. Whether or not they read it is a different question, and that is perhaps an issue to be investigated by the Banking Committee here in the Senate.

Senator SANDERS. Okay. So what I am hearing, though, from several of you, that if these debts were incurred in a way that was unconstitutional, that perhaps this debt should not have to be repaid?

Mr. PIERLUISI. Yes. And since the Senator raises the issue, or it has been raised, the issue of audits, let me say that Congress has the authority, this committee has jurisdiction to require GAO to do annual audits of the Puerto Rico government and financial transactions and issue recommendations. This committee had legislation before the committee providing for GAO to oversee or give guidelines and recommendations as to estimates, tax revenue, revenue estimates, expense estimates done by the territories.

I testified before this committee, and I asked the committee to include Puerto Rico in that legislation. And for some reason you left Puerto Rico out, and you allowed GAO to advise the other territories but not Puerto Rico. And now, you tell me that our records or financial records are not the types that you would like to see.

So what I say is definitely Congress has authority to—it did with the District of Columbia, and you can do it in a way that respects Puerto Rico's autonomy, and I think it should be done. And GAO could also——

Senator SANDERS. Thank you.

Mr. PIERLUISI.—consider the issue——

Senator SANDERS. Okay.

Mr. PIERLUISI.—the issue that was raised——

Senator SANDERS. My time is expired.

The CHAIRMAN. We are going to try to get one more Member in. Senator Warren?

Senator WARREN. Thank you, Madam Chair, and thank you all for being here.

I want to see if I can try to pull this together. The people of Puerto Rico are in a really lousy position. They have been hit hard by ten years of recession, and now they are crushed by debt they cannot repay. Ordinarily a city in this kind of financial trouble would declare bankruptcy, a country would go to the IMF, and in either case they would work out a reasonable debt reduction and a repayment plan.

Puerto Rico, by American law, cannot do either one of these, and that leaves the 3.5 million American citizens on the island at the mercy of the people who hold Puerto Rico's debt.

So who owns Puerto Rico's debt? Many of these owners are so-called vulture funds that wait until a borrower is in trouble and then they buy the debt at a big discount so they can make a profit even if some of the debt does not get repaid. But the vulture funds do not want to negotiate. Instead, what do the vulture funds want? Well, they want Puerto Rico to raise taxes, cut healthcare, fire teachers, cut pensions, sell off $4 billion worth of government buildings, privatize public ports, close neighborhood schools, and cut support for the University of Puerto Rico, all so that these vulture funds can squeeze out more profits.

Now, Mr. Marxuach, what would happen to the people of Puerto Rico and the economy of Puerto Rico if they did what the vulture funds are asking for?

Mr. MARXUACH. Well, it is essentially another round of austerity that would be imposed on the people of Puerto Rico. We already have done pension reform. We have fired government employees. We have cut expenditures. We have raised taxes since 2009. So obviously what it will do to the economy is, you know, make the actual recession or contraction even more acute.

Senator WARREN. Okay.

Mr. MARXUACH. So I do not think it is part of the solution.

Senator WARREN. So it will make things worse——

Mr. MARXUACH. Definitely.

Senator WARREN.—in Puerto Rico?

Mr. MARXUACH. In my opinion, it would.

Senator WARREN. Worse for the people, worse for the future——

Mr. MARXUACH. Yes.

Senator WARREN.—of this economy?

Mr. Weiss, I understand that the Treasury Department's position is that Congress should pass legislation so that Puerto Rico can force creditors to the negotiating table, the same way any American city or any country can do. I believe that Congress should pass a law. I have cosponsored such a law, and I will fight for it.

I also understand from your testimony that you have been working with other agencies to guarantee Puerto Rico has access to existing Federal programs. You have worked to encourage other agencies to pursue all administrative options. But I want to be clear on this point. Is it your position that Treasury itself has absolutely no power to help the people of Puerto Rico without congressional action?

Mr. WEISS. Thank you for the question.

The Administration has organized, led by the White House, an interagency effort, and we are part of that. There is a dedicated team at Treasury. There is also a dedicated team at HHS. We have been working closely with the Governor, with the legislative leadership.

Senator WARREN. I am sorry. Just help me out a little bit on what "working with" means. I just want to understand what Treasury is doing to try to help out in these circumstances.

Mr. WEISS. We have analyzed the finances of Puerto Rico. We are here to say today with no ambiguity that there is a liquidity crisis and that there is a fiscal crisis, and it is our strong belief that the most powerful way forward involves broader bankruptcy protection, as you stated, which would allow us to bring creditors to the table who would otherwise have no intention to enter into negotiations.

Senator WARREN. Mr. Weiss, I will push on Congress to try to pass these bills, but frankly, I think Treasury needs to step up and show more leadership here. I agree with Treasury's recommendations to Congress, but let us face it, in Washington sometimes things like this that sound good amount to just passing the buck.

During the financial crisis when the banks were in trouble, Treasury did a lot more than just bail them out. Treasury stretched the limits of its authority to make sure that the banks stayed afloat. It helped broker deals between banks. It applied pressure to get parties to accept deals they may not have liked very much. It has done that in multiple other crises as well.

Now the people of Puerto Rico are calling. They understand there is no bailout on the table for them, and they are not asking for one. After all, they are not a giant bank. But they are asking the Administration to do what it can to help broker deals, to stand up to the vulture funds that are pushing for a vision that is far at odds with the people of Puerto Rico and with all American citizens.

Puerto Rico is not trying to protect its profitability. They just want to make sure that the families of Puerto Rico have a chance to build a future for themselves and their kids. I urge Treasury to be just as creative in coming up with solutions for Puerto Rico as it was when the big banks called for help.

Mr. WEISS. Senator——

Senator WARREN. Thank you.

Mr. WEISS. We——

The CHAIRMAN. I am sorry. We are going to have to adjourn. The vote is about to be closed, so we will stand adjourned for about ten minutes or until Members can get back.

[Recess.]

The CHAIRMAN. I call this meeting back to order before the committee. We have got a little bit of a reprieve. The second vote is going to begin in about 10 or 15 minutes, so we will continue with the questioning and probably have to wrap it up by about five minutes after 12 p.m., or continue it, depending where we are in the process.

With that, we will turn to Senator Hirono from Hawaii.

Senator HIRONO. Thank you very much.

Regarding Senator Warren's line of questioning as to the Treasury being able to do more, I would share those sentiments because I think we need to do everything we can besides waiting for the legislation that would help Puerto Rico pass. That may take a while. I would like to echo her suggestion and her strong urging to Treasury that you be aggressive in doing what you can.

In fact, I would like to ask Governor Padilla, do you think that Treasury is doing all it can to help Puerto Rico in this crisis situation?

Governor PADILLA. Well, Senator, thank you for the question. And I want to be as comprehensive as you have been trying.

Yesterday, Treasury and the White House put out a plan to make Puerto Rico, as you said, and it is a more comprehensive and ambitious one in my lifetime. I think that, since Kennedy, especially when Munoz was Governor, no one has addressed the issue as President Obama and Treasury yesterday.

We can argue, for example, with HHS that they can fix Medicare right now, but what we cannot allow, Senator, is to let Puerto Rico struggle between the Hill and the White House with Congress arguing that the Administration should do more and the Administration arguing that we need to pass legislation. Maybe both are true, but Puerto Rico is in the middle.

Senator HIRONO. Yes. My point is that it may take a while for Congress to act, considering what the circumstances and the environment here is. So short of Congress acting—and, yes, I totally agree that Congress should act on the bills that we have before us, but in the meantime, we would want to be assured that the Administration is doing everything it can to assist Puerto Rico.

I have a question for Mr. Marxuach.

Mr. MARXUACH. Yes.

Senator HIRONO. In your testimony, you recommend that the extension of the earned income tax credit to Puerto Rican workers would be a very effective antipoverty program. It is that pretty much in the U.S. and all of the benefits of the earned income tax credit in promoting work, et cetera.

So if implemented today—by the way, forgive me for not knowing, but would we have to pass legislation in order for Puerto Rico to qualify? Yes——

Mr. MARXUACH. Yes.

Senator HIRONO.—that was yet another thing.

Let us say that we did pass it, and if it passed, how long would it take? How soon would the benefits of the earned income tax credit accrue so that your economy and your debt situation could be improved?

Mr. MARXUACH. Well, first of all, it depends when it is implemented, but assuming it is for the next——

Senator HIRONO. Just say——

Mr. MARXUACH.—tax year, it would be pretty much immediate. I mean there are dozens of studies here in the United States that demonstrate that this type of refundable credit has a direct impact on consumption and on the welfare of the poorest families since they basically spend all their income. They have basically no money left over to save. So the impact in the short-term could be very significant, but as I mentioned in my testimony, it is only part of the solution. I mean it will help. You know, it is like a shot in the arm in the short-term, but we need to think also about the longer-term policies.

Senator HIRONO. Did you want to add something, Governor?

Governor PADILLA. Yes, Senator, just to make my point very clear on the previous question, there is no doubt that congressional action is needed, not to kick the can. If you want to kick the can a little bit, a few months, maybe a year, but to solve the problem, this is very simple. The ball is right now in Congress's court. What we are asking is to throw the ball to our court.

I want to solve the issue we began. We need to finish that job. Right now, the ball is in your court. Please, pass it to ours. We need to do the job. It is our problem. We need the tools to do our job.

Senator HIRONO. I certainly get the sense of urgency that you have and that we all should share.

Governor, in May 2014, you signed legislation that required the Puerto Rico Electric Power Authority (PREPA) to ensure that the electricity from fossil fuels be generated more efficiently. Have efficiency goals been met as a result of this legislation that you signed?

Governor PADILLA. Let me give you just a little of background. When I was sworn in, we produced like 67 percent of our energy from oil. Now it is 54 percent, as Senator Sanders pointed out. When I was sworn in, energy was 31 cents per kilowatt hour; now it is 19. It is cheaper than in Hawaii or in the U.S. Virgin Islands. Puerto Rico is the offshore jurisdiction with cheaper energy than the United States. It is still high, 19 cents.

But let me tell you why we got there. Did you know that a previous Governor took a loan addressing our GDP liquidity just to reduce the energy for the election period? That was amazing. That was incredible, and that was part of the problem.

Yes, we are trying to add more renewables. We already signed for the building of 600 megawatts up to the amount of 3,200 megawatts on renewables, but we need to finish the restructuring of PREPA that we already began or we are about to end successfully to allow the trust of the financial world to invest. But those are the right facts. Puerto Rico three years ago was at 31 cents per kilowatt. It is now at 19, and that is the reality of Puerto Rico.

Senator HIRONO. Congratulations on that.

Governor PADILLA. Thank you.

Senator HIRONO. Hawaii, yes, we share certain common issues relating to reliance on fossil fuels. Thank you.

Thank you, Madam Chair.

The CHAIRMAN. Senator Wyden.

Senator WYDEN. Thank you, Madam Chair, and thank you, Madam Chair, for keeping this open as well.

I want to see if for a moment I can take a bit of a longer view with respect to this challenge, and this really goes back to the days when I was the Chair of this committee and Senator Murkowski was Ranking Minority member.

Let me direct this question if I might to you, Mr. Marxuach. To me, the central question if you are going to keep this from happening again, you have to resolve this issue of status. That, to me, is just basic. I see you are nodding your head yes, so let us kind of walk through a little bit of this.

In November 2012, the Puerto Rican government held a local referendum on Puerto Rico's political future. We noted, back again when I was Chair in August 2013, on that vote there was no dispute that a majority of the voters in Puerto Rico, 54 percent, clearly expressed their opposition to continuing the current territorial status.

So at that hearing, I expressed my concern that the lack of resolution of Puerto Rico's status not only distracts from addressing these huge challenges, it contributes to them. The President's Task Force on Puerto Rico's Status found that "identifying the most effective means of assisting the Puerto Rican economy depends on resolving the ultimate question," which they called status.

So it is still clear that, for Puerto Rico to get on top of these issues and really to achieve the full potential that all concerned are interested in, the issue has got to be resolved. Puerto Rico must either exercise full self-government as a sovereign nation or achieve equality among the States of the Union. Congress's response to the 2012 referendum, Congress responded to it by authorizing and allocating the funds for the first federally-sponsored status vote in Puerto Rico's history. I am not sure that that has been fully appreciated, but the enactment of this law is, again, one of the important steps to get this resolved. It is my hope that the government of Puerto Rico will use this funding to conduct a federally-sponsored vote.

A rejection of the current territory status by the voters of Puerto Rico leaves the Puerto Rico challenge with only two options: statehood under U.S. sovereignty or some form of separate national sovereignty. Once Puerto Rico does hold the vote, the Congress ought to respond in an appropriate fashion to implement the democratic desire of the U.S. citizens of Puerto Rico. So if you might, Mr. Marxuach, tell the committee a bit about how you see this question of political status, in effect, in suspended animation has harmed the economy of Puerto Rico.

Mr. MARXUACH. Certainly, it has harmed the economy of a Puerto Rico. I am going to leave the political——

Senator WYDEN. I asked you about the economy.

Mr. MARXUACH.—issue—yes. But economies are trained basically to deal with situations where they have to analyze and try to optimize a given event within certain restrictions. In the case of Puerto Rico, the restrictions have become overwhelming because precisely of this ambiguous status that we have that it is called Commonwealth.

You know, we are not a sovereign country. We are not a State of the Union. We have no authority to negotiate treaties, no access to emergency financing from multilateral institutions, no monetary policy instruments. We have limited fiscal policy tools, nominal representation in Congress, with all due deference to the commissioner here, and the U.S. Supreme Court has determined that it is constitutionally permissible to discriminate against Puerto Rico in the application of Federal programs as long as there exists a rational basis for doing so. So if you are trying to deal with an emergency or a crisis like the one we have now with no monetary tools, limited fiscal policy tools, and all these other political restrictions, it is almost an unsolvable problem.

So yes, there are certain things we can do in the short-term to alleviate this situation, but eventually, if you are going to think alleviating to longer-term, you have to solve the underlying issue, which obviously is status.

Senator WYDEN. Okay. I appreciate that point because I understand I missed some of the earlier discussion, and there was, as is the case in this committee, some fairly spirited debate. But what Mr. Marxuach has said—and I know it is not flashy and sensationalistic and will not drive this evening's headlines, but the underlying question which I feel strongly about and Mr. Marxuach just confirmed, the underlying question is resolving the issue of status. If you do not resolve that issue, you are on a glide path for a threat that this could happen again, and no one wants to see that.

I have to go back to the floor. I know one of the other witnesses wants to respond, I apologize for the discourtesy and perhaps——

Governor PADILLA. It is okay. I know you have a busy agenda.

Senator WYDEN. Why do you not just go ahead? Please, if you could——

Governor PADILLA. Very briefly.

Senator WYDEN. I apologize for——

Governor PADILLA. No, no, no, no. I appreciate your attention always to Puerto Rico, Senator. You are from Oregon, and we are glad that you are talking so much about us.

First, this is a crisis that we need to solve now, and I want to highlight that. Second, we can address the issue of status. We need to address the issue of status, but we will not argue that the Illinois fiscal problems are due to an issue of status, or New York or Detroit or Orange County. We may say that statehood is a problem for Illinois, but we will not argue that.

And I will urge the committee to take a look on the last report of Congress's request from the GAO, information on how statehood will potentially affect Puerto Rico.

Senator WYDEN. Let me do this if I might, because I will also be dealing with these issues, along with my colleague Senator Cantwell on the Finance Committee——

Governor PADILLA. I know.

Senator WYDEN.—and there are a whole host of measures that come up there as well. Clearly, action needs to be taken to deal with a number of the challenges right away. But what happens in American politics and in American government is people always say, oh, let us respond here in the next 36 hours and we will call it a day because we got it fixed. What Mr. Marxuach confirmed is essentially what I have been concerned about is that we could be back dealing with this again unless the issue of status is resolved. I look forward——

Governor PADILLA. Thank you.

Senator WYDEN.—to working with all of you.

Governor PADILLA. Thank you.

The CHAIRMAN. Thank you, Senator Wyden. I think your point is certainly well taken.

What we want to be able to do is not just address a short-term crisis. I think it is fair to say, whether it is a humanitarian crisis, as Mr. Weiss has used the terms, or financial crisis, fiscal crisis, we have a crisis. Several of the proposals I think that the Administration is proposing and I think that you, Governor Padilla, have put out on the table may deal with this in the short-term.

But I absolutely concur with what Senator Wyden has said. We do not want to be back here as a committee or as a Congress several years from now in the same situation. We need to be looking to a longer-term solution. As probably one of the few—maybe I am the only one, I will have to check on it—Members of the Senate at least that was born in a territory, I pay keen attention to the situation in Puerto Rico and on the issue of status.

Right now, what we are trying to do is figure out whether some of these short-term proposals are the fix that we need, and I think we have got a lot of work ahead of us.

I also want to agree with what Senator Warren raised and what was reinforced by Senator Hirono, that what we are talking about here are proposals that the Administration has now put before Congress, and I think we all recognize that Congress sometimes, even in the midst of a crisis, takes a long while to work its magic, if you can describe it as magic. So everything that the Administration can be doing within its tool box needs to be pursued and considered.

I do not know during the break, Mr. Weiss, if you had an opportunity to get a better handle on some of the numbers that I had asked you about in my questions, but I was able to get some information. Apparently, an energy analyst with the Height Securities report has provided a rough breakdown of the Administration's proposal. The EITC, is estimated to cost about $1.5 billion in annual payments; the child tax credit, about $850 million; the FMAP to the Federal average would be about $2.8 billion; and the ballpark that is estimated again—and I am just giving you what I picked up over a Blackberry in the past half an hour or so, is about $5 billion a year.

If, in fact, we are in this ballpark, you need to understand that it is going to take Congress a while to work through some of these proposals. Attempting to identify an offset is something that we need to know that the Administration is going to be willing to work with us on because that will be a part of the hang-up here.

That is a broad statement that leads to a response from you, Mr. Weiss, in terms of whether or not there are other administrative actions that you feel can be advanced at this point in time and if you feel that the proposal that you have laid out, that the Administration has laid out, is somewhere in the ballpark of what this Height Securities report has advanced.

Mr. WEISS. Thank you, Chairman Murkowski. And I would like to address the very fair comments made by Senators Hirono and Warren as well.

Let me assure this committee that Treasury and the broader Administration will apply all of its efforts and all of our creativity and all of our resources to the resolution of this financial crisis, just as we have in past crises, and we will leave no stone unturned. And so we recognize that the Administration has a role to play alongside Congress in crafting these proposals and in making sure that Puerto Rico sees through this crisis and gets back on the path to growth.

As to the costs of our proposals, I would like to highlight that bankruptcy involves no Federal funds. It costs nothing to the Federal Government. It is merely a means of bringing creditors to the table in order to achieve an orderly restructuring of liabilities.

As to healthcare and the EITC, let me emphasize that we have introduced these two as principles, not as detailed legislation, and we would look forward to working with you and your staff and other Members of Congress as to how to bring this to reality in a fiscally responsible way.

The CHAIRMAN. Okay.

Mr. WEISS. We understand that this is a fiscally constrained environment, but at the same time, I need to highlight 1.6 million American citizens in Puerto Rico out of the 3.5 million population depend on Medicaid, and it is the lack of Medicaid that is also prompting some of them to leave the island.

The CHAIRMAN. Understood. I do not mean to cut you off, but I am going to have to run to this vote because it is wrapping up also. I am also very cognizant of what this committee's jurisdiction is, and as important as the Medicaid piece is, I know that other committees are going to be looking to address that.

I wanted to ask a very quick question of Mr. Marxuach if I may because there has been a lot of discussion back and forth about the bondholders and gaining advantage and being paid 100 percent. Do you happen to have any idea what percent of the bondholders are actually Puerto Ricans? I have to imagine that they are not all outsiders who have no interest in what happens to Puerto Rico.

Mr. MARXUACH. You are right about that. The number seems to change every week, I guess, but the latest figure we have here it is between 25 and 30 percent of all outstanding bonded debt is held by either Puerto Rico institutions or Puerto Rico investors. However, I have no way of verifying that. You know, this is a number that has been put out by some investment banks. But I personally do not have—I mean I cannot vouch for the validity of that, but that is the number that has been put out.

Governor PADILLA. It is the same number that we have, Chairwoman.

The CHAIRMAN. Mr. Pierluisi?

Mr. PIERLUISI. And, Chairman, I would like to contribute. The best estimates that my office has obtained for the EITC, full application of EITC in Puerto Rico is roughly $500 million, so it is half a billion dollars, not this number that you quoted from some other source.

The CHAIRMAN. Well——

Mr. PIERLUISI. And child tax credit, full application of the child tax credit program, the number we have is roughly $150 million. And I agree with you, the challenge would be to identify an offset, but those are the best numbers I can provide you.

The CHAIRMAN. I think part of what we are dealing with today, the Governor released his proposal, last week the Administration released their proposal. This is all new. It is out there on the table. There is a lot of assessment, a lot of analysis. There are going to be a lot of numbers going back and forth.

This is why, at the end of the day, it really helps to understand what it is that we are dealing with, what are the true numbers, so whether it is what we have requested from the Governor and he has indicated we are going to see in the next couple weeks at least with the 2014 audited report, that is going to be important. It is going to be important that Treasury be able to rely on this. We need to have some keen understanding. I do not think that there is any disagreement that it is bad, but we also need to understand, again, if it is this bad, what are the costs that are associated——

Mr. MARXUACH. Madam Chairman——

The CHAIRMAN. Mr. Marxuach?

Mr. MARXUACH.—if I may, in my extended written remarks that I submitted to the committee, I did take the time to look at the audits we do have from 2013 all the way back to 1998 and calculate what is called the primary balance for Puerto Rico. What that means in non-technical terms is how much money you have left before paying interest on your debt. And it is clear that at least, you know, during that period between 1998 and 2013, Puerto Rico ran a primary deficit. That is, we had a deficit before even paying the interest on our debt.

So that essentially means that we are in a classic debt trap, what economists call a debt trap. You have to keep borrowing just to pay off the interest on outstanding debt. And when that game of financial musical chairs stops, you really cannot continue. And I think we have reached that point.

I do not have the numbers for 2014, but I did take the effort to, as I said, calculate this primary deficit for Puerto Rico and it is submitted in the longer statement that I presented to the committee.

The CHAIRMAN. We will all be looking at this, and it will not just be this committee, of course. It will be the other committees of jurisdiction: Judiciary and Finance.

Again, I apologize that we are not able to give more time to this. Obviously, as I was speaking with Senator Cantwell, we could have continued this hearing well into the afternoon to probe deeper into it.

But I appreciate all of you coming this morning and presenting the positions. We have much work to do. I think there is agreement that we must be working together to address the situation in Puerto Rico not only for the short-term, which is very precarious, but for the longer-term as well. There is so much material before the committee.

Thank you all, and we stand——

Mr. PIERLUISI. Thank you, Chairwoman.

The CHAIRMAN.—adjourned.

[Whereupon, at 12:06 p.m., the hearing was adjourned.]

APPENDIX MATERIAL SUBMITTED

U.S. Senate Committee on Energy and Natural Resources
October 22, 2015 Hearing: Puerto Rico's Economy, Debt and Options for Congress
Questions for the Record Submitted to Mr. Antonio Weiss

Questions from Ranking Member Maria Cantwell

Question 1: Would you please give the Committee more details on the consequences of Congressional inaction on legislation to stabilize Puerto Rico's financial conditions and ensure liquidity in the coming weeks. For example, I have heard reports of hospitals closing, and of electricity being cut off to critical facilities. Are these reports correct, and will there be risks to public safety in Puerto Rico in the coming months if Congress does not act?

Answer:

Deteriorating fiscal and economic conditions in Puerto Rico have increasingly complicated the delivery of core government services. Delays in health care reimbursements have forced many medical centers to close floors and eliminate specialized services, and, indeed, and at least one hospital shut down temporarily because of a failure to pay its bills.

I recently joined Secretary Lew for a visit to San Juan. While there, we toured Eleanor Roosevelt Elementary School, where recent budget cuts have left the school unable to repair crumbling infrastructure and provide children with adequate school supplies. We then toured the Centro Médico de Puerto Rico, the primary medical center in Puerto Rico, where funding cuts, a lack of specialists, medication rationing and an influx of patients from other hospitals that have reduced services have made it difficult to treat patients. In the afternoon, we walked through Paseo de Diego, once a busy commercial area that has seen more than 80 percent of businesses close, and spoke to local stakeholders who shared their views on how the crisis has forced them to reduce services and close their businesses.

Discussions at each stop focused on the real hardship already facing the residents of Puerto Rico as a result of this crisis, including escalating impacts on healthcare, legal and education services, and significant unemployment.

The Administration believes this situation has already harmed the health, safety, and welfare of the 3.5 million Americans living in Puerto Rico. There is an urgent need for congressional action to address this crisis.

In October, the Administration submitted a proposal to Congress that would establish an orderly process for Puerto Rico to restructure its debts, paired with independent fiscal oversight that respects Puerto Rico's self-governance. In addition, the Administration has proposed initiatives that improve health care policies and incentivize work to help solve Puerto Rico's longer-run challenges.

Puerto Rico can and will emerge from the current crisis and return to growth, but only bipartisan action from Congress can provide Puerto Rico with the comprehensive tools needed to accomplish this.

Question 2: Is assigning oversight responsibilities to the Comptroller General as proposed by Resident Commissioner Pierluisi an approach you are open to? Or, do you have alternative recommendations for ensuring that structural reforms are implemented and effective?

Answer:

The Administration has been clear that any legislation to address the crisis in Puerto Rico must provide a workable, comprehensive restructuring authority and appropriate oversight that respects Puerto Rico's self-governance. In addition to these urgent tools to bring order to the current crisis, the Administration's proposal released last year would also address the longer-term issues facing Puerto Rico, such as rewarding work and supporting growth through a locally-administered EITC and providing a long-term solution to Puerto Rico's historically inadequate Medicaid treatment.

Question 3: Some members have expressed a concern that extending the full coverage of Chapter 9 of the Bankruptcy Code to Puerto Rico would unfairly impact average Americans who have pensions that are invested in Puerto Rico bonds. However, it is my understanding that pension funds have not held Puerto Rico debt since it was downgraded below investment grade because pension funds are required to sell such low-rated debt.

> **Is that correct, or would extending Chapter 9 authority to Puerto Rico unfairly impact the pensions of average Americans?**

Answer:

Any legislative solution must include restructuring tools for Puerto Rico that are comprehensive and workable. The legislation must allow the Commonwealth to restructure all of its liabilities and enable an orderly resolution to Puerto Rico's worsening crisis. The restructuring regime should fairly balance the interests of Puerto Rico and all its creditors. It should also safeguard Puerto Rico's capacity to fund its public pensions and pay retiree benefits.

Monthly pension payments are the only source of steady income for many of the pension systems' 163,000 retirees. An additional 167,000 workers, who represent nearly 20 percent of Puerto Rico's workforce, are also counting on the pension systems for future retirement income.

For much of the past decade, while workers paid into the system, Puerto Rico failed to pay its annual required contributions. As a result of this underfunding, pension system assets will likely be depleted by 2019, where all future pension benefits will then need to be paid directly from the Commonwealth's General Fund. This will require an additional $700 million to $1 billion of outlays per year.

Question 4: Some Members have raised concerns that the Administration, and Treasury specifically, could be using additional tools to respond to the crisis in Puerto Rico that would not require Congress to act.

> **Would you describe the actions that Treasury has taken to date to assist Puerto Rico, beyond technical assistance, including any conversations with creditors regarding facilitating additional financing, acquisitions, or restructuring of Puerto Rico's debt?**

Answer:

Treasury has a dedicated team devoted to evaluating Puerto Rico's fiscal outlook more closely and sharing our expertise with the local officials. The team has visited Puerto Rico regularly to review its financial data and offer our perspectives on how other entities have managed through similar crises. We meet frequently with the Governor, members of Puerto Rico's legislature, and local business and labor leaders. We also remain in daily communication with the officials managing Puerto Rico's fiscal response.

The Administration remains committed to supporting Puerto Rico as its addresses its fiscal crisis and seeks to restore economic growth. However, Treasury has not identified any other administrative tools that it believes are sufficient to comprehensively address the crisis at hand. That is why Congressional action is essential to provide Puerto Rico with the tools it needs to manage through this crisis and restore growth.

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Questions from Ranking Member Maria Cantwell

Question 1: Would you please give the Committee more details on the consequences of Congressional inaction on legislation to stabilize Puerto Rico's financial conditions and ensure liquidity in the coming weeks. For example, I have heard reports of hospitals closing, and of electricity being cut off to critical facilities. Are these reports correct, and will there be risks to public safety in Puerto Rico in the coming months if Congress does not act?

These reports are correct. Puerto Rico's insolvency is impacting essential public services on the island: suppliers are demanding that hospitals pay for medicine and other materials upon delivery; power at the Santa Rosa Hospital was temporarily suspended on because of past due utility bills; Puerto Rico's largest children's hospital has been forced to close down two wings and 40 rooms and reduce employees' hours and pay. Health services will continue to be under threat without a comprehensive restructuring authority that protects Puerto Rico from a disorderly default.

Question 2: Is assigning oversight responsibilities to the Comptroller General similar to those assigned during the District of Columbia's financial crisis an approach you are open to? Or, do you have alternative recommendations for ensuring that structural reforms are implemented and effective?

[Per email from Mr. Stayman dated May 19, 2016, the Committee requested that this question be dropped.]

Question 3: What can the Federal government do to encourage PREPA's interest in and commitment to the adoption of new technologies, modernizing its equipment and making its operations more efficient?

The first step is providing a bankruptcy regime that provides an orderly process to restructure PREPA's unsustainable debt burden. Once PREPA's balance sheet is restructured, credit support from the U.S. Government – e.g. Department of Energy 1703 Program and/or USDA Rural Utilities Service program – will be needed for PREPA to modernize its geriatric and fuel oil dependent infrastructure.

Question 4: In 2011, the President's Task Force on Puerto Rico's Status found that "the calculation of Puerto Rico's GDP does not currently follow standards used for GDP for the rest of the United States," and that, "the current methodology has made it difficult to engage in short- and long-term economic planning that is critical for the Puerto Rican economy." The Task Force recommended that Puerto Rico Department of Economic Development and Commerce work with the U.S. Department of Commerce, Bureau of Economic Analysis (BEA), to update their statistical methods and develop their ability to produce accurate GDP data.

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Would you please provide an update of these joint efforts and an estimate of when Puerto Rico expects to issue GDP figures based on statistical methods used by BEA and the rest of the U.S.?

In September 2015, the Puerto Rico Planning Board ("PRPB") and the Puerto Rico Institute of Statistics ("PRIS") published the Road Map for the Modernization of Puerto Rico's National Accounting, a plan that describes a series of methodological milestones to implement the recommendations of the Task Force. At that time, the PRIS and the PRPB also initiated conversations with the BEA to secure technical assistance in order to execute the Road Map.

Over the past few months, the PRIS and the PRPB have worked to implement the 2016 milestones. In April, a high-level delegation from the BEA visited the Commonwealth to provide trainings on modern national accounting processes to the employees of the PRPB. As a result, the PRIS and the PRPB have taken stock of methodological improvements within the Commonwealth's reach.

The Road Map also calls for the gradual implementation of several additional methodological changes needed to ensure Puerto Rico GDP statistics comply with current international guidelines, including: (i) the 2008 System of National Accounts of the United Nations adopted by the BEA for U.S. GDP statistics; (ii) reorganize Puerto Rico's current 5 national accounts into 7 accounts; (iii) develop a new forecasting model for Puerto Rico's national accounts; and (iv) publish full-set of quarterly national accounting statistics that is consistent with annual estimates. The PRPB and the PRIS have estimated that implementing the Road Map requires a $3 million annual investment over a 5-year period. The Commonwealth's Fiscal and Economic Growth Plan incorporated those costs as part of its financial projections and investments necessary to improve fiscal decision-making.

As you know, Puerto Rico's exclusion from critical national datasets negatively impacts the quality and availability of statistical data about Puerto Rico. Congress should provide appropriate funding to include Puerto Rico in the 2017 U.S. Census of Governments, the National Agricultural Statistical Service surveys, and the Current Population Survey. Also, OMB and other appropriate federal agencies should conduct a comprehensive federal review of Puerto Rico's exclusion from other critical national datasets, such as the Job Opening Labor Turnover Survey, the American Time Use Survey, and the National Health Interview Survey.

Question 5: Several reports have identified the poor quality and transparency of Puerto Rico financial information as a contributing factor in the current crisis. In fact, one report I received is that the majority of Puerto Rico's 84 agencies do not regularly report their basic financial information such as revenues, expenditures, and deficits to the local Office of Management and Budget. Please describe the current state of agency reporting requirements including significant problems with the quality and timeliness of the information they provide?

What is the government's plan to improve the quality and transparency of financial data and what barriers exist to the full implementation of that plan?

The Puerto Rico Office of Management and Budget ("PR-OMB") has direct access to the financial information of the agencies that receive appropriations from the general fund. These transactions are recorded in the Puerto Rico Integrated Financial Accounting System (PRIFAS). However, five departments—including education and health, which account for a considerable part of the Commonwealth's general fund disbursements—use a different version of the accounting system. This arrangement delays the recording of their transactions in PRIFAS, mostly due to interface problems between the different versions of the accounting systems.

The delays in obtaining the necessary information to PRIFAS affects the decision-making process for policy stakeholders. PR-OMB and the Puerto Rico Department of Treasury are in the process of developing a single accounting system for all agencies. The new system will monitor expenditures on an integrated, timely and efficient manner.

Question 6: The Krueger report recommended increasing the income tax rate for Controlled Foreign Corporations (CFCs) from 0 to 4 percent, up to 10 to 15 percent. The report estimated that this change would raise about $1 billion a year. However, the "Fiscal and Economic Growth Plan" does not include implementation of this recommendation.

Why was this recommendation not adopted?

Increasing the income tax for CFCs up to 10 to 15 percent would have an adverse effect on our capacity to attract investment and retain our industrial base. Although such an increase might boost revenues in the short term, these increases would be offset by larger and long-term declines in revenue as CFCs ship their operations and jobs overseas.

For 2014, would you please provide a list of the major CFCs and for each: the approximate number of full-time employees these companies have in PR; their declared profits; and what they paid in corporate income taxes to Puerto Rico in FY 2014?

Enclosed is a list of major CFCs in Puerto Rico that includes their respective full-time employees. We are unable to provide declared profits and corporate tax payments for individual entities as such information is confidential under Puerto Rico law. Also enclosed, however, is a table that lists the amount of Act 154 companies as well as their total tax remittances for FYs 2011-14.

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Question 7: The Government of Puerto Rico has a program, under Act 22, to attract mainland investors to Puerto Rico through low tax rates. For example, one incentive is an exemption from the territorial tax on capital gains which was raised for long-term residents from 10 to 15 percent. I understand that the Government hired KPMG to make recommendations for reforms to Puerto Rico's tax system and that one of those recommendations was a repeal of this tax exemption. However, that recommendation was not adopted.

Why was this recommendation not adopted?

As explained in the enclosed "Commonwealth of Puerto Rico Tax Reform Assessment Project dated October 31, 2014 (the "KPMG Report"), KMPG was tasked with preparing a holistic assessment of the Puerto Rican tax system. The Commonwealth commissioned the report in order to generate additional revenues and rationalize its tax system. KPMG developed alternative scenarios to create a simplified tax system that would provide additional revenues through a more streamlined and effective system. KPMG recommended that most existing tax expenditures be repealed or modified. The recommendations made by KPMG included lowering the individual income tax rate while making it applicable to a broader base, which would be offset by a 16% value added tax. The report included other recommendations that where not adopted, such as repealing preferential rates for capital income and the alternative minimum tax.

With regards to Act 22, the KPMG Report failed to consider that the statute is a key element of the Commonwealth's economic development strategy. Continued outmigration coupled with the fiscal and economic crises have forced the Commonwealth to find new ways of attracting capital and diversifying its economy. Act 22 is part of a broader effort to transition into a knowledge services economy. And the Act has been essential in attracting capital to the island at a time of large deleveraging by the local banks and lack of access to the financial markets by the government.

Based on the KPMG Report a proposed tax reform was introduced in the Legislative Assembly. The legislative process resulted in Act 72-2015, which was mainly intended to stabilize the Commonwealth's short-term liquidity needs and did not include a comprehensive tax reform. A broad tax reform that focuses on taxing consumption and incentivizes labor participation by rewarding work will be a critical part to the island's recovery.

What are the government's estimates of the financial benefits to the insular economy of this program, and of the additional revenue that would be generated if these individuals paid the same capital gains tax rate, 15 percent, that is paid by longer-term residents?

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Most investment activities that would be subject to the 15% capital gains tax would not have been carried out in Puerto Rico without the incentives of Act 22.[1] The Department of Economic Development and Commerce published the enclosed "Act 20 & 22 Economic Impact Study" dated December 18, 2015 (the "DDEC Report"), which provides an overview of Acts 20 and 22. The DDEC Report concludes that Act 22 has attracted more than $150 million in residential real estate and $650 million in commercial properties investments and $100 million in deposit inflows to Puerto Rico's banking system. Moreover, the DDEC Report estimates that activities related to Act 22 have generated 2,483 direct jobs and 2,731 indirect and induced jobs.

Question 8: The Government also has a program, under Law 20, to attract service providers from the States to Puerto Rico with tax exemptions and rate reductions with a corporate tax rate of 1-4 percent. I understand the local corporate tax rate has been raised from 30 to 39 percent.

Please provide:

1. The number of companies that participate in this program
   - 360 companies as of December 2015.

2. The total amount of revenue they provided in 2014
   - $896 million in gross income.

3. The estimated number of direct jobs they have created.
   - 3,349 direct jobs.

Act 20 is the backbone of our plan to convert Puerto Rico into a knowledge services hub. It was enacted to encourage the export of local services and promote the development of new businesses in Puerto Rico by attracting foreign capital. Act 20 also complements our strength as a high quality manufacturing location by attracting high-value, knowledge-based industries by leveraging our position as a low-cost, high-skilled jurisdiction.

When it was enacted in 2012 the economy had been contracting for over six years, the number of jobs los exceeded 125,000 and the prospects for a quick turnaround were minimal. Act 20 was modeled after Act 73-2008 and its predecessor industrial incentives laws that helped Puerto Rico become a manufacturing powerhouse. In fact, export services activities covered by Act 20 were eligible for incentives under Act 73 from 2008 through 2012. During said period, the Commonwealth issued around 85 tax exemption decrees to companies providing services to foreign markets.

[1] Also note that individuals covered by a an Act 22 tax decree generate revenues by paying Puerto Rico income tax on active income (salaries and wages) and other taxes such as sales and use and excise taxes.

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Over 500 Act 20 applications have been received for the establishment of new export services operations in Puerto Rico, including the following industries: business process outsourcing, IT services, financial services, advertising and public relations services, engineering and architectural services, and research and development services. This has had a direct impact in the commercial real estate sector, the creation of direct and indirect jobs in the services industry, and the value of intangibles brought and developed in the island. Act 20 has attracted global companies like Infosys and Honeywell as well as helped local businesses export to foreign markets.

> I understand that KPMG recommended reforms to the Law 20 program. Would you briefly describe those recommendations and what action was taken on them?

> [Please see answer to Question 7 above.]

Question 9: Puerto Rico's constitution provides that payments on bonds are guaranteed by the government and will be made from any available revenue before any other expenditure of the government. The Governor has said that the government's debts are "unpayable".

> Would you clarify whether the Governor is saying that these constitutionally guaranteed bonds will not be paid?

According to Article VI, Section 8 of the Commonwealth's Constitution, the general obligation (GO) debt is afforded priority over other debt of the Commonwealth central government. Debt issued by other entities in Puerto Rico may or may not be impacted by this priority provision because such debt may be supported by other sources of revenue besides the central government. It should be noted that each provision of the Commonwealth's Constitution, like the U.S. Constitution, is subject in all cases to the right and obligation of the government to exercise its constitutional powers in order to defend and protect the security, health, education and welfare of the residents of Puerto Rico. In the event Puerto Rico's economic situation continues to worsens, it is unlikely that the Commonwealth will be able to honor all of its obligations as they become due—including debt service payments for GO bonded debt. As such, the responsibility of the Commonwealth to carry out this obligation will be given preference over even GO debt obligations.

> What amount of the $72 billion in debt is covered by the constitutional guarantee?

> Approximately $17 billion of bonded debt is GO or Commonwealth guaranteed.

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Enclosures

Commonwealth of Puerto Rico
Tax Reform Assessment Project

Unified Tax Code of Puerto Rico:

Tax Policy Implementation Options

General Explanation of Principal Options

October 31, 2014

Table of Contents

KPMG's role is limited to the services and deliverables articulated in the Contract for Professional Services dated March 18, 2014 as subsequently amended (the "Engagement Contract"). It is understood that any actions taken by the Government of the Commonwealth of Puerto Rico related to these services and deliverables may involve numerous factors that are outside of the Contract's scope. KPMG's services and deliverables cannot take such factors into account and, therefore, recommendations for such actions are not implied and should not be inferred from these services and deliverables. Further, while such deliverables may include analyses of certain legislative initiatives, no service described in the Engagement Contract and/or subsequent amendments will involve advising the Department regarding lobbying or other public policy advocacy activities related to legislation or regulation, including evaluating the likelihood of enactment of any proposed initiative or providing advice to the Department as to methodologies to ensure enactment. KPMG cannot undertake any role in connection with the Contract services that could be deemed lobbying, public policy advocacy, or impair the independence of KPMG as an auditor for the Department of the Treasury such as drafting legislation and engaging in implementation assistance.

2. General Explanation of Principal Options

Overview

This document addresses principal options with respect to changes to the existing consumption (sales and excise) taxes, individual income tax, business taxation, property tax and penalties. The discussion of the first three topics is organized as follows: Current Law; Reasons for Change; Description of Options; Analysis; and Revenue Effect. The latter two topics are discussed more summarily. The "Description of Options" section for each tax generally sets forth a single option. In each case there are many other options that could be considered to achieve different revenue, distributional or economic goals. In general, those alternatives are discussed and quantified in the "Revenue Effect" section relating to each tax.

2.1 Revise Consumption Tax to Provide a Goods and Services Tax (GST)

2.1.1 Current Law

A 6% sales tax is levied on every sale of a taxable item in Puerto Rico.[1] Further, a use tax is levied, at the same rate, on the use, storage, or consumption of a taxable item in Puerto Rico (collectively, the "IVU").[2]

The 78 municipalities also levy sales and use tax at the rate of 1% on the same tax base and with the same limitations – effectively bringing the sales and use tax rate to 7%.[3] The municipalities also have the right to levy the tax on food.

The sales tax is levied on all tangible personal property other than:

- Money;
- Certain vehicles and vessels;
- Certain petroleum products; and
- Electricity and water. [4]

The tax also is levied on all services and admission fees other than:

- Services rendered to a person in business (with the exception of certain defined services including bank charges, cleaning and laundry services, certain leasing of motor vehicles, telecommunication services, waste pickup services, security services, and certain repair and maintenance services);
- Services provided by the Government of Puerto Rico;
- Defined professional services and certain tax return services;
- Educational services;
- Certain financial services (including insurance services);

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1 PRIRC § 4020.01.

2 PRIRC § 4020.02.

3 PRIRC § 6080.14.

4 PRIRC § 4010.01(gg).

- Healthcare services; and
- Services rendered by businesses with a turnover of less than US$50,000. [5]

There are a number of sales and use tax exemptions, which can be based on:

- The nature of the good or service being supplied; or
- The person by whom, or to whom, the good or service is being supplied. [6]

Key exemptions based on the nature of the good or services being supplied include:

- Taxable items sold for use or consumption outside of Puerto Rico;
- Taxable items introduced to Puerto Rico for a temporary period;
- Promotional material;
- Admission to school athletic events;
- Food and prescription drugs;
- Equipment for the disabled;
- Leasing of real property;
- Child care and elderly care services;
- Funeral services;
- Solar electric equipment;
- Certain healthcare equipment;
- Uniforms, materials and textbooks; and
- Items introduced into Puerto Rico as a result of transfer of a residence.

Key exemptions based on the person by whom, or to whom, the good or service is being supplied include:

- Manufacturing plants on the purchase or raw material or equipment;
- Government agencies on the purchase of taxable items;
- Sales made by churches; and
- Certain sales made by manufacturers or wholesalers.

A merchant may be relieved of the requirement to withhold tax on sales to merchants holding an Eligible Reseller Certificate.[7]

A manufacturing plant or eligible reseller may request an Exemption Certificate or an Eligible Reseller Certificate exempting it from the payment of the sales and use tax in respect of the purchase of items for sales to persons who may acquire the goods exempt from tax for sale as a non-taxable items, where the manufacturing plant or eligible reseller makes 80% of their sales to such persons.[8]

Any merchant who acquires goods for resale may request a Reseller Certificate, which will identify the reseller as able to claim a credit. A registered merchant holding a Reseller Certificate

[5] PRIRC § 4010.01(nn).

[6] PRIRC § 4030.01 to PRIRC § 4030.21.

[7] PRIRC § 4020.07(d).

[8] PRIRC § 4030.02.

can claim a credit for sales tax paid on purchases of taxable items for resale.[9] This credit is limited to 75% of the tax liability reflected in the return. The Secretary has the authority to prescribe by regulation an increase or decrease in the percentage of credit that may be claimed.

Where a credit exceeds the tax payable in a particular month, the credit may be carried forward until used in full. If the merchant can demonstrate that, due to the nature of the merchant's business, the credit will never be used, the Secretary may authorize a refund of the accumulated credits.

Various other credits are available for items such as bad debts, merchandise returns, and purchases of products manufactured in Puerto Rico.

Merchants are required to file monthly sales and use tax returns and make payments by the twentieth of the month following the month in which the transactions occurred. Further, Use Tax Returns on Importations are required to be filed by the tenth of the month following the month in which the importation took place.[10]

Merchants are required to file a single state return by entity. However, merchants are also required to file separate municipality returns by location.

2.1.2 Reasons for Change

Sales and use taxes constituted 7.1% of internal tax revenues in Puerto Rico. Excise taxes constituted 11.9% of internal tax revenues. In comparison, globally, all consumption taxes (including excise taxes) account for almost 31% of revenue collected by OECD governments.[11] GST type taxes typically account for 20% of total revenue. This indicates that Puerto Rico's current consumption tax regime taxes a narrower base than the global benchmark and that the tax system is more reliant on income and corporate taxes. Moreover, there are inefficiencies within the system that result in unrealized revenue and there is evidence of a large underground economy in Puerto Rico with sales tax evasion affecting all aspects of society.

This evasion appears to be driven, in part, by the complexity of the current IVU and, in part, by the impression that the cost of compliance is greater than cost of evading, particularly due to reporting obligations in multiple municipalities. Further, the decentralized administration of the tax hampers decision making and gives rise to differences in interpretation of the tax base.

The current sales and use tax base is relatively broad. Nonetheless, currently excluded goods and services and exemptions increase the complexity of the tax regime and cost of administration by raising inevitable issues associated with determining whether a particular good or service is exempt. The exclusions and exemptions narrow the base of the consumption tax, foregoing revenue and creating the potential for distortion of economic decisions based on the operation of the tax.

The existing system often taxes business inputs even though the acquired goods are for business purposes. The inappropriate taxation of business inputs may result in the distortion of production decisions. The cascading of the tax through the supply chain increases the effective tax rate on consumers.

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[9] PRIRC § 4050.04.

[10] PRIRC § 4041.02 and PRIRC § 4042.03.

[11] OECD (2012), *Consumption Tax Trends 2012: VAT/GST and Excise Rates, Trends and Administrative Issues*, OECD Publishing, p. 11.

A credit system for goods acquired for resale requires the carrying forward of credits, which can create cashflow burdens. Further, the discretionary power in the Secretary to refund tax where merchants can demonstrate they will be in a regular refund position creates uncertainty.

The existing system is overly burdensome for taxpayers. It is estimated that the sales tax compliance rate is in the neighborhood of 56%, an obviously unacceptable number. While the elimination of the requirement to file sales and use tax returns by location rather than by entity has simplified the compliance process to a certain extent, the requirement to file separate municipality returns and use tax returns for imports imposes significant compliance costs. The inconsistency between the municipalities in the administration of the tax, combined with a lack of information sharing between the municipalities and Department of Treasury, hampers decision making and gives rise to differences in interpretation of legislation. For example, there are inconsistencies in determining the point in time a merchant is considered to have commenced trading – upon first sale, first payment of payroll, or upon laying the first stone of the establishment.

2.1.3 Descriptions of Options

The existing consumption tax structure could be replaced by a broad-based single rate Goods and Services Tax ("GST") with regressivity relief accomplished through direct transfer payments. Financial services, residential housing, water and electricity would be exempt. Certain goods and services subject to excise tax could also be exempt. (See excise tax discussion below.) Businesses below a certain level of receipts, for example $75,000, would not be required to register. Regressivity relief would be calculated to assure that households below a specified income level would not incur any additional tax burden under the new system. All consumption taxes would be collected and administered at the Commonwealth level and proceeds distributed to the municipalities from a dedicated fund pursuant to a revenue sharing formula

2.1.4 Analysis

GST, also known as Value Added Tax ("VAT"), is recognized as the most efficient consumption tax both in terms of revenue for governments and neutrality towards domestic and international trade. It is the most common consumption tax utilized today. Over 150 countries and 33 of the 34 OECD countries have implemented some form of GST.[12] Its recognized capacity to raise revenue in a neutral and transparent manner has contributed to its virtually universal adoption.

A broad based GST with a single rate minimizes compliance cost and, from an economic perspective, is the best policy choice.[13] From an efficiency perspective, a moderate GST rate with a broad base and few exemptions is preferable to a higher rate with exemptions.

The move to a GST would lead to enhanced compliance and revenue when compared to current law. The tax rate would be a function both of revenue needs and the desirability of using consumption tax revenues to reduce the tax burden in other areas, particularly the individual income tax, or to replace revenues lost through repeal of existing provisions, such as the Patente Nacional.

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[12] OECD (2012), *Consumption Tax Trends 2012: VAT/GST and Excise Rates, Trends and Administrative Issues*, OECD Publishing, p. 28.

[13] OECD (2012), *Consumption Tax Trends 2012: VAT/GST and Excise Rates, Trends and Administrative Issues*, OECD Publishing, p. 73.

The key features of the GST system would be:

- A single rate;
- GST on goods and services and on importation;
- GST relief for exported goods and services;
- Limited exemptions (i.e., financial services, residential accommodation, water, electricity and perhaps certain goods and services subject to excise tax));
- Low compliance costs for businesses and government;
- Neutrality between businesses; and
- Transparency in respect of its administration.

GST has a significant number of benefits over single stage consumption taxes. GST is charged at each leg of the supply chain, with a credit provided where the item has been purchased for business purposes, until the item is purchased by the final consumer who bears the ultimate burden of the tax. As GST is collected at various stages along the supply chain, rather than at a single stage, it is a more robust tax when it comes to revenue protection. This permits a lower rate, which in turn reduces the incentive for evasion.

Further, a GST is a relatively self-enforcing tax. A GST has formal invoicing requirements. In the absence of a valid invoice, a purchaser is unable to claim a tax credit. This creates an incentive for a purchaser to request an invoice. These invoices create an auditable paper trail. Also, due to the invoice-credit nature of the tax, transactions should appear on both the supplier's and the purchaser's tax returns, therefore providing better opportunities to detect evasion. Further, the tax authorities have a record of a taxpayer's purchases through the credit mechanism. This enables tax authorities to estimate what a reasonable level of sales should be. This is particularly useful at the retail level where there may not be a purchaser claiming a credit that would allow the matching of transactions.

Finally, GST is more conducive to growth than direct taxes because it is a business neutral tax that does not distort economic choices.[14] By definition, a GST exempts from taxation the normal rate of return on an investment, thus eliminating the "tax wedge" in investment decisions. A broad based GST applied at a single rate is economically efficient because it does not distort consumer spending and saving choices or the allocation of capital. In addition, because exports are not taxed, but imports are, a GST system does not discriminate between foreign and domestic products.

2.1.4.1 Exemptions

This topic is discussed in detail in Appendix E.

Exemptions increase the cost of collection (administration costs for the government and compliance costs for businesses). There are frequent disputes over which goods and services are included in the tax base. Exemptions also create political pressure for other businesses/industries requesting exemption.

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[14] Asa Johansson, Christopher Heady, Jens Arnold, Bert Brys, and Laura Vartia, "Tax and Economic Growth," OECD Economics Department Working Paper No. 620, pp. 42-45, Jul. 11, 2008, ECO/WKP (2008)28, p. 18.

Exemptions may also affect business decisions. Under a GST, suppliers making exempt supplies cannot claim credits or refunds for GST paid on their purchases. This creates an incentive to self-supply or vertically integrate rather than incur GST charged by third party suppliers.

Finally, a business that makes both exempt and taxable supplies may need to make complex calculations to determine how much GST it has paid on its purchases related to taxable supplies and can therefore be claimed as a credit or refund.

Consequently, any exemptions that are adopted should be carefully considered from a policy perspective and what they are intended to achieve. Ebrill et al[15] state "Exemptions are abhorrent to both the logic and the function of a VAT" as they narrow the tax base, result in taxation of business inputs, distort business decisions and result in tax cascades.

The majority of the currently existing exemptions would be eliminated. Food, education, healthcare, water, electricity and items currently subject only to excise tax are likely to be the most sensitive areas from a political and public relations perspective.

Rather than providing exemptions for food, education, and healthcare, regressivity issues related to the GST should be addressed by cash transfer payments to a defined class of taxpayers to eliminate the tax burden associated with the purchase of these necessities. Exemptions relieve all purchasers from the burden of the tax and therefore can be costly from a revenue perspective. Indeed, uniform application of the tax across all income levels should provide sufficient revenue to finance regressivity relief to the lowest income levels.

New Zealand is a good example. The evidence available at the time of introduction suggested that while the bottom 20% of households allocated between 23% and 29% of their budgets to food, the top two deciles spent between 7% and 10% of their budgets on food. However, overall, upper income households spent twice as much as low-income households. Of every NZ$100 spent on food in New Zealand, the least well off spent NZ$6.50, whereas the most wealthy spent NZ$12. Thus, taxing all food made revenue available to redistribute and supplement the income of the poor. [16]

Some jurisdictions exempt healthcare and education to ensure there is no competitive distortion between education or healthcare provided by the public and private sectors. While such exemptions can effectively result in subsidizing those sectors, they create significant administrative difficulties in determining which goods or services should fall within the exemption.

The treatment of water and electricity is a special case in Puerto Rico. The pre-tax cost of both of these commodities is already extremely high and subjecting them to an additional GST tax would impose unacceptable additional costs on consumers. As both are supplied by government authorities and are not in competition with the private sector, the exemption of these types of supplies is manageable.

Similarly, there are a number of goods and services that are currently subject to excise taxes but not IVU. The receipts from a number of those taxes are dedicated to particular uses and in four cases are pledged to secure revenue bonds. If the threshold decision is made to eliminate double taxation of these items the question arises as to whether that should occur by subjecting them to GST and reducing the excise tax or exempting them from GST and keeping the current excise

[15] Ebrill et al, *The Modern VAT*, International Monetary Fund, 2001.
[16] Ian Dickson and David White, *Tax Design Insights from the New Zealand Goods and Services Tax Model*, Working Paper Series, Work Paper No. 60, Victoria University of Wellington, Apr. 2008, p 6.

tax. In the case of excise taxes that are pledged to secure revenue bonds the least burdensome alternative could be to exempt those goods and services from excise tax.

2.1.4.2 Regressivity Relief

The practical and political key to acceptance of a broad based GST is the provision of adequate relief from the regressive nature of the tax. "Adequate" is not a self-defining term. The appropriate level of relief is a policy decision that is informed by a desired distribution of the tax burden. But no matter the ultimate outcome, it is generally agreed that certain levels of household income (a policy decision determined by elected officials) should not bear tax on their purchase of necessities (also a policy decision determined by elected officials).

As an empirical matter, to the extent data exist by household income levels on consumption of specific items (such as food, housing, medicine, education), it is possible to mitigate the consumption tax burden rather precisely by a cash payment to the taxpayer. The cash payment can either be a payment based on taxes paid on actual amounts spent by the taxpayer or can be calculated in bands using average consumption by income level. The distribution goals can be attained by adjusting the payment to those households. Using a precise calculation requires an extensive system to monitor (both from a technology and manual operational perspective).

The question then arises as to how the relief is to be delivered and what systems exist to ensure that it is being delivered only to those entitled to receive it. The delivery system can be accomplished using one or some combination of the following:

- Direct disbursement to households;
- Tax Credits; and
- Electronic Benefit Transfer System.

2.1.4.2.1 Direct Disbursement to Households

Historically, payments have been in the form of checks or warrants. This system is more expensive than other options. The distribution of checks requires a mailing address which is problematic for some people in the lower socioeconomic strata. If a mailing address is not practical, it requires the taxpayer to physically go to a government location to obtain the check. Furthermore, the lower socioeconomic strata tend to be disproportionately underserved by the banking system, which results in high fees paid to check cashing establishments. Thus this disbursement option tends to be costly to administer, inconvenient to the taxpayer and may provide a lower net benefit to the taxpayer.

2.1.4.2.2 Tax Credits

A second option to deliver the regressivity payments is to provide a tax credit. This can be done either by using the income tax system or at point of sale for sales taxes. Using the income tax as a basis for the payments is generally done on an annual basis. The delay in relief for most recipients would require them to pay the tax and wait for up to a year for reimbursement. The same delay would occur if the credit were refundable. Thus, this method would not provide timely relief. While this option could be cost efficient for the Commonwealth, it will be counterproductive for the intended purpose of the regressivity payment system.

2.1.4.2.3 Electronic Benefit Transfer System

Recently, payments have migrated to an electronic funds transfer. In the case of government disbursements, payroll and other disbursements are increasing done via ACH payments or direct deposit. In the case of benefit payments, the disbursements are increasing using an Electronic Benefit Transfer system or EBT Card. The EBT cards are less costly to administer (prepare, distribute and account for), provide timely benefits through online management and provide increased ability to track, control and potentially monitor usage. An electronic benefit system can also increase and standardize customer service by reducing the taxpayers need to interact with the limited operating hours of government operations in a finite number of locations. The EBT Cards and potential increased customer service hours assist the taxpayers by limiting the interference with their workplace requirements.

2.1.4.2.4 Puerto Rico's Electronic Benefit Transfer System

The above analysis indicates that the best option for the regressivity payment system is an electronic benefit system. The Puerto Rico Department of the Family currently administers an EBT system to issue health, human and social cash benefits to eligible participants via a magnetically encoded payment card. Key programs included in the EBT system are: Nutritional Assistance Program (NAP), Temporary Assistance for Needy Families (TANF), child support and child welfare payments, and other human and social programs. A recipient may have one EBT card, with multiple benefit types, or accounts, associated to an EBT card depending on program type and eligibility.

Eligible recipients use their EBT card to make purchases at approximately 6,000 certified participating retailers in Puerto Rico. Cash benefits may be used to purchase items at a participating retailer, as well as to obtain cash-back or make a cash withdrawal from a participating ATM machine.

Once eligibility and level of benefits are determined, information is transferred to the Commonwealth's EBT contractor and an account is established in the recipient's name, and benefits are deposited electronically in the account on a specified frequency each month. A debit card, similar to a bank issued debit or credit card, is issued and a personal identification number (PIN) is assigned or chosen by the recipient to give access to the account.

The Puerto Rico NAP program provides for up to 25% of the benefits in cash that can be legally spent at any retailer and the remaining benefits must be spent for the purchase of food in certified retailers. Puerto Rico has approximately 670,000 families (approximately 1,300,000 recipients) receiving benefits totaling approximately $133,000,000 in monthly benefits in EBT card payments. The two primary EBT cards in Puerto Rico are the Family Card (NAP and TANF accounts) and the Unica Card (child support and other programs). Each health and social program has a unique account on the EBT card. A recipient eligible for more than one program may have multiple program accounts on the same EBT card. Programs may have different allowable costs, program requirements or compliance accordingly to federal and/or local laws.

The Department of the Family contracts with the Government Development Bank (GDB) and EVERTEK to administer the EBT system. The GDB is responsible for batch processing, account settlements and reconciliations, reporting, a 24 hour-7 day a week customer service help desk for beneficiaries (assistance from EVERTEK) and maintains a web-portal with account information for beneficiaries. EVERTEK is the ATM provider and handles the electronic transfers for individual accounts on the EBT cards.

Hacienda is positioned to deliver regressivity relief by leveraging the existing contracts and Memorandums of Understanding (MOUs) with the GDB and EVERTEK. Regressivity relief is an extension of existing government assistance programs. The GDB began conducting a financial analysis of the cost to issue payments via check, ACH and electronic benefits. There may be cost efficiencies through the creation of a government card, which could include regressivity relief payments as well as tax refunds, if applicable.

States such as Georgia, Oklahoma, South Carolina, New York and Connecticut have implemented an electronic benefit system for government payments, including tax refunds.

2.1.4.2.5 Regressivity Relief Payments Leveraging an EBT System through Enterprise Architecture

Because of the scale and scope of the project, Hacienda should undertake a robust Enterprise Architecture project. The Enterprise Architecture will enable Hacienda to expand the current EBT system to fit the specific requirements, benefits and outcomes for regressivity relief payments to eligible participants. Enterprise Architecture helps reduce and manage the complexities of a transformational project that will link the tax administration business processes and organizational alignment with information technology system requirements and security to effectively and efficiently deploy a regressivity relief electronic benefit system.

There are four key reference models in the KPMG Enterprise Reference Architecture (KERA) to address the architectural domains at a strategic level:

1. **Capability Model** – The Capability Model is the business and application domain reference model which provides the foundation for Hacienda stakeholders to gain understanding of the business-centric view of the organization, goals and processes. Also the Capability Model facilitates prioritization of business or system capabilities specific to initiatives and prioritized scope for transformations
2. **Software Services Model** – The Software Services Model is the application domain reference model that provides a set of software functions to be aligned with models in other architecture domains. Also, it assists in determining the functional scope of information systems needed for identifying the current EBT system software, legacy system gap assessment, application portfolio rationalization assessment and potential vendor software fit-gap assessment
3. **Conceptual Data Model** – The Conceptual Data Model is the data domain model that describes the data to be shared by business processes (across departments, agencies or other entities) and facilitates the semantic interoperability requirements between organizations and supporting IT system
4. **Deployment Model** – The Deployment Model is the technology and security domain reference model that outlines the software, security zones, components and services

2.1.4.2.6 KERA Toolkit

KERA has been applied and deployed successfully on engagements to accelerate the planning, design and delivery of a transformation initiative. The KERA toolkit focuses on mitigating potential challenges using four elements:

- **Scoring** – Scoring focuses on client specific assessments. Tasks include reviewing high-level functional requirements (as outlined in a tax administration deliverable), IT fit-gap (legacy IT and other Department solutions) and an application portfolio rationalization.

- **Modeling** – Modeling focuses on the client specific blueprints. Tasks include reviewing targeting operating models (as outlined in tax administration deliverables), business and systems architecture, elaborating business and system requirements.
- **Prioritizing** – Prioritizing focuses on client specific roadmaps. Tasks include reviewing client strategic plans, prioritized list of business and technology requirements and associated business cases.
- **Costing** – Costing focuses on client specific transformation estimates. Tasks include initial scoping estimates and release specific funding estimates.

Benefits

Implementing KERA allows Hacienda to take one step closer to fulfilling the goals of Tax Reform: designing a more equitable tax system for all Puerto Ricans. Additionally, the Treasury will be equipped with a state of the art delivery system that includes:

- Integrated set of reusable tools, reference models and methods and courseware to support the design, planning, budgeting and implementation of a large tax design transformation
- Rigorous approach to the address complexities and challenges associated with IT-enabled transformations
- Business process mapping to prioritize requirements
- Leverages existing target operating model (TOM) elements within the Tax Administration work stream deliverables as a foundation for requirements
- Enables key stakeholders ability to provide emergency relief, if needed

Policy and Implementation Decisions:

Ultimately the rate and delivery vehicle for regressivity relief must be made by the Commonwealth's leadership. Decisions must be made regarding the regressivity payment frequency and whether the new system will be directly linked with existing EBT cards for alternate programs. Legal opinions regarding the ability to tax necessities will be required and potential support from other Federal agencies should be assessed. A policy decision concerning the extent or level of regressivity relief (income level and eligibility requirements) must be reached. Finally, eligibility and compliance monitoring systems must be created and implemented.

2.1.4.3 Non-taxation of Business Inputs

Under the current IVU business inputs are often taxed where goods are not acquired for resale.

A consumption tax should not tax business inputs or intermediate business transactions. The taxation of business inputs can result in the distortion of production decisions (potentially creating an incentive for vertical integration) and the cascading of the tax through the supply chain increasing the effective tax rate imposed on consumers.

From an operational perspective, the GST will be very similar to the current IVU with credits being provided for business acquisitions. The two key differences will be:

- A full credit will be given for all goods or services acquired for business purposes rather than only for goods acquired for resale or manufacturing; and
- Excess credits will be refunded rather than be carried forward.

A poor refund system can do significant harm to taxpayer acceptance of the tax and voluntary compliance. Failure to refund excess credits timely undermines the core principal of a GST – intermediate transactions between firms should not bear a GST cost.[17] It will also undermine the neutrality of the tax as business decisions will be influenced by the GST cash flow costs they may face. Therefore, it will be essential to ensure robust processes are in place to facilitate timely issuance of refunds.

2.1.4.4 Municipalities

The current structure with respect to municipalities is unnecessarily complex. However, the municipalities rely extensively on the revenue from this source. Consequently, any changes to the existing system have to accommodate that reality. One option is to centralize collection of the GST at the Commonwealth level and create a dedicated fund of some portion of the receipts to be distributed according to a pre-determined revenue sharing formula.

2.1.5 Revenue Effect

The revenue and distributional effects of a GST depend upon a number of principal factors: the tax base, tax rate, amount of regressivity relief and the compliance rate. The first set of tables below show the results of a 16% and 14% GST with exemptions for financial services, residential housing, water, electricity, fuel and hotel occupancy, appropriate regressivity relief, a small business registration level of $75,000 and a compliance rate of 75%. The second set of tables show the distributional effects of the two different tax rates.

GST ONLY, Exemptions on WATER, ELECTRICITY, FUEL, HOTEL OCCUPANCY		
Variable	14% GST, 75% Compliance	16% GST, 75% Compliance
Annual GST Collection	$5,860	$6,665
(Regressivity Relief)	($1,209)	($1,445)
(COFINA Payment): Per Treasury	($700)	($700)
(Loss of Revenue from IVU)	($1,150)	($1,150)
(Loss of Income Tax)	($121)	($125)
Annual Revenue Net of GE effects	$2,679	$3,246

[17] Ibid.

Distribution of GST Burden (14% GST)

Household Income	Households	Current IVU Liability	Share of Tax Weighted By Number of Households	Proposed 14% GST Liability (net of regressivity relief)	Share of Tax Weighted By Number of Households
Less than $21,800	681,339	$381	7.72%	$382	2.36%
Greater than $21,800, less than $33,000	233,080	$194	11.48%	$365	6.60%
Greater than $33,000, less than $50,000	215,568	$198	12.67%	$696	13.61%
Greater than $50,000, less than $69,500	116,015	$147	17.51%	$518	18.81%
Greater than $69,500, less than $84,200	45,579	$67	20.17%	$233	21.60%
Greater than $84,200	84,950	$188	30.44%	$746	37.02%
Total	1,376,531	$1,176	100.00%	$2,939	100.00%

Distribution of GST Burden (16% GST)

Household Income	Households	Current IVU Liability	Share of Tax Weighted By Number of Households	Proposed 16% GST Liability (net of regressivity relief)	Share of Tax Weighted By Number of Households
Less than $21,800	681,339	$381	7.72%	$382	2.09%
Greater than $21,800, less than $33,000	233,080	$194	11.48%	$398	6.37%
Greater than $33,000, less than $50,000	215,568	$198	12.67%	$791	13.68%
Greater than $50,000, less than $69,500	116,015	$147	17.51%	$589	18.92%
Greater than $69,500, less than $84,200	45,579	$67	20.17%	$266	21.72%
Greater than $84,200	84,950	$188	30.44%	$849	37.22%
Total	1,376,531	$1,176	100.00%	$3,275	100.00%

The final table shows the revenue effect of exempting food, medicine, medical services and education from the GST base.

Category to Exempt from GST Base	Total GST Collection at 14%	Revenue Loss at 14%	Total GST Collection at 16%	Revenue Loss at 16%
Tax all goods and services except water, electricity, fuel and hotel occupancy ($75K SBE)	$5,860	-	$6,665	-
Exempt Food	$5,166	$694	$5,873	$793
Exempt Medicine	$5,473	$387	$6,224	$441
Exempt Medical Services	$5,311	$549	$6,039	$627
Exempt Educational Services	$5,663	$197	$6,440	$225

2.2 Excise Taxes

2.2.1 Current Law

Excise tax receipts (excluding Law 154) for the fiscal year ending June 30, 2014 were $1.38 Billion, of which $919 Million was committed to the General Fund.

The provisions of Subtitle C of the Puerto Rico Internal Revenue Code of 2011 govern the imposition and administration of the excise tax regime in Puerto Rico, which also includes certain taxes on gambling and the levying of license fees on certain wholesalers and retailers, Subtitle C levies an excise tax on the sale, consumption, use, transfer or acquisition in, or the introduction into, Puerto Rico of the following articles[18]:

- Locally manufactured and imported cement;
- Sugar;
- Plastic products;
- Introduction or manufacture of cigarettes;
- Gasoline;
- Aviation fuel;
- Gas oil;
- Diesel oil;
- Crude oil;
- Unfinished oils, oil byproducts, and any other hydrocarbon mixtures (excluding natural gas); and
- Motor vehicles.

The tax is only paid once and the rates are specific to the particular article.

[18] PRIRC § 3020.01.

The rates are as follows:[19]

Cement	**6 cents for each hundredweight or fraction thereof.**
Sugar	14 cents on each pound or fraction thereof.
Plastic products	6.6 cents of the taxable price in Puerto Rico on specified plastic products that do not meet certain standards.
Cigarettes	$16.15 on every 100 cigarettes or fraction thereof ($17 from July 1, 2015).
Gasoline	16 cents on each gallon or fraction thereof.
Aviation fuel	3 cents on each gallon or fraction thereof.
Gas oil or diesel oil	4 cents on each gallon or fraction thereof.
Any other fuel	8 cents on each gallon or fraction thereof.
Crude oil, unfinished oils and end products derived from oil and other hydrocarbon mixtures	$9.25 per barrel or fraction thereof (subject to an annual inflation adjustment).
Vehicles – cars	$750 to 40% of the taxable price of the vehicle depending on the value and age of the vehicle.
Vehicles – truck tractors	17% of the taxable price of the vehicle.
Vehicles – buses	20% of the taxable price of the vehicle.
Vehicles – trucks, motorcycles and ATVs	10% of the taxable price of the vehicle.
Vehicles – manual hook or non-heavy equipment trailer	6.6% of the taxable price of the vehicle.
Vessels and heavy equipment	7% on the suggest retail price or cost respectively.
Smokeless tobacco	$1.00 per pound of chewing tobacco or fraction thereof. $3.02 per pound of snuff or fraction thereof.

The sections setting out the rates of excise tax also include a number of exemptions (e.g., certain ambulances, cigarettes for export and certain types of fuel when acquired by certain businesses are exempt).

[19] PRIRC § 3020.02 to § 3020.09.

Excise tax is required to be reported as follows:[20]

- Every importer is required to submit an excise tax statement on all articles introduced from abroad at the time of the payment of the excise taxes;
- Bonded dealers introducing vehicles, vessels or heavy equipment need to file an excise tax statement no later than 10 days following the taking of possession of those vehicles;
- For merchandise introduced by mail or air carriers, the excise tax statement must be filed no later than five days following the taking of possession of the merchandise;
- Merchants who introduce taxable items subject to use tax must include the excise tax information in the monthly use tax filing, where those merchants have given the required deposit; and
- A bonded importer or manufacturer of articles subject to excise tax should file a monthly return no later than the 10th day of the month following the date of the introduction or manufacture of such articles.

A number of exemptions or reliefs exist (subject to certain conditions), including:[21]

- A refund on a portion of the excise tax paid on certain vehicles powered by alternative or combined energy;
- Articles in transit, for export or returned to Puerto Rico;
- Vehicles for public transportation;
- Vehicles acquired or introduced by consular officers and employees;
- Specially modified vehicles acquired by handicapped persons;
- Certain vehicles acquired by churches;
- Vehicles acquired for donation to the Puerto Rican Police and Municipal Governments for police related work;
- Raw materials and certain equipment acquired for manufacturing processes;
- Limited amounts of cigarettes for travelers and cigarettes sold to foreign flagged ships;
- Articles sold in air and maritime terminal stores to persons leaving Puerto Rico;
- Certain vehicles for non-profit charitable institutions;
- Articles acquired by government agencies for official use;
- The introduction of vehicles by persons in government service who have been transferred to Puerto Rico;
- Contaminated gasoline or diesel oil;
- A refund of 11 cents for each gallon of gasoline which has been used in sea and air travel between Puerto Rico and foreign destinations; and
- Ships used to provide towing or bunkering services.

Subtitle C also levies a tax of 10% on certain gambling winnings obtained in banks and 20% on all winnings from pools, betting against the bank, daily doubles, and subscription funds or from any other betting transactions legally authorized on the racetracks of Puerto Rico.[22]

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[20] PRIRC § 3020.10.
[21] PRIRC § 3030.03 to § 3030.21.
[22] PRIRC § 3040.02.

Further, this Subtitle levies a five cent tax on each betting slip, 15 cents on each daily double, exact, betting against the bank and any other bet legally authorized, and 25 cents on each bet on a game of checkers made at a horse racing agency.[23]

Finally, this Subtitle levies annual license fees on wholesalers and retailers of goods subject to excise taxes, arms dealers, alcohol retailers, certain coin operated machines, operators of free-port stores, and on sea, air and land carrier business.[24]

A room tax of 9 or 11 percent is levied on hotel rooms depending upon whether there is a "casino" associated with the hotel.

The following table shows receipts and uses of the excise and room taxes.

Excise and Room Taxes Revenues for the year ended June 30, 2014				
Excise Taxes:	**General Fund Revenues**	**Special Revenue Fund Revenues**	**Total Revenues**	**Special Fund or Public Corporation Name**
Alcoholic Beverages	266,542.00	0.00	266,542.00	
Tobacco Products	171,108.00	30,376.00	201,484.00	Office of Services to Former Governors and 5 Public Corp.
Petroleum Products (Jet Fuel)	4,042.00	0.00	4,042.00	
Motor Vehicles	392,043.00	0.00	392,043.00	
Horces Races	16,354.00	0.00	16,354.00	
Insurance Premiums	42,642.00	0.00	42,642.00	
Cement	716.00	0.00	716.00	
Slot Machines	21,910.00	0.00	21,910.00	
Other Excise Taxes - mainly PVC Products	3,489.00	192.00	3,681.00	Agricultural Development Fund
Sugar and Coffee	0.00	8,333.00	8,333.00	Agricultural Development Fund
Petroleum Products	0.00	255,590.00	255,590.00	PR Highway Authority (Pledged for Revenue Bonds)
Gasoline	0.00	156,018.00	156,018.00	PR Highway Authority (Pledged for Revenue Bonds)
Diesel and Gas Oil	0.00	10,210.00	10,210.00	PR Highway Authority (Pledged for Revenue Bonds)
Total Excise Taxes	918,846.00	460,719.00	1,379,565.00	
Room Taxes	0.00	65,642.00	65,642.00	PR Tourist Company (Pledged for Revenue Bonds)
	918,846.00	526,361.00	1,445,207.00	

Source: Puerto Rico Office of Management and Budget

2.2.2 Reasons to Change

Only alcohol and tobacco are subject to the current IVU/IVA regime. All the goods and services listed above would be subject to the GST if it is implemented as described in the preceding section. Thus, those goods and services currently exempt from the IVA/IVU regime would be subjected to a significantly higher tax burden than exists under current law. Moreover, the proceeds of seven taxes are dedicated to particular uses. And the proceeds from four secure debt obligations.

2.2.3 Descriptions of Options

The question arises as to whether it is necessary or appropriate to subject any or all of these goods or services to both excise tax and GST. If double tax is to be avoided, it should be accomplished, if possible, by reducing the excise tax rather than exempting the item from the GST. Thus, the automobile excise tax could be replaced by the GST. However, as noted below,

[23] PRIRC § 3040.03.

[24] PRIRC § 3050.01 to § 3050.04.

due to the complications associated with renegotiating existing debt security arrangements, double tax on fuel and hotel rooms could be eliminated by exempting those items from GST.

2.2.4 Analysis

The extent to which any or all of these items should be subjected to both GST and Excise tax is a political question. However, implementing a decision to avoid double taxation raises structural issues, particularly with respect to dedicated funds. Ideally, to maintain the symmetry of the GST base and avoid the problems with exemptions that have been identified in the GST discussion, all the goods and services listed above would be subject to GST and the excise tax reduced in an amount sufficient to maintain the current tax burden. If that were done, an annual dedicated appropriation from the general fund would be necessary to assure sufficient liquidity to service the debt obligations of the Highway Fund and Tourist Commission. The need to assure funding for the other designated recipients could be re-examined. However, it may be too burdensome to renegotiate security arrangements, in which case double tax relief will have to occur through GST exemption.

The need to continue funding for the other designated recipients could be re-examined.

2.2.5 Revenue Effect

Assuming that only tobacco and alcohol will be subject to both GST and excise tax, the aggregate revenue raised by those two items will increase due to their inclusion in the GST base. With respect to vehicles, the aggregate revenue will not change materially but it will come from the GST rather than the excise tax.

2.3 Revise Individual Income Tax to Simplify Tax Base, Reduce Number of Income Taxpayers and Lower Rates

2.3.1 Current Law

Individual residents of Puerto Rico are subject to Puerto Rico income tax on their worldwide income. A resident individual's income tax liability includes: (1) the regular tax on "net income"; (2) the amount of tax paid at preferential rates on certain items of income; and (3) the alternative minimum tax. Net income means "gross income" reduced by certain exemptions, deductions, and income subject to preferential tax rates.[25] Individuals must calculate "adjusted gross income" to determine the amount of certain deductions and exemptions allowed in computing net income. Individuals may reduce their tax liability by certain tax credits.

2.3.1.1 Gross Income

Gross income means all income, gains, or profits from whatever source received or derived, other than certain items specifically excluded from gross income.[26] Items of gross income include: compensation for personal services, interest, dividends, capital gains, trade or business income, and income from certain pensions or annuities.[27]

Items excluded from gross income include: life insurance; gifts and inheritances; compensation for injuries or sickness; income from discharge of certain debts; child support payments; federal

[25] PRIRC § 1031.05.
[26] PRIRC § 1031.01.
[27] PRIRC § 1031.01(a).

social security payments; certain death benefits; and net long-term capital gain from the sale of certain new construction property.[28]

Over 40 categories of income are exempted from gross income. Key exemptions include: interest on certain debt obligations; certain amounts paid by an employer under a flexible benefits plan; employer contributions to health insurance plans; dividends received from certain organizations; lottery prizes; income from pensions or annuities; unemployment compensation; distributions from nondeductible individual retirement accounts; and gain from the sale or exchange of a principal residence or qualified property by certain individuals.[29] One particularly noteworthy series of exemptions are those provided by Law 22 which was enacted to entice high net worth individuals to relocate to Puerto Rico. It provides a total exemption from Puerto Rico income tax for all passive income realized or accrued after such individuals become residents of Puerto Rico. As of June, 2014, 288 exemption decrees had been issued under Law 22.

2.3.1.2 Adjusted Gross Income

Adjusted gross income is determined by subtracting certain "above-the-line" deductions from gross income (after exemptions).[30] These deductions primarily are for business and investment related expenses, as well as for alimony payments.[31]

2.3.1.3 Deductions from Adjusted Gross Income

In determining net taxable income, the Code also allows numerous "below-the-line" deductions from adjusted gross income. Key deductions available to individuals not engaged in a trade or business include: home mortgage interest; charitable contributions; interest on student loans; contributions to certain retirement or pension accounts; medical expenses above a certain threshold; contributions to an education or health savings account; and casualty losses on a principal residence not covered by insurance.[32] Additional deductions are available for individuals engaged in a trade or business.

If an individual taxpayer has $20,000 or more of income subject to preferential tax rates (discussed below), below-the-line deductions are disallowed to the extent allocable to income subject to preferential tax rates.[33]

The Code generally also allows a personal exemption deduction of $3,500 ($7,000 for married taxpayers filing joint returns), and a $2,500 dependent exemption deduction with respect to certain minor and elderly dependents.[34]

2.3.1.4 Regular Tax on Net Income

Regular income tax for resident individuals is determined by applying the tax rate schedule to net taxable income. The tax rate schedule is broken into five income tax brackets. The brackets for taxable years beginning in 2014 are:[35]

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[28] 42 PRIRC § 1031.01(b). The exclusion for new construction property is found in Acts 132-2010 and 216-2011, as amended.
[29] PRIRC § 1031.02.
[30] PRIRC § 1031.03.
[31] *Id.*
[32] PRIRC § 1033.15.
[33] PRIRC § 1033.20.
[34] PRIRC § 1033.13.
[35] PRIRC § 1021.01(a)(4).

Net Taxable Income Tax
Not over $12,000
0%

Over $12,000 but not over $26,000
7% of the excess over $12,000

Over $26,000 but not over $42,750
$980 plus 14% of the excess over $26,000

Over $42,750 but not over $62,750
$3,325 plus 25% of the excess over $42,750

Over $62,750
$8,325 plus 33% of the excess over $62,750

2.3.1.5 Income Subject to Preferential Tax Rates

The Code provides special preferential tax rates—or allows individuals to elect special tax rates—for certain items of income. Some of the special tax rates include:

- 10% rate on long-term capital gains[36];
- 10% (or 17%) rate on interest from deposits in certain types of accounts[37];
- 10% rate on eligible dividend distributions from certain corporations[38]; and
- 20% rate on distributions from certain retirement accounts.[39]

2.3.1.6 Alternative Minimum Tax

Certain resident individuals are subject to an alternative minimum tax equal to the excess of the tax on alternative minimum net taxable income over their regular tax liability.[40] Very generally, alternative minimum net taxable income is computed in the same way as net taxable income, except that certain exemptions and deductions from gross income are disallowed.[41]

2.3.1.7 Tax Credits

An individual may reduce his or her tax liability by available tax credits. The laws of Puerto Rico provide numerous refundable and nonrefundable tax credits. Tax credits are allowed for, amongst other things, investments in certain industries (e.g., film or tourism) or qualified investment funds,[42] investments in certain housing and development projects,[43] and the purchase of a new or existing home.[44] Additional credits are available for individuals engaged in a trade or business.[45]

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[36] PRIRC § 1023.02.
[37] PRIRC § 1023.04.
[38] PRIRC § 1023.06.
[39] PRIRC § 1023.09.
[40] PRIRC § 1021.02.
[41] Id.
[42] See, e.g., Acts 78-1993, 225-1995, 3-1987, 46-2000, and 27-2011.
[43] See, e.g., Acts 98-2011, 212-2002, and 140-2001.
[44] PRIRC § 1052.03 and .04.
[45] PRIRC § 1052.02(b).

2.3.1.8 Filing Obligations

The following categories of individuals must file Puerto Rico income tax returns: (1) every individual resident of Puerto Rico who is an individual or married taxpayer and has gross income (after exemptions) over $5,000; (2) every individual nonresident of Puerto Rico for all or part of the year who is a citizen of the United States and who has Puerto Rico source gross income (after exemptions) in excess of $5,000, unless the tax on the income has been fully paid at source; (3) every alien individual nonresident of Puerto Rico who has taxable Puerto Rico source gross income for the taxable year, unless the tax on the income has been fully paid at source; and (4) every individual whose alternative minimum net taxable income is $150,000 or more.[46]

2.3.2 Reasons for Change

The computation of individual income tax liability is inordinately difficult due primarily to the existence of exclusions, credits and preferential rates for certain forms of income as well as the need to calculate alternative minimum taxable income. While the base of the individual income tax contains relatively few itemized deductions, the special rates, exemptions and credits reduce potential revenue and produce an uneven distribution of the tax burden. One effect of these special provisions is to tax wage income more heavily than capital income, thus creating horizontal inequity.

These special provisions are called tax expenditures. Tax expenditures are "revenue losses attributable to provisions of the... tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability. Special income tax provisions are referred to as tax expenditures because in many cases they are substantively analogous to direct outlay programs, and the two can be considered as alternative means of accomplishing similar budget policy objectives....Tax expenditures are similar to ... direct spending programs that are available as entitlements to those who meet the statutory criteria established for the programs.[47]"

Tax expenditures affect the amount and distribution of the tax base. They also alter economic or social behavior. Thus it is important to understand who they affect, how much they cost and how they operate in order to assess their effect. Once identified, the tax expenditure can be analyzed as a direct spending program. Those eligible for the program can be identified and, if sufficient data exist, the cost of the provision can be compared to its benefits.

Economic efficiency, spending and/or rate reductions, and/or increased revenues could occur through the repeal or reduction of tax expenditures. But one must be clear about how much can realistically be accomplished by that form of base broadening. The largest individual tax expenditures are retirement savings incentives, the home mortgage interest deduction, interest exclusions and capital income rate preferences.

Apart from the political constituency that supports each of those items, one must recognize that many of them are spending programs that cannot be cut off without real economic consequences that must be analyzed and addressed. A number of the existing tax expenditures could be redesigned to provide benefits in a more rational way: for example, converting them to [refundable] credits that phase out as incomes rise.

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[46] PRIRC §106.01.

[47] Joint Committee on Taxation, Background Information on Tax Expenditure Analysis and Historical Survey of Tax Expenditure Estimates, JCX-15-11 (February 28, 2011).

Appendix A contains estimates of the static revenue loss attributable to most individual income tax expenditure provisions of the Puerto Rican tax code. It also shows the percent of the tax benefit enjoyed by taxpayers taxed at the highest marginal tax rate as well as the number of taxpayers claiming the benefits. Due to data limitations, it does not contain an estimate for the loss attributable to the provisions dealing with employer provided health insurance benefits, nor does it contain an estimate for the loss attributable to the provisions that provide a fair market value basis increase for property that is transferred at death and permit the deferral of gain on like kind exchanges.

2.3.3 Description of Options

Significant structural and compliance simplification, horizontal equity and revenue can be attained by the elimination or modification of existing tax preferences. With exception of the preferences relating to retirement benefits, health benefits, mortgage interest and charitable contributions every tax expenditure listed in Appendix A could be repealed. The home mortgage interest and charitable contribution deductions could be modified to achieve a more rational subsidy structure. For example, the former could be redesigned as a tax credit, the benefit of which would phase out as income increases. The benefit of the latter could be restricted principally to contributions to Puerto Rican charities. The retirement benefit provisions could be modified to make distributions fully taxable. Law 22 could be repealed.

The revenue obtained by modifying or eliminating tax preferences could be used to eliminate income tax liability for a significant number of households as well lower existing tax rates.

The analysis below assumes, **as an example**, exemption levels of $35,000 for singles taxpayers and $70,000 for married couples filing jointly.

The rate structure for single filers would be 15% for income above $35,000, 20% for income above $125,000 and 30% for income above $200,000. For married couples filing jointly the rates would be 15% for income above $70,000, 20% for income above $125,000 and 30% for income above $200,000.

2.3.4 Analysis

One initial observation is important. The elimination of the tax expenditures described below (except to the extent they are refundable credits under existing law) will have no impact on those individuals who do not have income tax liability under the tax structure described above. The distributional consequences of the hypothetical tax changes are described in the Revenue Effect section below.

2.3.4.1 Credits

As detailed in Appendix A, many of the existing tax credits are utilized by a limited number of taxpayers and none have been subjected to a cost-benefit analysis. By design, these credits (as well as many of the special rates, deductions, exemptions and exclusions) distort the tax base, create horizontal inequity and promote economic inefficiency. The burden of proof for retention of any of them should be a demonstration that the value of the intended tangible benefit exceeds the revenue cost.

2.3.4.2 Deductions

2.3.4.2.1 Charitable Contribution Deduction

The charitable contribution deduction could be re-examined. The rationale for special tax provisions for charitable giving is to encourage that activity. However, like any other tax expenditure the existence of the provision creates a revenue loss that must be offset. Moreover, as an analytic matter it is a government subsidy program pursuant to which the expenditure of government funds is determined by private individuals. Some question whether those who do not choose to make charitable contributions should bear the economic burden of the choices made by others. That is a political decision.

Assuming a charitable contribution deduction is retained, the deduction could be limited to contributions to Puerto Rican charities or other external charities designated by the Secretary as having significant charitable activities in Puerto Rico. There is no apparent reason for Puerto Rican taxpayers to be subsidizing charitable activity that has no discernible benefit to Puerto Rico.

If the charitable contribution deduction were limited as suggested a statutory structure to determine eligible Puerto Rican entities would have to be enacted and an administrative procedure created. The exempt organization provisions of the U.S. Internal Revenue Code provide one model.

2.3.4.2.2 Home Mortgage Interest Deduction

The home mortgage interest deduction is a prime example of a tax expenditure. A tax on economic income does not allow the deduction of expenses that produce non-taxed income. Home mortgage interest is an expense related to exempt income — the imputed rental value of the home it finances. Thus, it is a tax expenditure. When analyzed as a government spending program, the deduction is available only to those who own their homes, not to those who rent. Thus, it encourages homeownership. But while it is available to all taxpayers who have mortgages on their homes, the deduction is of no value to those without income tax liability and the value of the deduction increases as the taxpayer's tax bracket increases. When translated into a government program to subsidize housing, it is a program that provides greater government subsidies to high income taxpayers than to lower income taxpayers and provides no subsidy at all for homeowners who do not have tax liability.

There is a fear that total elimination of the subsidy would adversely affect housing prices and the housing market. However, if the subsidy is to be retained it could be redesigned to direct the benefits to those who most need it. In the first instance the benefit could be redesigned as a tax credit to assure that the benefit does not increase as income becomes higher. Because the subsidy is arguably not necessary for higher income individuals, it could be phased out as incomes increase. Finally, if the subsidy is to be provided to the lowest income categories, it could be made refundable.

The following is a hypothetical nonrefundable credit designed to meet the foregoing objectives:

If taxable income is:	The credit is:
Not over $125,000	Smaller of (a) 15 % of mortgage interest expense and (b) $5,250
Over $125,000, but not over $140,000	Smaller of (a) 12 % of mortgage interest expense and (b) $4,200
Over $140,000, but not over $155,000	Smaller of (a) 9 % of mortgage interest expense and (b) $3,150
Over $155,000, but not over $170,000	Smaller of (a) 6 % of mortgage interest expense and (b) $2,100
Over $170,000, but not over $185,000	Smaller of (a) 3 % of mortgage interest expense and (b) $1,050
Over $185,000	$0

The table below shows the value of a home mortgage interest subsidy under (a) current law, (b) current structure of the deduction and the tax rates and exemption levels described above, and (c) as a tax credit under the rates and exemption levels described above.

AGI Before Ded	Mortgage Expense Deduction	30% of AGI Limit	Max Deduction	AGI After Ded	Current Tax With Deduction	Proposed Tax With Deduction	Current Tax Without Deduction	Proposed Tax Without Deduction	Current Tax Reduction (value of ded)	Proposed Tax Reduction (value of ded)	Credit (value of ded)
12,000	35,000	3,600	3,600	8,400	$0	$0	$0	$0	$0	$0	$5,250
26,000	35,000	7,800	7,800	18,200	$434	$0	$980	$0	$546	$0	$5,250
42,750	35,000	12,825	12,825	29,925	$1,530	$0	$3,325	$0	$1,796	$0	$5,250
62,750	35,000	18,825	18,825	43,925	$3,619	$0	$8,325	$0	$4,706	$0	$5,250
100,000	35,000	30,000	30,000	70,000	$10,718	$0	$20,618	$4,500	$9,900	$4,500	$5,250
125,000	35,000	37,500	35,000	90,000	$17,318	$3,000	$28,868	$8,250	$11,550	$5,250	$5,250
140,000	35,000	42,000	35,000	105,000	$22,268	$5,250	$33,818	$11,250	$11,550	$6,000	$4,200
155,000	35,000	46,500	35,000	120,000	$27,218	$7,500	$38,768	$14,250	$11,550	$6,750	$3,150
170,000	35,000	51,000	35,000	135,000	$32,168	$10,250	$43,718	$17,250	$11,550	$7,000	$2,100
185,000	35,000	55,500	35,000	150,000	$37,118	$13,250	$48,668	$20,250	$11,550	$7,000	$1,050

2.3.4.3 Social Security

Social security receipts constitute economic income. While sometimes described as "insurance", social security is in fact a transfer payment that has not been actuarially determined. The increased exemption levels in the income tax option provide tax exemption for social security payments received by approximately 80 percent of filers. As to the balance, a 20 percent exclusion recognizes that some portion of a social security payment has been "financed" by tax payments that could be viewed as creating a "basis" in the amounts received.

2.3.4.4 Preferential Rates for Capital Income

An income tax does not distinguish between wage and capital income. The preferential treatment of capital income creates horizontal inequity and requires disproportionate taxation of wage income to achieve revenue goals.

The traditional rationalization for preferential treatment of capital income is that it encourages saving because it increases the after tax rate of return on investment as compared to labor. While it is true that the after tax rate of return on investment is increased relative to wage income it is by no means clear that the preferential rate in fact induces increased investment. Moreover, even if that were demonstrable as a general proposition, it questionable whether, with the exception of the exclusion for interest on Puerto Rican debt obligations and certain bank accounts, the existing capital income preferences have any material positive effect on the Puerto Rican economy. Other than those exceptions, the existing capital income preferences are not targeted to investments in Puerto Rico. Thus, Puerto Rican wage earners are subsidizing capital investments that have no relationship to the Puerto Rican economy. Preferential rates for dividends and capital gain on the sale of corporate stock are also rationalized as alleviating the burden of "double" taxation of corporate income. Options regarding elimination of "double" taxation of corporate income (and the need for a tax preference for dividends and capital gain) are discussed below.

2.3.4.5 Step up in Basis

The failure to tax unrealized appreciation in property held at death is one of the most glaring omissions from a comprehensive income tax base, producing horizontal inequity, inefficient resource allocation and substantial revenue loss. Step-up induces individuals to hold property until death. It creates an artificial impediment to sales that would normally occur and therefore distorts normal capital flows.

Horizontal inequity is illustrated by this simple example: A and B are siblings. Each bought stock X for $100,000. It is now worth $3 million and each has decided to sell. A meets B in the street outside their broker's office just after A has executed her trade and before B is going to do the same thing. A car hits them and both die. Assuming a 20-percent income tax rate, A's heirs receive $2,420,000. B's heirs get the stock with a new basis of $3 million and can sell the next day and pocket the entire $3 million. That is an indefensible result. If B borrowed money using the stock as collateral, B had the use of the appreciation during his life and the debt can be repaid from the tax free proceeds of the sale of the stock after B's death. That is also indefensible.

There are two polar ways that such unrealized appreciation can be included in the income tax base. The first is by providing that the basis of such property carries over to the transferee (the current rule with respect to property transferred by gift). The second is by treating death as an income tax realization and recognition event. The optional system adopts the latter principle, but provides an election to defer recognition of the realized gain until the sale of illiquid assets and provides a carryover basis for property transferred to a spouse.

The fundamental rule is that death is an income tax realization and recognition event with respect to any marketable property held by a decedent/donor that is transferred to any beneficiary other than a spouse or public charity. The transfer of non-marketable property at death to any beneficiary other than a spouse or public charity will be an income tax realization event and the gain calculated, but, at the election of the recipient of the property, the tax would not be due ("recognized") until the property is sold. Interest at a market rate, payable annually, would be charged on the deferred tax liability to assure that the present value of the deferred tax is equal to the tax that would be paid if death were a recognition event.

All lifetime transfers, other than those to a spouse or a public charity, will be income tax recognition events, subject to appropriate loss limitation rules. Property transferred to a spouse or public charity would receive a carryover basis with a special rule for split interest transfers.

Principal residences transferred at death would be exempt from the realization regime and would receive a date of death value, as would tangible personal property other than collectibles. No other property would be exempt from this system. Anti-avoidance rules would be enacted to deter the creation of non-marketable interests to defer recognition.

The tangible personal property exclusion is based on the premise that most of such property is not appreciated in value and in any event it is not likely that cost basis records exist. Including "collectibles" in the regime provides a boundary for the exclusion, although it admittedly introduces identification issues. The principal residence exclusion is based on a combination of pragmatism and administrative convenience. Experience in administering existing law with respect to collecting the tax on gain realized on lifetime sales of residences indicates that this is an area in which compliance can best be described as shoddy. One does not generally want to reward shoddy compliance with tax exemption, but in this instance it may be appropriate.

The proposed realization/recognition regime proceeds from the premise that to the extent possible all income tax accounts should be closed upon a taxpayer's death. The deferral election for non-marketable property addresses liquidity concerns posed by those assets. The exemption for property transferred to a spouse is simply an extension of the principle that the spousal unit is treated as a single unit for tax purposes so that such transfers are "non-events" for tax purposes. Exempting transfers to public charities preserves current law with respect to the transfer of appreciated property to such entities.

2.3.4.6 Preferential Rates for Retirement Plan Distributions

The tax structure for retirement benefits is substantively a consumption tax, i.e., the tax base is reduced by the retirement contribution (saving). The two principal methods are (1) an immediate deduction for retirement savings with full inclusion of distributions or (2) no deduction for contributions but no inclusion of distributions. If tax rates remain the same those two models are economic equivalents.

By definition, in both of these structures, the normal rate of return on the retirement contribution is tax free (the well-recognized "immediate deduction-yield exemption" equivalence). The existing Puerto Rican system departs from the conceptual consumption tax model—and actually creates a tax subsidy for retirement benefits - due to the fact that distributions from qualified plans enjoy preferential rates and exclusions. There is no policy justification for this additional subsidy. Distributions should be fully taxed as ordinary income.

2.3.5 Revenue Effect of Income Tax Changes

The following tables show the revenue and distributional effects of the income tax base changes described above at exemption levels of $35,000 for singles/$70,000 for married couples filing jointly and at two different rate schedules. The effective rate of tax at various income levels is also shown.

Income tax rate schedule Single: <35 0; 35-125 15%; 125-200 20%; >200 30% Married: <70 0; 70-125 15%; 125-200 20%; >200 30%	Filers	Income Tax Under Proposed Structure ($ Millions)	Income Tax Under Current Structure ($ Millions)	Decrease (%)
Less than $21,800	493,960	$0	$10	100.00%
Greater than $21,800, less than $33,000	189,106	$0	$72	100.00%
Greater than $33,000, less than $50,000	169,742	$47	$221	78.65%
Greater than $50,000, less than $69,500	75,765	$95	$214	55.78%
Greater than $69,500, less than $84,200	29,839	$70	$152	54.15%
Greater than $84,200, less than $100,000	18,643	$74	$146	49.43%
Greater than $100,000, less than $140,000	22,012	$159	$273	41.75%
Greater than $140,000, less than $200,000	10,964	$171	$240	28.99%
Greater than $200,000, less than $300,000	4,906	$161	$204	21.29%
Greater than $300,000	4,078	$733	$547	-34.10%
Total	1,019,015	$1,509	$2,079	27.43%

Income tax rate schedule Single: <35 0; 35-62.5 15%; 62.5-100 20%; >100 30% Married: <70 0; 70-125 15%; 125-200 20%; >200 30%	Filers	Income Tax Under Proposed Structure ($ Millions)	Income Tax Under Current Structure ($ Millions)	Decrease (%)
Less than $21,800	493,960	$0	$10	100.00%
Greater than $21,800, less than $33,000	189,106	$0	$72	100.00%
Greater than $33,000, less than $50,000	169,742	$47	$221	78.54%
Greater than $50,000, less than $69,500	75,765	$96	$214	55.02%
Greater than $69,500, less than $84,200	29,839	$78	$152	48.86%
Greater than $84,200, less than $100,000	18,643	$85	$146	42.08%
Greater than $100,000, less than $140,000	22,012	$203	$273	25.52%
Greater than $140,000, less than $200,000	10,964	$209	$240	12.84%
Greater than $200,000, less than $300,000	4,906	$181	$204	11.55%
Greater than $300,000	4,078	$751	$547	-37.27%
Total	1,019,015	$1,650	$2,079	20.64%

2.3.6 Combined Revenue and Distributional Effects of GST and Income Tax Changes

The following four tables show the combined revenue and distributional consequences of the GST and Individual Income Tax changes combined at two different rate schedules. The first two tables present the results at the 14% GST rate and the second two tables present the results at the 16% GST rate.

14% GST

Income tax rate schedule Single: <35 0; 35-125 15%; 125-200 20%; >200 30% Married: <70 0; 70-125 15%; 125-200 20%; >200 30%	Households	Income Tax Under Current Structure	IVU	Total Income and Sales Tax	Proposed Income Tax	Proposed GST of 14% (net of regressivity relief)	Total Income and GST	Increase Per House hold
Less than $21,800	681,339	$10	$381	$392	$0	$392	$392	$0
Greater than $21,800, less than $33,000	233,080	$72	$194	$266	$0	$381	$381	$491
Greater than $33,000, less than $50,000	215,568	$221	$198	$419	$44	$696	$740	$1,491
Greater than $50,000, less than $69,500	116,015	$214	$147	$361	$89	$518	$607	$2,116
Greater than $69,500, less than $84,200	45,579	$152	$67	$218	$66	$233	$299	$1,768
Greater than $84,200, less than $100,000	27,587	$146	$45	$192	$70	$180	$250	$2,121
Greater than $100,000, less than $140,000	25,428	$273	$48	$321	$150	$190	$340	$764
Greater than $140,000, less than $200,000	18,741	$240	$45	$285	$161	$177	$338	$2,823
Greater than $200,000, less than $300,000	10,045	$204	$33	$237	$152	$130	$282	$4,429
Greater than $300,000	3,149	$547	$17	$564	$691	$68	$759	$61,859
Total	1,376,531	$2,079	$1,176	$3,255	$1,421	$2,965	$4,387	

14% GST

Income tax rate schedule Single / Married <35 0 / <70 0 35-62.5 15% / 70-125 15% 62.5-100 20% / 125-200 20% >100 30% / >200 30%	Households	Income Tax Under Current Structure	IVU	Total Income and Sales Tax	Proposed Income Tax	Proposed GST of 14% (net of regressivity relief)	Total Income and GST	Increase Per House hold
Less than $21,800	681,339	$10	$381	$392	$0	$392	$392	$0
Greater than $21,800, less than $33,000	233,080	$72	$194	$266	$0	$396	$396	$559
Greater than $33,000, less than $50,000	215,568	$221	$198	$419	$45	$696	$741	$1,495
Greater than $50,000, less than $69,500	116,015	$214	$147	$361	$92	$518	$610	$2,140
Greater than $69,500, less than $84,200	45,579	$152	$67	$218	$74	$233	$308	$1,956
Greater than $84,200, less than $100,000	27,587	$146	$45	$192	$81	$180	$261	$2,528
Greater than $100,000, less than $140,000	25,428	$273	$48	$321	$194	$190	$384	$2,508
Greater than $140,000, less than $200,000	18,741	$240	$45	$285	$200	$177	$377	$4,919
Greater than $200,000, less than $300,000	10,045	$204	$33	$237	$173	$130	$303	$6,532
Greater than $300,000	3,149	$547	$17	$564	$717	$68	$785	$70,165
Total	1,376,531	$2,079	$1,176	$3,255	$1,576	$2,981	$4,557	

16% GST

Income tax rate schedule Single: <35 0; 35-125 15%; 125-200 20%; >200 30% Married: <70 0; 70-125 15%; 125-200 20%; >200 30%	Households	Income Tax Under Current Structure	IVU	Total Income and Sales Tax	Proposed Income Tax	Proposed GST of 16% (net of regressivity relief)	Total Income and GST	Increase Per House-hold
Less than $21,800	681,339	$10	$381	$392	$0	$392	$392	$0
Greater than $21,800, less than $33,000	233,080	$72	$194	$266	$0	$469	$469	$868
Greater than $33,000, less than $50,000	215,568	$221	$198	$419	$40	$791	$832	$1,917
Greater than $50,000, less than $69,500	116,015	$214	$147	$361	$82	$589	$671	$2,670
Greater than $69,500, less than $84,200	45,579	$152	$67	$218	$66	$266	$332	$2,489
Greater than $84,200, less than $100,000	27,587	$146	$45	$192	$72	$205	$278	$3,118
Greater than $100,000, less than $140,000	25,428	$273	$48	$321	$173	$217	$390	$2,732
Greater than $140,000, less than $200,000	18,741	$240	$45	$285	$179	$201	$380	$5,091
Greater than $200,000, less than $300,000	10,045	$204	$33	$237	$154	$148	$302	$6,497
Greater than $300,000	3,149	$547	$17	$564	$641	$77	$718	$49,052
Total	1,376,531	$2,079	$1,176	$3,255	$1,409	$3,355	$4,764	

16% GST

Income tax rate schedule Single / Married <35 0 / <70 0 35-62.5 15% / 70-125 15% 62.5-100 20% / 125-200 20% >100 30% / >200 30%	Households	Income Tax Under Current Structure	IVU	Total Income and Sales Tax	Proposed Income Tax	Proposed GST of 16% (net of regressivity relief)	Total Income and GST	Increase Per House-hold
Less than $21,800	681,339	$10	$381	$392	$0	$392	$392	$0
Greater than $21,800, less than $33,000	233,080	$72	$194	$266	$0	$450	$450	$787
Greater than $33,000, less than $50,000	215,568	$221	$198	$419	$44	$791	$836	$1,936
Greater than $50,000, less than $69,500	116,015	$214	$147	$361	$90	$589	$679	$2,741
Greater than $69,500, less than $84,200	45,579	$152	$67	$218	$73	$266	$338	$2,634
Greater than $84,200, less than $100,000	27,587	$146	$45	$192	$79	$205	$285	$3,379
Greater than $100,000, less than $140,000	25,428	$273	$48	$321	$191	$217	$407	$3,410
Greater than $140,000, less than $200,000	18,741	$240	$45	$285	$197	$201	$398	$6,039
Greater than $200,000, less than $300,000	10,045	$204	$33	$237	$170	$148	$318	$8,024
Greater than $300,000	3,149	$547	$17	$564	$705	$77	$782	$69,286
Total	1,376,531	$2,079	$1,176	$3,255	$1,549	$3,336	$4,885	

2.4 Revise Domestic Business Income Taxation to Simplify the Corporate Tax Base, Reduce the Number of Corporate Taxpayers and Rationalize Flow-Through Taxation Regimes

Domestic Business Taxation

Choice of Entity

2.4.1 Current Law

Business owners have broad flexibility to conduct business activities in Puerto Rico through numerous forms of legal entities. Individual business owners also may conduct their activities as sole proprietorships, which do not involve a separate legal entity. Under current law, the taxation of income earned by a business typically depends on the type of entity through which the business is conducted. For income tax purposes, Puerto Rico business entities generally are taxed either: (1) as regular corporations; (2) as pass-through entities; or (3) pursuant to a special tax regime. Some business entities may elect the manner in which they are taxed.

2.4.1.1 Corporations

Regular corporations are subject to two levels of taxation. The income of a regular corporation is taxed at the corporate level when the income is earned, and the shareholders of a regular corporation are taxed on dividend distributions of the corporation's after-tax income. The shareholders also are subject to tax on gain from the sale of stock in a regular corporation. Business trusts generally are treated as regular corporations for income tax purposes.

2.4.1.2 Pass-Through Entities

The Puerto Rican tax rules contain a number of different regimes relating to business entity taxation that generally provide for only one level of tax to be incurred with respect to earnings. Certain of the regimes provide "pass-through" treatment so that owners of the entity are taxed by reference to the income and losses of the entity.

Entities legally formed as partnerships generally are taxed on a pass-through basis under rules similar to the U.S. federal income tax rules applicable to partnerships. Limited liability companies ("LLCs") generally are treated as corporations for Puerto Rico income tax purposes, unless the LLC elects to be treated as a partnership or corporation of individuals or the LLC elected to be treated as a partnership for U.S. federal income tax purposes. This rule applies regardless of whether an LLC has a single member or multiple members. Unlike U.S. law, Puerto Rico does not treat a single member LLC as an entity disregarded as separate from its owner for income tax purposes.

A corporation or partnership that meets certain eligibility requirements may elect to be treated as a corporation of individuals, a special entity that is taxed under a simplified pass-through regime

A professional corporation generally is taxed as a regular corporation, unless it elects to be taxed as a corporation of individuals.

A Special Employee-Owned Corporation ("SEOC") is a corporation for legal purposes that is taxed based on a blend of cooperative and pass-through principles.

2.4.1.3 Special Entities

The Code provides for several additional types of entities that generally are not taxed at the entity level. An entity that qualifies as a real estate investment trust ("REIT") or registered investment company ("RIC") is exempt from tax in Puerto Rico so long as it distributes at least 90 percent of its earnings on an annual basis. REIT and RIC shareholders generally are subject to tax on distributed earnings.

The Code also provides an exemption or reduced rate of taxation for income earned by an International Banking Entity or International Financial Entity.

2.4.2 Reasons for Change

The availability of multiple forms of legal entities with varying tax treatments creates undue complexity and distorts taxpayer behavior. In most cases, there is no compelling reason to tax a business's income on a pass-through versus entity-level basis solely by reference to the legal form through which the business is conducted. Indeed, as discussed in below, efficiency and simplification generally are best served by allowing most domestic businesses to be taxed primarily at the individual level via a pass through regime, regardless of the legal form of the business. Certain business entities, however, always should be taxed as corporations.

2.4.3 Description of Options

One option to reduce complexity and encourage pass-through taxation is to allow most business entities to elect to be treated as pass-through entities for income tax purposes, regardless of whether the business was formed as a corporation, a partnership, or an LLC. Similar to the U.S. entity classification rules (commonly referred to as the "check-the-box" rules), any business entity that is not treated as a "per se" corporation for income tax purposes (an "eligible business entity") may elect to be taxed as a pass-through entity. An eligible business entity that satisfies the requirements to be treated as a corporation of individuals may elect to be taxed either as a corporation of individuals or a regular partnership. An eligible business entity that does not elect to be taxed as a pass-through entity generally will be taxed as a regular corporation. Consistent with current law, a business entity with a single owner that does not choose to be taxed as a corporation is respected as a separate tax entity, 100% of whose items of income, deduction, credit and loss flow-through to its owner (rather than being disregarded as separate from its owner, as is the case under the U.S. "check-the-box" rules). Thus, a single member LLC, for example, may be taxed either as a corporation or a pass-through entity.

Certain business entities automatically will be classified as per se corporations for income tax purposes. These entities may not elect to be taxed on a pass-through basis. Per se corporations could include publicly traded corporations, banks, insurance companies, and business entities with, for example, more than 200 owners.

2.4.4 Analysis

Allowing eligible business entities to elect to be treated as pass-through entities for income tax purposes will reduce complexity in many cases and further the goal of increasing the number of domestic business entities that are taxed on a pass-through basis, thus allowing a more accurate measurement of income at the individual level. It is anticipated that many eligible business entities that currently are taxed as corporations will elect to be taxed either as corporations of individuals or partnerships. As discussed in below, transition rules will be needed to allow business entities to convert from corporate to pass-through status in a tax efficient manner.

Corporations

2.4.5 Current Law

A regular corporation is subject to Puerto Rico income tax as an entity separate from its shareholders. A regular corporation's income generally is subject to two levels of taxation: the income is taxed at the corporate level when earned and is taxed again at the shareholder level when distributed as dividends. This section provides a general overview of corporate level taxation.

2.4.5.1 Gross Income Less Exclusions and Exemptions

The gross income of corporations includes all gains, compensation for services performed, income from sales and dealings in properties, rent, interest, dividends, partnership profits, transactions in securities, and any other gains, profits, and income derived from any source whatsoever.).

The Code provides numerous exclusions and exemptions from gross income for items such as interest on certain obligations (e.g., obligations issued by the government of Puerto Rico), dividends received from certain corporations (e.g., dividends from limited dividends corporations), and income from the conduct of certain activities (e.g., rents from the lease of property in the Historic Zone). In addition, corporations may qualify for various tax incentives designed to stimulate economic development and reduce unemployment. Corporations qualifying for such incentives may obtain certain relief from Puerto Rico income, property, and municipal taxes. The income that is exempted under such tax incentives laws is excluded from gross income when determining the Puerto Rico corporate income tax liability.

There also are certain transactions in which the gain realized is not recognized for tax purposes and, therefore, is excluded from gross income. In general, the reason for not recognizing such gains is that the underlying transaction is not considered sufficient to break the continuity of the investment. Such is the case, for example, with certain exchanges of like kind property, certain involuntary conversions, certain corporate reorganizations, transfers to a corporation controlled by the transferor, property received by a corporation in a complete liquidation of its controlled subsidiary, securities exchanged for securities of the same corporation, and certain transfers of qualified securities to an employee stock ownership plan.

2.4.5.2 Net Taxable Income

The net taxable income of a corporation is determined by reducing gross income less exclusions and exemptions by allowable business deductions. Expenses incurred during the taxable year by a corporation that are directly connected to its business activities are generally deductible provided they are ordinary, necessary, reasonable, and not in violation of public policy. In general, the rules for the deductibility of the business expenses of a corporation closely follow the rules applicable under the U.S. Internal Revenue Code. Examples of allowable deductions include dividends received from certain Puerto Rico corporations, business debts that become worthless, contributions to pension or other qualified retirement funds, and charitable contributions.

The Code also limits the ability of corporations to deduct certain expenses that might otherwise qualify as a business expense. For example, life insurance premiums paid by a corporation on the life of an officer, employee, or person financially interested in the trade or business of the corporation, when the corporation is directly or indirectly the beneficiary of the policy, are not deductible. In addition, corporations are only allowed to deduct capital losses to the extent of capital gains, with a five-year carryover of the excess capital losses.

A corporation's net operating loss for a taxable year may be carried forward to offset up to 90% of the corporation's liability in a subsequent year.[48] If a corporation acquires, by reorganization or by the liquidation of a controlled corporation, substantially all the assets and liabilities of the acquired corporation, the net operating loss of the acquired corporation may only be used to

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[48] Net operating losses incurred in tax years beginning January 1, 2005 through December 31, 2012 may be carried forward 12 years. Net operating losses incurred in tax years beginning after December 31, 2012 may be carried forward 10 years.

reduce the net income of the acquiring corporation derived from the same commercial activity or trade or business that generated the loss. Also, if a corporation undergoes a change in ownership, the use of its net operating loss in subsequent years may be limited.

Capital expenditures are included as part of the basis of an acquired or improved asset. Depending on the asset and the circumstances involved, such capital expenditures will be depreciated, amortized, or depleted pursuant to the applicable depreciation, amortization, or depletion rules, or included as part of the basis until the asset is sold or disposed of.

2.4.5.3 Corporate Tax Rates including Patente Nacional

Income tax liability is generally determined by applying the corresponding Puerto Rico income tax rate to net taxable income. The regular tax rate for corporations is 20%. Corporations also are subject to a graduated surtax on net taxable income in excess of $25,000, with rates ranging from 5% to 19%. In addition to the regular tax and surtax, corporations are subject to an alternate minimum tax in certain situations when the regular tax liability is less than the alternative minimum tax liability. For taxable years commencing after December 31, 2012, a portion of tax liability of certain Puerto Rico corporations having gross revenues above certain amounts is based on gross revenues. This is the Patente Nacional.

In addition, certain items of income are taxed at special rates, and the tax on such items must be computed separately and added to the income tax on the net taxable income not subject to special rates. For example, net long-term capital gains may be taxed at the flat tax rate of 20%.[49] In addition, dividends paid to non-Puerto Rico corporations that are not engaged in a trade or business in Puerto Rico from Puerto Rico earnings are generally subject to a flat 10% tax. Non-Puerto Rico corporations or partnerships operating in Puerto Rico thus may be subject to a 10% branch profit tax and the withdrawal from doing business in Puerto Rico by a non-Puerto Rico corporation is considered a taxable event.

An accumulated earnings penalty tax may be imposed if a corporation is determined to have been formed or used to prevent the imposition of income tax on its shareholders by accumulating corporate earnings instead of distributing such earnings to the shareholders.

Individual shareholders of a non-exempt Puerto Rican corporation are taxed at 15% on dividends received from the corporation, and Puerto Rican resident individuals are taxed at 15% on capital gains from sales of stock in such corporations.[50]

2.4.5.4 Tax Credits

The income tax liability that is finally due is determined by deducting allowable tax credits from the income tax determined in the manner described above. The Code and various incentive Acts provide numerous tax credits for investments in certain activities (*e.g.*, tourism, agriculture, and waste disposal and treatment).

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[49] Act 77-2014, Passed July 1, 2014, increased the corporate capital gain rate from 15%.
[50] Act 77-2014 increased the individual dividend and capital gain rates from 10% to 15%.

2.4.6 Reasons for Change

A classical corporate tax system (such as the current system), in which tax is collected independently at the individual and corporate levels, will almost always lead to distortions and to a higher aggregate tax burden on domestic business activity than a pass through or integrated regime. The rate, base, and structure of the corporate tax system also interacts with the individual tax system both in terms of rule complexity as well as overall tax burden. The current corporate tax regime is neither necessary nor appropriate for most non-publicly traded businesses. There were 42,740 corporate tax returns filed in 2011. Of that number, 38,838 reported net income of $60,000 or less. Equity, efficiency and simplification are best served by allowing businesses with relatively small numbers of owners to be taxed primarily at the individual level via a pass-through regime, particularly when the entity has little taxable income (see discussion of existing regimes and suggested changes below). Where the equity of a business is publicly-traded (there currently are six publicly traded corporations), or where the investors are not Puerto Rican resident individuals, it is preferable to collect a tax at the corporate level.

Without regard to the number of entities to which it applies, the current corporate tax regime contains alternative minimum taxes, multiple rates, and numerous exemptions, credits, and exclusions that create complexity, distort economic choices, and produce horizontal inequities. Unless justified on a cost-benefit basis, elimination of these provisions (listed in Appendix B) would materially simplify the system and reduce economic distortions.

Certain corporations also are subject to the Patente Nacional, the corporate tax that is determined on the basis of gross receipts. The stated purpose of this alternative minimum tax is to assure that businesses with significant revenues in Puerto Rico make an appropriate tax contribution to the general revenues. However, an unapportioned gross receipts tax has the potential to subject high volume, low margin businesses to tax liabilities that far exceed the amounts that would be due if the tax base was income. Indeed, it is possible for entities with no taxable income to be responsible for significant tax payments on the basis of their gross receipts. The Patente Nacional is not the appropriate tool to achieve the desired revenue objective

2.4.7 Description of Options

The objective of domestic corporate tax reform is to create, within specified revenue goals, a simple, transparent, and equitable system that will raise sufficient revenue and encourage economic activity in the Commonwealth.

2.4.7.1 Conform Individual and Corporate Tax Rates

The highest corporate income tax rate (including the surtax) currently is higher than the highest individual income tax rate. Conforming the corporate tax rate to the highest individual tax rate would reduce distortions that arise when the rates are different. Further distortions would be eliminated by taxing dividends received from Puerto Rican corporations and gain on the sale of stock in a Puerto Rican corporation at ordinary rates. The preferential treatment of dividends and gains on sales of stock is usually justified as a means to alleviate the burden that results from imposing tax at both the corporate and shareholder level. These rules, however, are imperfect, create opportunities for tax avoidance, and increase complexity (in part by the adoption of additional rules to try and combat the tax avoidance that the preferential treatment created in the first place). By making pass-through taxation available to virtually all small business, the inequities of full taxation at both the corporate and shareholder level can be avoided in the vast majority of cases. In the case of publicly-traded corporations (at least those with a single class of stock and no undue concentration of ownership), consideration should be given to fully or partially forgiving the shareholder level tax—although in order to maintain the integrity of the system, losses on sale of such stock would have to become non-deductible.

2.4.7.2 Repeal Certain Tax Preferences

The Code and various incentive Acts provide numerous tax preferences to corporations. A list of corporate tax expenditures is attached as Appendix B. The cost of many of these preferences does not appear to justify the benefits, and the multitude of preferences creates undue complexity and distorts economic decisions. Further, many of the tax preferences are claimed by only a small number of taxpayers.

2.4.7.3 Repeal the Patente Nacional and Audit Inbound Companies Suspected of Transfer Pricing Abuse and Other forms of Base Erosion

There is wide consensus that the Patente Nacional should be repealed. The Patente Nacional is, in economic terms, a consumption tax. The revenue lost by repeal can be replaced by revenue from the economically equivalent GST described above. Further, inbound companies suspected of transfer pricing and base erosion abuse should be identified and audited and, if necessary, robust transfer pricing and base erosion rules enacted.

2.4.7.4 Repeal or Limit the Alternative Minimum Tax

The corporate alternative minimum tax ("AMT") regime adds additional complexity and taxpayer burden to an already complex regime. Depending on the extent to which corporate tax preferences are reduced or eliminated, consideration should be given to repealing or limiting the scope of the AMT.

2.4.7.5 Repeal the Accumulated Earnings Tax

If corporate and individual tax rates are conformed, the accumulated earnings tax would no longer serve a meaningful purpose and therefore could be repealed.

2.4.8 Analysis

2.4.8.1 Conform Individual and Corporate Tax Rates

One principal objective of reform is to reduce the number of taxpayers subject to the corporate tax regime. Increasing the number of businesses subject to a single layer of tax simplifies the business tax system, enhances economic efficiency, and reduces distortions in business decision making (e.g., whether to engage in debt or equity financing, how and when to make distributions, and how to organize business activity). It also could have salutary enforcement and compliance consequences.

When the individual income tax rate is equal to or less than the corporate tax rate, there is an incentive for business owners to choose pass-through taxation rather than corporation taxation to avoid two layers of taxation on business earnings. This is particularly true when corporate dividend distributions are taxed at ordinary individual tax rates. Eliminating the graduated corporate tax rates and setting the rate at the highest individual rate should create an economic (mathematical) incentive for every eligible business entity to elect pass-through taxation because of the graduated rate structure of the latter as compared to the flat rate of the former. As discussed below, transition rules should be adopted to allow business entities to convert from corporate to pass-through taxation with minimal or no tax cost. Although a pass-through entity is not itself a taxpayer, in order to aid in collection, consideration should be given to requiring withholding to be done at the entity level.

Where the equity of a business is publicly traded, it is generally preferable to collect a final tax at the corporate level due to the complexity of allocating income and providing pass-through information statements to a large and frequently changing population of shareholders. In these circumstances, there is little or no potential for using a corporation to avoid or defer the imposition of Puerto Rican tax at shareholder level and thus, in theory, there is no need for further tax at the shareholder level on distributions or sales of corporate stock. Significant rule complexity can arise, however, from an attempt to define the boundaries where such treatment does not facilitate avoidance and to deal with situations where a corporation may cross those boundaries as its ownership changes. These considerations are what generally make most "integrated" corporate tax regimes relatively complex. Given the small number of corporations that would not be eligible to either elect pass-through taxation under the proposed entity classification rules or obtain negotiated incentives under Law 73 (see below), it is unclear whether there would be material benefit from adopting an integrated regime. Rather, the most straightforward approach may be to conform the individual and corporate tax rates, thus giving eligible business entities a strong incentive to choose a pass-through regime and to continue to alleviate the potential over taxation of inbound investment via negotiated decrees. Note, however, that the considerations may differ depending on the ultimate resolution of issues relating to Law 154 (see below).

For publicly-traded companies where flow-through taxation is impractical, it may be possible to mitigate the avoidance possibilities of providing shareholder level relief from taxation of dividends and capital gains. This is particularly true if shareholders are denied a deduction for loss on the sale of publicly-traded stock (while this may seem unfair, it is just as appropriate to ensure that deductions are not claimed at both the corporate and shareholder level as it is to try and prevent gains from being taxed at both levels). Shareholder level relief should be limited, however, to shareholders of publicly-traded corporations that have only a single class of stock, no more than, e.g. 10 percent of which is owned by any single shareholder (taking into account related party attribution).

2.4.8.2 Repeal Certain Tax Preferences

Appendix B lists all of the current corporate tax expenditures. The Appendix also lists the number of entities taking advantage of each preference item for the 2011 tax year, as well as the static revenue loss attributable to each item, to the extent data was available. One striking aspect of the list is the limited number of entities taking advantage of many of these preferences, indicating that repeal would in essence terminate limited special interest provisions that have not, to our knowledge, been subjected to any cost benefit analysis. As discussed below in the economic analysis section, repeal of the tax preferences would produce sufficient revenue to partially finance the corporate rate cut described below.

2.4.8.3 Repeal the Patente Nacional

The Patente Nacional apparently was enacted to address the perceived opportunity under existing law for domestic subsidiaries of U.S. parent corporations that do not have tax decrees under Law 73 to manipulate inter-company charges to reduce their Puerto Rican source income to reduce or eliminate Puerto Rican tax liability. The Patente Nacional was intended to ensure that inbound businesses with significant Puerto Rico revenues make an appropriate economic contribution to the Commonwealth. A gross receipts tax, however, is not the optimal means to address this concern. A more appropriate solution is to create robust transfer pricing and base erosion rules to ensure that income that is attributable to Puerto Rico is properly calculated and taxed. Further, to our knowledge, none of the inbound companies that the Patente Nacional was intended to target has been audited to examine whether it has engaged in transfer pricing abuse or other forms of base erosion. A comprehensive audit of these companies should be conducted, and, to the extent that abuse is detected, an appropriate legislative or regulatory response can be implemented.

The imposition of a GST in place of the Patente Nacional also could offset the lost revenues from repeal and would in many respects collect tax from a similar base.

2.4.8.4 Repeal or Limit the Alternative Minimum Tax

The purpose of the AMT is to ensure that a corporation cannot eliminate its income tax liability through the excessive use of certain corporate tax preference items. The AMT regime significantly increases complexity and taxpayer burdens. The benefits of maintaining the AMT regime must be weighed against these costs. To the extent corporate tax reform includes the repeal or reduction of corporate tax preference items—thereby reducing the incremental difference between net income for regular tax purposes and alternative minimum net income for AMT purposes—further consideration should be given to whether the incremental revenues justify the continued existence of the AMT regime. An alternative to repealing the corporate AMT regime in its entirety is to limit the scope of the regime to only large businesses with gross revenues above a certain threshold (*e.g.*, $5 million).

2.4.8.5 Repeal the Accumulated Earnings Tax

As discussed above, when the individual tax rate is equal or close to the corporate tax rate, individual business owners generally prefer pass-through taxation. Thus, if corporate and individual tax rates are conformed, it is unlikely that individual business owners will elect corporate taxation over pass-through taxation solely for the purpose of avoiding current shareholder level taxation on the business's earnings. Accordingly, the accumulated earnings tax no longer would be needed to prevent the abuse for which it was enacted.

Pass-Through Entities

2.4.9 Current Law

The Puerto Rican tax rules contain a number of different regimes relating to business entity taxation that generally provide for only one level of tax to be incurred with respect to earnings. Certain of the regimes provide "pass-through" treatment so that owners of the entity are taxed by reference to the income and losses of the entity. Others provide for an exemption from tax at the entity level so long as certain requirements are met, including the distribution of a baseline portion of annual earnings. Other regimes go even further, reducing or eliminating both entity-level and shareholder-level taxes with respect to specifically described earnings.

2.4.9.1 Pass-Through Entities

2.4.9.1.1 Partnerships

With limited exceptions, prior to the enactment of the 2011 Puerto Rico Income Tax Act (the "2011 Act"), entities legally formed as partnerships were taxed as corporations. Following the 2011 Act, entities legally formed as partnerships generally are taxed on a flow-through basis under rules similar to the U.S. federal income tax rules applicable to partnerships. However, losses with respect to such partnerships can be used only to offset income from other pass-through entities (i.e., other partnerships, corporations of individuals, and special partnerships) and cannot offset income from other sources. A partner generally is subject to withholding ("remittances") by the partnership with respect to its allocable share of partnership income.

From a tax perspective, a conversion from corporation to partnership status is treated as a liquidation of the corporation followed by the formation of a partnership; the liquidation often is taxable. However, the 2011 Act generally treated these deemed liquidations as tax-free during a transition period, with the entity generally becoming subject to special rules, such as the recapture of certain items, deemed distribution of accumulated earnings and profits, and a 10-year built-in gain recognition period during which a corporate level tax would apply.

Although some of the operative tax rules for partnerships are similar to the operative rules for corporations of individuals, as a general matter, the partnership rules are more complex than the rules for corporations of individuals (described below). The partnership rules, however, allow for more flexible economic arrangements than the corporation of individuals rules. In addition, the partnership rules impose no requirements relating to earning Puerto Rican source income to qualify for taxation as a partnership.

2.4.9.1.2 Limited Liability Companies

Although an entity legally formed as a limited liability company ("LLC") generally is subject to tax as a corporation, it can elect to be taxable as a partnership or a corporation of individuals. With limited exceptions, however, an LLC must be taxed under the partnership rules if it is treated as a partnership or a "disregarded entity" under the laws of a foreign jurisdiction (such as the U.S. "check-the-box" regulations). If an LLC elects partnership status at a time after its formation, the transition from corporation to partnership status for tax purposes gives rise to a deemed liquidation of the corporation; this liquidation can be taxable for current conversions. An LLC with a single owner is regarded as a separate entity for Puerto Rican tax purposes.

2.4.9.1.3 Corporations of Individuals

A corporation of individuals is a corporation or a partnership that elects to be treated as a corporation of individuals and that meets certain eligibility requirements. The eligibility requirements are similar, but not identical, to the eligibility requirements for "S corporations" under U.S. law. Among other things, a corporation of individuals must: (1) be organized under the laws of Puerto Rico, a U.S. state, or the District of Columbia; (2) be engaged in the active conduct of a trade or business solely in Puerto Rico; (3) have no more than 75 shareholders; and (4) have only shareholders that are individuals, estates, and certain kinds of trusts. In addition, only 10 percent of gross receipts of a corporation of individuals can be derived from passive activities or from sources outside of Puerto Rico. These eligibility requirements limit the businesses that can use the corporation of individual's regime.

A corporation of individuals is taxed on a flow-through basis so that income and losses generally flow through and are taxed only at the owner level. As in the case of partnerships and special partnerships, losses of a corporation of individuals can only be used to offset income from other pass-through entities. In addition, an owner of a corporation of individuals is subject to withholding by the corporation with respect to his or her share of corporate income. There also are taxes that can apply as a result of a corporation's conversion to corporation of individuals status (such as certain recapture taxes and a 10-year built-in gain recognition period during which a corporate-level tax would apply).

2.4.9.1.4 Special Partnerships

Rules relating to "special partnerships" were made applicable to qualifying local law partnerships, LLCs, and corporations for taxable years beginning after December 31, 1984. In order to qualify as a special partnership, an electing entity must derive at least 70 percent of its gross income for each taxable year from sources within Puerto Rico and from certain defined activities (such as construction, land, substantial rehabilitation of buildings, sale or rental of buildings, manufacturing generating substantial employment, tourism, agriculture, exports, films, infrastructure, and green energy).

A special partnership is taxed as a pass-through entity. Like a partnership or a corporation of individuals, its income and losses flow through and are taxed at the owner level. The rules relating to the taxation of special partnerships evolved significantly over the years. Although the special partnership rules currently are similar in some respects to those applicable to partnerships, there are some differences between the regimes. For example, to address certain aggressive tax planning that took place in the past regarding partners' use of losses, the special partnership rules provide that liabilities of a special partnership do not increase a partner's basis in its partnership interest. In addition, for a period, flow-through losses could not reduce a partner's net income by more than 50 percent, although this limitation is no longer applicable. Partners of special partnerships are subject to withholding with respect to their shares of partnership income; however, the withholding rates applicable to foreign partners not otherwise engaged in a trade or business in Puerto Rico can be lower than under the partnership rules.

As a result of the 2011 Act, no special partnership elections have been allowed for taxable years beginning after December 31, 2010. However, special partnerships in existence at that time were grandfathered. There are procedures pursuant to which special partnerships currently can convert into partnerships in transactions that are exempt from immediate tax.

2.4.9.1.5 Special Employee Owned Corporations

The tax regime relating to Special Employee-Owned Corporations ("SEOCs") was introduced in 1990 to promote certain labor incentives for manufacturing entities that were operating in Puerto Rico following the repeal of section 936 of the U.S. Internal Revenue Code (relating to the possessions tax credit). Although a SEOC legally is a corporation, the taxation of such entities is a blend of cooperative and flow-through principles. For example, a SEOC takes into account various deductions and credits on its information tax return and then passes certain items through to its members. A SEOC may have regular members (employees of the SEOC), special members (customers), and corporate members. Regular members must control the SEOC's management.

We are not aware of any studies addressing whether the SEOC rules have achieved their intended objectives.

2.4.9.2 Single-Level of Tax for Certain Investment Entities

2.4.9.2.1 Real Estate Investment Trusts

The Puerto Rican Code has provided special tax rules for real estate investment trusts ("REITs") since 2000. The REIT provisions generally follow the U.S. tax model, with numerous requirements relating to shareholder dilution, property ownership and operation, and required distributions. Property ownership must be focused in Puerto Rico by virtue of a requirement that 75 percent of gross income be derived from, among other sources, rents from real property located in Puerto Rico and interest on obligations secured by mortgages on real property located in Puerto Rico. A REIT is exempt from entity level tax in Puerto Rico so long as it distributes at least 90 percent of its earnings on an annual basis. REIT shareholders generally are subject to tax at a rate of 10 percent on distributed earnings, which tax is withheld at the source.

Anecdotal evidence indicates that the REIT regime may not be operating as it originally was intended. The regime apparently was directed at encouraging Puerto Rican entrepreneurs to invest in local real estate through such entities. Because of the dilution requirements patterned after U.S. rules, however, the target audience has not found the regime attractive, as these parties are used to taking larger ownership stakes in real estate investments. As a result, of the few REITs that have been formed in Puerto Rico, most (and possibly all) have been formed by U.S. entrepreneurs.

2.4.9.2.2 Registered Investment Companies

Provisions relating to registered investment companies ("RICs") initially were adopted as part of the Puerto Rico Income Tax Act of 1954. These rules have been amended over the years, most recently as part of the 2011 Act. As with REITs, a RIC will incur no tax at the entity level as long as at least 90 percent of its earnings are distributed annually. RIC shareholders generally are subject to tax at a rate of 10 percent on distributed earnings, which tax is withheld at the source. Exempt dividends and dividends from industrial development income are excludible from income.

In 2013, the Puerto Rican rules were altered fairly significantly in an attempt to promote economic activity and public interest in Puerto Rico. Dividends from a U.S. RIC now generally are taxed at ordinary income rates for Puerto Rican residents, creating a disincentive for Puerto Rican residents to invest in U.S. RICs. In addition, effective for taxable years beginning after December 31, 2013, a RIC qualifying under the Puerto Rico Investment Companies Act of 2013 and satisfying certain additional rules may qualify as an "exempt investment trust." The "eligible sources" of income for an exempt investment trust generally must relate to the promotion of economic activity and public interest in Puerto Rico or the raising of Puerto Rican capital. A qualifying exempt investment trust is subject to more favorable rules in that the trust is exempt from tax regardless of its level of distributions, and eligible shareholders are completely exempt from Puerto Rican tax on eligible distributions. An exempt investment trust also may elect to be taxed as a partnership, and members will be exempt from tax on income allocated by such entities.

2.4.9.3 Exempt or Reduced-Reduced Rate Income at Entity Level

2.4.9.3.1 International Banking Entities

The regime for International Banking Entities ("IBEs") has been in place since 1989 and apparently was intended to encourage banking activities in Puerto Rico for clients outside of Puerto Rico and for capital deposits used outside of Puerto Rico. An IBE is entitled to an income tax exemption for net income generated by its qualifying activities. If the IBE operates as a branch or unit of a bank, the tax exemption is limited to 20 percent of the total net income of the bank. No income tax withholding applies to dividends paid from income generated by the qualifying activities.

An IBE was required to apply for IBE status. Once IBE status was granted, the IBE became subject to the applicable rules provided under Act 52. After September 25, 2012, no new applications have been accepted for IBE status; however, renewals of IBE licenses could still be processed and existing licenses remained in effect. Although existing IBEs can apply to be

International Financial Entities ("IFEs"), described below, the IBE rules are generally more favorable than the IFE rules.

2.4.9.3.2 International Financial Entities

Since September 25, 2012, a separate regime for IFEs has been in effect. An IFE is subject to rules that are similar to the rules applicable to IBEs, except that tax at a rate of 4 percent is applicable to net income from qualifying activities (subject to the same 20 percent limitation for IFEs operated by a bank). Income tax withholding applies to dividends at a rate of 6 percent on dividends paid from income generated by the qualifying activities. Upon approval of the licensing request, the IFE operates under a tax exemption decree that provides for the IFE's tax treatment. The tax exemption decree is effective for a period of 15 years, with two possible renewal extensions of 15 years each. The tax rate for the last possible 15-year period can range from 4 percent to 10 percent. No exemption decrees (other than renewals) can be issued for IFEs after December 31, 2019.

2.4.10 Reasons for Change

Two alternative sets of considerations should be taken into account in analyzing reform efforts with respect to pass-through entities. The first set involves an analysis of largely duplicative regimes and a determination of whether certain regimes may be eliminated or combined. The second set relates to encouraging a large segment of the business community currently operating in corporate form to convert to taxation under a pass-through regime. More specifically, as part of the effort to transition more businesses to a pass-through regime, certain adjustments relevant to the operation of the pass-through regimes may be considered to (1) make such regimes accessible to such a broad group of taxpayers, and (2) prevent abuse by taxpayers operating under such regimes.

2.4.10.1 Consolidating Duplicative Regimes

Regimes relating to the taxation of entities that are largely duplicative, with only slight differences, force taxpayers to expend effort in making choices that may have de minimis consequences. Also, if taxpayers can choose between different entity regimes that are designed to promote the same policies and activities, they often will choose the one that results in the lowest tax, possibly resulting in a loss to government revenues.

From the tax administrator's perspective, significant resources must be expended in developing and maintaining rules and procedures necessary to properly administer alternative regimes. In addition, training audit teams to enforce such duplicative regimes consumes scarce resources that could be deployed more efficiently elsewhere.

As new regimes are created, it is useful to analyze whether existing regimes continue to be necessary to promote the policies that originally justified such regimes. It also can be productive to periodically evaluate specific regimes to determine the extent to which the regimes are being used and are promoting the policies that are intended. Periodic accumulation of data and statistics with respect to the various regimes can be useful in undertaking these analyses to corroborate the effectiveness of current regimes that are intended to promote distinct policies.

As is readily apparent from the description of current law, there is significant overlap between a number of the regimes that are currently in place for subjecting business income to one level of tax. In certain situations, regimes have been left in place when new regimes were adopted that provide similar tax treatment. For example, the regime for special partnerships was retained after the more broad-based regime for partnerships was enacted in 2011. Similarly, the regime for IBEs was left in place after the modified regime for IFEs was adopted. In both situations, only grandfathered entities continue to be taxed under the prior regimes; no new entities can elect special partnership or IBE status. Thus, a different set of rules can apply to similarly situated businesses.

There is less of an overlap between certain other regimes. For example, although partnerships and corporations of individuals provide similar pass-through treatment for their owners, the corporation of individuals rules offer the benefit of simplicity for businesses with simple capital structures (provided those businesses can meet the requirements regarding the type and source of income). By contrast, the operative tax rules applicable to partnerships are more complex, but provide for more flexible economic arrangements. Thus, differences in businesses and capital needs provide justification for retaining simple corporation of individuals rules as well as more complex partnership tax rules.

Some of the other regimes, as currently structured, appear to be underutilized. For example, there are very few REITs. Also, most (if not all) existing RICs are operating under longstanding rules; however, the new exempt interest trusts, which are intended to promote economic activity and public interest in Puerto Rico, have been in effect for only a relatively short period thus far.

2.4.11 Description of Options

2.4.11.1 Consolidating Duplicative Regimes and Eliminating Unnecessary Regimes

2.4.11.1.1 Special Partnerships and Partnerships

It appears that entities currently operating under the special partnership regime could operate under the 2011 Act partnership regime with minimal disruption. Accordingly, consideration should be given to eliminating the rules for special partnerships and allowing such entities to convert to partnerships on a tax efficient basis.

2.4.11.1.2 SEOCs

Given the lack of studies regarding SEOCs, it is not clear whether the objectives of the SEOC regime are being achieved or whether the regime could be eliminated without negatively affecting the level of Puerto Rican manufacturing activities. It may be prudent to have a study conducted to determine whether the economic benefits of the regime justify its continued existence. If these special tax rules are not encouraging the stated goals, such entities might be converted to partnerships with little disruption.

2.4.11.1.3 REITs

If anecdotal evidence regarding the limited use of REITs is accurate, consideration could be given to eliminating the REIT regime and allowing existing REITs to remain subject to the REIT rules for a transition period. Thereafter, tax efficient conversion to partnership status could be permitted for such entities.

2.4.11.1.4 RICs

Usage of the new exempt investment trusts should be monitored, and if after some reasonable time it appears that the economic benefits in Puerto Rico sought through the promotion of such entities will not be realized, the regime for these entities should be eliminated.

2.4.11.1.5 IBEs

The IBE rules could be repealed and IBEs could be allowed a short grace period to request licenses for treatment as IFEs. Such entities would become subject to the IFE regime upon the issuance of a tax exemption decree.

2.4.12 Analysis

2.4.12.1 Consolidating Duplicative Regimes and Eliminating Unnecessary Regimes

2.4.12.1.1 Special Partnerships and Partnerships

There would seem to be little justification for retaining the separate special partnership and partnership regimes that exist under current law. Although certain foreign investors may incur a higher tax burden with respect to their existing investments under the partnership regime than under the grandfathered special partnership rules due to differences in withholding amounts, the elimination of the special partnership rules would seem to present little threat to the level of future investment by those investors. Furthermore, providing a benefit to parties by reference to historical ownership of certain entities does not promote a level playing with respect to such property investment.

The transition to the 2011 Act partnership regime seemingly would be simple for grandfathered special partnerships that were formed as partnerships or LLCs under the relevant jurisdictional law. Because juridical corporations cannot be taxed as partnerships under existing law, however, some accommodation would have to be made for special partnerships that are legally formed as corporations. If non-traded corporations generally are allowed to elect taxation as a partnership, no further adjustment to the rules would be required. If not, transition rules could provide that a special partnership could elect to be taxed as a partnership without any immediate tax on the conversion and without generating recapture of specified items from the period it was a special partnership, notwithstanding its legal status as a corporation.

Special partnerships that become partnerships no longer would be subject to the requirement that at least 70 percent of their gross income be derived from within Puerto Rico and be from certain specified business activities. Under current law, grandfathered special partnerships that have difficulty meeting this requirement can convert to partnership status anyway; thus, not imposing this requirement in the future should not have a significant impact on Puerto Rican economic activity.

2.4.12.1.2 SEOCs

The SEOC rules are complicated, and it is not readily apparent that the regime is well designed to accomplish its intended purpose of promoting labor incentives for manufacturing taking place in Puerto Rico. Depending on the outcome of the study suggested above, it may make sense to repeal the SEOC rules and allow existing SEOCs to convert to partnerships without triggering any immediate tax and without being subject to recapture.

2.4.12.1.3 REITs

Given what apparently is limited use of REITs by Puerto Rican entrepreneurs fourteen years after adoption of the original legislation, it appears that such a regime may not be useful in an economic environment like Puerto Rico's. While immediate elimination of the rules could impose an undue hardship on the limited real estate concerns that are operating under this regime, the adoption of transition rules that would allow the parties investing in such entities to properly reap a justifiable portion of the anticipated benefits without continuing those benefits in perpetuity may be appropriate. There is precedent in the United States in relation to the taxation of publicly traded partnerships for grandfathering the current tax treatment of entities for 10 years prior to transition to taxation as a corporation. Given the generally passive nature of REITs, providing for tax efficient conversion to partnership status following termination of REIT status could be appropriate.

2.4.12.1.4 RICs

Rules relating to the taxation of exempt investment trusts were adopted with the intent of encouraging economic development in Puerto Rico. Given the significant limitations on the permissible activities and investments of such entities, it is not clear that the exempt investment trust regime will be successful in achieving its goals. Accordingly, this regime should be monitored, and if usage of the entity indicates that the desired goals are not being achieved, the regime should be eliminated.

2.4.12.1.5 IBEs

The IBE regime is applicable only to grandfathered entities and is intended to encourage the same activities as the current IFE regime. There would seem to be little justification for retaining the IBE regime under these circumstances. IBEs do not operate under tax exemption decrees and have no vested right with regard to their current treatment. In transitioning existing IBEs to IFEs, IBEs should submit to an expedited IFE licensing process. Prior qualification as an IBE could be a favorable, heavily weighted, factor in granting an IFE license, so as to ease concerns that ultimate conversion may be improbable. Although current IBEs may complain about losing a tax status that is more favorable than that accorded to IFEs, it is valid to question whether taxpayers who were fortunate enough to operate under the prior regime should continue to benefit from a lower tax rate than their competitors indefinitely.

2.4.12.2 Accounting for Broader Usage of Pass-Through Entities

In considering whether to allow entities currently operating under the corporate tax system to transition into a pass-through tax regime, it will be important to evaluate the pass-through regimes that will be made available for conversion and whether the current regimes are well designed to accommodate the businesses that would be the subject of the conversions.

As an initial matter, it is important to recognize that over 90 percent of corporations operating in Puerto Rico have less than $60,000 of annual income. It is likely that the individuals running these businesses lack the sophistication and resources to operate under a tax regime with a high degree of complexity. While pass-through taxation generally is thought to be beneficial, due to the avoidance of a second level of tax, any variance from a basic capital structure and cash-funding of asset acquisitions and operations can introduce significant complexity to the tax reporting exercise for such entity. To the extent possible, the promotion of a straight-forward pass-through reporting regime for the relatively simple businesses would seem important.

Of equal importance, if a materially broader group of taxpayers will be given access to one or more pass-through regimes, there should be a heightened sensitivity to opportunities for abuse that might be facilitated through such regimes. While many of the parties who would convert to a pass-through regime will operate simple businesses and will not be inclined toward (or possess the sophistication to engage in) such abusive transactions, it should be assumed that this will not be the case for all who are encouraged to operate under such a regime.

A corporation of individuals is a relatively simple tax regime that presents little opportunity for abuse. The regime requires that the entity have only one class of stock. With such a simple capital structure, income allocations must be pro rata and thus are quite straightforward. The inability to undertake non-pro rata allocations also provides some limit on the opportunities for abuse. The inability to include liabilities in shareholder basis (for purposes of sheltering losses and distributions) also is a significant limitation on abuse potential.

Given the simplicity and limited opportunity for abuse inherent in the corporation of individuals, it seems that this regime should be made available and encouraged for many of those who would convert. The current rules provide that a corporation of individuals will terminate if the corporation has gross receipts other than from the conduct of a trade or business in Puerto Rico in excess of ten percent for the taxable year. Not only does the rule restrict activities to Puerto Rico, but it also necessitates the earning of a high level of gross income that is trade or business income rather than passive investment income. The rule, while arguably encouraging economic activity in Puerto Rico, provides a barrier to usage for some. The importance of making such a simple tax regime available to a broader constituency arguably should outweigh the reasons originally supporting the imposition of this limitation. Accordingly, consideration should be given to eliminating this limitation. In connection with the elimination of this limitation, steps should be taken to ensure that the corporation of individuals could not be used by individuals to avoid the limitation on deductibility of investment expenses under section 1033.02(a). Requiring that such expenses must be "separately stated" and allocated to the owners as separate items subject to the limitation would seem to provide adequate protection. Further, there is no compelling reason to limit the availability of corporation of individual's status to entities with 75 or less owners. Under this option, any eligible business entity with 200 or less owners may elect to be taxed as a corporation of individuals, so long as the entity satisfies the other applicable requirements.

In addition, given a target audience of taxpayers who may be relatively unsophisticated, there is a risk that numerous taxpayers will make "footfault" errors that cause disqualification as a corporation of individuals. A relief provision currently exists for excusing "inadvertent terminations" with the approval of the Secretary of the Treasury. However, in recognition that many of the mistakes will be "innocent" and cause no real compromise of the tax system, consideration should be given to implementing expedited procedures for correcting such errors and retroactively reinstating corporation of individual's status.

Business entities with more sophisticated capital structures or a shareholder base in excess of, e.g., 200 persons will not qualify as a corporation of individuals. If such businesses operating as corporations are allowed to convert to pass-through status, a partnership will be the most rational regime for these entities.

As noted above, partnerships are very flexible entities. Allocations of income and loss can be very flexible, non-recognition treatment generally is provided in connection with the contribution and distribution of assets, and partners are entitled to include their share of liabilities in the basis of their partnership interests. With such flexibility comes a heightened potential for abuse, and encouraging additional businesses to operate as partnerships could open the door to such abusive transactions. In this regard, many of the abusive transactions that have occurred in Puerto Rico in the past apparently have involved the use of allocated liabilities in the adjusted basis of partnership interests. Rules should be adopted to prevent the re-emergence of such abusive transactions.

Currently, the rules relating to special partnerships prevent partners from including partnership liabilities in the basis of their partnership interests. This rule has the benefit of simplicity, although some would view such a rule as improperly denying tax benefits to parties who take on true risk with respect to debt financed transactions through guarantees, indemnification arrangements, etc. The "at-risk" rules under the U.S. Internal Revenue Code try to strike a balance in this regard – these rules generally permit taxpayers to claim benefits in the form of tax losses only to the extent that taxpayers truly are bearing risk of loss with respect to the expenditures that generate the losses. This regime illustrates a potentially more fair, albeit more complicated, option and should be considered. The U.S. at-risk regime includes certain rules that provide favorable treatment for "qualified nonrecourse financing" relating to certain nonrecourse debt attributable to real estate. Given the nonrecourse nature of the debt, partners who share in such debt do not truly undertake risk with respect to such debt. If the desire is to provide credit only for debt with respect to which a partner is truly at-risk, the rules relating to qualified nonrecourse financing should not be adopted.

2.4.12.3 Transition from Corporate to Pass-Through Regime

As previously described, it would be more efficient for many of the businesses currently operating under tax rules applicable to corporations to instead operate under a pass-through regime. In order to promote transition to the more efficient model of taxation, consideration should be given to permitting many of the entities that currently are taxable as corporations to convert with minimal or no tax cost to taxation under a pass-through regime.

In analyzing the parameters of entity transition rules, a number of factors must be taken into account. First, it is necessary to determine what entities within the pass-through regime would be available for conversion from taxation as a corporation. Once a decision is made with respect to the available entities, consideration must be given to the tax cost of the conversion. Issues related to the future taxation of converted entities also must be considered in light of decisions relating to the chosen taxation of the conversion transaction. Finally, if favorable transition rules are adopted relating to entity conversions, the duration of such transition relief must be determined.

With respect to the entities available for conversion, it seems that any entity that would not be taxable as a per se corporation under the entity classification rules discussed above should be permitted to efficiently convert into either (1) a corporation of individuals (if requirements for qualification can be satisfied), or (2) a partnership. Corporations that could qualify as a corporation of individuals should be strongly encouraged to convert to such an entity. The rules for operating under this regime are much simpler and generally will accommodate the needs of smaller businesses with simple capital structures. In addition, transition issues and the potential for abuse with respect to such entities generally are more straightforward. Other non-per se entities should be permitted to convert to the partnership tax regime.

There is precedent in the Puerto Rican tax system for permitting favorable transition from corporate to pass-through treatment. Most recently, as part of the 2011 Act, a partnership or LLC that was subject to tax as a corporation was permitted to become taxable as a partnership effective as of the first day of the entity's taxable year beginning after January 1, 2011. Under these rules, on the last day of the taxable year beginning prior to January 1, 2011, the partnership or LLC that was taxable as a corporation was treated as transferring its assets and liabilities to its partners or members in liquidation of the partnership or LLC, and immediately thereafter the partner or member contributed the distributed assets and liabilities to an entity that was treated as a partnership for tax purposes. The transition provision stated that, except for limited situations, no gain or loss would be recognized in connection with the distribution by the entity taxable as a corporation, and the contribution transaction would be analyzed under the general non-recognition provision applicable to partnerships. The exceptions where gain or income could be recognized paralleled the rules that apply when a corporation converts to a corporation of individuals. Specifically, upon conversion, the partnership or LLC that was taxable as a corporation was required to: (1) recapture LIFO benefits; (2) recapture benefits of flexible or accelerated depreciation; (3) recognize deferred income under long-term contracts; (4) recognize deferred income from installment sales; and (5) treat earnings and profits as if they were currently distributed. In addition, a corporate tax would be imposed on the entity treated as a partnership with respect to built-in gain as of the date of conversion if recognized within a 10-year period following conversion.

A similar approach could be taken with respect to entity conversions under the new regime, although in the interest of encouraging more taxpayers to convert into a more rational tax regime for their businesses, consideration may be given to forgoing the deemed distribution of earnings and profits and 10-year built-in gain period. The other recapture and recognition provisions relate to tax-advantaged elections or alternatives that the corporation affirmatively took advantage of, and it seems more rational to recapture or recognize those amounts in all events.

In many situations, the total adjusted basis of the stock held by shareholders will be higher than the adjusted basis of the assets held by the corporation. In those situations, by electing to convert to a corporation of individuals or partnership on a largely tax-free basis, shareholders could realize some detriment, as they would lose the adjusted basis in their stock, and the adjusted basis in the corporation of individuals stock or partnership interests would be determined by reference to the bases of the assets that were deemed distributed to these persons (each holder would succeed to a proportionate part of the basis of each distributed asset based on a ratio determined as the value of the holder's equity interest over the total value of all outstanding equity interests, and the basis of such holder's interest in the corporation of individuals or partnership would equal to total basis of the portion of the assets deemed contributed by such holder.) This appears to have been the construct for conversions from a partnership or LLC taxed as a corporation to taxation as a partnership in 2011, and in that context, the parties still had to account for the deemed distribution of earnings and the 10-year built-in gain recognition period. In addition, parties wishing to convert to a corporation of individuals still would have the option to convert under the existing regime, in which case the shareholders would preserve their stock basis, but at the cost of the deemed distribution of earnings and 10-year built-in gain recognition period.

The adoption of a conversion mechanic that equates inside asset basis and outside basis in equity interests will facilitate rational reporting on a going forward basis with respect to the converted entities, particularly those that are partnerships. The partnership tax regime generally operates on the assumption that inside asset basis should equal outside equity interest basis.

The economic rights of partners generally will be accounted for by reference to "capital accounts." In general, a partner's ultimate rights upon liquidation of a partnership should equal the partner's initial capital account in a partnership, increased by "book" income allocations and the value of property contributions, and reduced by "book" loss allocations and the value of property distributions. Under the proposed regime for partnerships, following conversion, initial capital accounts for each partner would be set at the amount that the partner would be entitled to receive if the partnership sold its assets for fair market value on the date of conversion and liquidated. Each partner would have a share of adjusted basis in the partnership assets equal to such partner's adjusted basis in its partnership interest. The difference between a partner's capital account and its share of inside basis would be taken into account under principles similar to the principles relating to contributed property under section 1071.04(c) of the Puerto Rican Code. Each partner would have a proportionate share of built-in gain or loss in each asset determined by reference to the partner's built-in gain or loss in its partnership interest. Following these rules, if all partnership assets are sold, and the partnership liquidates, distributing cash to each partner consistent with such partner's economic share, the partner should recognize no gain in connection with the liquidating distribution. This result is consistent with a properly operating partnership tax regime.

With respect to the corporation of individual's regime, the allocation regime should be more straightforward. The concept of "capital accounts" is not relevant in the context of corporations of individuals. Instead, given the "single class of stock" capital structure, all allocations of income and loss are simply made on a pro rata basis.

Finally, a decision must be made regarding the period during which conversions may be accomplished on the tax-favored basis. When entities previously were allowed to convert in connection with the 2011 Act, the relevant entities were provided with a one-time opportunity to convert as of the entity's first taxable year beginning after January 1, 2011. Anecdotal evidence indicates that many entities that could have benefited from such an election failed to take advantage of this option. In order to provide a greater opportunity to educate the relevant constituency of the presence of the conversion option and the benefits that might be obtained, consideration should be given to a longer period of e.g. three years when entities may take advantage of this conversion option.

Beyond the initial transition period, any non-per se entity taxable as a corporation could be allowed to convert to pass-through status for Puerto Rican tax purposes. After a reasonable transition period during which favorable conversion conditions are permitted, however, the more traditional tax treatment would apply, including recognition of gain upon the deemed liquidation of the entity taxable as a corporation (except for certain controlled subsidiary liquidations.

2.5 Rationalize Allocation of Incentives for Inbound Business Taxation

2.5.1 Current Law

2.5.1.1 In General

The taxation of income of nonresident aliens, foreign corporations, and foreign partnerships ("foreign persons") generally depends on the source of the income and whether the foreign person is engaged in the conduct of a trade or business in Puerto Rico. A foreign person that is not engaged in a trade or business in Puerto Rico is subject to Puerto Rico income tax only on certain items of Puerto Rico source income. A foreign person that is engaged in the conduct of a trade or business in Puerto Rico is subject to Puerto Rico income tax on all income effectively connected with that trade or business ("ECI"). If a foreign person is engaged in a trade or business in Puerto Rico at any time during a taxable year, all Puerto Rico source income and gains received by the person during the year are treated as ECI. Non-Puerto Rico source income is treated as ECI only if the income consists of a certain type of income, the foreign person has an office or other fixed place of business in Puerto Rico, and the income is attributable to that office or fixed place of business. A branch profits tax is imposed on the withdrawal of assets from

Puerto Rican operations in order to equalize the treatment of foreign corporations that do business directly in Puerto Rico and those which operate through a Puerto Rican subsidiary.

2.5.1.2 Law 73 and Law 135

Inbound investment in Puerto Rico has long been encouraged by tax subsidies. The Economic Incentives for the Development of Puerto Rico Act ("Law 73") became effective on July 1, 2008. Law 73 replaced the Tax Incentives Act of 1998 ("Law 135"), which continues to apply to a number of decrees that were issued prior to 2008. While there are some differences between the two Laws, the substantive parameters are generally the same. Because Law 73 governs current grants, this discussion will focus on Law 73.

Under Law 73, exemption decrees are issued to qualifying businesses by the Office of Industrial Tax Exemption. The Puerto Rico Industrial Development Company ("PRIDCO") is responsible for the promotion of the incentives program.

Law 73 provides reduced tax rates on net industrial development income of exempt businesses and reduced withholding tax rates on payments made by exempt businesses (generally 4% and 12%, respectively, or alternatively, 8% and 2%, respectively), as well as additional deductions for acquiring, constructing, or remodeling certain buildings, structures, machinery and equipment, and tax credits for purchases of Puerto Rico manufactured products, for special eligible investments, for investment in energy producing machinery and equipment, for reduction of energy costs, and for investment in strategic projects. Dividends or profit distributions by an exempt business of industrial development income to its shareholders or partners are not subject to tax. In addition, the Law provides a 90% exemption from property taxes, 100% exemption from municipal license taxes during the first 3 semesters of operations and at least 60% thereafter, and 100% exemption from excise taxes and sales and use taxes with respect to the acquisition of raw materials and certain machinery and equipment used in exempt activities. The length of the exemption period generally is 15 years and generally may be extended for an additional 10 years. Businesses eligible for the exemption include manufacturing and service units, owners of properties used by exempt businesses, research operations, energy suppliers, recyclers, value added activities related with the Las Americas Port and various other ports, software developers, renewable energy equipment assemblers, certain specified strategic projects, the construction of social interest housing and the planning and development of self sustainable housing projects, and repair, maintenance and overhaul of aircraft.

2.5.1.3 Law 20

Law 20, the "Export Services Act," enacted in 2012, is the latest business incentive measure. It is intended to encourage local businesses to expand their operations in Puerto Rico and foreign businesses to move their operations to Puerto Rico, by providing preferential tax treatment to businesses that export certain services from Puerto Rico to customers around the world. Eligible businesses must obtain an exemption decree to receive benefits under Act 20.

To be eligible for benefits under Law 20, a business must have an office or bona fide establishment located in Puerto Rico that carries out, or may carry out, "Eligible Services" that are either "Export Services" or "Promoter Services."

Eligible Services (to the extent provided for export) include: research and development; advertising and public relations; economic, environmental, technological, scientific, managerial, marketing, human resources, computer, and auditing consulting services; consulting services for any trade or business; commercial arts and graphic services; drafting of construction plans and engineering, architectural, and project management services; professional services such as legal, tax, and accounting services; centralized management services that include, but are not limited to strategic location, planning, and budgetary services carried out at the headquarters or similar regional offices of an entity engaged in rendering such services; electronic data processing centers; computer program development; voice and data telecommunications between persons located outside Puerto Rico; call centers; shared service centers that include, but are not limited to accounting, finance, tax, auditing, marketing, engineering, quality control, human resources, communications, electronic data processing, and other centralized management services; storage and distribution centers of companies engaged in the business of transportation of items and products that belong to third parties, known as "hubs"; educational and training services; hospital and laboratory services; investment banking and other financial services insofar as these services are provided to foreigners; and any other service designated by the Secretary of the Department of Economic Development and Commerce of Puerto Rico.

An Eligible Service is considered a service provided for export (i.e., an Export Service) if such service is rendered for the benefit of a person or entity that is not a resident of Puerto Rico and the service does not have a connection with Puerto Rico.

Certain services that have a connection with Puerto Rico (and thus fail to qualify as Export Services) may qualify as Eligible Services if they constitute Promoter Services. Promoter Services are services provided to non-resident persons related to the establishment of a new business in Puerto Rico.

To receive benefits under Law 20, a Puerto Rico service provider must apply for and receive a tax exemption decree from the Department of Economic Development and Commerce of Puerto Rico. A tax exemption decree constitutes a binding contract between the service provider and the Government of Puerto Rico, and benefits are guaranteed for the term of the decree regardless of a subsequent change in law. The decree will have a term of 20 years, with a possible 10 year extension.

The tax benefits under Law 20 include:

1) 4% fixed income tax rate on net income derived by an Eligible Business from Export Services;

2) 3% fixed income tax rate on net income derived by an Eligible Business from Export Services if more than 90% of the Eligible Business's income is derived from Export Services and the Export Services are considered "Strategic Services" under the Act;

3) 100% exemption from Puerto Rico income tax on dividend distributions received by shareholders or members of an Eligible Business that holds an exemption decree; and

4) 100% exemption from personal and real property taxes during first five years of operations for personal and real property used by an Eligible Business that provides services related to corporate headquarters, call centers, or shared service centers. After the first five years, a 90% exemption applies for the remaining term of the decree.

2.5.1.4 Law 154

2.5.1.4.1 Background

Law 154, enacted on October 25, 2010, materially affects the tax burden borne by inbound investors. Law 154 modified the Puerto Rico Internal Revenue Code to expand the circumstances in which a foreign person may be treated as engaged in a trade or business in Puerto Rico and to treat certain income derived by foreign persons as Puerto Rico source ECI, and thus subject to Puerto Rico income tax. Law 154 applies only to foreign persons who engage in high volumes of transactions with related parties engaged in business within Puerto Rico. As a result, there is a very high overlap between those multinational groups whose Puerto Rican subsidiaries have been granted decrees under Law 73 and those who are subject to Law 154.

Prior to the enactment of Law 154, an office or other fixed place of business of a Puerto Rico person was attributed to a foreign person only if the Puerto Rico person had the authority to negotiate contracts in the name of the foreign person, the Puerto Rico person regularly exercised that authority or maintained an inventory of merchandise from which it regularly filled orders on behalf of the foreign person, and the Puerto Rico person was not a general commission agent, broker, or other independent agent acting in the ordinary course of its business. Law 154 expanded this rule to attribute the office or fixed place of business of a Puerto Rico resident to a related foreign person if the related parties engage in certain types of transactions (the "Related Party Attribution Rule"). If the Related Party Attribution Rule applies, a portion of the foreign person's income is treated as Puerto Rico source ECI, and thus subject to Puerto Rico income tax (the "Source Rule"). Law 154 also adopted an excise tax (the "Excise Tax") that is imposed on certain foreign persons in lieu of the income tax that the foreign persons would pay under the Source Rule.

Two features of the law are very important to understanding its history and its function. As an initial matter, the decrees granted pursuant to Law 73 severely restricted Puerto Rico's ability to collect revenues directly from the operating Puerto Rican subsidiaries of multinational corporations. By taxing the Puerto Rican source income (as redefined) of related parties dealing with those subsidiaries, the decrees were circumvented and Puerto Rico was able to tax income related to the activities governed by the decrees without violating their terms. In addition, the regime has had the benefit of generally allowing U.S. groups to claim a credit against their U.S. taxes for the amounts paid under Law 154, while still benefitting from indefinite deferral of the U.S. tax on the income reported by the Puerto Rican subsidiary. As a result, the impact of the tax on the worldwide effective tax rate of the group is substantially less than it would be in the case of a tax imposed directly on the Puerto Rican subsidiary.

2.5.1.4.2 The Operation of Law 154

2.5.1.4.2.1 Related Party Attribution Rule

The Related Party Attribution Rule applies in situations where a foreign person (a "Foreign Purchaser") purchases goods from a related [51] company that manufactures property or performs services in Puerto Rico (the "Seller"), and, for the taxable year or any of the three preceding taxable years, one of the following requirements is satisfied:

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[51] Corporations are related for this purpose if they are members of the same controlled group. Corporations generally are members of the same control group if one corporation owns, directly or indirectly, at least 50 percent of the total voting power and value of stock of the other corporation, or a common parent owns, directly or indirectly, at least 50 percent of the total voting power and value of the stock of each corporation.

1) The Seller's total gross receipts from the sale to the Foreign Purchaser of personal property manufactured or produced in Puerto Rico, or from the performance of services in Puerto Rico for or on behalf of the Foreign Purchaser, accounted for at least 10% of Seller's gross receipts;

2) The Foreign Purchaser's purchases of personal property manufactured or produced in Puerto Rico by the Seller, or services performed in Puerto Rico by the Seller, accounted for at least 10% of the total costs of the Foreign Purchaser's purchases of property or services;

3) The Foreign Purchaser earns commissions with respect to property manufactured or produced in Puerto Rico by the Seller, or services performed in Puerto Rico by the Seller, and such commissions account for at least 10% of the amount of the Foreign Purchaser's commissions or other fees from similar transactions; or

4) The Foreign Purchaser facilitates the Seller's sale of personal property manufactured or produced in Puerto Rico, or the performance of services in Puerto Rico, and, together with the transactions in the first three categories, the facilitated transactions account for at least 10% of the gross receipts of the Seller or at least 10% of the gross receipts of the Foreign Purchaser.

Law 154 provides an anti-abuse rule that disregards any transaction, or series of transactions, if one of the principal purposes of the transaction or series of transactions is the avoidance of the Related Party Attribution Rule.

2.5.1.4.2.2 Source Rule

If a Foreign Purchaser satisfies the Related Party Attribution Rule and otherwise maintains an office or other fixed place of business in Puerto Rico, or is treated as maintaining an office or fixed place of business in Puerto Rico apart from the Related Party Attribution Rule, a portion of the Foreign Purchaser's income is treated as income from Puerto Rico sources. If a Foreign Purchaser that is not otherwise engaged in a trade or business in Puerto Rico has income that is treated as Puerto Rico source income under the Source Rule, the Foreign Purchaser is treated as engaged in a trade or business in Puerto Rico and the Puerto Rico source income is treated as ECI (and thus subject to Puerto Rico income tax).

The Source Rule applies if the Seller's gross receipts from sales to the Foreign Purchaser of personal property manufactured or produced in Puerto Rico, and services performed for or on behalf of the Foreign Purchaser in Puerto Rico, does not exceed $75,000,000 for any of the three preceding taxable years. If the Seller's gross receipts exceed $75,000,000 for any of the three preceding years, the Foreign Purchaser is subject to the Excise Tax in lieu of the income tax that the Foreign Purchaser would owe on any income treated as Puerto Rico source income under the Source Rule.

The portion of a Foreign Purchaser's income that is treated as Puerto Rico source income under the Source Rule is determined by multiplying the total amount of the Foreign Purchaser's income by a fraction based on four equal factors: property, payroll, sales, and purchases (the "Apportionment Formula"). The numerator of the Apportionment Formula is the sum of four fractions: (1) the value of real or tangible personal property owned and used by the Foreign Purchaser in Puerto Rico over the value of the Foreign Purchaser's total worldwide real and tangible personal property; (2) the amount the Foreign Purchaser paid or accrued in Puerto Rico for compensation over the Foreign Purchaser's total worldwide compensation expense; (3) the

Foreign Purchaser's sales in Puerto Rico over the Foreign Purchaser's total worldwide sales; and (4) the Foreign Purchaser's purchases of property in Puerto Rico over the Foreign Purchaser's total worldwide purchases of property. The denominator of the Apportionment Formula is four.

If a Foreign Purchaser believes the Apportionment Formula has operated or will operate to subject a greater portion of its income to taxation than is reasonably attributable to business or sources within Puerto Rico, the Foreign Purchaser may file an objection to the application of the Apportionment Formula and propose an alternative method of apportionment that it believes to be proper under the circumstances.

If a Foreign Purchaser subject to the Source Rule is unwilling or unable to provide sufficient documentation to support its computation of the Apportionment Formula, and the Foreign Purchaser does not file a timely objection to the use of the Apportionment Formula, 50 percent of the Foreign Purchaser's gains, profits, and income from the sale or exchange without Puerto Rico of personal property manufactured or produced in whole or in part within Puerto Rico will be treated as ECI.

The Related Party Attribution Rule and Source Rule apply to income accruing after December 31, 2010.

2.5.1.4.2.3 Excise Tax

The Excise Tax is imposed on the value of certain personal property and services acquired by a foreign person from a related Puerto Rico entity with gross receipts of at least $75,000,000 if the foreign person has, or is treated as having, an office or fixed place of business in Puerto Rico under the Related Party Attribution Rule or through an agent, and the related party transactions exceed a certain threshold. Similar to the Related Party Attribution Rule, the Excise Tax only applies if Foreign Purchaser acquires personal property manufactured or produced in Puerto Rico and services performed in Puerto Rico from a member of the same controlled group, or where one person provides distribution or facilitation services for another member of the same controlled group, that during any of the three preceding taxable years account for:

1) At least 10% of the Seller's total gross receipts from the sale of personal property manufactured or produced in Puerto Rico, or from the performance of services in Puerto Rico;

2) At least 10% of the total cost of the Foreign Purchaser's acquisitions of personal property and services;

3) At least 10% of the total amount of the Foreign Purchaser's commissions or other fees; or

4) In the case of transactions facilitated by the Foreign Purchaser, such transactions, together with the transactions in the first three categories, account for at least 10% of the total gross receipts of the Seller or at least 10% of the total gross receipts of the Foreign Purchaser from facilitation services.

If the aforementioned requirements are satisfied, the Excise Tax is imposed at a 4% rate on the value of the tangible property manufactured in whole or in part in Puerto Rico and the services performed in Puerto Rico in connection with the manufacture or production of tangible property that the Foreign Purchaser acquires from Seller. The Excise Tax provides an anti-abuse rule that disregards any transaction, or series of transactions, if one of the principal purposes of the transaction or series of transactions is the avoidance of the Excise Tax.

The Excise Tax liability is imposed on the Foreign Purchaser but is collected and remitted by the Seller. A Foreign Purchaser that is subject to the Excise Tax is allowed a credit for taxes paid to any U.S. state on the acquisition of tangible property manufactured or produced in Puerto Rico, or services performed in Puerto Rico by certain persons in connection with the manufacture or production of tangible property.

As originally enacted, the Excise Tax rate was scheduled to be phased out and eliminated after 2016. In 2013, the Excise Tax was extended at a 4% rate through 2017.

2.5.2 Reasons for Change

2.5.2.1 In General

It is generally believed that in the absence of the benefits granted under statutes such as Law 73 and Law 20, existing foreign investors would reduce or eliminate their business activities in Puerto Rico and the procurement of new inbound investment would be severely hampered. Given the direct revenue contribution, as well as the significant economic contribution made by these companies, that would be an unacceptable result. Thus, this project assumes that Puerto Rico must maintain a robust incentives program in order to maintain and attract inbound investment. However, certain subsidy programs, such as Law 20, can be strengthened to ensure that they achieve their stated objectives. Additionally, further study is needed to evaluate whether the optimal design features of the current subsidy programs may be improved or may lie outside the tax area.

2.5.2.2 Law 154

Although there is to some extent a sense of dissatisfaction with Law 154, in-depth conversations with companies currently benefitting under Law 73 and 154 that are also subject to Law 154 suggest a general acceptance of the current regime. Like any taxpayers, the companies would prefer a lower tax burden, and there is a measure of concern relating to the issues discussed below. Nonetheless, the companies did not suggest a wholesale replacement or reworking of the Law 154 regime. Rather there was a measure of consensus that if similar amounts of revenue are to be raised from the constituency affected by Law 154, it would be best to do so by extending the existing regime.

2.5.2.2.1 Complexity

The Related Party Attribution Rule, Source Rule, and Excise Tax are without doubt a very complex set of rules. Although the Tax Reform Committee that was convened in 2010 believed that the Related Party Attribution Rule and Source Rule would be simpler to implement than a combined reporting system that treated a Puerto Rico manufacturer and its related foreign affiliates as a single unitary business subject to tax in Puerto Rico, the Tax Reform Committee recognized that the Related Party Attribution Rule and Source Rule also could be difficult to administer. Accordingly, the legislature adopted the temporary Excise Tax to apply in certain cases in lieu of the income tax that otherwise would be owed under the Source Rule.

The Statement of Motives to Law 154 explains that "[t]he benefits in the administration and oversight of an excise tax such as this one are particularly significant in the use of high volume manufacturers." Thus, while the simpler Excise Tax applies to certain Puerto Rico manufacturers or service providers with gross receipts from related-party transactions in excess of $75,000,000, the more complex Related Party Attribution Rule and Source Rule apply to Puerto Rico entities with gross receipts below that threshold. Further, all taxpayers will be subject to the more complex rules when the Excise Tax expires after 2017.

2.5.2.2.2 Temporary Nature

The Related Party Attribution Rule and Source Rule were intended to constitute permanent changes to the Code. The Excise Tax, on the other hand, was intended to be a temporary provision. The Statement of Motives to Law 154 explains that the "temporary excise tax as an alternative to the Income Source Rule would be in effect exclusively for a six (6) year period and would gradually drop during this period of time in order to facilitate the implantation of the fiscal responsibility measures of this Administration." In 2013, however, the Excise Tax was extended at a flat 4% rate through 2017.

2.5.2.2.3 Uncertainty regarding the Creditability of the Excise Tax for U.S. Federal Income Tax Purposes

The United States generally allows a U.S. corporation to elect to claim a credit against its U.S. income tax liability for income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country. Puerto Rico generally is treated as a foreign country for purposes of the U.S. Internal Revenue Code. Accordingly, a U.S. corporation generally is eligible to claim a credit against its U.S. income tax liability for income taxes paid to the government of Puerto Rico.

The United States also allows a credit for any tax paid to a foreign country in lieu of a tax on income, war profits, or excess profits. The Excise Tax was enacted with the expectation that it would be treated as a creditable tax for U.S. tax purpose because the excise tax is imposed in lieu of the income tax that a Foreign Purchaser otherwise would be required to pay pursuant to the Source Rule. Some taxpayers and practitioners have expressed uncertainty, however, as to whether the Excise Tax is a creditable tax for U.S. tax purposes.

Following the enactment of Law 154, U.S. taxpayers asked the U.S. Internal Revenue Service and Treasury Department to issue a ruling regarding the creditability of the new Excise Tax. On April 18, 2011 the U.S. Internal Revenue Service issued Notice 2011-29,[52] stating that:

> The IRS and the Treasury Department are evaluating the Excise Tax. The provisions of the Excise Tax are novel. The determination of the creditability of the Excise Tax requires the resolution of a number of legal and factual issues. Pending the resolution of these issues, the IRS will not challenge a taxpayer's position that the Excise Tax is a tax in lieu of an income tax under section 903. This notice is effective for Excise Tax paid or accrued on or after January 1, 2011. Any change in the foreign tax credit treatment of the Excise Tax after resolution of the pending issues will be prospective, and will apply to Excise Tax paid or accrued after the date that further guidance is issued.

Although this was a taxpayer-favorable Notice, the Notice did not eliminate taxpayer uncertainty because the Notice can be revoked prospectively at any time.

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[52] 2011-16 I.R.B. 663.

2.5.2.2.4 Constitutionality

Some taxpayers and practitioners also have raised concerns regarding the constitutionality of Law 154. Specifically, these parties have questioned whether the law violates the so-called "Dormant Commerce Clause" of the U.S. Constitution. Very generally, the "Commerce Clause" of the U.S. Constitution provides that the U.S. Congress shall have the power "to regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."[53] In addition to this affirmative grant of authority, the U.S. Supreme Court has long held that the Commerce Clause, by negative implication, forbids the states from enacting laws that discriminate against or unduly burden interstate commerce.[54] This negative implication is known as the Dormant Commerce Clause. The U.S. Court of Appeals for the First Circuit has held on two occasions that Puerto Rico "is subject to the constraints of the dormant Commerce Clause doctrine in the same fashion as the states."[55] Although modeled on state income taxes which employ worldwide apportionment fractions to impose tax on amounts of income that may be greater than what is reported by in-state affiliates on their separate books, a critical difference between Law 154 and such regimes is that Law 154 does not attempt to collect the tax from the Puerto Rican affiliate, but rather from the non-Puerto Rican (frequently U.S.) affiliate through an imputation of nexus. This distinguishes Law 154 from regimes that have been previously held to be constitutional, and thus creates at least some measure of uncertainty in this regard as well.

2.5.2.2.5 Taxpayer Response

Law 154 was quickly enacted with little input from taxpayers or tax practitioners. In addition to objections to the substance of Law 154, many taxpayers and their representatives criticized the government for failing to involve them in the legislative process and to provide them with an opportunity to review the law and provide their comments and concerns before the law was enacted. The Legislative Assembly is aware of these criticisms and has solicited the comments and concerns of interested parties in developing a replacement for Law 154.

2.5.3 Description of Options

2.5.3.1 Examine and Rationalize Existing Incentives

The current incentives structure should be examined to determine whether, on a prospective basis, there are more efficient alternatives to encourage the desired investment activity. Further, all incentive programs should be subject to periodic rigorous cost-benefit review.

2.5.3.2 Amend Law 20 to Require a Certain Threshold of Specific Puerto Rico Economic Activity as a Condition of Awarding Grants

Consideration should be given to amending Law 20 to condition the receipt of benefits under the Law on a certain minimum threshold of activity in Puerto Rico, based either on number of employees, payroll expense, or property owned in Puerto Rico.

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[53] Article I, Section 8, Clause 3.

[54] *See, e.g., Cooley v. Board of Wardens of Port of Philadelphia*, 13 L.Ed. 996 (1852).

[55] *Trailer Marine Transport Corp. v. Vazquez*, 977 F.2d 1, 7 (1st Cir. 1992); *see also Antilles Cement Corporation v. Fortuno*, 670 F.3d 310, 327 (1st Cir. 2012).

2.5.3.3 Extend Law 154 Excise Tax

Consideration should be given to a short extension (*e.g.*, five years or less) of the Law 154 excise tax.

2.5.4 Analysis

2.5.4.1 Examine and Rationalize Existing Incentivizes

As noted above, this project assumes that Puerto Rico must continue to grant benefits under statutes such as Law 73 and Law 20 to maintain and encourage inbound investment. A broad based low rate tax regime (such as that of Ireland) would not attract material amounts of investment and would reduce the revenue collected from domestic corporate business activity. Thus, as a practical matter, negotiation of individual arrangements with existing and inbound investors appears to be the most promising way to attract and maintain inbound investment. However, if the tax system is chosen as the delivery mechanism for these incentives, the structure of the incentive programs must be carefully designed to assure that the benefits are targeted. Moreover, the arrangements negotiated by PRIDCO should be subjected to regular, rigorous cost benefit analysis and the incentives adjusted if necessary.

2.5.4.2 Amend Law 20 to Require a Certain Threshold of Specific Puerto Rico Economic Activity as a Condition of Awarding Grants

A company should not be entitled to benefits under Law 20 unless the company makes a certain minimum contribution to the Puerto Rico economy. The efficacy and objectives of Law 20 would be improved by requiring companies that receive benefits under Law 20 to maintain a minimum threshold of either employees, payroll expense, or business property in Puerto Rico.

2.5.4.3 Extend Law 154 Excise Tax

The Commonwealth needs the revenue from Law 154 (estimated at approximately $2 billion for FY 2015), and the inbound sector appears to be the most viable source to obtain the bulk of that revenue. Although the major inbound companies initially objected to the enactment of Law 154 – in particular the lack of transparency in connection with the legislation that brought it into being, those companies now seek certainty, predictability, and sustainability of the Puerto Rican laws that determine their Puerto Rican tax burden rather than attempting to rewrite past history. While in an ideal world it would be preferable from a tax policy standpoint to replace Law 154 with a simpler regime, the majority of the major inbound companies were unable to identify an alternative regime that they would find preferable to Law 154 (based on the assumption that Puerto Rico will continue to impose a similar tax burden on inbound companies regardless whether Law 154 is continued or repealed). Further, none of the major inbound companies indicated that an extension of Law 154, in and of itself, would cause them to revisit their investments in Puerto Rico. Accordingly, a short extension (no more than five years) of the Law 154 excise tax appears to be the best option for the Commonwealth to meet its short-term revenue needs.

In connection with the process, possible responses of the U.S. federal government acting through its Treasury Department and Internal Revenue Service were considered. For both political and tax policy reasons, it seems likely that the federal government would be more accepting of a short-term extension of the Law 154 excise tax, as compared to a permanent or long-term extension of the excise tax. There is reason to believe the latter action would be much more likely to cause the U.S. Treasury Department to revisit the 2011 Notice.

2.5.4.4 Elimination of Branch Profits Tax

The options to amend the taxation of Puerto Rican corporations generally do not do away with withholding taxes on dividends paid to foreign shareholders. The retention of the taxation of dividends in general (including withholding) is to prevent the use of corporations in creating artificial losses or otherwise avoiding taxes properly collected at the shareholder level. In the case of branch operations of a foreign corporation, these considerations are not relevant. Therefore, in connection with the changes to the taxation of domestic corporations (and in particular making flow-through taxation more generally available) consideration should be given to eliminating the branch profits tax.

2.6 Property Tax

2.6.1 Current Law

Property taxes are the primary source of funding for the municipalities of Puerto Rico. Property tax receipts were $979, 398 000 in FY 2012-13 of which $631.7 million was attributable to real property taxes and $347.69 million was attributable to personal property taxes.

Puerto Rico imposes property tax on real property located in Puerto Rico and personal property located in Puerto Rico that is used in a trade or business. Property taxes are imposed by the Municipal Property Tax Act of 1991 ("MPTA"),[56] and taxes are collected by the Municipal Revenue Collection Center (commonly known by its Spanish acronym as "CRIM"). Property taxes are partly imposed by the government of the Commonwealth and partly by each municipality, but all property taxes are collected by the CRIM based on a single combined rate.

The Commonwealth levies a tax on all non-exempt real and personal property located in Puerto Rico equal to 1.03% of the assessed value of the property.[57] The municipalities generally are authorized to levy a tax of up to 4% of the appraised value of all personal property and up to 6% of the appraised value of all real property.[58] The municipalities also have limited authority to assess additional property tax.[59] The combined tax rate for real property generally ranges from 8%-10% and the combined tax rate for personal property generally ranges from 6%-8%.[60]

2.6.1.1 Taxable Property

All personal property and real property located in Puerto Rico is presumed to be taxable unless an exemption applies.[61]

2.6.1.2 Real Property

Real property includes land, subsoil, and all structures, objects, machinery, and devices attached to a building or fixed on the ground in a permanent manner.[62]

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[56] Codified at 21 LPRA § 5001 et. seq.
[57] 21 LPRA § 5002.
[58] 21 LPRA § 5001.
[59] 21 LPRA § 5002.
[60] See Ríos-Méndez and Alemar-Escabí, 7320 T.M., Business Operations in Puerto Rico, Part IV.G.2.
[61] 21 LPRA § 5061.
[62] 21 LPRA § 5061.

2.6.1.3 Personal Property

Personal property generally includes all property other than real property.[63] The MPTA specifically provides that personal property includes: machinery, containers, instruments, and other devices not attached to a building or land in a permanent nature; livestock; money; bonds, stock, and other financial instruments; and copyrights, trademarks, franchises, and concessions.[64]

2.6.1.4 Exemptions

The MPTA expressly exempts numerous categories of property from personal and real property tax.[65] Exempt property includes: household personal property strictly for personal use; certain intangible property such as bank accounts; the first $15,000 of the value of real property resided in by its owner; property of the United States or the Commonwealth of Puerto Rico; property held by municipalities for public use; stock, bonds, promissory notes, and other securities or debts issued by Puerto Rico entities or certain foreign entities; property owned by nonprofit organizations and hospitals; motor vehicles subject to the payment of license plates; livestock and the structures and equipment for raising them; certain watercraft; real property located in historic zones; renewable energy equipment; and property of international banking institutions.[66]

2.6.1.5 Assessment and Collection

2.6.1.5.1 Personal Property

Personal property is assessed based on the book value of the property as of January 1 of each year.[67] Book value means the cost of acquisition or production of the personal property adjusted for depreciation, obsolescence, or other factors as reflected in the accounting books and records in accordance with generally accepted accounting principles.[68] If book value does not reasonably reflect fair market value the personal property may be assessed based on fair market value.[69]

Every person that is engaged in a trade or business and owns personal property used in that trade or business as of January 1 must file a personal property tax return for that taxable year.[70] Persons that own only exempt personal property on January 1 generally do not need to file a property tax return.[71] Every for-profit corporation with sales over $3,000,000 must submit certified financial statements with its property tax return and have the return reviewed by a CPA.[72] Effective December 25, 2013, the return of these corporations also must include certain supplemental information.[73]

The personal property tax return is due on May 15 immediately following the January 1 assessment date.[74] For taxable years commencing after December 31, 2013, the self-assessed

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[63] *Id.*

[64] *Id.*
[65] See generally 21 LPRA §§ 5002, 5003, 5151.
[66] *Id.*
[67] 21 LPRA § 5204.
[68] 21 LPRA § 5202(g).
[69] 21 LPRA § 5204.
[70] 21 LPRA § 5203(a).
[71] 21 LPRA § 5203(b).
[72] 21 LPRA § 5203(c).
[73] 21 LPRA § 5203(c), modified by Act No. 163-2013.
[74] 21 LPRA § 5205(a).

tax on personal property must be paid through four equal estimated payments due on August 15 and November 15 of the current year, and February 15 and March 15 of the following year.[75]

2.6.1.5.2 *Real Property*

Real property is assessed according to its status and condition as of January 1 of each year.76 The Commonwealth has not conducted a real property reassessment since 1958. As a result, all real property taxes are based on the assessed valuation of real property in fiscal year 1957-58.[77] New construction also is assessed based on what the value of the property would have been in 1958. Accordingly, the overall assessed valuation of real property for taxation purposes is substantially lower than the actual fair market value. Real property taxes must be paid in two equal installments by July 1 and January 1 immediately following the assessment dates.[78] No tax return is required to report and pay real property tax.

2.6.2 Reasons for Change

A primary objective of property tax reform is to create an efficient and equitable revenue stream that will enable each municipality to "stand on its own bottom."

Many object to the personal property tax in general, but more specifically the inclusion in the tax base of business inventories. The real property tax base is significantly undervalued. It has been suggested that the real property tax base be revalued and the revenue from such a revaluation (and possible rate revision) be used to eliminate the personal property tax and perhaps augment general revenues. Indeed the New York Federal Reserve has noted that Puerto Rico, in comparison with states in the United State, has "a notably low reliance on property taxes."[79]

The current system has multiple deficiencies when compared to international best practices. Options to improve the system include repeal of the personal property tax, updating and maintaining real property values at current fair market value, creating systems to capture new construction and improvements, consideration of differential rates for different property uses, creating a modern system for recording property transfers, consideration of a real property transfer tax, devising a system for allocating property tax receipts and a systematic examination of the current structure for administering the tax.

2.6.3 Description of Options

If the scope of the engagement is expanded, subsequent reports will quantify the economic and distributional effects of the options described above as well transition options to implement the new regime most efficiently.

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[75] 21 LPRA § 5205(h).
[76] 21 LPRA § 5068.
[77] *See* Commonwealth of Puerto Rico, Financial Information and Operating Data Report (Oct. 18, 2013), available at http://www.gdbpr.com/spa/documents/commonwealthreport.pdf.
[78] 21 LPRA § 5091.
[79] [Fed Report, p.16].

2.7 Penalties

2.7.1 Current Law

The current Puerto Rico Tax Code[80] has an extensive set of provisions that provides for penalties, additions to tax, and surcharges for various acts, omissions, and violations of the Puerto Rico tax laws. These penalties and additions to tax apply to any taxes, license fees, or levies with respect to the income taxes; estate and gift taxes; excise taxes; sales and use taxes, and alcohol beverage taxes.[81] Most of these penalties and additions to tax are found in Subtitle F, Administrative Provisions, Procedures, Interests, Penalties, and Additions to Taxes. There are civil penalties that result in monetary fines and also loss of tax benefits,[82] and there are criminal penalties (misdemeanor and felony) that can result in monetary fines and imprisonment. The more frequent penalties that are associated with income taxes, estate and gift, excise taxes, and sales and use tax are highlighted below.

With respect to income taxes, the failure to file penalty is 5% for the first 30-day period and 10 percent for each 30-day period or fraction thereof not to exceed 25 percent;[83] the failure to timely pay penalty is 5% if made during the 30-60 day period after due date and 10% if made after 60 days;[84] the accuracy-related penalties for negligence, substantial undervaluation of income, substantial overvaluation of property, substantial overvaluation of contributions to pension plans, and transactions lacking financial substance are 20% of the deficiency but increased to 40% for grossly overvalued property or contributions to pension plans;[85] and the failure to pay estimated tax for both individuals and corporations (and partnerships) is 10% for each due and unpaid installment.[86] Any deficiency as a result of fraud with intent to evade taxes is subject to a penalty of 100% of the assessed amount.[87]

With respect to estate and gift tax, the failure to file required returns and failure to timely pay are subject to the same penalties discussed above. However, the accuracy-related provisions contain a penalty not to exceed double the deficiency for an undervaluation of property included in an estate as a gift for less than its value.[88]

With respect to excise taxes, the failure to file required returns and failure to timely pay as discussed above would be applicable. In addition, the Secretary of the Treasury of Puerto Rico (Secretary) may administratively impose a fine not greater than $20,000 for each violation of the excise tax provisions based on the magnitude of the violation. No penalty is to exceed $2,000 unless it involves fraud, tort, or systemic evasion. However, for repeat offenders, an additional penalty of 50 to 100% of the tax may be imposed.[89] In addition, any person who fails to file required excise statements and monthly returns is subject to a $100 penalty for each failure.[90]

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[80] All section references in this memorandum refer to Title 11 of the Puerto Rico Tax Law unless otherwise denoted.
[81] Section 6010.01.
[82] Section 1052.01(g) – 10-year denial period for fraudulently claiming the Earned Income Credit.
[83] Section 6030.11.
[84] Section 6030.02.
[85] Section 6030.03.
[86] Section 6030.09 for individuals and Section 6030.10 for corporations and partnerships.
[87] Section 6030.03(b).
[88] Section 6030.03(c).
[89] Section 6042.01.
[90] Section 6042.15.

With respect to sales and use tax provisions there are also substantial penalties. The failure by a merchant that is required to register is subject to a penalty of up to $10,000; selling or transferring a registration without authorization is subject to a penalty of $5,000; providing false information is subject to a penalty of $5,000; forgery of a registration certificate or knowing use of a fraudulent registration is subject to a $10,000 penalty.[91] The failure to remit the sales and use tax timely and in the required manner is subject to a penalty of not less than 25% and not more than 50% of the unremitted amount with a 100% penalty for repeat offenders.[92] Any person required to file the monthly sales and use tax return timely and in the manner required is subject to the greater of $100 or 10 percent of the tax liability on the tax return (failure to file electronically when required is considered a failure.)[93] Any merchant that fails to keep documents is subject to a penalty of up to $20,000 for each violation.[94]

With respect to real property taxes, there is an addition to tax of 5% if payment is made after 30 days but within 60 days from the due date, the penalty is increased to 10% for a delay of more than 60 days.[95] Any owner of property that willfully fails to report assets that have not been appraised for the levy of taxes to the Collection Center is subject to a misdemeanor and a fine of $500 and/or imprisonment for six months.[96]

With respect to personal property tax, if there is a delay in making a timely payment, there is a surcharge of 5% for a payment after 30 days but before 60 days, 10% penalty for a payment made after 60 days but before 90 days, and 15% for a payment after 90 days. In addition, if there is a failure to file the return timely, there is a penalty of 5% if the delay is not more than 30 days and an additional 5% per for each 30-day period or fraction thereof not to exceed 25%. In case of a deficiency, there is a 10% penalty for negligence or intentional disregard of the rules or regulations, and a 100% penalty if due to fraud. The interest on delinquent taxes is 10%.[97]

The interest rate for tax due on nonpayment and deficiencies is 10%[98] while the interest paid to the taxpayer on a credit or refund is 6%.[99] Thus, although not a penalty, the interest rate at 10 percent may be an incentive for taxpayers to make their tax payments on time.

2.7.2 Description of Options

Section 6030.02 provides for additions to tax for failure to pay. In general, there is no penalty if the payment is made within 30 days of the required payment date; 5% if the payment is made after 30 days but before 60 days, and 10% if made after 60 days. Although the date for payment may be extended, there is no general reasonable cause exception for failure to pay. However, there is a special rule for excise taxes and sales and use taxes. Section 6030.07 provides that the Secretary may release a taxpayer from the surcharges and interest established in section 6030.02 at his or her judgment and discretion. Also, the Secretary may fix a new date for payment under four stated conditions.[100] The conditions appear to be very limited. Moreover, there does not

[91] Section 6043.03.
[92] Section 6043.04.
[93] Section 6043.05.
[94] Section 6043.06.
[95] 21 L.P.R.A. §5091.
[96] 21 L.P.R.A. §5069.
[97] 21 L.P.R.A. §5221.
[98] Sections 6030.01 and 6030.02.
[99] Section 6025.03.
[100] 1) When, within six (6) months of the effectiveness of a new provision of law or a regulation, a taxpayer submits a written consultation to the Secretary concerning a construction of such legal or regulatory provision due to the complexity of the matter involved, and the Secretary takes over ninety (90) days from the date of receipt of such consultation at his/her office to issue his/her answer.

appear to be a clear reason why this exception should only be applied to excise and sales and use taxes and not the other taxes.

Although interest continues to accrue on the nonpayment of tax after the 60th day, no additional penalty for failure pay apples. Perhaps, the penalty should continue to apply until it reaches a maximum, e.g., 5% per month or fraction thereof until it reaches a maximum of 25%.

Section 6030.03 provides for accuracy-related penalties on deficiencies for negligence or intentional disregard for rules and regulations, substantial undervaluation of income taxes, a substantial incorrect valuation of property; substantial overvaluation of contributions to certain pension plans, absence of financial substance in transaction, and estate tax incorrect valuation of a gift. The penalty is 20% of the deficiency except it is increased to 40% for gross valuation errors. Except for the negligence or disregard for rules and regulations, the penalty applies mechanical. There does not appear to be a reasonable cause exception for this penalty. Section 6030.08 provides a limited exception from penalties that would not apply in many cases. 156 Thus, it appears that a taxpayer who in good faith relied on a well-reasoned opinion from a qualified tax adviser with respect to a complex or complicated transaction would be subject to this penalty if the mechanical test applied.

If there is no reasonable cause relief for accuracy-related penalties, a taxpayer may be reluctant to file an amended return correcting an error because it would result in an automatic penalty. Consideration could be given to permitting a "qualified amended return". If a taxpayer files a qualified amended return (a return reporting an increased tax liability), before the taxpayer is contacted by the taxing authority for an examination for that year, the amount reported on the amended return will be deemed to have been reported on the original return and the taxpayer would not be subject to the penalty under section 6030.03 with respect to this increased amount.

Section 6030.09 provides that if taxes are not paid within 10 days of notice and demand after completing bankruptcy or receivership proceedings, interest shall accrue. A surcharge of 5% will if payment is after 30 days but before 60 days and 10% for over 60 days. This provision appears to be duplicative of section 6030.02.

The Code provides for various exceptions from penalties and surcharges if the taxpayer meets certain standards equating reasonable cause. The term "reasonable cause" is used with respect to section 6041.14 (failure to furnish information statement to recipient of income); section 6041.11 (failure to file certain information statements and statements of brokers or stockbrokers); section 6041.12 (failure to deposit taxes withheld); section 6041.13 (failure to furnish reports to special employee-owned corporation members; section 6042.15 (failure to file excise tax statement and monthly return); and section 6043.05 (failure to file monthly sales and use tax return); and section 6043.06 (failure to violating other provisions of sales and use tax).

The Code also uses the term "reasonable cause and not from willful carelessness" or "reasonable cause and not due to willing carelessness" for section 6030.11 (penalty for failure

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(2) When dealing with new items or taxable items that are new in the market of Puerto Rico, which create a reasonable doubt in terms of their taxable status, classification, or extent pursuant to the laws in effect, insofar as.
(3) When the taxpayer files a well-grounded, written allegation concerning his/her status as exempt from paying taxes, and the Secretary, by reason of the legal difficulty or complexity, takes more than ninety (90) days from the date of receipt of such consultation in his/her office to issue his/her answer.
(4) When the Secretary clearly and definitely leads a taxpayer to error when the taxpayer submits a written consultation concerning a contentious issue that until that time has not been clarified by any regulations or promulgation.

to file tax returns); section 6041.09 (individual failure to pay estimated tax; and section 6041.10 (corporation failure to pay estimated tax).

Section 6071.03 provides for administrative sanctions and monetary penalties for Specialists (tax return preparers) for violations such as failure to keep a copy of the return, furnish a copy to the taxpayer, failure to sign the return. However, the penalties are waived if "just cause is proven."

The use of these different standards to establish an exception from a penalty is confusing. A single standard should be considered.

Section 6071.03(a)(5) provides that when an underpayment of tax can be attributed to a deliberate act of a Specialist (tax return preparer), a fine of $1,000 can be imposed on the Specialist for each tax return or refund claim but is limited to $25,000 per year. The $25,000 annual limitation is the same as for a Specialist that acted negligently. For a deliberate act, the annual limitation be increased to a significantly higher.

Section 6071.02(a)(7) provides that the Specialist is required to include the registration number on the prepared return. However, there is no penalty for failure to include the registration number. The monetary penalties under section 6071(a)(3) for failure to sign the return could be modified to include failure to provide a registration number.

2.8 Transition

2.8.1 Issues

2.8.1.1 Cash Flow

Maintaining adequate cash flow is critical. Once alternatives are selected cash flow alternatives must be modeled. These considerations will affect the form and timing of transition relief

2.8.1.2 Time to Implement

A number of proposed changes will take time to implement. Failure to allow sufficient time to implement changes may jeopardize the project. In particular, moving to a GST may require from 18 months to two years to implement. In the interim, the revenue base must be maintained. Once decisions are taken as to the contours of the Governor's proposals appropriate timing and revenue options can be explored.

2.8.1.3 Protecting Economic Expectations

Fundamental fairness requires that tax changes protect the consequences of economic decisions that have been made in reliance on existing law. Thus, effective dates and phase-in provisions have to be considered carefully.

2.8.1.4 Public Education

A robust and comprehensive public education effort should commence as soon as practicable, particularly with respect to the introduction of a GST. The New Zealand program could be a template for the scope of a similar program in Puerto Rico.

Commonwealth of Puerto Rico

Tax Reform Assessment Project

Unified Tax Code of Puerto Rico:

Tax Policy Implementation Options

Appendix

October 31, 2014

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KPMG's role is limited to the services and deliverables articulated in the Contract for Professional Services dated March 18, 2014 as subsequently amended (the "Engagement Contract"). It is understood that any actions taken by the Government of the Commonwealth of Puerto Rico related to these services and deliverables may involve numerous factors that are outside of the Contract's scope. KPMG's services and deliverables cannot take such factors into account and, therefore, recommendations for such actions are not implied and should not be inferred from these services and deliverables. Further, while such deliverables may include analyses of certain legislative initiatives, no service described in the Engagement Contract and/or subsequent amendments will involve advising the Department regarding lobbying or other public policy advocacy activities related to legislation or regulation, including evaluating the likelihood of enactment of any proposed initiative or providing advice to the Department as to methodologies to ensure enactment. KPMG cannot undertake any role in connection with the Contract services that could be deemed lobbying, public policy advocacy, or impair the independence of KPMG as an auditor for the Department of the Treasury such as drafting legislation and engaging in implementation assistance.

Appendix A: Individual Tax Expenditures

Appendix A: Estimates of Individual Tax Expenditures

This document provides estimates of individual income tax revenue losses attributable to provisions of the Puerto Rico tax laws that allow an exclusion, exemption or deduction from gross income, or provide a special credit or preferential rate of tax. These estimates attempt to measure reductions in personal income tax liability stemming from tax provisions that provide tax benefits (relative to a normative income tax law) to a particular group of taxpayers. Items that provide less favorable tax treatment, which can be viewed as negative tax expenditures, are excluded from these estimates.

The estimates contained in Table 1 below are based on (1) actual income tax returns of 1,053,703 taxpayers who filed tax returns (Form 481.0 or Form 482.0) for the 2012 calendar year and (2) the most current tax rate schedule.

The magnitude of a tax expenditure is the difference between tax liability under current law and the tax liability that would result in the absence of the tax benefits of a particular provision (e.g., exclusion from measure of gross income). The estimates in Table 1 below use a methodology that serves as a proxy for re-computation of each individual taxpayer's tax liability in the absence of a given provision. It does not consider the effect of a provision on the computation of the alternative minimum tax, its effect on possible credit limitations, or any other indirect effects on tax liability.

Additionally, the estimates assume no change in taxpayer behavior in response to changes to the current tax regime. For example, while eliminating a deduction to one type of business activity may induce taxpayers to engage in such activity less frequently (thereby making the tax expenditure estimate an overestimation), the estimates below assume no such reduction in the activity generating the deduction.

Estimation Methodology

Tax Expenditure Estimates Related to Credits

Since credits provide a dollar for dollar reduction in tax liability, tax expenditure was estimated simply as the aggregate of all credits claimed by all taxpayers on Form 481.0, Part 1, Line 13, Form 482.0, Part 3, Line 23, or Form 482.0, Schedule B, Part II.

Tax Expenditure Estimates Related to Items Excluded or Exempted from the Measure of Gross Income

Tax expenditures on excluded and exempted items were each estimated using the same methodology. The excluded or exempted amount reported on Schedule IE of the taxpayer's return was added to net taxable income reported on the return to arrive at a modified taxable income measure. Based on the taxpayer's modified taxable income, a marginal tax rate was assigned to the taxpayer using the 2013 tax rate schedule. The tax expenditure was thereafter estimated to be the amount claimed, multiplied by the marginal tax rate calculated.

Tax Expenditure Estimates Related to Deductions from Gross Income

The deduction reported on Schedule A of the taxpayer's return was added to net taxable income reported on the return to arrive at a modified taxable income measure. Based on the taxpayer's modified taxable income, a marginal tax rate was assigned to the taxpayer using the 2013 tax rate schedule. The tax expenditure was thereafter estimated to be the amount of the deduction, multiplied by the marginal tax rate calculated.

Tax Expenditure Estimates Related to Preferential Rate Items

The measure of income taxed at specified rates reported on Schedule A2 Individual of the taxpayer's return was added to Net Taxable Income at regular rates (Line 10, Column A of Schedule A2) to arrive at modified net taxable income taxable at regular rates. Based on this modified net taxable income measure, a marginal tax rate was assigned to the taxpayer using the 2013 tax rate schedule. The tax expenditure was thereafter estimated to be the amount claimed, multiplied by the marginal tax rate minus the preferential rate.

Table 1: Individual Income Tax Expenditure Table

Items in red could be repealed

Items in blue could be modified

Item	Expenditure	Percent of Tax Benefit Enjoyed By Taxpayers Taxed At Highest Marginal Tax Rate	Number of Claimants
Exclusion of employment provided health insurance	No Data		
Individually purchased health insurance	No Data		
Basis step-up at death	No Data		
Like-kind exchanges	No Data		
CREDITS			
Credit for investment in film industry development	$798,838	98.1%	10
Credit attributable to losses or for investment in Capital Investment	$19,224	N/A	4

Fund, Tourism or other funds, or direct Investments			
Credit for payments of Membership Certificates by Ordinary and Extraordinary Members of Employees-Owned Special	$419	35.8%	3
Credit for the purchase of tax credits	$76,388,886	98.11%	405
Credit for Investment in housing Infrastructure	$287,071	93.61%	7
Credit for Investment in the construction or rehabilitation of rental housing projects for low or moderate income families	$85,000	100.00%	2
Credit for construction Investment in urban centers	$3,690,201	90.98%	32
Credit for merchants affected by urban centers revitalization	$373,636	100.00%	9
Credit to Investors who acquire an exempt business that is in the process of closing its operations in Puerto Rico	$14,183	65.95%	6
Credit for purchases of products manufactured in Puerto Rico and Puerto Rican agricultural products	$0	N/A	N/A
Credit for contributions to Santa Catalina's Palace Patronage	$77,000	100.00%	1
Credit for the establishment of an eligible conservation easement or donation of eligible land	$0	N/A	N/A
Exemption for persons that operate as bookseller	$117,095	99.82%	2
Credit for Investment Act 73-2008	$1,224,956	99.80%	8

Credit for investment Act 83-2010	$398,270	98.43%	8
Credit for alternate basic tax from previous taxable years	$2,300,671	95.69%	108
Credits carried from previous years	$14,015,046	57.58%	155
Other credits not included on the preceding lines	$5,202,666	92.86%	252
DEDUCTIONS			
Allowable deduction for mortgage interest	$278,554,515	62.50%	239,845
Casualty loss on your principal residence	See Note 1	N/A	N/A
Medical expenses	$6,987,818	42.52%	17,731
Charitable contributions	$22,588,652	73.30%	56,197
Loss of personal property as a result of certain casualties	$544,369	29.21%	1,968
Contributions to governmental pension or retirement systems	$56,428,128	36.72%	173,071
Total contributions to individual retirement accounts	$18,906,891	84.58%	17,774
Total contributions to health savings accounts with a high annual deductible medical plan	$12,107	69.92%	227
Educational Contribution Account	$797,485	89.60%	3,674
Total interest paid on students loans	$6,350,331	63.08%	26,542
EXCLUSIONS FROM INCOME			
Compensation for injuries or sickness	$6,930,160	60.03%	1,785
Benefits from federal social security for old-age and survivors	$130,731,918	31.79%	60,126

Income derived from discharge of debts	$1,501,713	75.82%	308
IVU Loto prizes	$207,292	86.34%	44
Meal and travel expenses paid to Certain Volunteers up to $1,500 under Act 261-2004	$17,906	36.80%	46
Other exclusions	$4,729,903	60.33%	1,753
EXEMPTIONS FROM INCOME			
Fringe benefits paid by the employer in relation to a cafeteria plan	$209,035	43.85%	263
Obligations from the United States Government, any of its states, territories or political subdivisions	$7,400,575	93.44%	986
Obligations from the Government of Puerto Rico	$39,155,077	95.49%	2,126
Securities under Agricultural Loans Act	$873,445	82.36%	379
Certain Mortgages	$8,910,858	89.22%	1,642
Obligations secured or guaranteed under the Servicemen's Readjustment Act of 1944	$79,619	82.21%	25
Securities issued by cooperative associations up to $5,000	$78,694	79.08%	248
Deposits in Puerto Rico interest bearing accounts up to $2,000 ($4,000 for married filing jointly)	$4,467,606	66.73%	24,214
Obligations issued by the Conservation Trust, Housing and Human Development Trust and San Juan Monuments Patronage	$147	0.00%	2
Limited dividends corporations	$1,893,505	85.97%	855

Cooperative associations	$1,485,144	74.12%	3,131
International Insurer or Holding Company of the International Insurer	$217,517	86.30%	168
Expenses of priests or ministers	$150,117	19.92%	117
Recapture of bad debts, prior taxes, surcharges and other items	$10,592	0.00%	7
Stipends received by certain physicians during the internship period	$2,710,003	43.79%	495
Prizes from the Lottery of Puerto Rico and the Additional Lottery	$4,852,671	92.90%	401
Income from pensions or annuities, up to the applicable limitation	$137,388,225	18.46%	84,027
Christmas Bonus, Summer Bonus and Medicine Bonus	$127,086	28.41%	2,166
Gain from the sale or exchange of principal residence by certain individuals	$8,674,939	87.08%	642
Certain income related to the operation of an employee's owned special corporation	$31,519	26.43%	34
Cost of living allowance (COLA)	$6,633,382	70.60%	6,646
Unemployment compensation	$701,893	45.13%	2,249
Compensation received from active military service in a combat zone	$960,610	33.16%	291
Income received or earned in relation to the celebration of sports games organized by international associations	$7,098	0.03%	10
Compensation received by an eligible investigator or scientist	$755,946	94.54%	57

Compensation received by an eligible investigator or scientist in the District under Act 214-2004	$152,969	91.74%	20
Rents from the Historic Zone	$773,172	76.32%	101
Compensation to citizens and aliens nonresidents of Puerto Rico for the production of film projects	$60,950	99.84%	6
Remuneration received by employees of foreign governments or international organizations	$465,765	95.59%	29
Income from buildings rented to the Government of Puerto Rico for public hospitals, health or convalescent homes	$2,842,883	70.64%	1,439
Income derived by the taxpayer from the resale of personal property or services which acquisition was subject to tax	$127,160	67.55%	17
Accumulated Gain in Nonqualified Options	$1,113,573	86.58%	97
Distributions of Amounts Previously Notified as Deemed Eligible Distributions under Section 1023.06	$7,028,034	98.68%	50
Distributions from Non Deductible Individual Retirement Accounts	$2,698,698	85.02%	274
Special Compensation Paid due to a Liquidation or Close of Businesses under Article 10 of Act No. 80 of May 30, 1976	$24,573,971	89.10%	1,167
Distributions of Dividends or in Liquidation from Exempt Businesses	$30,205,021	99.24%	91
Salaries from Overtime during Emergency Situations	$1,259,858	76.90%	576

Income from copyrights up to $10,000 under Act 516-2004	$38,424	72.92%	27
Income received by designers and translators up to $6,000 under Act 516-2004	$7,378	10.85%	17
Distributable share on exempt income from flow-through entities	$19,489,785	99.01%	116
Other exemptions	$37,934,015	83.38%	5,892
PREFERENTIAL RATE ITEMS			
Net Long Term Capital Gain at 10%	$66,304,818	99.51%	2,562
Eligible Distribution of Dividends at 10%	$40,874,647	98.5405%	6,163
Distributions from Qualified Retirement Plans at 20%	$3,797,274	105.7357%	935
Distributions from Qualified Retirement Plans at 10%	$3,196,794	93.9605%	592
Interest on Deposits from Financial Institutions at 10%	$3,260,447	96.2749%	1,210

Note 1: There appear to have been data entry issues related to this particular deduction on the Short Form. The entries are duplicates of the charitable contributions deductions according to the data provided by personnel at the Commonwealth's Treasury Department.

Appendix B: Business Tax Expenditures

Appendix B: Business Tax Expenditures

Item	Total Expenditure	Regular Corporations	Exempt Corps And Other Business Entities	Number of Claimants
ACT 8 OF 1987 INCENTIVES				
Total reduction				
Special Deduction- Payroll	$140,193		$140,193	10
Special Deduction- HR Training	$0		$0	0
Special Deduction- R&D Expense	$0		$0	0
Special Deduction- Investment on buildings, structure, M&E	$345,492		$345,492	2
ACT 135-1997				
Total reduction				
Special Deduction- Payroll	$9,755,962		$9,755,962	127
Special Deduction- HR Training	$1,296,309		$1,296,309	21
Special Deduction- R&D Expense	$8,596,386		$8,596,386	5
Special Deduction- Investment on buildings, structure, M&E	$102,981,067		$102,981,067	88
Special credits granted	$3,348,016		$3,348,016	4
Credit for products manufactured in Puerto Rico	$1,946,366		$1,946,366	17
Credit for losses of United States parent company	$842		$842	1
Credit for taxes withheld on royalty payments	$13,300,000		$13,300,000	1
Credit for donation of an eligible conservation	$0		$0	0

easement or donation of eligible land				
Credit for construction investment in urban centers	$5,581,202		$5,581,202	1
Credit for merchants affected by urban centers revitalization	$0		$0	0
Credit for purchases of products manufactured in Puerto Rico	$40,546,667		$40,546,667	54
Credit for investment in research and development	$6,979,314		$6,979,314	8
Credit for investment in machinery and equipment	$0		$0	0
Credit to reduce the cost of electric power	$23,730,060		$23,730,060	100
Credit for investment in strategic projects	$0		$0	0
Credit for industrial investment	$0		$0	0
Credit for acquisition or manufacture and installation of electrical solar equipment	$16,836		$16,836	2
Other applicable credits	$18,376,813		$18,376,813	17
ACT 20-2012				
Total reduction				
ACT 73-2008				
Total reduction				
Special Deductions	$10,170,000		$10,170,000	3
Credit for purchases of products manufactured in Puerto Rico	$1,318,456		$1,318,456	3
Credit for job creation	$0		$0	0
Credit for investment in research and development	$1,998,523		$1,998,523	1
Credit for investment in machinery and equipment	$0		$0	0

Credit to reduce the cost of electric power	$467,639		$467,639	5
Credit for intellectual property transfer	$0		$0	0
Credit for investment in strategic projects	$0		$0	0
Credit for industrial investment	$23,916		$23,916	1
Credit for donation of an eligible conservation easement or donation of eligible land	$7,993		$7,993	1
Credit for construction investment in urban centers	$0		$0	0
Credit for merchants affected by urban centers revitalization	$0		$0	0
Credit for acquisition or manufacture and installation of electrical solar equipment	$0		$0	0
Other applicable credits	$0		$0	0
ACT 83-2010				
Total reduction				
Credit for purchases of products manufactured in Puerto Rico	$0		$0	0
Credit for job creation	$0		$0	0
Credit for investment in research and development	$0		$0	0
Credit for the transfer of intellectual property	$0		$0	0
Credit for donation of an eligible conservation easement or donation of eligible land	$0		$0	0
Credit for construction investment in urban centers	$0		$0	0
Other applicable credits	$0		$0	0
ACT 27-2010				

Total reduction				
SCHEDULE L PARTIALLY EXEMPT INCOME				
Total reduction				
CREDITS				
Credit for increase in investment	$111,642	$71,913	$39,729	5
Credit attributable to losses or for investment in Capital Investment, Tourism or other funds	$2,526,277	$1,781,611	$744,666	4
Credit for investment on Film Industry Development	$286,568	$286,568	N/A	12
Credit for investment in Housing Infrastructure	$570,690	$570,690	N/A	4
Credit for investment in the Construction or Rehabilitation of Rental Housing Projects for Low or Moderate Income Families	$23,603	$23,603	N/A	1
Credit to investors in an exempt business that is in the process of closing its operations in Puerto Rico	$2,939	$2,939	N/A	2
Credit for purchases of products manufactured in Puerto Rico and Puerto Rican agricultural products	$2,917,510	$2,820,683	$96,827	16
Credit for contributions to Santa Catalina's Palace Patronage	$9,793	$9,793	N/A	1
Credit for the establishment of an eligible conservation easement or donation of eligible land	$0	$0	$0	0
Credit for construction investment in urban centers	$1,825,534	$982,521	$843013	4
Credit for merchants affected by urban centers revitalization	$10,518	$10,518	$0	2
Exemption for persons that operate as publisher	$3,649	$3,649	N/A	2

Exemption for persons that operate as printer	$0	$0	N/A	0
Exemption for persons that operate as bookseller	$533	$533	N/A	1
Credit for investment Act 73-2008	$725,743	$725,743	N/A	5
Credit for investment Act 83-2010	$140,229	$140,229	N/A	1
Credit for the 2006 Extraordinary Tax	$2,790,484	$1,289,278	$1,501,206	44
Credit for additional tax on gross income paid in case of financial business	N/A	N/A	N/A	
Other credits not included on the preceding lines	$7,028,757	$6,684,245	$344,512	69
DEDUCTIONS				
Dividends received from domestic corporations	$63,562,029	$63,562,029		144
Accelerated depreciation		N/A		N/A
Charitable contributions	$6,325,832	$6,325,832		5,788
Contributions to pension or other qualified plans	$23,385,047	$23,385,047		895
Bad debts		N/A		N/A
EXCLUSIONS FROM INCOME				
Plantation insurance		$0		
Income derived from discharge of debts	$637,923	$637,923		9
IVU Loto prizes	$21	$21		1
Other exclusions	$321,350	$321,350		17
EXEMPTIONS FROM INCOME				
Interest earned from obligations from the United States Government, any of its states, territories or political subdivisions	$26,328,544	$26,328,544		98
Interest earned from obligations from the Commonwealth of Puerto Rico	$103,855,658	$103,855,658		221

Interest earned from securities under Agricultural Loans Act	$36,801	$36,801		5
Interest earned from certain Mortgages	$237,359	$237,359		25
Interest earned from obligations secured or guaranteed under the Servicemen's Readjustment Act of 1944	$0	$0		
Interest earned from securities issued by cooperative associations up to $5,000	$0	$0		
Interest earned from obligations issued by the Conservation Trust, Housing and Human Development Trust and San Juan Monuments Patronage	$0	$0		
Interest earned from loans granted by a commercial bank to an employees	$0	$0		
Interest earned from loans granted by a commercial bank in Puerto Rico for acquisition and payment of membership certificates in an employees owned special corporation	$0	$0		
Interest earned from loans granted by a commercial bank in Puerto Rico for the purchase or investment in preferred stocks of an employees owned special corporation	$0	$0		
Interest earned from loans for the establishment or expansion of small and medium businesses up to $250,000	$14,728	$14,728		1

Interest earned from loans for the capitalization of small and medium businesses up to $250,000	$3,066	$3,066		1
Dividends from industrial development income derived from certain interests	$16,819	$16,819		8
Dividends from limited dividends corporations	$47,972	$47,972		7
Dividends from cooperative associations	$351	$351		2
Dividends from international Insurer or Holding Company of the International Insurer	$0	$0		
Recapture of bad debts, prior taxes, surcharges and other items	$307,952	$307,952		2
Income from news agencies or unions	$0	$0		
Certain income related to the operation of an employees owned special corporation	$0	$0		
Income received or earned in relation to the celebration of sports games organized by international associations or federations	$299,146	$299,146		1
Income derived by the International Insurer or Holding Company of the International Insurer	$1,267,051	$1,267,051		1
Rents from the Historic Zone	$521,618	$521,618		12
Income from International Banking Entities	$31,132,576	$31,132,576		7
Income from vessels owners associations and mutual protection and indemnity	$0	$0		
Income from buildings rented to the Commonwealth of	$27,836	$27,836		3

Puerto Rico for public hospitals or schools, or health homes				
Income derived by the taxpayer from the resale of personal property or services which acquisition was subject to tax under Section 3070.01 or Section 2101 of the Internal Revenue Code of 1994	$0	$0		
Distributions of Amounts Previously Notified as Deemed Eligible Distributions under Section 1023.06(j)	$0	$0		
Distributions of Dividends and Benefits from Industrial Development Income of Exempt Businesses and in Liquidation under Act 73-2008 and Act 135-1997	$1,395,789	$1,395,789		2
Rent of residential property under Act 132-2010	$437,841	$437,841		45
Other exemptions	$17,261,128	$17,261,128		88
PREFERENTIAL RATE ITEMS				
Preferential treatment of capital gains	$8,139,392	$8,139,392		168
Interest subject to preferential rate	$195,224	$195,224		5
Other income subject to preferential rate	$420,844	$420,844		6
Income subject to preferential rates from partnerships and special partnerships		N/A		
Income subject to the 4% tax rate from the operations of an international financial entity that operates as a banking unit		N/A		

Note 1: There appear to have been data entry issues related to this particular deduction on the Short Form. The entries are duplicates of the charitable contributions deductions according to the data provided by personnel at the Commonwealth's Treasury Department.

Appendix C: Options for Goods and Services Tax

Appendix C: Goods and Services Tax

a. General Description of a Goods and Services Tax

This document outlines the form a Goods and Services Tax ("GST") in Puerto Rico could take.

This first section sets out how a GST generally operates. It is introduces and defines key GST concepts and terminology that is used in the following sections.

The second section sets out how the main operating provisions of the GST law could be structured.

The third section examines how each of the main operating provisions could be drafted based on leading practices derived from four comparable jurisdictions – New Zealand, Singapore, Malaysia and Ireland. In addition to these comparable jurisdictions, the International Monetary Fund VAT Act – Commonwealth of New Vatopia was reviewed.

The document does not address special cases such as grouping related parties for registration purposes, the treatment of branches, agents, sales of going concerns, loyalty programs, vouchers, gambling, non-resident GST refunds, electronic services supplied by a non-resident, and domestic reverse charge. Special cases are addressed in Appendix D.

Further, it does not address the administrative powers of the tax authority with respect to debt collection, disputes, rulings, audits, and penalties and any rules in respect of language requirements, currency and documentation retention. These powers and rules are generally not GST specific and the existing Puerto Rico administrative provisions could be leveraged.

1.1 Operation of a GST

GST, also known as a Value Added Tax ("VAT"), is the most common general consumption tax in the world and is recognized as the most efficient consumption tax both in terms of revenue and economic neutrality. Over 150 countries and 33 of the 34 OECD countries have implemented some form of VAT where it generally accounts for one fifth of tax revenue.[1] The recognized capacity to raise revenue in a neutral and transparent manner has contributed to the spread of GST around the world.

The key features of a GST include:

- It is a tax on final consumption;
- It is not a tax on business – GST does not generally result in a cost to a business – businesses effectively act as collection agents. A credit is provided for tax incurred on business inputs;
- GST is a multi-stage, transaction based tax that is levied at each stage of the supply chain, including imports; and

[1] OECD (2012), *Consumption Tax Trends 2012: VAT/GST and Excise Rates, Trends and Administrative Issues*, OECD Publishing, p. 28.

- It is a broad based tax that applies to most goods and services.

A GST system seeks to tax the value added at each stage in the supply chain. There are a number of methods that can be used to calculate the value added at any particular stage in a supply chain and levy the tax (including the addition, subtraction and invoice-credit methods). The addition and subtraction methods are not very common (only Japan uses a certain version of subtraction method) and do not represent practical options for Puerto Rico. These methods are not discussed.

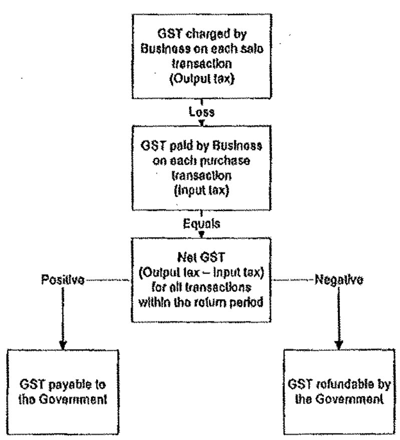
The invoice-credit method is the most common method and the only practical option if a GST is to be considered in Puerto Rico.

The OECD describes the invoice-credit method as follows:

"...each trader charges VAT at the specific rate on each sale and passes to the purchaser an invoice showing the amount of tax thus charged. The purchaser is in turn able to credit such payment of input tax against the output charged on his sales, remitting the balance to the tax authorities and receiving refunds when there are excess credits. This method is based on invoices that could, in principle, be cross-checked to pick up any overstatement of credit entitlement. By linking the tax credit on the purchaser's inputs to the tax paid by the purchaser the invoice-credit method is designed to discourage fraud."[2]

This right to deduction through the supply chain until the final consumer, where no credit is allowed, results in a business neutral tax, the burden of which lies on the final consumer (i.e., avoiding the issue of the taxation of business input that arises under an SUT).

The operation of an invoice-credit GST is illustrated as follows:

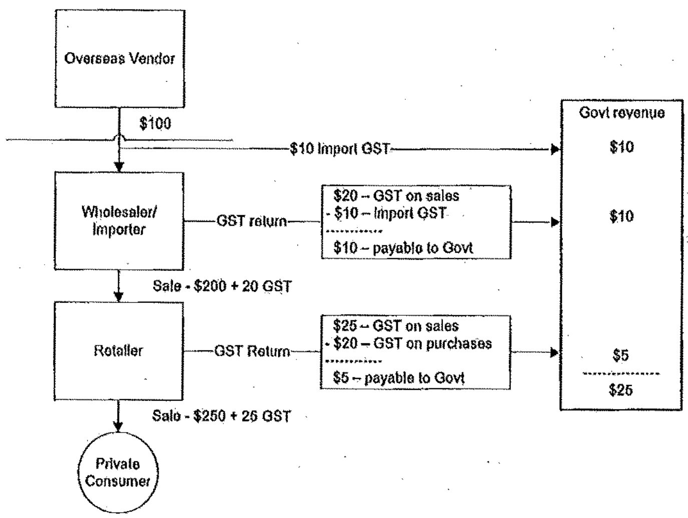


[2] OECD (2012), *Consumption Tax Trends 2012: VAT/GST and Excise Rates, Trends and Administrative Issues*, OECD Publishing, p 32.

The invoice-credit method tends to be preferred over other methods of value added taxation for the following reasons:

- The tax is levied on a transaction by transaction basis allowing the application of different rates, where required; and
- The use of an invoice for evidencing the charging of the GST and the right to deduct creates a good audit trail.

An example of the invoice-credit method applied to a supply chain is as follows (assuming a 10% GST):



Key Principles and Terminology

GST laws generally levy the tax on supplies of goods and services made in the jurisdiction for consideration in the course or furtherance of a taxable activity carried on by a taxable person.

The above statement introduces a number of GST specific terms and concepts:

- Supply;
- Consideration;
- Taxable Activity;

- Taxable Person;
- Goods and services; and
- Made in the jurisdiction.

Each of specific terms is discussed in detail in the third section of this document. However, a brief overview of each term is discussed below.

Supply – the term "supply" defines a transaction that is captured in a GST. It is often broader in concept than a "sale" to ensure that the tax captures every economic transaction, subject to limited exceptions. For example, many jurisdictions deem certain actions that would not normally be considered to be a sale as a supply for GST purposes to maintain the neutrality of the tax – e.g., goods provided free of charge to employees are deemed to be a supply for GST purposes and are subject to the tax.

Consideration – consideration generally refers to something of value that is provided in return for goods and services. However, as with the definition of supply, many jurisdictions will deem consideration to be provided in respect of certain supplies to maintain the neutrality of the tax. The example noted above of the deemed supply of goods that are provided free of charge to employees would generally require a provision deeming that the supply was for consideration in order to bring the activity within the scope of the tax.

Taxable Activity – a taxable activity is similar to the term "business" – e.g., the activity of traders, producers or service suppliers. However the term is often broader than what is traditionally thought of as a business to include such things as certain government activities. There is generally no requirement that the activity be carried on with the intention of making a profit. However, employment, hobbies and private recreational pursuits are often excluded.

Taxable Person - the term "taxable person" describes a person who is carrying on an activity that falls within the GST regime, rather than the term "taxpayer." The distinction is generally made to avoid any confusion with the person who bears the ultimate economic incidence of the tax, which is the person receiving the taxable sale.[3]

Goods and services – a supply for GST purposes will either be a supply of goods or a supply of services. The distinction between the two is important because the nature of the transaction may influence where the supply should be taxed (i.e., within Puerto Rico or outside Puerto Rico), when the supply should be accounted for, and who is liable to collect the GST.

Made in the jurisdiction – GST laws include various "place of supply" rules that help determine whether a supply is made in the jurisdiction and should be subject to the tax.

Additional principles and terms that should be noted are as follows:

Taxable supply – a supply subject to GST, whether it be it at the standard or zero rate.

Zero-rated supply – a supply subject to GST at a notional 0% (discussed in more detail below).

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[3]David Williams, *Tax Law Design and Drafting*, Chapter 6 Value Added Tax, Volume 1; International Monetary Fund, 1996, p. 12.

Exempt supply – a supply that falls within the scope of the GST law but is exempt from the tax (discussed in more detail below).

Outside scope – a supply that falls outside the scope of the GST law and is effectively ignored for GST purposes.

Input tax – GST that is paid by the recipient of a supply.

Output tax – GST that is charged by the supplier of a supply.

Tax invoice – a formal document issued under the GST law evidencing the supply.

Accounting for the tax – generally the supplier is required to collect and remit the GST to the government. However, in certain circumstances, the recipient is required to account for the tax – e.g., where the supplier is a non-resident with no presence in the jurisdiction.

Time of supply – the time of supply refers to when the transaction should be accounted for in the GST return.

Input tax credits - Generally, GST incurred by a taxable person can be claimed as a credit if the supply that was subject to GST was acquired for the purpose of making taxable or zero-rated supplies. Where the supply was acquired for making exempt supplies, the GST cannot be claimed as a credit.

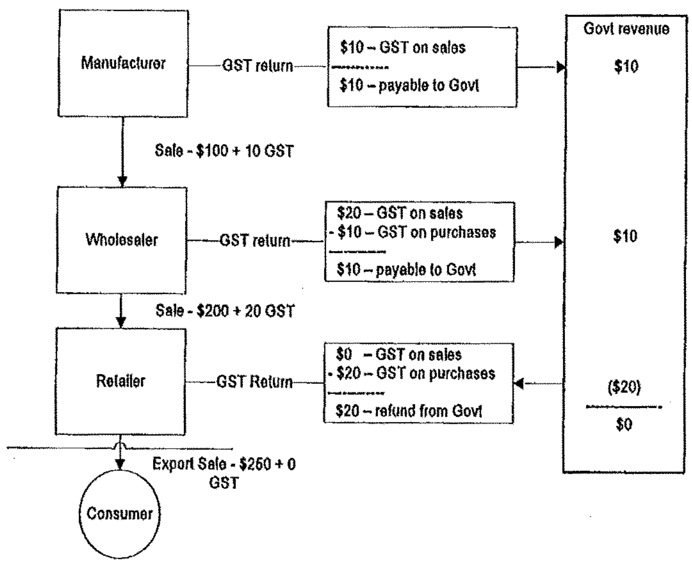
The concepts of zero-rating and exemption are extremely important and are discussed in more detail below.

Zero-rating

Where a supply of a good or service is zero-rated, no GST is charged on the sale or provision of that service. However, the person making that supply is able to recover the GST it has incurred on its purchases related to the making of that zero-rated supply (contrast this with exempt supplies below).

Zero-rating relieves the entire supply chain from tax if zero-rating is at the final stage of the chain – see diagram below.

Zero-rating is often used for exported goods and services to ensure that foreign customers do not bear the burden of domestic consumption tax.

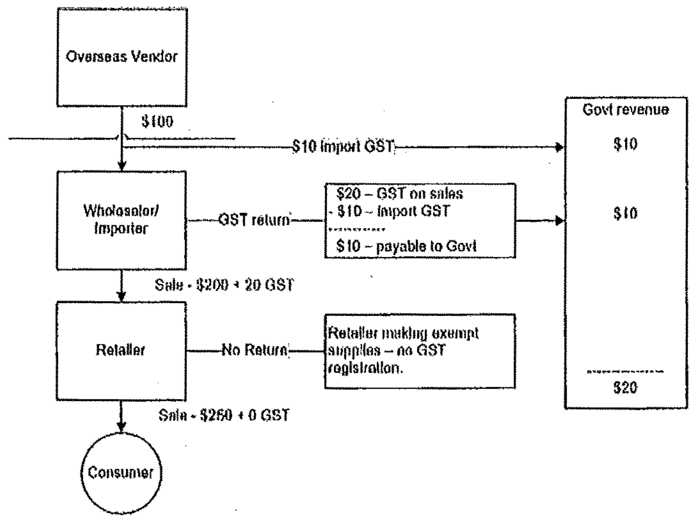


Exemption

Where a supply of a good or service is exempt from GST, no GST is charged on the sale or provision of that good or service. However, the person making that supply is unable to recover the GST it has incurred on its purchases related to the making of that exempt supply (contrast this with zero-rating above).

Exemptions are usually implemented for social reasons (e.g., healthcare and education) or because they are difficult to tax (e.g., financial services).

Exemptions have the following impact on the supply chain and the collection of the tax:



In summary, when examining the GST treatment of a supply, the following questions should be asked:

1. Is there a supply for consideration?
2. Is the supply made by a taxable person?
3. Is the supply made within the GST jurisdiction?
4. Is the supply exempt or zero-rated?
5. Who is liable to account of the tax and when?
6. Can the GST be recovered?

The following sections set out how the main operating provisions of the GST law could be structured and how each of the main operating provisions could be drafted based on leading practices.

b. Outline of Goods and Services Tax Legislation

This section sets out how a GST law could be structured in Puerto Rico. It sets out the main operating provisions of a GST. It does not set out rules for special cases, which address such things as the grouping of related parties for registration purposes and the treatment of branches, agents, sales of going concerns, loyalty programs, vouchers, gambling, non-resident GST refunds, electronic services supplied by a non-resident, and domestic reverse charge.

In addition, it does not set out the administrative powers of the tax authority with respect to debt collection, disputes, rulings, audits, and penalties and any rules in respect of language requirements, currency and documentation retention. These powers and rules are generally not GST specific and the existing Puerto Rico administrative provisions could be leveraged.

2.A Interpretation/General Definitions

This chapter will set out the definitions of certain terms.

The following principal GST terms will be defined in separate sections:

i. "Taxable Person"

ii. "Taxable Activity"

iii. "Supply"

2.B Imposition of the Tax

i. *Imposition of the Tax*–This section will be the main charging provision of the law and will set out when GST should be charged on a supply (i.e., supplies made in Puerto Rico) and who is liable to account for the tax.

ii. *Place of supply* – This section will set out the rules for determining when a supply is deemed to be made in Puerto Rico for the purpose of the imposition of the tax.

iii. *Time of supply* – This section will set out the rules for determining when the supply is deemed to take place and the period in which the supply should be reported and GST accounted for.

iv. *Imported Services/Reverse charge* – This section will set out the rules for supplies of services made by non-residents and where the recipient of the supply should account for the tax.

v. *Value of the supply* – This section will set out the rules for determining the value of a supply upon which the GST should be charged. It will also include rules for transactions between related parties and the supply.

vi. *Imported goods* – This section will set out the rules for levying GST on the importation of goods and the interaction with the Customs rules and related relief provisions.

vii. *Value of imported goods* – This section will set out the valuation rules for goods imported into Puerto Rico, consistent with the customs rules.

viii. *Zero-rated supplies* –This section will provide the rules for zero-rating goods and services and which categories of goods and services are zero-rated.

ix. *Exempt supplies*– This section will list which categories of goods and services are GST exempt.

2.C Registration

i. *Registration* – This section will set out who is required to be registered and who can voluntarily register, including the rules in respect of calculating a taxable person's turnover for registration threshold determination, and exceptions to the registration requirement.

ii. *Cessation of requirement to be registered and cancellation of registration* – This section will set out the rules for when a taxpayer will cease being required to be registered and the cancellation of a GST registration, including notification rules and effective dates.

2.D Calculation of Tax Payable, Tax Periods, and Tax Returns

i. *Taxable periods* – This section will set out the rules for the periods the GST return must cover.

ii. *Filing of returns and payment of the tax* – This section will set out the rules for when a return must be filed and payment of any tax due should be made.

iii. *Accounting basis* – The section will set out the rules for when taxable persons are able to complete returns on a cash basis versus an accrual basis, including the conditions required to be met for each type of accounting basis.

iv. *Calculation of tax payable* – This section will set out the rules for calculating the tax payable for a particular period, including offsetting input tax against output tax.

v. *Input tax deductions/credit rules* - This section will set out the rules for determining whether an input tax credit may be claimed in respect of GST incurred on expenses by the taxable person, including deemed input tax deductions for such things as insurance payments and secondhand goods.

vi. *Adjustment and apportionment rules* - This section will set out the rules for apportioning input tax credits between taxable and non-taxable activities and where adjustments are required to be made to account for private or non-taxable use.

vii. *Bad Debts* – This section will set out the rules for recovering output tax previously accounted for on a supply but the recipient never paid for that supply.

viii. *Refund of excess tax* – This section will set out the rules relating to the payment of refunds where input tax exceeds output tax for a particular period.

ix. *Tax invoices, credit notes and debit notes* – This section will set out the rules for when a tax invoice, credit note or debit note should be issued, including the form such documents must take.

c. Goods and Services Tax Design Leading Practices

The following section sets out the leading practices for designing a GST.

The OECD International VAT/GST Guidelines describe basic neutrality principles that should apply to a GST:

- The burden of value added taxes should not lie on taxable businesses except where explicitly provided for in legislation.
- Business in similar situations carrying out similar transactions should be subject to similar levels of taxation.
- VAT rules should be framed in such a way that they are not the primary influence on business decisions.

These principles have been followed when outlining the possible structure of a GST for Puerto Rico.

In drafting these leading practices, we have reviewed four comparable jurisdictions, as follows:

- New Zealand – Goods and Services Tax Act 1985 ("NZ GST Act");
- Singapore – Goods and Services Tax Act 1993 ("Singapore GST Act");
- Malaysia - Goods and Services Tax Act 2014 ("Malaysia GST Act"); and
- Ireland - Value-Added Tax Consolidation Act 2010 ("Irish VAT Act").

In addition, we reviewed the International Monetary Fund model VAT Act – Commonwealth of New Vatopia ("IMF Model Law").

New Zealand was chosen as a comparative regime as it is widely regarded as having the gold standard of consumption tax regimes, with the following key features:

- One single rate;
- GST on goods and services and on importation;
- Limited exemptions;
- Low compliance costs for businesses and government;
- Neutrality between businesses;
- Transparency in respect of its administration.

Singapore and Ireland were chosen as they are considered competitors to Puerto Rico from a global inbound investment perspective. Further, Ireland is based on the older European model of a VAT/GST and provides a contrast against how newer consumption tax regimes have been implemented.

Malaysia was chosen as it is the most recent GST law to have been introduced.

The IMF Model Law was chosen as it has served as a guide for the implementation of a consumption tax regime in many countries and it is a broad based tax with few exemptions with a structure based on the more modern VAT/GST structures.

Below, we set out a proposed structure of a GST law and the leading practice approach for each of the relevant operational provisions.

3.A Interpretation/General Definitions

3.A.1 Taxable Person

Overview of Concept

In VAT/GST regimes the term "taxable person" is used to describe a person who is carrying on an activity that falls within the VAT/GST regime, rather than the term "taxpayer." The distinction is generally made to avoid any confusion with the person who bears the ultimate economic incidence of the tax, which is the person receiving the taxable sale.[4] This is driven from the nature of a VAT/GST being a consumption tax with the suppliers of goods and services upon which the tax is charged merely collecting that tax for and on behalf of the government.

The concept of taxable person can be compared to the concept of "merchant" used under Puerto Rico's current SUT.[5]

In a broad based GST system, the term "taxable person" generally includes all persons irrespective of their residency, establishment or incorporation. A narrow base GST system would generally define a taxable person as only those which are established or incorporated within the GST jurisdiction, for example Mexico.

Leading Practice

The definition of "Taxable person" should be drafted to include the following:

- Any person registered or required to be registered under the GST law.

The definition of "Person" should be drafted to include the following:

- A state, a local authority, board, natural person, trust, company, and partnership;
- Exclude the US Federal Government and its instrumentalities.

Discussion

The GST legislation in Singapore and Malaysia state that a person is a taxable person for GST purposes where it is required to be registered under the GST Act.[6]

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[4]David Williams, *Tax Law Design and Drafting,* Chapter 6 Value Added Tax, Volume 1; International Monetary Fund, 1996, ibid.
[5]PRIRC § 4010.01(h).
[6] Singapore GST Act, § 8(2); Malaysia GST Act, § 2.

The IMF Model Law also defines "taxable person" as a person who is registered or is required to register under the law.[7]

The New Zealand GST Act does not have the concept of taxable person but uses the term "registered person" for someone who is registered or required to be registered under the Act[8].

Singapore and Malaysia do not define the term "Person," however New Zealand defines person as company, an unincorporated body, a public authority and a local authority. The IMF has a similar definition that includes the state, a local authority, board, natural person, trust, company, and partnership.[9]

All the above jurisdictions utilize the term "taxable person" or "registered person" in the main charging provision to require the levying of the tax. This is generally done by requiring tax to be charged where a supply is made by the taxable or registered person within the jurisdiction, in the course or furtherance of a business or taxable activity. The imposition of GST and taxable activity are discussed under their respective sections in more detail below.

Ireland takes a slightly different and more convoluted approach, defining "taxable person" as a person who independently carries on a business.[10] This term is utilized within the main charging provision to levy the tax on any supply made by such a person. Ireland then has an additional term called an "an accountable person", which is effectively equivalent to a registered person to require the collection and returning of the tax.[11]

Leading practice would be to adopt the more certain and simple approach of New Zealand and the IMF.

Most of the comparable jurisdictions include governments and their bodies either explicitly or implicitly in the definition of "taxable person," however this is often limited to whether such public bodies are in competition with the private sector. This ensures broad based taxation and avoids any distortion arising where the private and public sector could be in competition.

Where governments and their bodies are included with the GST regime, it is often necessary to specifically include their activities within the definition of taxable activity and deem the provision of certain public goods and services to be a supply for GST purposes. We discuss these issues under "Taxable Activity" below. The issue of determining whether a public body is in competition with the private sector is also a complex issue and we discuss this under the "Taxable Activity" section below.

Given Puerto Rico is part of the United States, the constitutionality of including the federal government, state governments, and their instrumentalities should be addressed. Under the Supremacy Clause and the doctrine of sovereign immunity, the federal government and its

[7] IMF Model VAT Law, § 6.
[8] New Zealand GST Act, § 2(1).
[9] IMF Model Law, § 2.
[10] Irish VAT Act, § 2(1).
[11] Irish VAT Act, § 6.

instrumentalities are immune from state and local taxation.[12] Consequently, the federal government and its instrumentalities must be excluded from the definition of "person." While many states currently exempt state governments, their agencies, municipalities, and their political subdivisions, there is no constitutional prohibition against state taxation of these bodies.

Consequently, in order to achieve a broad based taxation model and avoid any economic distortion where the private sector may be in competition with the state, state governments, municipalities, and their political subdivisions these bodies should be included within the definition of "person."

This leading practice approach would be similar to the current definition of "person" under the current Puerto Rico SUT regime, which already includes the government, its political subdivisions, municipalities, state agencies, bureaus or departments and public corporations.[13] The U.S. federal government and its instrumentalities are also excluded from the definition of person, since "state" means any U.S. state, the District of Columbia or a U.S. possession.[14]

It should be noted that the inclusion of such government bodies within the regime will not result in those bodies ultimately bearing a tax burden as the burden is ultimately born by the end consumer. It merely simplifies the operation of the tax through reducing the number of exemptions and exceptions.

3.A.2 Taxable Activity

Overview of Concept

The concept of "taxable activity" is a central term in a GST system as only goods or services supplied within the course or furtherance of a taxable activity will be subject to the tax. The concept of taxable activity can be related to the concept of "in business" under the current SUT.[15]

VAT/GST jurisdictions use different terms for this concept, including economic activity or business, however the objective of this concept is consistent across most jurisdictions – that any transactions made in the course of a business and not of a personal nature should be included within this term. A key difference between GST and income tax is that GST does not require there to be any intention to make a profit.

Leading Practice

The definition of "Taxable activity" should be drafted to include the following:

- Any activity:
    - Carried on continuously or regularly;
    - Whether or not for profit;

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[12] *McCulloch v. Maryland*, 17 U.S. 316 (1819).
[13] PRIRC § 4010.01(bb).
[14] PRIRC § 4010.01(0).
[15] PRIRC § 4010.01(h).

  - o Involving the supply of goods and services;
  - o For consideration;
  - o By any person (which includes public bodies).
- The commencement and ending of a taxable activity.
- Any activity of public bodies that qualify as taxable person.

It is recommended that the definition excludes hobbies and activities of employees.

Discussion

New Zealand defines "taxable activity" as "any activity which is carried on continuously or regularly by any person, whether or not for a pecuniary profit, and involves or is intended to involve, in whole or in part, the supply of goods and services to any other person for a consideration; and includes any such activity carried on in the form of a business, trade, manufacture, profession, vocation, association, or club."[16] The NZ GST Act explicitly includes in this definition the activities of any public authority or any local authority. The NZ GST Act also clarifies that anything done in connection with the beginning or ending of a taxable activity is treated as "taxable activity." Expressly excluded from the term are private recreational pursuits or hobbies and employment.

The IMF Model Law has a similar definition as the NZ GST Act. However, the law explicitly excludes any activity to the extent that the activity involves the making of exempt supplies.[17] Further the exclusion of employment is under the definition of supply, rather than under the definition of taxable activity.

Singapore uses the term "business" rather than "taxable activity." The term "business" is defined as including any trade, profession or vocation.[18] The following is also deemed to be the carrying of business: the provision by any club, association, society, management corporation or organization (for a subscription or other consideration) of the facilities or advantages available to its members or subsidiary proprietors, as the case may be; and the admission, for a consideration, of persons to any premises.[19]

However, any organization which has objects in the public domain and carries on activities which are political, religious, philanthropic or patriotic in nature, cannot be considered as carrying on a business, as it only receives subscriptions from its members without providing any services to the members in return.[20]

Finally, while the Singapore GST Act recognizes that acts done in connection with the termination of a business are treated as being done in the course of that business, it does not address acts

[16] New Zealand GST Act, § 6(1).
[17] IMF Model Law, § 5(2).
[18] Singapore GST Act, § 3(1).
[19] Singapore GST Act, § 3(2).
[20] Singapore GST Act, § 3(3).

done in connection with the beginning of business.[21] However, a person can register for GST in Singapore if he or she intends to make supplies in the course of furtherance of a business.

Malaysia adopted the same definition of "business" and "deemed business" as Singapore.[22] However, the Malaysian GST Act does not exclude from the definition of business subscriptions received by political, religious, philanthropic organizations. In addition, the Malaysian GST Act explicitly states that the commencement and termination of a business is treated as being done in the course of the business.[23]

Ireland also uses the term "business" which is defined as any activity, whatever the purpose or results of that activity, and includes any activity of producers, traders or persons supplying services, including mining and agricultural activities and activities of the professions, and the exploitation of tangible or intangible property for the purposes of obtaining income there from on a continuing basis.[24]

The GST law should provide a precise definition of "taxable activity." A precise definition of "taxable activity" will promote efficiency, certainty, and effectiveness of the tax.

Common elements of the definition of a taxable activity or business across all of the comparative jurisdictions are as follows:

- An activity that is carried out continuously or regularly – excluding one-time transactions;
- Whether or not for profit.

Key differences include whether the definition includes the requirement that the activity must involve a supply of goods or services for consideration. New Zealand and the IMF adopt such a definition, while the other comparable jurisdictions general imply that there would be consideration for a supply though the use of such terms such as trade or commerce.

Certain jurisdictions explicitly exclude the following within the definition of taxable activity:

- Hobbies or recreational activities;
- Employment (whether expressly or through the operation of other sections of the legislation).

While others practically exclude such activities through either stating the activity must be carried on independently (implying that employment is not included) or through the use of the terms trade or professions (implying that hobbies and recreational activities are excluded).

For certainty and simplicity, leading practice would be to adopt a similar approach to New Zealand and the IMF.

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21 Singapore GST Act, § 3(6).
22 Malaysia GST Law, § 3(1) and 3(2).
23 Malaysia GST Law, § 3(3).
24 Irish VAT Act, § 2(1).

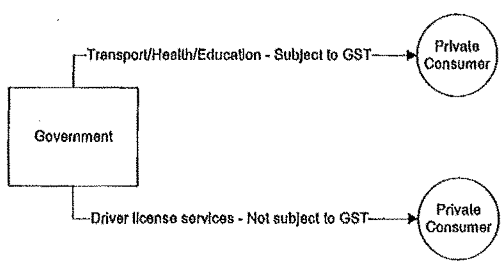
As discussed above in relation to the definition of "Taxable person," the inclusion of public bodies within the scope of a GST is a complex and controversial issue.

The approach adopted by the comparative jurisdictions of taxing public bodies varies significantly, and we summarize these approaches below:

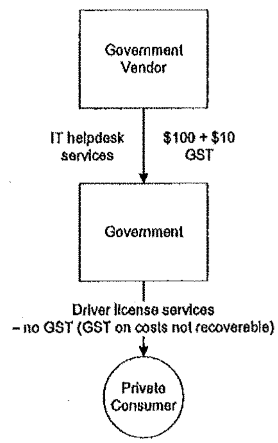
- New Zealand – includes public bodies within the definition of "person" (as discussed above) and "taxable activity". Within the definition of "supply", New Zealand deems most government fees to be consideration for a supply of goods or services.
- Singapore – treats public bodies as falling within the regime through a special provision that deems any supplies made by the government in course of business, except certain excluded supplies, to be subject to GST.
- Ireland and Malaysia – Exclude supplies made by public bodies unless they are in competition with the private sector.
- IMF – Includes the public bodies within the definition of taxable person.

The inclusion of public bodies within the scope of the GST regime promotes neutrality and reduces complexity in the application of the law and helps eliminate any distortion of competition between the public and private sector. It should be noted that the inclusion of such government bodies within the regime will not result in those bodies ultimately bearing a tax burden as the burden is ultimately born by the end consumer. It merely simplifies the operation of the tax through reducing the number of exemptions and exceptions.

A common approach globally is to treat those goods and services provided by the public sector that are in competition with private businesses as subject to GST in order to ensure there is a level playing field with the private sector. Those goods and services provided by the public sector in a non-commercial context are generally considered to be outside the scope of GST – see the below diagram:

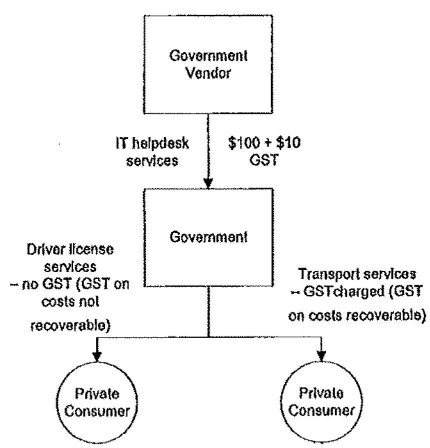


However, there are a number of challenges with this approach. Firstly, one of the biggest issues faced is how to determine whether a public body is in competition with the private sector and therefore should be taxable. Secondly, for those public bodies providing non-commercial services, input tax recovery in respect of GST incurred on their purchases is denied. This can lead to self supply bias and a distortion of production decisions where public bodies are required to minimize costs. See diagram below for illustration.

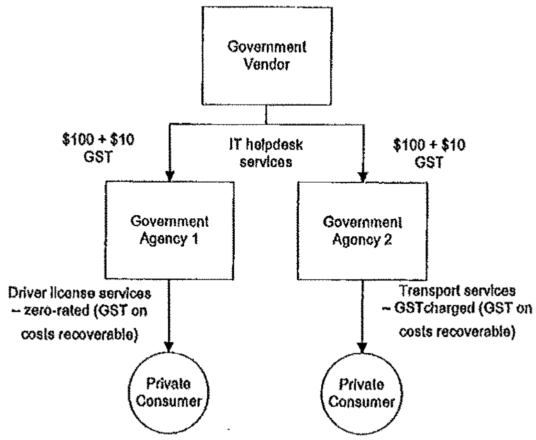


In the above example, the $10 becomes a cash cost to that government department, impacting its budget.

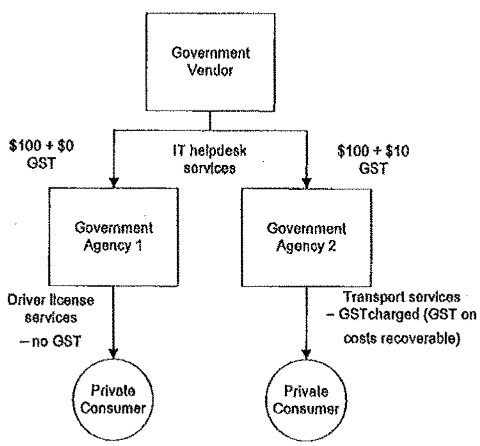
Where public bodies provide both taxable and non-taxable services, input tax apportionment issues can arise, similar to those discussed below in respect of financial services. In the diagram below, the IT helpdesk services are used by the government in the delivery of the transport services (subject to GST) and in the delivery of the driver license services (not subject to GST). The $10 GST charged by the services provider may only be recovered to the extent they are applied to the provision of transport services. Calculating this recovery percentage can result in significant compliance issues. Please refer to sections 3.D.5 and 3.D.6 for a more detailed discussion on input tax recovery and apportionment issues.



Input tax credits for GST on purchases can eliminate this self supply bias and any distortion of input choices – effectively deeming all supplies made by public bodies as zero-rated for GST purposes (other than those competing with the private sector). However the issue of determining whether the public body is in competition with the private sector remains. This is illustrated in the following diagram:

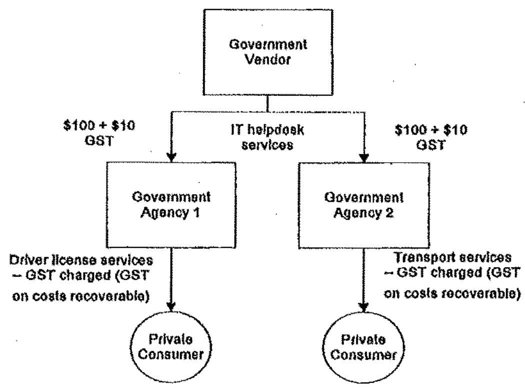


Alternatively, supplies of goods and services made to government bodies not in competition with the private sector can be treated as zero-rated. However, this can create additional complications for suppliers with respect to the requirement to identify whether the particular government body is eligible to receive zero-rated supplies or whether it should be treated as a taxable person as it is in competition with the private sector. This is illustrated in the diagram below:



Further issues are created in respect of those suppliers that primarily contract with government entities perpetually being in a GST refund position, with the associated cash flow impact this has and issues where full refunds of GST are not paid in favor of a carry forward mechanism.

Another approach, as adopted in New Zealand, is to treat the public sector as fully taxable in respect of all of its activities where there is consideration for the goods or services supplied. This eliminates the issues associated with determining whether the supplies made by the public sector are in competition with the private sector and any apportionment issues associated with claiming input tax credits. See diagram below:



The recommendation made by Copenhagen Economics when considering reform of the VAT treatment in the public sector is a full taxation model because it is a future proof model that can deal with any changes in how public and private sector entities compete, promotes a broader base and has lower compliance costs than those associated with the other options.[26]

Such a model would deem all supplies of goods and services by a public body to be subject to GST irrespective of whether they are in competition with the private sector. Further, to eliminate any issues associated with apportionment of input tax credits, public bodies would be deemed to be fully taxable and entitled to recover 100% of VAT incurred on their purchases.

We consider such an approach constitutes a leading practice in the case of Puerto Rico. As such, the definition of taxable activity should include the activities of public bodies in Puerto Rico.

However, the treatment of water and electricity is a special case in Puerto Rico. The pre-tax cost of both of these commodities is already extremely high and subjecting them to an additional GST tax would impose unacceptable additional costs on consumers. As such, a full taxation model may not be appropriate in Puerto Rico in respect of these sectors. As both are supplied by

[26] Copenhagen Economics, *VAT in the Public Sector and Exemptions in the Public Interest*, Final report for TAXUD/2011/DE/334, 10 January 2013.

government authorities and are not in competition with the private sector, such an approach is manageable.

Notwithstanding the discussion above and as discussed under Section 3.A.1, due to constitutional issues, activities of the U.S. government and its instrumentalities cannot perform a "taxable activity" for GST purposes.

3.A.3 Supply

Overview of Concept

This section addresses the definition of supply. A GST is generally designed to bring within its scope every economic transaction subject to limited exceptions.[26] GST laws usually refer to transactions subject to GST as "supplies."[27] The concept of supply can be related to sales of taxable items under the current SUT.[28] GST laws usually divide supplies into "supplies of goods" and "supplies of services." Similarly, the current SUT law divides "taxable items" into tangible personal property, taxable services, and admission fees and combined transactions.[29]

Similar to the current SUT, defining "supply of goods" and "supply services" is important because the nature of the transaction may influence the place of supply rules, the time of the supply, and the person liable to collect the GST.

Leading Practice

The definition of "Goods" should be drafted to include the following:

- All movable and immovable property (personal and real property);
- Utilities such as water and electricity; and
- Excludes money.

The definition of "Supply of Goods" should be drafted to include the following:

- Transfer of the right to dispose of a good as owner.
- A transfer or provision of thermal or electrical energy, heat, gas, refrigeration, air conditioning, or water.

The definition should also include any deemed supplies of goods in accordance with Puerto Rico's commercial laws and economic realities.

The definition of "Services" should be drafted to include the following:

- Anything that is not goods or money.

The definition of "Supply of services" should be drafted to include the following:

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[26]David Williams, *Tax Law Design and Drafting*, Chapter 6 Value Added Tax, Volume 1; International Monetary Fund, 1996.
[27]David Williams, *Tax Law Design and Drafting*, Chapter 6 Value Added Tax, Volume 1; International Monetary Fund, 1996, p. 5.
[28]*See* e.g., PRIRC § 4010.01(h).
[29]PRIRC § 4010.01(aa)..

- Anything that is not a supply of goods.

The definition should also include any deemed supplies of goods in accordance with Puerto Rico's commercial laws and economic realities.

Discussion

Definition of "goods"

In New Zealand, the GST Act defines "goods" as including all kinds of personal or real property; but not chooses in action (i.e., a right to use), money, or a product transmitted by a non-resident to a resident by means of a wire, cable, radio, optical or other electromagnetic system, or by means of a similar technical system.[30]

The Malaysian GST Act defines goods as any kind of movable and immovable property, but excludes money except a bank note or coin before it becomes legal tender or a collector's piece.[31]

The IMF Model Law defines "goods" as "all kinds of corporeal movable or immovable property, thermal or electrical energy, heat, gas, refrigeration, air conditioning, and water, but does not include money."[32]

The Irish VAT Act defines "goods" as all moveable and immovable objects (other than things in action or money).[33]

The Singapore GST Act simply defines "goods" as not including money but provides greater guidance in under the definition of "supply of goods", discussed below.[34] Singapore includes the supply of utilities as a supply of goods in the supply of goods definition.

The GST law should define what is considered a "good" for GST purposes.

The common factors across the comparable jurisdictions in relation to the definition of "goods" include:

- All movable and immovable property (personal and real property);
- The exclusion of money.

In addition, leading practice demonstrates that the definition should include utilities such as water and electricity as this removes any complications arising from determining the place of supply of such transactions.

[30] New Zealand GST Act, § 2.
[31] Malaysia GST Act, § 2.
[32] IMF ModelLaw, § 2.
[33] Irish VAT Act, § 2(1).
[34] Singapore GST Act, § 2(1).

Such a leading practice definition of goods goes beyond the current Puerto Rico definition of "tangible personal property," which does not include automobiles, intangibles, gasoline, electricity, and water.[35]

Definition of "supply of goods"

New Zealand does not provide a separate definition for supply of goods. However, the general definition of "supply" includes all forms of supply.[36] New Zealand has an extensive list of what it is deemed to be a supply of goods, including, goods retained upon deregistration.[37]

In Singapore, the GST Act defines "supply" to include all forms of supply, but not anything done otherwise than for consideration. Moreover, the GST Act provides a non-exhaustive list of transactions that qualify as a "supply of goods."[38] This list states, among other things, that the transfer for the whole property in goods is a supply of goods but a transfer of any undivided share or of the possession of the goods is a supply of services.

The Malaysian GST Act's definition of "supply" includes all forms of supply.[39] The first schedule of the GST Act provides a list of transactions that are classified as a "supply of goods." The list includes, amongst other things, the transfer of the whole property in movable goods, the transfer of land, the supply of utilities, and the transfer of business assets.[40]

The IMF Model Law defines a supply of goods as a transfer of the right to dispose of tangible property as owner, including an agreement of sale and purchase; a transfer or provision of thermal or electrical energy, heat, gas, refrigeration, air conditioning, or water, is a supply of goods; or a supply of goods for goods or services is a supply of goods.[41] Similar to New Zealand, the Model Law also includes a list of certain deemed supplies, such as for lay-bye agreements. However, in contrast to most of the other comparable jurisdictions, the leasing of a good is treated as a supply of goods.

Ireland focuses its definition on the transfer of ownership of the goods.[42]

Other than New Zealand, the definitions adopted by the other comparable jurisdictions focus on the transfer of ownership. Such an approach results in the hiring, renting, or leasing of goods being deemed to be a supply of services. This is the more common approach across the globe.

For clarity and certainty, leading practice would be adopting a more prescriptive approach, such as that adopted by the IMF. Inclusion of the various utilities in the IMF definition removes any uncertainty that may arise from determining whether a person using electricity acquires the right to dispose of the electricity as owner. In addition, similar to New Zealand and the IMF, the definition of supply of goods should also include any deemed supplies of goods based on Puerto

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[35] PRIRC § 4010.01(gg).
[36] NZ GST Act, § 5(1).
[37] New Zealand GST Act, § 2.
[38] Singapore GST Act, § 10(2)
[39] Malaysia GST Act, § 4.
[40] Malaysia GST Act, First Schedule.
[41] IMF Model Law, §4.
[42] Irish VAT Act, § 19.

Rico's commercial laws and economic realities and to facilitate the operation and neutrality of the law (e.g., deemed supply of assets retained upon deregistration where input tax has previously been claimed).

Definition of "services" and "supply of services"

The NZ GST Act defines "services" as anything that is not "goods" or "money."[43] However, New Zealand has an extensive list of what it deems to be a supply of services, which includes gambling and vouchers. New Zealand also deems many payments to public bodies to be in consideration for a supply of goods or services.

Singapore, although not defining "services," defines "supply of services" as anything which is not a supply of goods but is done for consideration (including the granting, assignment or surrender of any right).[44] The Second Schedule of the Singapore GST Act includes the transfer of the possession of goods as a supply of services.

In Malaysia, "services" means anything done or to be done including the granting, assignment or surrender of any right or the making available of any facility or benefit but excludes supply of goods or money.[45] The First Schedule of the GST law provides a list of transactions that are considered a "supply of services" and includes, amongst other things, the transfer of possession of a movable property, leasing or tenancy of land, and treatment or process.[46]

The IMF Model Law also defines services as anything that is not goods or money.[47] In addition, the definition of "supply of services" provides a non-exhaustive list of what is considered supplies of services; e.g., making available any facility or advantage; or refraining from or tolerating any activity.[48]

Ireland does not define "services" but defines "supply of services" as the performance or omission of any act or the toleration of any situation other than the supply of goods. Various other deeming rules exist to treat certain supplies of goods as supplies of services.[49] However, such a prescriptive approach to the definition of services adds complexity and as such, is not recommended.

There is a balance to be struck between having a general definition of "services" and "supply of services" and being prescriptive in the definition with various deeming provisions to help maintain the neutrality of the tax. The comparable jurisdictions differ significantly in respect of their approaches.

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[43] New Zealand GST Act, § 2.
[44] Singapore GST Act, § 10(2)(b).
[45] Malaysia GST Act, § 2.
[46] Malaysia GST Act, First Schedule.
[47] IMF, Model Law, § 1.
[48] IMF Model Law, § 4.
[49] Irish VAT Act, § 26.

Ultimately, the definition adopted will be specific to the business and economic environment in Puerto Rico. However, as a starting point, the definition of "services" and "supply of services" should be as follows:

"Services" – anything that is not goods or money.

"Supply of services" – anything that is not a supply of goods.

The definition of supply should also include any deemed supplies of services based on Puerto Rico's commercial laws and economic realities and that maintain the neutrality of the tax.

Such a leading practice definition departs from the current definition of "taxable services" under the SUT. While the SUT definition includes any service rendered to any person, it does not include, amongst other, intangibles, professional services, and services by the Government of Puerto Rico, educational services, insurance services, and healthcare services.[50]

3.B Imposition of the Tax

3.B.1 Imposition of the Tax

Overview of Concept

This is the main charging provision of the law. It sets out what types of transactions are subject to GST, the territorial scope of the GST and who is required to charge the tax.

Puerto Rico currently has two charging provisions: one for sales tax and another one for the compensatory use tax.[51]

Leading Practice

The main charging provision should be drafted to include the following:

- GST shall be levied on the taxable supply of goods and services made in Puerto Rico by a taxable person in the course of a taxable activity.
- GST shall be levied upon the importation of goods into Puerto Rico.
- GST charged on a supply must be accounted for by the taxable person making the supply
- GST levied upon the importation of the goods is the liability of the importer.

Discussion

Each jurisdiction has a main charging provision which achieves the same results. However, the wording of this charging provision and how it interacts with related sections of the law varies significantly from one jurisdiction to another.

New Zealand's main charging provision states that GST shall be charged on the supply of goods and services in New Zealand by a registered person, in the course or furtherance of a taxable

[50] PRIRC § 4010.01(nn).
[51] PRIRC § 4020.01 and PRIRC § 4020.01.

activity carried on by that person.[52] The charging of GST on the importation of goods into New Zealand is addressed under a separate section.[53] Taxable activity and registered person are defined in the Interpretation Part of the Act. The liability to pay GST is also provided for in a different section.[54]

In contrast, Singapore's main charging provision includes most of the key concepts and rules within the same provision.[55] It states that GST shall be charged on the supply of goods and services in Singapore and the importation of goods into Singapore where it is taxable supply made by a taxable person in the course or furtherance of a business carried on by him. Further the section also states that the tax charged is the liability of the person making the supply.

As discussed above, the term taxable person and business are effectively equivalent to the New Zealand terms of registered person and taxable activity. Therefore the key difference between the two jurisdictions is Singapore's inclusion of the importation GST charging provision within the main charging provision.

The IMF, in section 9 of Model Law, and Malaysia, in section 9 of the Malaysia GST Act, adopt a very similar approach to Singapore.

The Irish VAT Act's main charging states that a supply for consideration of goods or services made by a taxable person acting in that capacity where the supply is made in Ireland, is subject to VAT. In addition, the charging provision includes the levying of VAT upon the importation of goods.[56]

The Singaporean approach is preferred over the New Zealand approach as it includes the provision charging GST on the importation of the goods within the main charging provision. Further, this approach clearly sets out who is liable to account for the tax compared to the New Zealand approach which sets out this rule following the calculation of the tax payable in a particular period.

3.B.2 Place of supply

Overview of Concept

The place of supply rules determine whether a supply of goods or services is deemed to be made within Puerto Rico and therefore, whether the supply is subject to the charging provision. These

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[52] New Zealand GST Act, § 8.
[53] New Zealand GST Act, § 12.
[54] New Zealand GST Act, § 20.
[55] Singapore GST Act, §s 7 and 8.
[56] Irish VAT Act, § 3.

rules are conceptually similar to the rules for determining the source of the income generated by the sale of taxable items under the current SUT.[57]

One of the biggest issues in respect of the place of supply concept is the GST treatment of cross border transactions. This is the current focus of international discussions and the area which has seen the most recent development.

There is widespread consensus that the destination principle (that goods and services should be subject to tax in the country of destination or where they are consumed - following the core principle that GST is a tax on consumption) is preferable to the origin principal from both a theoretical and practical standpoint.[58]The destination principle preserves the intended neutrality of the tax with respect to international trade.

Cross border transactions involving goods is a fairly straight forward issue – imports should be subject to GST and exports should be zero-rated. This is in line with the destination principle and ensures that imported goods are placed on a level playing field with domestically produced goods and exporters are not competitively disadvantaged on the world market with local GST either being charged to foreign purchasers or being an embedded cost on the supply chain. We refer to the Zero-rating section (3.B.8) for a discussion of the effect that zero-rating has on the supply chain.

The GST treatment of the cross-border trade in services is more complex as there are no border controls such as those which facilitate the efficient taxation of goods. Further, actual consumption or use of services is often difficult to track so proxies are often used to determine the place of supply of services.

While most jurisdictions apply the destination principle in respect of the application of GST, subtle variances in each jurisdiction's rules can result in double taxation, non-taxation, and uncertainties for businesses and tax authorities. Such uncertainties and inconsistent treatment can result in distortions of consumer and business consumption decisions in respect of cross border transactions. This prompted the OECD to develop international VAT/GST guidelines to provide guidance to governments on apply VAT to cross border trade.[59]

In addition to the general VAT neutrality guidelines mentioned above, the OECD Guidelines also set out GST principles for international trade. These key principles have been taken into account when determining the leading practice for the GST place of supply rules and zero-rating rules discussed below.

To effectively manage the neutrality of the tax, the place supply rules are interdependent with the importation of goods, zero-rating and the imported services rules.

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[57]PRIRC § 4020.03.
[58] OECD (2012), *Consumption Tax Trends 2012: VAT/GST and Excise Rates, Trends and Administrative Issues*, OECD Publishing, p. 34.
[59]*OECD International VAT/GST Guidelines.*

Leading Practice

The place of supply rules should be drafted to include the following:

- Place of supply of goods:
  - Where the goods are located at the time of supply.
- Place of supply of services:
  - If the supplier is established in Puerto Rico, the place of the supply is in Puerto Rico;
  - If the supplier is not established in Puerto Rico, the place is outside Puerto Rico unless the services are physically performed in Puerto Rico.

Where necessary, the GST law should include specific place of supply rules for deemed supplies.

Discussion

New Zealand has adopted very broad place of supply rules from a jurisdictional perspective. In practice however, these rules do not impose GST on a greater range of supplies in comparison to other jurisdictions. However, it can result in the requirement to treat certain supplies as zero-rated where other jurisdictions would treat such supplies as out of scope, thus resulting in a reporting obligation in respect of those supplies.

New Zealand includes its place of supply rules in its main charging provision.[60] The primary rule is based on the residency of the supplier - goods and services are deemed to be supplied in New Zealand if the supplier is resident in New Zealand (with zero-rating rules applying to maintain the destination principle) and deemed to be supplied outside New Zealand if the supplier is non-resident in New Zealand. However, this primary rule has a number of exceptions to ensure the destination principal is maintained.

If the supplier is a non-resident, a supply of goods is deemed to be supplied in New Zealand if the goods are in New Zealand at the time of supply (earlier of invoice issuance or payment). A supply of services is deemed to be supplied in New Zealand by a non-resident if the services are physically performed in New Zealand by a person who is in New Zealand at the time the services are performed. In order to avoid the unnecessary registration of non-residents, where goods and services are deemed to be supplied in New Zealand but are supplied to a person who can claim a credit for any GST charged, the supply is deemed to be made outside of New Zealand.

Finally, New Zealand also has a reverse charge rule for services not performed in New Zealand that are received by a taxable person that is unable to claim a full input tax credit. In such cases the services are deemed to be made in New Zealand and the recipient is required to account for the GST (refer to section 3.B.4 below for a discussion on reverse charge).

New Zealand also has specific rules in relation to telecommunications suppliers.

[60] New Zealand GST Act, § 8.

Singapore focuses on the transport of goods for determining the place of supply.[61] A supply of goods is treated as being supplied in Singapore if the supply does not involve their removal to or from Singapore. Further, if the supply involves the removal of the goods from Singapore, then the goods are deemed to be supplied in Singapore (potentially subject to zero-rating as an export). If the supply involves the removal of the goods to Singapore, the supply is deemed to be outside of Singapore.

In respect of supplies of services, services are treated as supplied in Singapore if the supplier belongs in Singapore and are not treated as supplied in Singapore if the supplier belongs outside of Singapore. The "belongs" test is similar to the New Zealand residence test focusing on the supplier's presence in the country.

Malaysia has adopted similar rules as Singapore in section 12 of the Malaysian GST Act.

The key difference between the New Zealand approach and the Malaysian and Singaporean approaches relates to the treatment of services. While all three countries tax a supply of services by a business established in the jurisdiction (with zero-rating rating rules applying for certain exported services), only New Zealand taxes services physically performed in the country by a non-resident, potentially resulting in a non-resident being required to register for GST in New Zealand. Malaysia and Singapore do, to a certain extent tax services physically performed in their respective countries by non-established entities through their reverse charge regimes (we discuss the reverse charge regimes in section 3.B.4 below). However, many services can escape the tax net. As such the New Zealand approach is preferred.

The IMF Model Law adopts the approach of the EU that was in place prior to 2010.[62] While the place of supply rules for goods remain unchanged, the EU substantially changed the place of supply rules for services to have more of a destination principle focused VAT. Given a destination principle is regarded as leading practice, we do not consider the IMF Model VAT Law place of supply rules to be an appropriate comparable and do not discuss these rules in detail.

The place of supply rules as implemented by Ireland are as follows.

A supply of goods is deemed to take place where the goods are made available to the supplier. If the supply of the goods involves transportation of those goods, then the place of supply is deemed to take place where the transport begins.[63]

The Irish VAT Act also provides specific rules for the supply of electricity, water and similar utilities; being where the supply is received.[64]

Supplies of services in a business to business transaction are deemed to take place where the customer is located.[65] However, various exceptions to this general rule include:

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[61] Singapore GST Act, § 13.
[62] IMF Model Law, § 12.
[63] Irish VAT Act, § 29 - 30.
[64] Irish VAT Act, § 31.
[65] Irish VAT Act, § 33 - 34.

- Supplies connected with immovable property – where the property is located.
- Passenger transport – where the transport takes place.
- Admission to certain cultural, artistic and sporting activities – where the event takes place.
- Restaurant and catering services – where the services are physically carried out.
- Restaurant and catering services onboard ships, aircraft and trains – the place of departure.
- Short term hiring of means of transport (less than 30 days) –where the means of transport is collected.

Supplies of services in a business to consumer transaction are deemed to take place where the supplier is located. However, various exceptions to this general rule also exist, including:

- Services provided by an intermediary – taxed where the main transaction takes place.
- Supplies connected with immovable property – where the property is located.
- Valuation of, or work on, tangible personal property – where the services are physically delivered.
- Passenger transport – where the transport takes place.
- Transport of goods – where the transport takes place.
- Ancillary services to the transport of goods – where the service are physically performed.
- Any service related to certain cultural, artistic and sporting activities – where the event takes place.
- Restaurant and catering services – where the services are physically carried out.
- Restaurant and catering services onboard ships, aircraft and trains – the place of departure.
- Short term hiring of means of transport (less than 30 days) – where the means of transport is collected.
- Long term hiring of means of transport (more than 30 days) – where the customer is located.
- Electronically supplied services, radio and television broadcasting services and telecommunication services – the location of the customer (post 2015).
- Advertising, consulting and legal services, financial services, transferring trademarks, patents and similar rights – where the customer is located.
- Restraint of trade – where the customer is located.
- Supply of staff – where the customer is located.
- Hiring of moveable tangible property (other than means of transport) – where the customer is located.

There are various other place of supply rules and use and enjoyment rules that override the above.[66]

The prescriptive nature of the Irish place of supply rules, while effectively achieving a destination principle VAT system (with certain exceptions) create barriers to compliance due to their complexity.

For this reason, and the reason discussed above in respect of the Malaysian and Singaporean rules, adopting place of supply rules similar to the New Zealand model constitute leading practice. The GST law should, where necessary, provide specific place of supply rules for deemed transactions. In addition, special taxation provisions should be created for telecommunication, broadcasting and electronic supplies services provided to final consumers in Puerto Rico by non-residents in order to ensure that the destination principle is maintained. Because the latter constitute specific transactions, the specific taxation rules for these transactions should be addressed outside the main taxing provisions as a Special Case.

3.B.3 Time of Supply

Overview of concept

The time of supply rules primarily determine when VAT should be accounted for in respect of a supply (i.e., the period/return in which the transaction should be reported). However, it also sets a reference point for when a tax invoice should be issued (e.g. within 21 days of the time of supply) and can be used as a reference point for determining the place of supply (e.g., the place of supply of goods is where they are located at the time of supply).

Leading Practice

The time of supply rules should be drafted to include the following:

- The time of supply is the earlier of:
  - The issuance of any invoice;
  - The receipt of any payment; or
  - The delivery of making available of the goods or the completion of the performance of the services.
- For continuous supplies, the time of supply should be deemed to occur when each successive payment is made or becomes due or when an in invoice relating to that payment is issued.

Specific time of supply rules should be drafted for such supplies as gambling, vouchers, imported goods, imported services and should be addressed under their respective provisions.

[66] Irish VAT Act, § 35.

Discussion

New Zealand takes a very simplistic approach with its basic time of supply rule.[67] The time of supply is the earlier of the issuance of an invoice or the receipt of any payment. This basic rule is modified in the case of supplies between associated persons to ensure that the liability to account for GST is not artificially deferred. In such cases, the time of supply is deemed to be as follows where no invoice or payment has been made:

- For supplies of goods:
  - If the goods are to be removed, at the time of the removal.
  - If the goods are not to be removed, at the time they are made available to the recipient.
- For supplies of services:
  - The time the services are performed.
  - For related party imported services, the end of the taxable period that is 2 months after the first balance date of the recipient following the performance of the services.

Special rules also exist for layaway arrangements (when title is transferred), lotteries, casinos, vending machines, supplies by government authorities, major construction, hire purchase agreements and vouchers. Further, where goods or services are supplied under an agreement which provides for periodic payments, the time of supply is triggered at the point when each successive payment is made or becomes due or when an in invoice relating to that payment is issued.

Singapore has the same general time of supply rule as New Zealand – earlier of invoice or payment – but it is modified to state "to the extent that the supply is covered by the invoice or consideration."[68] However, Singapore's exception to this rule, which is drafted in the same manner as New Zealand's, does not apply to associated persons but applies to specific supplies that are listed in the legislation, including:

- A supply of goods consisting of the grant, assignment or surrender of any interest or right over land;
- Where a taxpayer has applied to the Comptroller to apply this exception to the general time of supply rules; and
- A supply by an agent that is deemed to be made by him as principal under a specific provision of the law.

The Singaporean law then provides specific rules for the following:

- When input tax may be claimed – general rule;
- Calculation of turnover threshold for registration purposes – general rule;

[67] New Zealand GST Act, § 9.
[68] Singapore GST Act, § 11.

- Disposal of assets of a business for no consideration – at the time the goods are transferred or disposed of;
- Business assets used for private purposes for no consideration – the last day of the accounting period in which the goods were used for private purposes;
- Where goods are provided on a trial basis – at the end of 12 months following the goods removal if no invoice or payment has been issued or received;
- Where goods or services are made available to a non-registered person prior to the seller's registration but invoiced after registration – there is a choice on how to treat the transaction;
- Where the parties are associated persons and no invoice has been issued or consideration paid – at the end of 12 months after the goods have been removed;
- Financial services paid on installments – treated as wholly taking place at the time when the invoice for the first installment is issued or paid; and
- Where a person deregisters from GST after the goods are made available or removed or the services are performed and issues an invoice/receives payment after deregistration – the time of supply is the day immediately before deregistration (this is included in the definition of supply in the New Zealand law).

The Comptroller may also alter the time of supply at the request of the taxable person. The GST regulations provide certain exceptions to the associated persons' time of the supply rule, and rules around continuous supplies of services where payments are made periodically.

Malaysia takes a more complex approach to the general time of supply rule.[69] For goods the time of supply is as follows:

- At the time of the removal of the goods if the goods are to be removed;
- At the time when the goods are made available to the recipient if the goods are not to be removed;
- Where goods are provided on a trial basis – the time when it because certain that a taxable supply has taken place or 12 months after removed, whichever is earlier.

For the supply of services, the time of supply is when the services are performed.

Notwithstanding the above rules, if a tax invoice is issued or payment is made prior to the above tax point being triggered, then the invoice or payment will trigger the time of supply to the extent the payment or invoice covers the supply. However, if a tax invoice is issued within 21 days of the time of supply determined under the basic rule, the date the tax invoice is issued becomes the tax point.

The Director General may also alter the time of supply at the request of the taxable person.

[69] Malaysia GST Law, § 11.

Malaysia also has specific rules as follows:

- Disposal of assets of a business – at the time the goods are transferred or disposed of; and
- Business assets used for private purposes – at the time when the goods were used for private purposes.

The regulations provide further rules for periodic supplies/payments by installment.

The time of supply rules under the IMF Model VAT Law effectively takes elements from a number of jurisdictions.[70]

The primary rule is that the time of supply is the earlier of:

- The delivery or making available of the goods or the completion of the performance of the services;
- The issuance of an invoice; or
- The receipt of any payment.

Specific rules are provided for:

- The supply of goods under a credit agreement – at the time the agreement is entered into;
- The supply of goods under a lay-bye agreement – at the time the goods are delivered to the purchaser;
- The making available of goods for private or employee use – at the time the goods are applied to that use;
- The deemed supply of repossessed goods by the debtor to the creditor – at the time of repossession;
- The deemed supply of services under a cancelled lay-bye agreement – when the seller obtains the right to retain any amounts paid by the purchaser;
- Supplies made through vending or other coin operated machines – when the money is removed from the machine;
- Goods under a rental agreement or supplies under an agreement which provides for periodic payments – when each payment is due or received;
- For major construction work or utilities where payments are due periodically – the earlier of the when the payment is due, made or when an invoice is issued; and
- Tokens, vouchers, forfeiture of deposits, deemed supply of good on hand at deregistration.

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[70] IMF Model Law, § 10.

The Irish time of supply rules are as follows:[71]

- For B2B transactions, the date of the issuance of the invoice or when the invoice should have been issued;
- For B2C continuous supplies of telecommunication, gas and electricity, when a statement of account is issued;
- For all other B2C supplies, when the goods or services are supplied; and
- For advance payments, if the goods or services are yet to be supplied, then the time of supply is triggered at the time of payment to the extent payment has been received. If received after the supply of the goods or services but before invoice, then the time of supply is triggered at the time of payment for the full value of the supply.

Various other specific time of supply rules are provided, similar the various specific rules noted for the other jurisdictions.[72]

Given the greater risk of fraud in Puerto Rico, it is likely the New Zealand and Singapore approach of relying solely on the issuance of an invoice or receipt of any payment to trigger the time of supply could create greater opportunities to artificially defer tax liability. Further, the complexities of the Irish and Malaysian rules do not promote the principle of simplicity. As such, we consider the better approach would be the IMF Model Law.

The GST law should also, where required, provide specific time of supply rules for deemed supplies if not addressed under Special Cases.

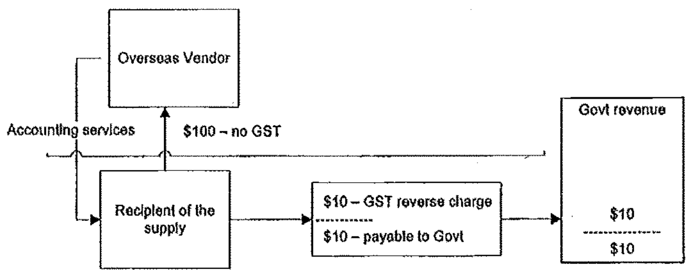
3.B.4 Imported Services/Reverse charge

Overview of Concept

In order to effectively maintain the neutrality of a GST and minimize the compliance obligations placed on non-residents that do not have any presence in the jurisdiction, many jurisdictions adopt an imported services or reverse charge regime. Such a regime generally deems services acquired by residents from overseas to be self-supplied by the resident recipient with the recipient being required to account for GST on that transaction (akin to a use tax).

An example of how the reverse charge operates is noted in the diagram below (assuming a 10% GST rate with no recovery for the recipient of the supply):

[71] Irish VAT Act, § 74.
[72] Irish VAT Act, § 76.



Such a regime relieves any potential distortion in the economic decision of a resident of whether to purchase domestic services or services from overseas and creates a level playing field for domestic and international supplies, preserving the neutrality of the tax.

Leading Practice

The imported services/reverse charge rules should be drafted to include the following:

- Where services are supplied by a non-resident to a person in Puerto Rico, that are not otherwise deemed to be supplied in Puerto Rico under the place of supply rules, the supply should be deemed to be supplied in Puerto Rico by the recipient of the supply.
- The provision should not apply if the recipient is able to claim a full input tax credit in respect of the service received.

Discussion

New Zealand includes its reverse charge regime under the place of supply provision.[73] It states that where a supply is made by a non-resident and it is not deemed to be supplied in New Zealand under any other place of supply rules, that the supply is deemed to be made in New Zealand. A provision within the definition of supply then deems this transaction to be made by the recipient, therefore requiring the recipient to account for tax on the transaction. However, these provisions only apply where the recipient is not in a position to claim full input tax credits for any GST charged. If the recipient can claim full input tax credits, then the reverse charge would simply be an accounting exercise creating an additional compliance burden with no benefit to the revenue authority.

Singapore imposes a reverse charge regime under a discrete section that includes not only the deeming of the supply to be made in Singapore by the taxable person but also sets out the time of supply and valuation rules.[74] Technically this section also applies irrespective of the input tax recovery position of the recipient. This is in contrast to the New Zealand approach which includes valuation and time of supply in relation to such transactions under those respective sections. We do note that Singapore is yet to enforce this reverse charge provision.

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[73] NZ GST Act, § 8(4B).

[74] Singapore GST Act, § 14.

Malaysia adopts a similar approach to Singapore.[75]

The IMF Model Law takes a completely different approach by including the importation of services within the main charging provision of the Act[76] and then defining the importation of services within the definitions section.[77] However, similar to New Zealand, there is no requirement to account for the reverse charge where a full input tax credit may be claimed. Unusually, the IMF Model Law then requires an import of services declaration to be made to the Commissioner and pay the tax within 20 days of the end of the taxable period in which the service were imported.[78]

Ireland addresses imported services through the place of supply and the liability rules.[79] Where a supply of services is deemed to be made in Ireland and the supplier is not VAT registered nor has an establishment in Ireland, the liability to account for the tax falls on the recipient. This rule applies irrespective of whether the recipient can claim a full input tax credit in respect of the transaction.

To meet the neutrality objective of a GST and promote the destination principle, leading practice would be to adopt a reverse charge regime for imported services. It is recommended that a combination of the New Zealand and Singaporean approach be adopted – the Singaporean approach of including the importation of services provisions in a separate section but not requiring the reverse charge to be accounted for when a full input tax credit may be claimed by the recipient for simplicity purposes.

3.B.5 Value of the Supply

Overview of concept

The rules governing the value of the supply determines the taxable base upon which the VAT rate will be applied.

Leading Practice

It is recommended that the valuation rules be drafted to include the following:

- The value of the supply is, with/without the addition of tax charged (depending on the commercial laws of Puerto Rico), equal to the consideration for the supply. For imported services, the value should be, without the addition of tax charged, equal to the consideration for the supply.
- The value of supplies of services between related parties below the open market value should be the open market value unless the recipient can claim an input tax credit for any tax charged.

[75] Malaysia GST Act, § 13.
[76] IMF Model Law, § 9.
[77] IMF Model Law, § 2.
[78] IMF Model Law, § 19.
[79] Irish VAT Act, § 12 and 34.

- If the consideration is not in money, it is the open market value of the consideration.
- The value of the supply should include any other taxes, duties or levies (or similar charges).

Specific valuation rules should be adopted for deemed supplies, specific transaction, or special cases that are not adequately dealt with in the general valuation provisions.

Discussion

The general rule under the New Zealand law is that the value of the supply of goods and services shall be, with the addition of tax charged, equal to the consideration for the supply. If the consideration is in money, it is the amount of money payable. If the consideration is not in money, it is the open market value of the consideration.[80] An exception to this tax inclusive valuation of the supplies is in respect of imported services subject to the reverse charge regime. In such cases the value is treated as the consideration for the supply before the addition of tax.

If a supply is between associated persons and is made for no consideration, or consideration that is less than the open market value of the supply, then the supply is treated as the open market value, unless the recipient could claim an input tax credit for any tax charged.

There are a number of rules that are specific to the New Zealand regime which are not relevant here and, as such, are not discussed. However, relevant specific valuation rules include the following:

- Imported services subject to the reverse charge where those services are supplied between related parties;
- Credit contracts to exclude any interest component;
- Long term residential accommodation in a commercial establishment;
- Fringe benefits provided to employees;
- Deemed sale of business assets upon deregistration;
- Deemed supply of services following the cancellation of a lay-by sale;
- Supplies by government bodies;
- Betting, gambling and casinos; and
- Certain cross border intra- group company transactions.

The New Zealand valuation provision also addresses mixed supplies – where the consideration relates to both taxable and non-taxable supplies. In such cases, the consideration should be apportioned to the relevant parts of the supply.

The Singapore GST Act adopts the same general valuation rules as New Zealand.[81] Further Singapore has a similar associated person rule for when there is no consideration or the

[80] New Zealand GST Act, § 10.
[81] Singapore GST Act, § 17 and Third Schedule.

consideration is less than open market value however, the uplift to open market value is at the discretion of the Comptroller.

Singapore has specific rules to address the valuation of the following:

- Valuation rules for the disposal or business assets or the deemed disposal of business assets upon ceasing to be a taxable person;
- Provision of food and beverages or hotel accommodation (or similar) to employees;
- The inclusion of other taxes or duties in the taxable base;
- Leasing of residential premises; and
- Used motor vehicles.

Malaysia has a similar general valuation rule as New Zealand and Singapore, with the exception of the treatment of supplies made for no consideration. In such cases the value is deemed to be the open market value irrespective of the relationship between the parties.[82]

Malaysia also provides the Director General the power to deem a sale to be at open market retail value where the goods are sold by a registered person to non-registered persons for resale.[83]

Malaysia provides a similar valuation rule as New Zealand for gambling.

The IMF Model Law is similar to New Zealand.

The IMF Model Law provides a number of special valuation rules, as follows:

- Credit agreements to exclude any interest component;
- Value of the deemed supply upon repossession of goods;
- Deemed supply of services following the cancellation of a lay by sale;
- Vouchers;
- Betting;
- Deemed supply where a part of the transfer of a going concern is acquired for non-business use;
- Deemed sale of business assets upon deregistration.

The Irish valuation rule states the amount on which tax is chargeable is the total consideration which the person supplying goods or services becomes entitled to receive, including all taxes, commissions, costs and charges, but not including value-added tax chargeable in respect of that supply.[84]

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[82] Malaysia GST Act, § 16.
[83] Malaysia GST Act, Schedule 3, subparagraph 6.
[84] Irish VAT Act, § 37.

Where the consideration does not consist of or does not consist wholly of an amount of money, the amount on which tax is chargeable shall be the total amount of money which might reasonably be expected to be charged if the consideration consisted entirely of an amount of money equal to the open market price.

The Commissioner has a discretion to determine the value of a transaction, based on the open market value of the supply, to ensure the correct amount of VAT is paid.[85]

Specific valuation rules are provided for such things as vouchers, reverse charge, and non-business use of immovable goods.

The approach to the valuation rules by each jurisdiction is very similar. However, Ireland treats the consideration as VAT exclusive while the other jurisdictions treat the consideration as GST inclusive. The ultimate decision on whether to treat the consideration as being GST inclusive or exclusive for the purposes of the GST valuation rules will depend on the commercial or consumer laws of Puerto Rico. However, for imported services, the consideration should be deemed to be GST exclusive.

In any event, the valuation for GST purposes should include any other taxes, duties, levies paid on that supply because GST is not an alternative to those taxes and the value of the supply including those taxes represents the real value of the final consumption of the good or service.[86]

The use of the open market value uplift should be limited and prescriptive, similar to the New Zealand approach, rather than be discretionary such as in Ireland and Singapore in order to provide certainty within the tax system.

Specific valuation rules should be adopted for deemed supplies, specific transactions or special cases that are not adequately dealt with in the general valuation provisions.

3.B.6 Imported Goods

Overview of Concept

A key concept of GST is the levying of the tax on imported goods. As mentioned above in respect of the place of supply rules, this is consistent with the destination principle and ensures that imported goods are placed on a level playing field with domestically produced goods.

Key challenges that will need to be addressed relate to the importation of goods into Puerto Rico from the United States given Puerto Rico's relationship with the United States.

Leading Practice

The levying of GST upon the importation of goods should be included within the main charging provision, as discussed above.

[85] Irish VAT Act, § 38.
[86] David Williams, *Tax Law Design and Drafting*, Chapter 6 Value Added Tax, Volume 1; International Monetary Fund, 1996, p. 45.

However, this specific section should address the time at which a good is considered to be imported (e.g., when the goods are cleared by customs) and any import GST suspension or relief regimes.

The provision should provide relief for certain importations by contract or toll manufacturing operations and in respect of the temporary importation of goods.

For taxable persons in good standing, a GST deferral regime should be available to allow those taxable persons to self account for import GST in their GST returns, relieving them of any cash flow burden that may arise from having to pay the GST to release the goods at the border and the subsequent claiming of a credit in the later return.

Discussion

As discussed above in respect of the imposition of the tax, New Zealand has a separate section that imposes GST on upon importation (other than fine metals).[67] This is in contrast to the other comparable jurisdictions, which include the importation of goods within their respective main charging provision.

The charging provision refers to the Customs Laws to determine when goods are considered to be imported into New Zealand. As such, any relief provisions under the Customs Laws (e.g., temporary importation) also apply to the GST.

Within this section, New Zealand also sets out various rules in respect of when GST should not be applied upon importation, including:

- Goods intended solely for the use of an organization, visiting force, expedition or other body approved by New Zealand Customs that may be established or temporarily based in New Zealand under a government or international agreement; and
- Goods intended for the use of a person temporarily resident in New Zealand for the purposes of serving as a member of any of the above organizations.

The section also sets out the value of the imported goods for the purposes of levying the GST.

Further, reliefs are provided for reimported goods (where the importer is the same person as the exporter and the goods were not treated as a zero-rated exported supply).

Various provisions are included to address the refund of GST for goods re-exported from the country where the importer was not entitled to an input tax credit and the goods were of the wrong specification or were faulty.

Additional exemptions are provided for certain specified items under the New Zealand Tariff including:

- Certain gifts;

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[67] New Zealand GST Act, § 12.

- Personal baggage and effects (subject to certain limits); and
- Limited amounts of alcohol and tobacco.

Singapore imposes GST on importation in the main charging section of the act, effectively treating GST as if it were a customs duty and all goods imported into Singapore are dutiable. Exemption from import GST for investment precious metals is separately provided for.

Singapore provides discretion to the Minister to issue orders granting relief from import GST for such things as re-imported goods, temporary imported goods, and goods related to an international agreement or arrangement. In addition, similar to the New Zealand law, Singapore defers to the customs legislation for the levying of GST unless there is contrary intention noted in the GST law.

The Singapore GST Act also provides the Minister with the power to issue regulations relieving or deferring the levying or payment of GST where goods are imported by any taxable person in the course of that persons business.[88]

Such schemes include:[89]

- The exemption of the importation of petroleum products where imported for the business of the taxable person;
- Exemption of imports by persons approved under the Major Exporter Scheme and approved third party logistics company scheme (this is a scheme available to taxable persons where the majority of their supplies are exports or supplies of international services);
- Approved import suspension scheme (for taxable persons in the aerospace industry);
- Import Goods and Services Tax Deferment Scheme (allows taxable persons to self account for import GST in their tax return);
- Approved contract manufacturer scheme (where the taxable person carries out work on goods under contract with an overseas person); and
- Approved refiner scheme (who imports investment precious metals and make supplies of refining or supplying such metals).

Malaysia is similar to Singapore in that the charging provision for the levying of GST on importation is in the main charging provision.[90] Malaysia has a number of special regimes, very similar to a number of Singaporean regimes.

The IMF Model Law also has the levying of VAT on importation in the main charging provision.[91] The exemption from import VAT is covered by section 17, referring to Schedule III, which essentially states that import VAT is not payable if the goods are not dutiable. Further, if the

[88] Singapore GST Act, § 27 and 27A.
[89] Singapore GST Regulations, Part IV.
[90] Malaysia GST Act , § 9.
[91] IMF Model Law, § 9.

supply of the goods within the country would be zero-rated or exempt, then no import VAT should apply.

The IMF Model Law also includes a section providing the Commissioner of Customs with the obligation to collect the VAT and requires the importer to provide the Commissioner with an import declaration.

Ireland levies VAT upon the importation of goods in the main charging provision.[92] Ireland includes the following exemptions or reliefs from import VAT:[93]

- Import into a free trade zone;
- Imports into customs warehouse;
- Inward processing arrangements (similar to the contract and toll manufacturing schemes in Malaysia and Singapore);
- Temporary importation arrangement;
- Transit arrangement;
- A regime similar to Singapore's major exporter scheme; and
- A deferred payment scheme.

All comparable jurisdictions levy GST on the import of goods within the territory. This is in line with the current SUT regime, under which use tax must be paid upon importation of goods into Puerto Rico before the person takes possession of the goods.[94]

Amongst the comparable jurisdictions, only New Zealand does not include the levying of GST upon importation within the main charging provision. For clarity purposes, the leading practice would be to follow Singapore, Malaysia, the IMF, and Ireland in this respect.

The section should also address the point in time that a good is considered to be imported (e.g., when the goods are cleared by customs) and any import GST suspension or relief regimes. For this purpose the comparable jurisdictions generally refer to the customs laws.

Given Puerto Rico's economy, special consideration should be given to regimes related to contract or toll manufacturing operations and the temporary importation of goods, which would eliminate the levying of import GST in certain prescribed situations. For example, the importation of raw materials for processing into final goods that are to be exported from Puerto Rico.

For taxable persons in good standing, a GST deferral regime should be available to allow those taxable persons to self account for import GST in their GST returns, relieving them of any cash flow burden that may arise from having to pay the GST to release the goods at the border and the subsequent claiming of a credit in the later return.

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[92] Irish VAT Act§ 3.
[93] Irish VAT Act, §s 53 to 58.
[94]PRIRC § 4042.03(a).

In this regard, the special schemes in Singapore, Malaysia, and Ireland should be considered and adapted to Puerto Rico's needs.

Like the existing rule for collection of sales tax on sales by mail order,[95] the GST law should also address separately the specific case of mail order deliveries to private individuals from the U.S.

3.B.7 Value of Imported Goods

Overview of Concept

It is common to have separate valuation rules for the importation of goods that refer to the customs valuation rules. This reduces an administrative complexities that would arise if the valuation for GST purposes is different than for customs purposes but the GST is levied and collected using the same mechanism as for the collection of duties. Further, such valuation rules assist in determining the taxable base for GST purposes where there is no reference transaction.

Leading Practice

The valuation rules for levying the GST on the importation of goods into Puerto Rico should be based on the customs valuation rules, plus any duties or levies payable upon importation.

Discussion

The New Zealand charging section for levying GST on imported goods also sets out the value of the imported goods for the purposes of levying the GST. The valuation provisions refer to the customs valuation rules plus any other duties or levies payable upon importation.[96]

The IMF, Ireland, Singapore, and Malaysia have separate valuation sections.[97] All sections refer to the valuation prescribed under the customs laws and operate in the same manner as New Zealand.

3.B.8 Zero-rated Supplies

Overview of Concept

Where a supply of a good or service is zero-rated, no GST is charged on the sale or provision of that service. However, the person making that supply is able to recover the GST it has incurred on its purchases related to the making of that zero-rated supply (contrast this with exempt supplies below).

The main issue with zero-rating, is that the entire supply chain is relieved from tax if zero-rating is at the final stage of the chain as illustrated in the diagram below. As such, zero-rating is more costly to the government in terms of revenue foregone. Further, zero-rating requires more controls to ensure refunds claimed by taxable persons making zero-rated supplies are valid.

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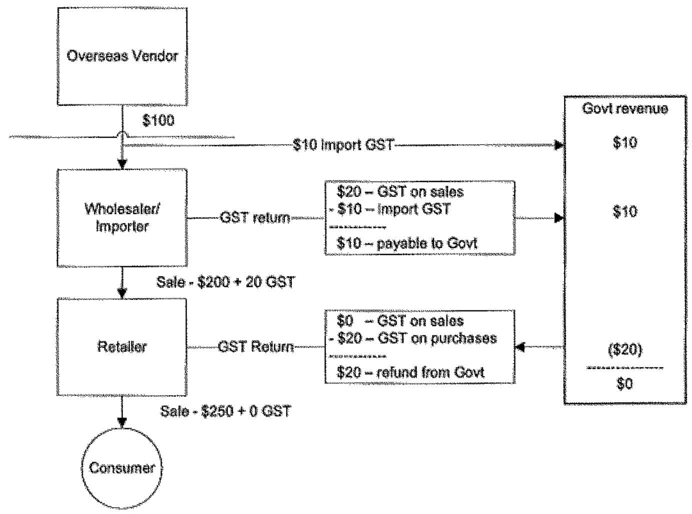
[95] PRIRC § 4020.08.
[96] New Zealand GST Act, § 12(2).
[97] Singapore GST Act , § 18, Malaysia GST Act, § 16, IMF Model Law, § 14, Irish VAT Act, § 54.

Zero-rating has the following impact on the supply chain and the collection of the tax:



A few countries zero rate some domestic supplies for social and political reasons: sales of food, medicines, books, children clothes and shoes (UK, Ireland) to completely remove the tax burden from the supply chain. This is widely viewed as inappropriate, because it amounts to a subsidy of the activity or transaction treated in this way and zero-rating is costly in terms of government revenue forgone as tax is relieved from the entire supply chain. It would usually be better to identify the policy reason for the subsidy and address it through a direct subsidy.[98]

Leading Practice

Zero-rating should be limited to exported goods and services where the effective consumption takes place outside of the GST jurisdiction, maintaining the destination principle of GST. As such, to the extent the services supplied to non-residents relate to real or moveable personal property in Puerto Rico, GST should be charged.

For the reasons explained under 3.A.1 supplies to the U.S. Federal Government and its instrumentalities should also be zero-rated.

In addition, to avoid double taxation in respect of fuel and hotel rooms and an additional tax burden being placed on consumers, given those supplies are subject to excise tax and the excise tax is unable to be adjusted due to debt obligations, such supplies should be zero-rated.

[98] David Williams, *Tax Law Design and Drafting*, Chapter 6 Value Added Tax, Volume 1; International Monetary Fund, 1996, p. 52.

Discussion

New Zealand zero-rates the following goods:[99]

- Exported goods;
- Duty free goods for travelers;
- Supply of a boat or aircraft leaving New Zealand under its own power;
- Goods not situated in New Zealand at the time of supply and the goods are subsequently imported by the recipient and subject to import GST;
- Goods used for the provision of zero-rated repair, renovation, modification services and those goods are consumed or affixed to the goods that are the subject of the zero-rated repair, renovation, modification services (e.g., good used in the repair of ships or aircraft temporarily in New Zealand);
- Goods for the use on a pleasure craft temporarily imported into New Zealand related to the operation of the craft;
- Consumable stores supplied for use on ships or aircraft leaving New Zealand;
- Sale of a taxable activity;
- Supply of land for the use in a taxable activity;
- Supply of any new fine metal after its refining; and
- Supply of tools to a non-resident that are to be used in New Zealand for the purpose of manufacturing goods solely for export.

Various rules are listed that restrict the application of zero-rating in certain circumstances to mitigate evasion opportunities.

New Zealand zero-rates the following types of services:[100]

- International transport of passengers or goods, including ancillary services such as the loading and unloading of goods, insurance related to such transport;
- Services supplied directly in connection with land or moveable personal property situated outside New Zealand;
- Services supplied to overseas postal organizations for the delivery of mail in New Zealand which originated from overseas;
- Services supplied directly in connection with temporarily imported goods;
- Services physically performed outside New Zealand or the arranging of services physically performed outside New Zealand;

[99] New Zealand GST Act, § 11.
[100] New Zealand GST Act, § 11A.

- Services supplied to a non-resident who is outside New Zealand at the time the services are performed and the services are not supplied directly in connection with land or moveable personal property in New Zealand;
- Supply of information to a non-resident where the services are supplied directly in connection with moveable personal property in New Zealand;
- Services supplied to a non-resident which are directly in connection with goods to be exported;
- Services supplied to a non-resident which are directly in connection with tools that are to be used solely to produce goods to be exported;
- Services related to imported goods under warranty to the extent the services are provided under the warranty and supplied to a warrantor who is a non-resident; and
- Certain telecommunication services supplied to a non-resident telecommunications supplier.

Singapore zero-rates the following types of goods:[101]

- Exported goods;
- Use as stores or fuel on aircraft or ship (including retail as merchandise to persons carried on a ship or aircraft);
- For installation on a ship or ship under construction;
- For use in the maintenance or operation of a ship;
- Supply of tools to a non-resident that are to be used in Singapore for the purpose of manufacturing goods for that non-resident; and
- Certain supplies to approved marine customers.

Singapore zero-rates international services which include the following:[102]

- International transport of passengers or goods, including ancillary services such as the loading and unloading of goods, insurance related to such transport;
- The letting on hire of any means of transport for use in a place outside Singapore which is exported by the lessor to such a place or are outside Singapore;
- Services supplied directly in connection with land or goods situated outside Singapore;
- Services supplied to a non-resident which are directly in connection with goods to be exported;
- Prescribed financial services supplied in connection with goods for export outside Singapore or for the removal of goods from a place outside Singapore to another place outside Singapore;

[101] Singapore GST Act, § 21(6), (6A).
[102] Singapore GST Act, § 21.

- Cultural, artistic, sporting, educational, entertainment, exhibition, convention (and ancillary services) wholly performed outside Singapore;
- Services supplied to a person who belongs outside Singapore and which directly benefit a person who belongs outside Singapore at the time the services are performed including computer server co-location services relating to equipment owned by the non-resident;
- Services supplied in connection with the handling of ships or aircraft, the handling or storage of goods carried on any ship or aircraft;
- Pilot age, salvage; or towage services performed in relation to ships or aircraft;
- Services comprising the surveying of any ship or aircraft;
- The supply of any ship or aircraft and certain parts;
- Prescribed services comprising the repair, maintenance or broking or management of any ship or aircraft;
- Prescribed services relation to telecommunication;
- Services supplied to a trust where the services and the person supplying the service satisfy the conditions as may be prescribed;
- Prescribed services in connection with the provision of an electronic system relating to the import or goods or export of goods out of Singapore;
- Supply of advertising services where the advertising is substantially made outside Singapore;
- Air and sea containers and certain services related to air and sea containers;
- Services supplied to a non-resident which are directly in connection with tools that are to be used solely to produce goods to be exported; and
- Grant or assignment of lease, tenancy or license to occupy land where the supply is to a non-resident and it is an approved warehouse.

The IMF Model Law is very similar to the New Zealand zero-rating provisions.

Ireland zero-rates an extensive list of goods including the following:[103]

- Export of goods;
- Certain food items;
- Books;
- Medicines and certain medical equipment; and
- Children's' clothing.

VAT relief for exported services, as found in the other jurisdictions, is addressed through the place of supply rules, treating the supplies as outside of the scope of Irish VAT to maintain the

[103] Irish VAT Act, Schedule 2.

destination principle rather than treating as within the scope of VAT and zero-rating the transaction (see section 3.B.2).

At the time of drafting, the Malaysian regulations governing zero-rating were only available in the local language.

The above lists are not exhaustive but are the principal and most relevant supplies that are zero-rated.

Zero-rating should be limited to exported goods and services where a local consumption tax should not be imposed on foreign purchasers where the effective consumption takes place outside of the GST jurisdiction, maintaining the destination principle of GST. Please refer to section 4.2.2.4 in the deliverable entitled *Analysis of Current Structure and Optional Tax Strategies* (Sept. 9, 2014) and Appendix E for the policy discussion around the implementation of multiple rates or exemptions in a GST regime and why a broad based system is preferred.

The described leading practice GST constitutes one of the biggest changes from the current applicable SUT regime, which provides a vast list of exempt transactions.[104] However, when addressing concerns of reducing existing exemptions and thus effectively broadening the scope of the GST, the following points should be reminded:

- Certain key exemptions remain under the leading practice GST in the form of GST exemptions (see section 3.B.9);
- Business inputs will be relieved based on the input tax credit system (see section 3.D.5);
- The regressivity resulting from eliminating key exemptions may be addressed via other means (see section 4.2.2.4 in the deliverable entitled *Analysis of Current Structure and Optional Tax Strategies* (Sept. 9, 2014));
- Export transactions will remain untaxed as explained above; and
- Key import transactions remain untaxed under special import provisions (see section 3.B.6).

3.B.9 Exempt Supplies

Overview of Concept

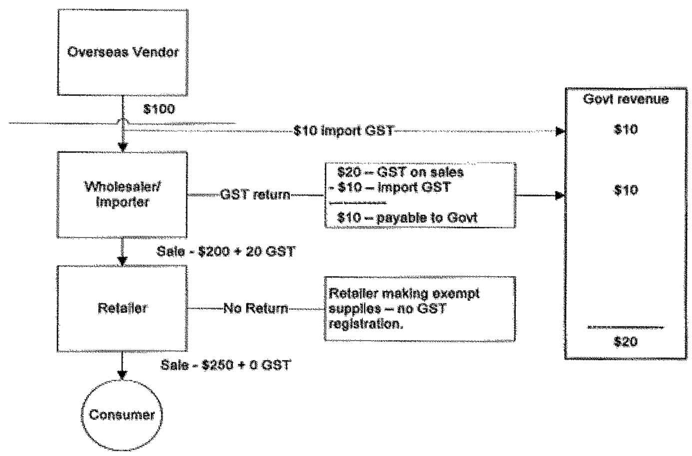
Where a supply of a good or service is exempt from GST, no GST is charged on the sale or provision of that good or service. However, the person making that supply is unable to recover the GST it has incurred on its purchases related to the making of that exempt supply (contrast this with zero-rating above).

Exemptions are usually implemented for social reasons (e.g., healthcare and education) or because they are difficult to tax (e.g., financial services). Please refer to section 4.2.2.4 in the deliverable entitled *Analysis of Current Structure and Optional Tax Strategies* (Sept. 9, 2014) and

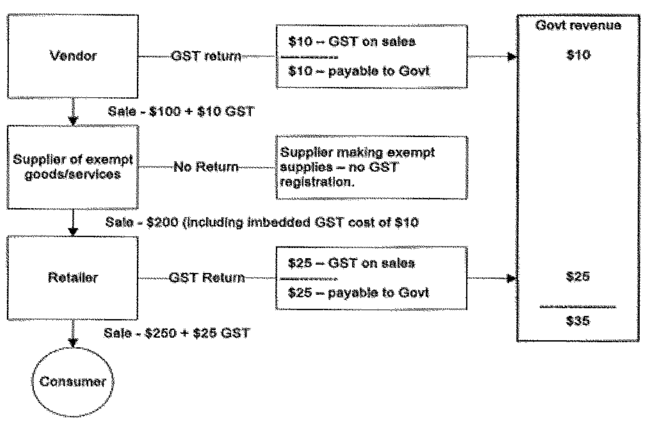
[104] PRIRC § 4030.01 to PRIRC § 4030.21.

Appendix E for the policy discussion around the implementation of multiple rates or exemptions in a GST regime and why a broad based system is preferred.

Exemptions have the following impact on the supply chain and the collection of the tax:



Where an exempt supply occurs further up the supply chain, tax cascading can occur, resulting in a higher effective tax rate at the end of the supply chain or creating incentives for vertical integration. Tax cascades arise when a supplier of exempt goods or services cannot recover the GST incurred on its purchases. That GST then becomes part of the cost of providing the services or producing the goods. Where a business that makes taxable supplies acquires these goods or services with this imbedded GST, and then charges GST on its supplies, there is effectively a tax on tax resulting in a higher effective tax rate. See diagram below:



In the above example, the tax rate is 10%. However, the effective tax rate is 14%.

Further challenges with exemptions include:

- Suppliers making exempt supplies can have an incentive to self supply or vertically integrate as GST charged by third parties is not recoverable;
- Entities making taxable and exempt supplies are required to track and apportion the GST charged on business inputs to ensure only GST related to taxable supplies that entity makes is recovered gives rise to higher compliance costs. This is difficult to achieve accurately and disputes can arise between the taxpayers and tax authority regarding the methods used to apportion input tax credits;
- Provides the opportunity for exemption creep due to political pressures from related industries that may not be subject to the exemption; and
- There are often issues with defining what should come within the scope of the exemption and what should not be included the interpretation of those definitions.

Exemptions should be carefully considered from a policy perspective and what they are intended to achieve. Ebrill et al[105] state "Exemptions are abhorrent to both the logic and the function of a VAT" as they narrow the tax base, result in taxation of business inputs, distort business decisions, and result in tax cascades.

However, should no other options be available to reduce the regressivity of a VAT, exemption is a better option, economically and administratively, than zero rating or reduced rates for the goods and services that require for some tax concession. Exemptions can be less costly to the government in terms of revenue generation as those businesses making exempt supplies are still being taxed on their inputs. Further, exemption is simpler than the reduced rate alternative, and politically, it is an easier sell to the general public.[106]

That said, exempting financial services and real estate are generally considered unavoidable. These areas are discussed below.

Financial Services

Financial services transactions generally include the provision of loans, taking of deposits, and trading in securities (e.g., shares) among other related services.

Financial services are almost universally exempt under GST systems around the world due to the challenges associated with identifying the base upon which the tax should be levied – the value of financial intermediation is usually included in the interest rate spread and is difficult to determine on a transaction by transaction basis. Extracting the value of the service element from this spread is problematic. Aside from the valuation issues, GST is generally a tax on consumption of goods and services whereas returns on savings are to compensate for the time value of money

[105] Ebrill et al, *The Modern VAT*, International Monetary Fund, 2001.
[106] Tuan Minh Le, *Value Added Taxation: Mechanisms, Design and Policy Issues*, May 2003.

and therefore should not be included in the consumption tax base until those savings are applied to purchases of goods or services. The taxation of the time value of money would effectively result in double taxation. In order to preserve the neutrality of a GST, there should not be a difference in the treatment of current versus deferred expenditure.

Such challenges do not exist where there are specific fees or commissions charged for services such as safe keeping services, debt collection, investment advisory services, etc. and these are generally treated as subject to GST. The problem becomes apparent with deposit and loan type transactions.

A number of options for the taxation of financial services to tax the margin of a financial intermediary (without taxing pure interest) and to eliminate the tax cascading effects have been considered around the world, including the Cash-Flow Approach,[107] addition method (tax on wages and profits),[108] zero-rating of B2B financial services,[109] and allowing financial intermediaries to claim input tax credits on a prescribed recovery percentage.[110]

The discussion of such options for taxation are beyond the scope of this paper as the complexities associated with such regimes for the taxation of financial services would create significant challenges with the implementation of a GST in Puerto Rico.

Although exempting financial services will depart from the objective of implementing a broad based GST system in Puerto Rico, such an exemption is current leading practice from a GST perspective.

Exported financial services should be zero-rated consistent with international practice and to ensure that Puerto Rican financial service industry is not competitively disadvantaged.

Real Estate

The application of GST to the real estate sector needs to be considered in the context of the following:

- Residential real estate;
- Commercial real estate; and
- Construction.

Nearly all jurisdictions exempt the renting or leasing of residential real estate. However, some choose to tax the sale of new residential real estate.

It is sometimes asserted that residential housing should be treated favorably because it is an essential part of household consumption and that favorable treatment would address the

[107] Podder & English, *Taxation of Financial Services Under a Value – Added Tax: Applying the Cash-Flow Approach,* National Tax Journal, Vol 50 No.1 (March 1997) pp. 89-112.
[108] Historic Israeli VAT treatment of financial services.
[109] New Zealand GST treatment of financial services.
[110] Singapore GST treatment of financial services.

regressivity issues that would otherwise arise if residential housing is subject to GST.[111] From a practical standpoint, the exemption of residential housing is generally driven by the fact that the taxation of owner-occupied housing is inherently challenging with a requirement to calculate an imputed rental value, not to mention the compliance/administrative burden perspective with all owner-occupiers being required to register and account for GST. While rental and leasing contracts are easier to tax as they are traded in the marketplace and therefore the taxable base is easy to determine, a difference in the GST treatment between owner- occupied housing and residential rental or leasing will distort consumers choices between buying a renting. Thus, residential real estate is generally exempt.

The treatment of commercial real estate varies from being exempt, taxable or exempt with the option to tax.

The treatment of construction services materials also varies in some jurisdictions depending on what the construction services relate to or the types of materials. This can cause significant compliance and administrative issues from a definitional perspective.

Leading Practice

The following supplies should be treated as exempt from GST:

- Financial services (other than zero-rated financial services);
- Supply by any non-profit body of any donated goods and services;
- The supply of residential accommodation by way of lease or otherwise;
- Supply of any fine metal (other than a supply of fine metal that is zero-rated);
- Supply of water and electricity.

Discussion

New Zealand exempts the following supplies:[112]

- Financial services (other than zero-rated financial services);
- Supply by any non-profit body of any donated goods and services;
- The supply of residential accommodation by way of lease or otherwise; and
- Supply of any fine metal (other than a supply of fine metal that is zero-rated).

Singapore exempts the following supplies:[113]

- Financial services;
- Investment precious metals; and
- Residential property.

[111] Alan A. Tait, *Value Added Tax - International Practice and Problems*, International Monetary Fund, 1988, p. 61.
[112] New Zealand GST Act § 14.
[113] Singapore GST Act § 22, Fouth SCh, Part 1.

The IMF Model Law exempts the following supplies:[114]

- Financial services;
- Prescription drugs and medical services;
- Education services;
- Accommodation in a dwelling; and
- Supply of goods or services by the State or not for profit where the consideration for the goods and services is nominal in amount or not intended to recover the cost of such goods or services.

Ireland has an extensive list of exemptions that include the following:[115]

- Financial services;
- Welfare;
- Insurance;
- Education and training;
- Betting and lotteries;
- Medical Services;
- Postal services; and
- Letting of immovable property.

At the time of drafting, the Malaysian regulations governing exemptions were only available in the local language.

To facilitate the implementation of a leading practice GST system with a broad base and limited exemptions, leading practice would be to exempt the following services:

- Financial services (other than zero-rated financial services) – as discussed above, the exemption should be limited to financial services that are not based on a specific fees or commission;
- Supply by any non-profit body of any donated goods and services – because these goods or services likely contain an imbedded GST cost;
- The supply of residential accommodation by way of lease or otherwise; and
- Supply of any fine metal (other than a supply of fine metal that is zero-rated) – investment metals are generally considered a form a financial services.

The treatment of water and electricity is a special case in Puerto Rico. The pre-tax cost of both of these commodities is already extremely high and subjecting them to an additional GST tax would impose unacceptable additional costs on consumers. As such, a full taxation model may

114 IMF Model Law, § 16, SCh. II.
115 Irish VAT Act, schedule 1.

not be appropriate in Puerto Rico in respect of these sectors. As both are supplied by government authorities and are not in competition with the private sector, such an approach is manageable.

Regressivity issues associated with a GST in respect of basic food items, healthcare, and education for consideration should be dealt with via transfer payments. We refer to Appendix E for the policy discussion around the implementation of multiple rates or exemptions in a GST regime, why a broad based system is preferred, and exemptions relating to basic food items, education, and health care should be avoided.

3.C Registration

3.C.1 Registration

Overview of Concept

GST registration is similar to the current requirement for merchants to register in the Merchants' Registry.[116] Many jurisdictions set a monetary annual gross receipts threshold, whereby businesses that fall under this threshold do not need to register for GST. This not only means that those businesses are relieved from the obligation to collect and remit GST to the government but those businesses are also unable to claim credits for GST incurred on their business inputs.

The registration threshold will affect the revenue base of the tax (i.e., a higher registration threshold will result in fewer registered taxpayers).

GST registration thresholds vary widely from jurisdiction to jurisdiction. Thresholds vary partly as a reflection of the economic structure of a country. Some countries have a comparatively greater number of small businesses involving one person or one family than other countries. These small businesses or self-employed individuals will contribute little to the collection of GST. It is also administratively difficult—and therefore expensive—to collect tax from such people.[117] Further, GST compliance costs tend to be regressive (i.e., small businesses tend to spend proportionally more on compliance than larger businesses). The setting of a high threshold mitigates some of these issues.

Another advantage of setting a higher threshold, particularly at the introduction of the tax, is that there is less of a strain put on limited administrative resources during a time when there is limited taxpayer knowledge of the tax.

Overall, the main reason for excluding small businesses by setting a registration threshold is that the costs of tax administration and taxpayer compliance are disproportionate to the GST revenues generated from the activity of those businesses. The level of the threshold is generally a trade-off between minimizing compliance and administration costs and losing GST revenue.[118]

Setting the registration threshold is an important decision. The first VAT in Ghana failed, in part, due to the registration threshold being set too low. The second, and successful, implementation VAT in Ghana, avoided this problem by setting a higher threshold for the retail sector. In 1999 the

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[116] PRIRC § 4060.01.
[117] David Williams, *Tax Law Design and Drafting*, Chapter 6 Value Added Tax, Volume 1; International Monetary Fund, 1996, p. 15.
[118] OCED (2012), *Consumption Tax Trends 2012: VAT/GST and Excise Rates, Trends and Administrative Issues*, OECD Publishing, p. 76.

threshold registration rate for the VAT was 200 million cedi ($80,000), up from 25 million cedi ($15,000) in 1995.[119]

Some countries have different registration thresholds for suppliers of goods and suppliers of services (e.g., France) and many others allow voluntary registration for businesses falling below the registration threshold. Further some jurisdictions have different registration thresholds for residents versus non-residents.

In summary, the advantages of adopting a low registration threshold includes:

- No artificial discrimination between taxpayers based on a threshold level;
- It enables to collect revenues at full potential; and
- There is no possibility to avoid taxation by artificially splitting of businesses.

However, as noted, this can give rise to a higher compliance burden on small businesses when introducing a new tax and a higher compliance cost for small businesses and tax administration that is disproportionate to the GST revenues.

The advantages of allowing voluntary registration for businesses falling below the registration threshold include:

- Enabling small businesses to recover GST on their inputs, potentially allowing them to become more competitive by reducing the price point of their goods or services without affecting their profit margin;
- Small businesses exporting goods will be able to recover GST on their inputs ensuring there is no embedded GST cascading through the system and indirectly imposed on foreign customers; and
- It can help avoid any distortionary effects arising from businesses operating just below the threshold.[120]

However, a voluntary registration program is not without its challenges. It can result in an increased burden on the tax administration arising from a higher number of registered taxpayer to manage and give rise to uncertainty in respect of the potential number of voluntary registrants on implementation, thus making resource planning difficult.

Leading Practice

During the implementation stage, a relatively high registration threshold should be set to limit the number of GST registered businesses to a manageable number. There is anecdotal evidence that upon the implementation of the IVU in Puerto Rico, the number of taxpayers that would register was grossly underestimated, which put a significant strain on Hacienda. A high registration threshold would help avoid this issue.

[119] *Introducing a value added tax: lessons from Ghana*, The World Bank, PREM Notes – Public Sector, December 2001 Number 61.
[120] Ebrill et al, *The Modern VAT*, International Monetary Fund, 2001.

The registration threshold should be gradually reduced, as required over the two years following the implementation of the GST to the optimal level for Puerto Rico. This would enable a gradual implementation of GST and ensure that businesses and consumers get progressively used to the new tax.

Voluntary registration should be permitted and anti-avoidance provisions should be introduced to avoid artificial splitting of businesses to avoid GST registration obligations. Safeguards should be put in place to ensure those taxable persons voluntarily registering for GST are carrying on bona fide taxable activities. A requirement, similar to Singapore's, that if a business voluntarily registers it must remain registered for a certain period, may help deter frivolous registrations.

There should be no difference in the threshold level between suppliers of goods or services to promote simplicity and there should be no different in treatment between resident and non-resident taxpayers to promote neutrality.

Finally, the registration threshold calculation should exclude exempt supplies.

Discussion

New Zealand requires any person carrying on a taxable activity to register for GST at the end of any month where the total value of their supplies made in New Zealand exceeds NZ$60,000 in that month and the previous 11 months or is expected to exceed that amount in the next 11 months.[121] Exceptions are provided where there is no expectation that the supplies will exceed that amount in the following 12 months or where the exceeding of the threshold was due to the ending or substantial reduction in size of the taxable activity, or the replacement of any plant or capital asset.

Where a person does become liable, that person is required to apply for registration within 21 days.

Voluntary registration is possible where a person is carrying on, or intends to carry on, a taxable activity but has not breached the registration threshold and any person purporting to charge tax on a supply is also deemed to be a registered person.

New Zealand also allows the registration of non-residents where that person would be eligible to register if carrying on its business in New Zealand for the purposes of input tax recovery.[122]

Singapore takes a similar approach to New Zealand but refers to quarters rather than months and the annual threshold is SG$1 million. Singapore also includes a provision that prevents the artificial splitting of taxable activities such that a taxable person falls below the registration threshold.

[121] New Zealand GST Act, § 51.
[122] New Zealand GST Act § 54B.

Where a person becomes liable to be registered in Singapore, that person is required to apply for registration within 30 days.

As with New Zealand, a person can voluntarily register for GST in Singapore. However, where a person voluntarily registers for GST in Singapore, that person must remain registered for at least two years.

Malaysia is similar to Singapore and New Zealand.[123] However, imported services are excluded from the turnover threshold calculation. The registration threshold is RM500,000 and where a person becomes liable to be registered in Malaysia, the person must apply for registration within 28 days. Voluntary registration is also permissible. Malaysia also contains a rule to prevent the artificial splitting of businesses to avoid breaching the turnover threshold.

The IMF is also similar. However, the law includes specific rules for auctioneers, promoters of public entertainment and the display of registration certificates.[124]

Ireland is similar. However a different threshold applies for those businesses supplying goods as opposed to services (EUR75,000 and EUR37,500 respectively) and there is no threshold for non-residents making supplies in Ireland.

The threshold calculation in all cases excludes exempt supplies. Jurisdictions achieve this through various mechanisms (e.g., excluding exempt supplies from the definition of taxable activity or using the term taxable supplies for calculating the registration threshold).

In most cases, the value of imported services is included in the calculation of the registration threshold. However, Malaysia requires businesses to account for imported services even where businesses are not registered, while most other jurisdictions only require registered businesses to account for the reverse charge on imported services.

3.C.2 Cessation of requirement to be registered and cancellation of registration

Overview of Concept

It is important to determine when a taxable person ceases to be required to be registered and the consequences of that deregistration.

Leading Practice

Deregistration should be permitted where the tax authority is satisfied that the taxable person's value of taxable supplies is, or is not expected to exceed the turnover threshold, or where the taxable person ceases carrying on a taxable activity.

Rules should be included to deem goods on hand at the time of registration to be supplied and GST should be accounted on the lesser of cost or open market value of those assets.

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[123] Malaysia GST Act, §s 19 to 24.
[124] IMF Model Law, § 20 and 21.

Retrospective deregistration should be provided for where a person has been registered in error.

Discussion

New Zealand deems a person to cease being liable to be registered where at any time the Commissioner is satisfied that the value of that persons taxable supplies in the next 12 months will be below the registration threshold. A person that satisfies this requirement may cancel the registration effective on the last day of the taxable period in which the Commissioner was satisfied.[125]

A person that ceases carrying on all taxable activities must notify the commissioner within 21 days.

The commissioner may also cancel the registration where he is satisfied that the person is not carrying on a taxable activity.

The Singapore, Malaysian and IMF cancellation rules are similar to New Zealand's. However, for Singapore and Malaysia the notification period is 30 days rather than 21 days.

A key aspect of deregistration applicable to all jurisdictions is that the assets on hand upon deregistration are deemed to be supplied at the time of deregistration. Jurisdictions often include this rule in the definition of supply (with associated valuation and time of supply rules). The valuation rules can require the deemed supply to be accounted for on the lesser of open market value or the original cost of the asset or simply the open market value.

Ireland has similar deregistration rules,[126] but, it does not deem goods on hand at deregistration to be supplied. Instead it requires an adjustment to the previous input tax claimed. Such a provision is more complex to administer than the deemed supply rules adopted by the other jurisdictions. As such, deregistration rules similar to New Zealand, Singapore, Malaysia and the IMF constitute leading practice.

3.D Calculation of Tax Payable, Tax Periods, and Tax Returns

3.D.1 Taxable periods

Overview of Concept

The taxable period is the period of time in respect of which a return is required to be filed to report the tax position of a taxable person. Consequently, the taxable period is closely related the payment and refund of GST. The length of the taxable period is generally a policy decision that needs to be made taking into account administration and compliance burdens and cash flow issues. The approach of jurisdictions varies from monthly, bi-monthly, quarterly, or annual taxable periods.

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[125] New Zealand GST Law § 52.
[126] Irish VAT Act, § 65 and Regulation 19(3).

Leading Practice

The taxable period provision should be drafted to include the following:

- The taxable period for taxable persons whose taxable supplies over a consecutive 12 months period are equal or above a certain dollar value threshold shall be the calendar month.
- The taxable period for taxable persons whose taxable supplies over a consecutive 12 months period are below the dollar value threshold shall be the calendar quarter.
- Taxable persons subject to the calendar quarter taxable period should be allowed to apply for authorization to use the calendar month as taxable period.

Discussion

New Zealand allows monthly, two-monthly, and six monthly periods. The 2-month period is the standard taxable period.[127] A taxable person may apply for the six monthly period where, in a 12-month period, the taxable person makes (or is likely to make) taxable supplies of less than NZD 500,000.[128]A person whose taxable supplies are (or are likely to be) more than NZD24 million in a 12-month period must adopt a monthly taxable period.[129]In all other cases, a person can choose between a monthly or bi-monthly taxable period. A person's taxable periods must align with their balance date for income tax purposes. The period will usually end at the end of the relevant calendar month.

Singapore requires the filing of GST returns every month, quarter, or half a year, or any frequency approved by the tax authority.[130] The default filing frequency is quarterly. Taxable persons are assigned prescribed accounting periods according to their financial year-end at the point of GST registration. Taxable persons may request a change in their filing frequency. However, filing of a return every half a year is available only to taxable persons whose annual value of taxable supplies is less than SGD1 million on a retrospective or prospective basis.

Malaysia allows two taxable periods: monthly and quarterly.[131] The monthly taxable period applies to taxable persons whose taxable supplies in a 12-month period are MYR 5 million or more. Taxable persons with annual taxable supplies of less than MYR 5 million are subject to the quarterly taxable period but can request to file monthly returns.

In the IMF Model Law, the taxable period is the calendar month, but the Minister may by regulations authorize different tax periods for specific types of taxable persons.[132]

Ireland has a two-monthly filing frequency, but smaller taxable persons may apply to adopt a four-monthly filing period where their annual liability is between EUR3,001 and EUR14,400. If a taxable person's annual liability is below EUR3,000, a taxable person can apply to file on a six-

[127] New Zealand GST Act, § 15(1).
[128] New Zealand GST Act, § 15(2).
[129] New Zealand GST Act, § 15(4).
[130] Singapore GST Act, § 41(1) and GST Regulations, regulation 52.
[131] Malaysia VAT Act, § 40.
[132] IMF Model Act, art. 23.

monthly basis.[133] A key difference between Ireland and the other comparable jurisdictions is that the thresholds for filing frequency focus on GST liability rather than gross receipts.

In order to ensure the efficiency and effectiveness of the GST, the taxable period should be short. A common approach is to use a calendar month taxable period. The monthly taxable period is also used under the current sales and use tax regime and will thus not result in a change for businesses.[134] However, because a shorter taxable period could increase the administrative burden on small businesses compared to revenues collected it is advisable to allow smaller taxable persons to adopt longer taxable periods such as two-monthly or calendar quarter.

The difference between taxable persons subject to the monthly and quarterly taxable period should be determined based on the value of taxable supplies made over a 12 months period. Consequently, the monthly taxable period would apply to taxable persons who estimate that over the next 12 months their taxable supplies will be above a certain dollar value threshold. The quarterly taxable period would thus apply to those taxable persons with taxable supplies below the threshold. In addition, taxable persons subject to the quarterly taxable period should be allowed to file a request to the Commissioner to be allowed to be subject to the monthly taxable period.

An alternative option to alleviate cash flow burdens on the tax administration would be to adopt a similar approach as Ireland, basing the taxable period on net VAT liability, but making the longer taxable periods mandatory rather than optional for those taxable persons frequently in a refund position. Such an approach is not leading practice and can result in significant cash flow burdens on taxpayers such as exporters.

3.D.2 Filing of returns and payment of the tax

Overview of Concept

Under a GST, taxable persons are required to provide information to the tax authority at regular intervals. The information is provided through the filing of a "GST return." The GST law or regulations should precisely describe what information taxable persons must provide and the deadline for filing GST returns. In addition, GST laws generally prescribe when payment of the tax is due.

The main consideration relates to providing sufficient time following the end of the taxable period to gather the required information and calculate the GST liability.

Leading Practice

The filing of returns and payment of tax provision should be drafted to include the following:

- Every taxable person should be required to file a GST return and pay any GST by the 28th of the month following the end of the taxable period.

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[133] Irish VAT Act, § 76 and 77.
[134] PRIRC § 4041.02.

- GST return should be submitted electronically.

The provision or regulation should also set out what information is required to be included in the GST return.

Discussion

New Zealand requires taxable persons to file their GST returns on or before the 28th day of the month following the end of the taxable period unless the month following the end of the taxable period is December, in which case the deadline is January 15, or April, for which the deadline is May 7.[135] This is to provide the taxable person with extra time given the December holidays and the March end of financial year obligations. The tax authority has the discretion to change the due date for the return for non-profits and in special circumstances.[136] GST returns can either be filed in paper or electronic format.

In Singapore, returns (and payments) are due within one month of the end of the prescribed accounting periods; e.g., for the prescribed accounting period from January to March, ending on March 31, the filing (and payment) due date is April 30. The due date for the prescribed accounting period from April to June, ending on June 30, is July 31, and so on.[137] Returns must be filed electronically[138].

In Malaysia, every return for each taxable period is required to be submitted to the tax authority no later than the last day of the month following the end of the taxable period.[139] Electronic filing is encouraged but not mandatory.

In the IMF Model Law, taxable persons are required to file a tax return for each tax period with the Commission within 21 days after the end of the period, whether or not tax is payable in respect of that period.[140] The return should be filed in the manner prescribed by the Commissioner.

Ireland requires a return to be filed within 19 days of the end of the taxable period.[141]

In all jurisdictions, the deadline for payment of VAT/GST is the same as the deadline for the filing of the return. All jurisdictions reviewed, other than Ireland, have a deadline close to, or at, the end of the month following the end of the taxable period.

3.D.3 Accounting Basis

Overview of Concept

GST laws generally have two distinct methods of accounting: accruals (or invoice) and cash (or payments) accounting. Most jurisdictions adopt the accrual basis of accounting. Any supplies in

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[135] New Zealand GST Act, § 16.
[136] New Zealand GST Act, § 16(3).
[137] Singapore GST Act, § 41(1) and GST Regulations, regulation 52.
[138] Singapore GST Act, § 42 and GST Regulations, regulation 53.
[139] Malaysia GST Law, § 41(4).
[140] IMF Model Law, art. 24(1).
[141] Irish VAT Act§ 76.

respect of which the time of supply has been triggered within the taxable should be included in the tax return, irrespective of payment. Cash accounting, or payments basis accounting, requires only those supplies in respect of which payments have been made or received within the taxable period to be accounted for in the tax return. In addition, because GST is only accounted for when payment is received, there is no need for a bad debt relief mechanism (see section 3.D.7). However, the cash accounting system delays the moment when GST is creditable to the time when vendors are paid.

Leading Practice

The accounting basis provision should be drafted to include the following:

- All taxable persons must account for GST according to the accrual basis.
- Taxable persons whose taxable supplies over a consecutive 12 months period are below a certain dollar value threshold may opt to account for GST under a cash basis.

Discussion

The NZ GST Act provides three types of accounting methods: the invoice (or accruals) basis, the payments (or cash) basis, and the hybrid basis.[142] The invoice basis is the default method.

The payments basis is mandatory for non-residents who are registered solely for the recovery of input tax, and resident non-profit entities. Any other taxable person that makes taxable supplies of NZD 2 million or less within any 12 month period may request to be on a payments basis.[143]

New Zealand also has a hybrid basis (essentially a combination of payments and invoice basis) where, the registered person must account for output tax on an invoice basis, but claim input tax credits for purchases and expenses using the payments basis.

Singapore requires all taxable persons to account for output and input tax in line with the time of supply rules (accruals basis). In addition, taxable persons whose annual taxable supplies do not exceed SGD 1 million can opt to account for VAT on a cash basis.[144]

The Malaysian GST Act also requires all taxable persons to account for GST on an accrual basis.[145] However, the Director General may, upon application in writing and subject to the prescribed conditions, approve the registered person to account for the tax on a payment basis.

The IMF Model Law does not contain any specific provision regarding the accounting basis. Therefore, output and input VAT must be accounted in line with the time of supply rules.

[142] New Zealand GST Act, § 19.
[143] New Zealand GST Act, § 19A.
[144] Singapore GST Act, § 41 and GST Regulations, regulation 67 to 76.
[145] Malaysia VAT Act, § 37(1).

Ireland is similar to the above jurisdictions in that the accrual basis is the default accounting basis and payments basis is permitted if the taxable makes supplies less than EUR 1 million or it makes 90% or more of its supplies to non-registered persons.[146]

Leading practice is to have the accrual basis of accounting as the default accounting basis and to provide an option for cash accounting where a taxable person's turnover is less than a specified threshold.

3.D.4 Calculation of Tax Payable

Overview of Concept

GST payable for a particular taxable period should correspond to the output tax attributable to a taxable period less any input tax attributable to a taxable period, consistent with the accounting basis adopted by the taxable person. Including a provision relating to the calculation of tax payable provides clear guidance to the tax authority and taxable persons on how the tax liability or refund should be computed for any given tax return.

Leading Practice

The calculation of tax payable provision should be drafted to include the following:

- Tax payable for a taxable period by a taxable person under the GST law amounts to any output tax attributable to the taxable period less any input tax attributable to the taxable period, subject to the specific input tax deduction rules.
- Where during a taxable period the amount of deductible input tax exceeds the attributable amount of output tax, the excess input tax amount shall be refunded to the taxable person in accordance with the refund of excess tax rules.

This section should also state in which periods output tax and input tax are attributable.

Discussion

The New Zealand GST Act includes a tax calculation section that determines how the tax payable or refund for a particular taxable period should be calculated.[147]

The section states that the amount of tax payable corresponds to the amount of output tax accounted for in the taxable period less the amount of input tax deductible in the taxable period. Further, where the amount of input attributable to the period exceeds the amount of output attributable to the period, the amount is required to be refunded by the Commissioner.

New Zealand also includes input tax deductibility rules within this section. These are analyzed separately in section 3.D.5 below.

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[146] Irish VAT Act, § 80.
[147] New Zealand GST Act, § 20(1).

Ireland adopts a similar approach to New Zealand.[148]

Singapore takes a similar approach but includes the input tax deductibility rules in a separate section.[149] However, the tax calculation provision also details the apportionment and adjustment rules,[150] while in New Zealand these are addressed under a separate section.

Malaysia adopts a slightly different approach to the other jurisdictions. While it also has a single provision governing the computation of the tax position of the taxable person similar to Singapore,[151] it has separate provisions addressing what input tax may be deducted. Unlike Singapore and similar to New Zealand, the adjustment and apportionment rules are dealt with in a separate provision. In addition, Malaysia includes specific refund rules under this provision that govern when a refund is paid or when a refund should be carried forward or applied for another purpose.

For simplicity, leading practice would be to adopt an approach similar to the IMF,[152] which effectively is a combination of the approaches from all of the comparable jurisdictions. This includes having separate provisions for:

- The calculation of the tax liability;
- The input tax deductibility rules;
- The apportionment and adjustment rules; and
- The refund rules.

The separate provisions relating to input tax deductibility, apportionment and adjustments, refund rules are addressed below.

3.D.5 Input Tax Deductions/Credit Rules

Overview of Concept

Input tax is generally defined as any GST paid to a supplier. In principle, any input tax incurred by a taxable person should be deductible or creditable against any output tax liability provided the supplies are used in a taxable activity carried on by the taxable person. This deductibility feature of a GST facilitates the staged collection process of a GST while ensuring GST does not become an absolute cost to businesses and shifting the economic burden of the tax onto the consumer.

Specific rules are required to ensure the correct amount of input tax is deductible by a taxable person.

[148] Irish VAT Act, § 59(2).
[149] Singapore GST Act, § 19.
[150] Singapore GST Act, § 19(4).
[151] Malaysia GST Act, § 38.
[152] IMF Model Law, § 26.

Leading Practice

The input tax deductions/credit rules should be drafted to include the following:

- A taxable person should be allowed to deduct:
    - the total amount of input tax incurred on taxable supplies paid during a taxable period;
    - the total amount of input tax paid on imports of goods during a taxable period;
    - any amount allowed as additional input tax deduction under the adjustment, apportionment and bad debt rules;
    - Less any amount that is deemed output tax under the adjustment and apportionment rules.
- Input tax should only be deductible if the goods and services purchased are used by the taxable person for making taxable supplies or supplies that would be taxable if made in Puerto Rico.
- Deemed input tax credits for certain industries such as secondhand goods dealers and certain insurance company payouts.
- Input tax credits for goods and services acquired by government entities.
- Input tax credits for goods and services acquired by non-profit bodies for activities other than those related to exempt supplies.
- Input tax should only be deductible provided that the taxable person holds a valid tax invoice, credit, debit note, or import document.

To promote a broad based, neutral GST system there should be no categories of goods or services in respect of which input tax recovery is denied.

Discussion

New Zealand defines "input tax" as GST imposed on goods and services acquired by a person under the GST Act, GST imposed at import, and a tax fraction of the purchase price of second hand goods.[153]

In general, input tax can be deducted only to the extent to which the goods or services acquired are used for, or available for use in making taxable supplies,[154] which is determined at the time of acquisition. In addition to this general rule, New Zealand provides a number of specific rules for input tax deductions, including the following:

- Tax invoice, debit or credit note must be held (unless certain exceptions apply);
- Timing of input tax credits in respect of output tax accounted for under the reverse charge regime;
- Import GST;

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[153] New Zealand GST Act, § 3A(1).
[154] New Zealand GST Act, § 20(3C).

- Input tax credits for goods and services acquired by charities;
- Insurance payments;
- Amounts calculated under the adjustment and apportionment rules;
- Bad debts; and
- Non-resident recovery.

In addition, input tax incurred in relation to entertainment expenses is only deductible to the extent permitted under the income tax law.

Singapore takes a more prescriptive approach, defining input tax more narrowly than most other jurisdictions. The definition of "input tax" does not include input tax incurred on supplies of goods or services to a taxable person and importations of goods by a taxable person, where the goods or services are not used or not to be used partly for the purposes of his business.[155] Further, rather than having a general rule that input tax is deductible to the extent the good or service are used in the taxable person's taxable activity, the GST Act states that taxable persons are entitled to credit input tax at the end of a prescribed accounting period to the extent that the input tax is attributable to the following supplies made or to be made by the taxable person in course of business:

- taxable supplies;
- supplies outside Singapore that would have been taxable supplies if made in Singapore;
- supplies of goods made while the goods are under customs control; and
- supplies made for which no output tax is chargeable under the various schemes in the GST Act.[156]

Input tax deduction is disallowed for GST paid on any of the following expenses: club subscription fees, medical and accident insurance premiums, medical expenses, family benefits, and any transaction involving betting, sweepstakes, lotteries, fruit machines, or games of chance.[157]

The tax authority may require that any claim for input tax credit to be supported by a tax invoice or import permit.[158]

Under the Malaysian GST Act, a taxable person is allowed to deduct input tax for GST incurred in the course of making taxable supplies and supplies made outside Malaysia, which would have been taxable if made in Malaysia.[159] In addition, for importation of goods, only GST which has actually been paid on importation can be claimed.

Input tax is only deductible where the following conditions are met:

- the claimant is a taxable person;
- the goods or services are acquired for business purpose;

[155] Singapore GST Act, § 19(4).
[156] Singapore GST Act, § 20.
[157] Singapore GST Regulations, regulation 26.
[158] Singapore GST Regulations, regulation 61.
[159] Malaysia GST Act, § 38.

- the goods are acquired for the purpose of making taxable supplies;
- there must be a valid tax invoice;
- the invoice is issued under the name of the claimant, and
- the goods and services acquired are not subject to any input tax restrictions.[160]

The GST Act denies an input tax deduction for GST incurred on certain types of expenses such as private motorcars and certain employee benefits.[161]

The IMF Model Law allows a taxable person to deduct input tax payable in respect of taxable supplies made to the person during the taxable period, and paid in respect on any import of goods by the person during the tax period, where the supply or import is for use in a taxable activity carried on by the person.[162]

The IMF law also clearly indicates that a taxable person is allowed an input tax deduction relating to input tax allocation and bad debts, and specific situations such as gambling and vouchers.[163]

An input tax deduction is only granted if the taxable person holds a tax invoice, tax debit or tax credit note, or a bill of entry for customs purposes.[164] However, the Commissioner may allow input tax deduction where an invoice is missing if the Commissioner is satisfied that (1) the taxable person took all reasonable steps to acquire a tax invoice, (2) the failure to acquire a tax invoice was not the fault of the taxable person, and (3) the input tax amount is correct.[165]

Taxable persons are not allowed to deduct input tax incurred in relation to the following purchases: passenger vehicles, entertainment, and fees or subscriptions paid for memberships.[166]

Ireland adopts a similar approach. However, Ireland has more restrictions in terms of what cannot be claimed as an input tax deduction, including:

- Limited deduction on purchase or hire of motor cars;
- Any business entertainment;
- Accommodation (except for qualifying hotel conferences);
- Food and drink;
- Petrol (VAT on diesel is claimable);
- Employee personal services (e.g., dry cleaning).[167]

Because input tax deduction is the cornerstone of any neutral, efficient, and fair GST law, special attention should be paid to the drafting of the input tax deduction/credit rules.

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[160] Malaysia, GST Guide for Input Tax Credit, at 33.
[161] Malaysia, GST Guide for Input Tax Credit, at 11.
[162] IMF Model Law,§ 27(1)(a).
[163] IMF Model Law,§ 27(1).
[164] IMF Model Law, § 27(2).
[165] IMF Model Law, § 27(3).
[166] IMF Model Law, § 28(2).
[167] Irish VAT Act, §§ 59 -62.

All the comparable jurisdictions adopt a similar approach whereby input tax should be deductible on any input tax incurred or paid on imports that are used by the taxable person to carry out taxable supplies. Differences arise in respect of specific disallowances or specific deeming rules for claiming input tax credits (e.g., an insurance payout in New Zealand, the acquisition of secondhand goods, or goods and services acquired by charities).

The commonly adopted approach will ensure that input tax paid on private consumption is not deductible by the taxable person. As goods may be acquired either for business or private or use, it is advisable to address such situations under the adjustment and apportionment rules (see section 3.D.6).

Only input tax incurred during the taxable period should be recoverable under this provision. A specific provision under the adjustment and apportionment rules should address the case where a taxable person does not report input tax in the correct taxable period (see section 3.D.6). For clarity purposes, the input tax deduction provision should also clearly state that input tax calculated based on the adjustment and apportionment rules and the bad debt rules is also recoverable, but any output tax adjustment under the adjustment and apportionment rules should also be taken into consideration.

In order to prevent fraud, the provision should also state that input tax is only deductible provided that the taxable person holds a valid tax invoice, credit note, debit note or import document (see section 3.D.9).

Other than New Zealand, most of the comparable jurisdictions deny an input tax deduction for certain specific goods and services. Such an approach goes against the principles of neutrality, efficiency, and fairness as generally all expenses incurred by a taxable person for the purposes of the business should be considered creditable. As such, leading practice should be an approach similar to the New Zealand approach.

In Puerto Rico, to maintain the simplicity of the operation of the GST, supplies made to government bodies should be treated in the same manner as any other supply (i.e., subject to GST). However, in order to ensure that the GST does not impact the budget of a government body, such government bodies should be entitled to input tax credits in relation to their acquisitions regardless of their activity.

3.D.6 Adjustment and Apportionment Rules

Overview of Concept

The rules for allowing input tax deduction present few difficulties for taxable persons making exclusively taxable supplies. However, the GST law should address two issues. First, the GST law must address the situation where a taxable person makes both taxable and exempt supplies. Second, the GST law must address private or non-business use of goods and services.

Apportionment rules

Given that the premise for input tax recovery is that the taxable person uses the goods and services purchased to carry out taxable supplies, taxable persons making both taxable and exempt supplies should be entitled to a partial recovery of input tax to the extent the goods and services are applied to the taxable part of the taxable person's business. Consequently, the GST law must limit the right to deduct input tax to the extent the goods and services are applied to the making of exempt supplies.

This requires a careful review of the total input tax paid by a taxable person to apportion the input tax into three categories:

- Input tax exclusively incurred for making taxable supplies (fully recoverable);
- Input tax incurred for making exclusively exempt supplies (non-recoverable); and
- Input tax incurred for making both taxable and exempt supplies (partially recoverable).

The apportionment rules address the third category.

Adjustment rules

In addition to apportionment, adjustment rules are used to address situations such as follows:

- Goods and services acquired for use in the taxable activity but subsequently used for a non-business purpose;
- Goods acquired for a non-business purpose but subsequently used in a taxable activity; and
- Post sales adjustments to the purchase price, including discounts.

Leading Practice

The apportionment rules should be drafted to include the following:

- Where a taxable person carries out taxable and exempt supplies, input tax should be deductible as follows:
  - Input tax incurred exclusively to carry out taxable supplies should be fully deductible;
  - Input tax incurred exclusively to carry out exempt supplies should not be deductible; and
  - Any residual input tax should be deductible based on the following formula: residual input tax deductible = residual input tax * total taxable supplies (excluding GST) during taxable period / total supplies (excluding GST) during taxable period.
- The above rule should not apply where exempt supplies do not exceed a specified dollar value threshold in a month and a certain percentage threshold of the total value of total supplies made in that period.
- Supplies considered as incidental financial supplies should not be subject to the above rules.
- Where a taxable person is in the business of carrying out exempt supplies the incidental financial supplies rule should not apply.

The adjustment rules should be drafted to include the following:

- Where the use of goods and services of a certain dollar value threshold changes within a certain timeframe after the end of the taxable period, the taxable person is required to make the following adjustments:

  - Any over-deducted input tax should be accounted for as output tax in the tax return for the taxable period in which the change of use takes place.
  - Any short claimed input tax should be accounted for as additional input tax in the tax return for the taxable period in which the change of use takes place.
- An adjustment should not be required where the change of use of the goods and services purchased is below a certain percentage threshold.
- No adjustment should be required where the goods or services are lost or unintentionally destroyed.
- Where a registered person issues a credit note in accordance with the tax invoice, tax credit note, and tax debit note rules, the additional tax specified in the tax credit note is deemed to be output tax for the registered recipient of the credit note and additional input tax for the supplier.
- Where a registered person issues a debit note in accordance with the tax invoice, tax credit note, and tax debit note rules, the additional tax specified in the tax debit note is deemed to be input tax for the registered recipient of the debit note and additional output tax for the supplier.

In addition, the adjustment rule should also address the situation where a taxable person does not report input tax in the correct taxable period.

Discussion

Apportionment rules

New Zealand applies a minimum threshold for apportionment where goods and services are acquired for both the making of taxable and exempt supplies.[168]Under this provision, registered persons are not required to apportion a deduction for input tax if in an "adjustment period" (generally a 12-month period) they make both taxable and exempt supplies and have reasonable grounds to believe that the total value of their exempt supplies will not be more than the lesser of: NZD 90,000; and 5% of the total consideration for all their taxable and exempt supplies for the adjustment period. Above this threshold, apportionment is required, and is calculated by multiplying the full input tax deduction by the percentage intended use.[169]

"Percentage intended use" for a registered person, means the extent to which the goods or services are intended to be used by the person for making taxable supplies, estimated at the time of acquisition and expressed as a percentage of total use.[170] According to the New Zealand tax authority, the method for determining the extent of intended taxable use will largely depend on the nature of the goods and services in question (e.g., for a car the logbook of the previous car may be used). New Zealand has a number of specific rules relating to such thing as:

- Apportionment for suppliers of financial services; and

[168] New Zealand GST Act, § 20(3D).
[169] New Zealand GST Act, § 20(3H).
[170] New Zealand GST Act, § 21G(1)(b).

- Use of certain assets.

Singapore also applies a *de minimis* rule whereby, if during an accounting period the exempt supplies do not exceed both an average of SGD 40,000 per month and 5% of taxable and exempt supplies, no apportionment of input tax is required.[171] In addition, the Singapore GST Act provides that where a taxable person supplies incidental exempt supplies (e.g., deposit of money, exchange of currency, issue of own shares or debt securities, loan, assignment of trade derivatives, issue of units, and purchase of bonds) a taxable person is not required to apportion the input tax incurred.[172] This rule does not apply if the taxable person's main activity involves these transactions (e.g., financial institution).

Where the foregoing rules cannot be applied, input tax is deductible on supplies and imports that can be identified as used or to be used exclusively in making taxable supplies. Input tax paid on supplies and imports used exclusively in making exempt supplies or in carrying on any activity other than making taxable supplies is not deductible. Any input tax ("residual input tax") used for both taxable and exempt supplies must be apportioned according to use based on the following formula:[173]

> Residual input tax recoverable = residual input tax * value of taxable supplies / (value of taxable supplies + value of exempt supplies)

Like New Zealand and Singapore, Malaysia applies a *de minimis* rule when the total value of exempt supplies does not exceed an average of RM5,000 per month and does not exceed 5% of the total value of total supplies made in that period.[174]

Similar to Singapore, Malaysia also excludes from any apportionment obligation incidental financial supplies such as deposit of money, exchange of currency, holding of bonds, transfer of securities, loan, holding of any unit, and hedging.[175] These supplies will not be considered as incidental if the taxable person is considered to be in the business of making exempt supplies. The GST Act provides a list of persons falling in this category (e.g., banks, moneylenders, and credit card companies).

In Malaysia, where the foregoing rules cannot be applied, input tax on supplies and imports that can be identified as used or to be used exclusively in making taxable supplies is deductible. Input tax paid on supplies and imports used exclusively in making exempt supplies or in carrying any activity other than making taxable supplies is not deductible. Any input tax ("residual input tax") used for both taxable and exempt supplies must be apportioned according to use based on the following formula:[176]

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[171] Singapore GST Regulations, regulation 28.
[172] Singapore GST Regulations, regulation 33.
[173] *See e.g.*, Internal Revenue Authority Singapore, IRAS e-Tax Guide – GST: Partial Exemption and Input Tax Recovery (Dec. 31, 2013).
[174] Malaysia, GST Guide for Input Tax Credit, at 21.
[175] Malaysia, GST Guide for Input Tax Credit, at 17.
[176] Malaysia, GST Guide for Input Tax Credit, at 23.

> Residual input tax recoverable = total value of taxable supplies (excluding GST) / total value of all supplies (excluding GST) * residual input GST

The IMF Model Law also provides for a *de minimis* rule that applies where the proportion of taxable supplies of total supplies (including exempt supplies) is more than 90% during the preceding financial year.[177] Unlike Malaysia and Singapore, the IMF Model Law does not address incidental exempt supplies. Where the *de minimis* rule does not apply, input tax on supplies and imports that can be identified as used or to be used exclusively in making taxable supplies is deductible. Input tax paid on supplies and imports used exclusively in making exempt supplies or in carrying any activity other than making taxable supplies is not deductible. Any input tax ("residual input tax") used for both taxable and exempt supplies must be apportioned according to use based on the following formula:[178]

> Residual input tax recoverable = total residual input tax * total amount of taxable supplies made by the taxable person during the preceding financial year / total amount of supplies made by the taxable person during the preceding financial year

In Ireland, where a taxable person carries out both taxable and exempt transactions, the taxable person is entitled to deduct a proportion of tax which correctly reflects the extent to which the goods and services are used for the purposes of that person's taxable supplies or activities and has due regard to the range of that person's total supplies and activities. In practice, Ireland allows the use of any apportionment method to the extent the apportionment correctly reflects the use to which the goods and services are put and also reflects the range of the taxable person's activities.[179]

In order promote neutrality, fairness, and certainty of the tax, the GST law should contain an apportionment provision addressing the special case of taxable persons carrying on both taxable and exempt supplies.

Based on the comparative jurisdictions, it is recommended for simplicity, fairness, and flexibility purposes that the GST law contains a *de minimis* provision. Such a provision should relieve the taxable person from any apportionment obligation where the taxable person only performs a certain dollar value threshold of exempt supplies and under a certain percentage of exempt supplies of total supplies. For this purpose the dollar value threshold should be based on a calendar month and the percentage threshold on a taxable period basis.

Referring to the previous financial year, as does the IMF Model Law, would increase the complexity of the law and require an end of year adjustment to reflect the reality of the supplies performed during the current financial year.

The GST law should also provide that incidental financial transactions do not fall within the apportionment rules. For this purpose, the GST law may include a list of supplies that qualify as

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[177] IMF Model Law, § 28(4).
[178] IMF Model Law, §. 28(3).
[179] Irish VAT Act, § 61.

"incidental." The GST law should further clarify that where a taxable person is in the business of carrying out exempt supplies, the incidental financial transactions rule does not apply.

Finally, the GST law should clearly state that, where a taxable person performs taxable and exempt supplies and the above *de minimis* rules are not applicable, input tax for the purpose of carrying out taxable supplies is deductible, but input tax incurred for carrying out exempt supplies is not deductible. Any residual input tax should be apportioned according to the following formula:

> Residual input tax deductible = residual input tax * taxable supplies during taxable period/total supplies during taxable period

Adjustment Rules

In New Zealand, after the initial claim of input tax deduction based on the intended use of the goods or services, a review of the actual use of the asset must be carried out every "adjustment period" (generally every 12 months).If the value of the goods and services (excluding GST) is more than NZD 5,000 and the *de minimis* rule described above did not apply to the acquisition, then at the end of an adjustment period the registered person must carry out an input tax adjustment if the "percentage actual use" of the asset differs from the "percentage intended use" by more than 10 percentage points and the adjustment amounts to more than NZD 1,000.[180]

The formula which must be applied in each "adjustment period" for calculating the required input tax adjustment is as follows: full input tax deduction * percentage difference.[181] If the adjustment is positive and the asset has actually been used for taxable purposes more than originally estimated, then adjustment is allowed as an additional input tax deduction.[182]If the adjustment is negative and the asset has actually been used for taxable purposes less than originally estimated, then the adjustment is a positive amount of output tax.[183]

The "first adjustment period" is defined as the period starting on the date of acquisition of the good or service and ending, at the person's election, on the person's first balance date following the date of acquisition or the person's first balance date that falls at least 12 months after the date of acquisition.[184]After the first adjustment period, each "subsequent adjustment period" is the 12-month period following the previous adjustment period.[185]For goods and services other than land, adjustments do not have to be made indefinitely. If the value of the goods and services (exclusive of GST) is:[186]

- between NZD 5,000 and NZD 10,000, there are only two adjustment periods;
- between NZD 10,000 and NZD 500,000, there are five adjustment periods; and
- greater than NZD 500,000, there are ten adjustment periods.

[180] New Zealand GST Act, 21(2).
[181] New Zealand GST Act, § 21D.
[182] New Zealand GST Act, § 21D(3).
[183] New Zealand GST Act, § 21D(3).
[184] New Zealand GST Act, § 21G(2)(a).
[185] New Zealand GST Act, § 21G(2)(b).
[186] New Zealand GST Act, § 21G(4)(a).

For a supply of land, there is no limit to the number of adjustment periods.[187] A final adjustment must be calculated upon disposal or deemed disposal of an asset in the course of a taxable activity, where the original supply of the asset was subject to an input tax apportionment.[188]

Similar to New Zealand, in Singapore a taxable person, who has deducted input tax that has been attributed to taxable supplies because the intended use of the goods or services was for the making either taxable supplies or both taxable and exempt supplies, is required to adjust his input tax deduction when he subsequently uses or forms an intention to use the goods or services concerned to make (a greater proportion of) exempt supplies.[189] On the other hand, the tax authority must allow a deduction for input tax previously denied to a taxable person if the taxable person subsequently uses or forms an intention to use the goods or services concerned to make (a greater proportion of) taxable supplies.[190]

Singapore requires partially exempt persons to perform adjustments of their input tax deducted during a period of five years commencing on the first day of the accounting period in which the input tax was claimed.[191] Where the *de minimis* rule described above, in respect of apportionment, does not apply in a certain accounting period, but does over the relevant five year period, taxable persons can deduct the input tax not previously claimed. Conversely, if they pass the de *minimis rule* in any prescribed accounting period, but fail the rule at the end of the relevant five year period, they are required to adjust the input tax previously deducted.

The Malaysian adjustment regulations are not available in English.

The IMF Model Law does not contain a special provision regarding the change of use of goods and services purchased.

Ireland adopts a similar adjustment regime as New Zealand and Singapore. The differences between the Irish regime and those regimes are not material.[192]

The common theme among the comparable jurisdictions is that, after the initial apportionment, ongoing adjustments are required based on actual use. The extent and duration of the adjustments and when those adjustments should be made vary from jurisdiction to jurisdiction.

For a GST to be neutral and fair, the GST law should provide special rules where the use of goods and services changes following the initial apportionment of input tax credits. However, for efficiency and simplicity purposes, the rule should only apply to goods and services of a certain dollar value threshold where the use changes within a pre-determined time period.

However, taxable persons should not be required to make any adjustment of the input tax deducted where the change in use is not above a certain percentage. For simplicity purposes, it

[187] New Zealand GST Act, § 21G(5).
[188] New Zealand GST Act, § 21F.
[189] Singapore GST Regulations, regulation 37.
[190] Singapore GST Regulations, regulation 39.
[191] Singapore GST Regulations, regulation 36.
[192] Irish VAT Act, § 64.

is recommended that no adjustment is required where the goods or services subject to the adjustment provisions are lost or unintentionally destroyed.

The GST law should also address in this section, adjustments resulting due in the issuance of tax credit notes or tax debit notes. Please refer to section 3.D.9 regarding credit notes and debit notes.

3.D.7 Bad Debts

Overview of Concept

Given that GST is generally accounted for prior to payment being received under the accrual basis of accounting, situations frequently occur where GST is paid to the tax authority but payment for the underlying supply is never received by the taxable person from the recipient of the supply, giving rise to a bad debt. In such cases, requiring the taxable person to pay the GST on the supply conflicts with the intended business neutrality of the tax and the principle that GST should be levied on the consideration for supply.

As such, where a bad debt arises and GST has already been accounted for by the taxable person, the taxable person should be permitted to claim a credit for the GST to the extent of the non-payment for the supply.

Leading Practice

The bad debt provision should be drafted to include the following:

- Bad debt should be defined as any debt relating to a supply of goods or services that is not recovered within a certain timeframe from the time of supply or where the customer has become insolvent.
- The supplier should send a credit note to the customer to inform him that the debt qualifies as bad debt under the GST law.
- Suppliers should be allowed to deduct input tax equal to the GST portion of bad debts after sending the credit note.
- Any amount recovered after the bad debt relief is applied is considered as a taxable supply and the supplier must account for output tax on the amount recovered.

Discussion

In New Zealand, a supplier is entitled to a deduction from output tax in the case of a bad debt that the supplier has written off.[193]The deductible amount is the portion of GST charged on the supply, calculated from the ratio of the amount written off as a bad debt to the total consideration for the supply.[194]If the written-off debt is wholly or partly recovered by the registered person, that portion of the amount of the deduction which has been claimed, calculated from the ratio of the amount of the bad debt recovered to the bad debt written off is deemed to be the tax charged

[193] New Zealand GST Act, § 20(3)(i).
[194] New Zealand GST Act, § 26.

in relation to a taxable supply made during the taxable period in which the bad debt is wholly or partly recovered.[195]

Singapore allows suppliers who have attempted to collect a GST debt, but are unable to recover the money after 12 months, to apply for bad debt relief and receive a refund of the GST previously accounted for and paid provided they took reasonable steps to recover the debts.

In addition, Singapore also has rules that apply to the recipient of the supply. A taxable person who fails to pay his supplier the consideration for the supply of any goods or services, and who has credited the input tax to which the consideration which he failed to pay relates, is required to repay such amount to the Comptroller in the prescribed accounting period.[196] Should he subsequently make payment to his supplier, the taxable person is allowed to credit the same amount of input tax in the prescribed accounting period in which he makes the payment.[197]

In Malaysia, the GST portion of the bad debt can be reclaimed provided that the claimant has not received any payment after 6 months of date of supply or the debtor has become insolvent before the period of 6 months has elapsed, and the tax authority is satisfied that all reasonable efforts have been made by the claimant to recover the debt.[198] The refund of the GST portion of the bad debt is done through an adjustment to the input tax in any taxable period. Any payment recovered by the taxable person after the adjustment is deemed to be a taxable supply.[199]

Under the IMF Model Law, a taxable person is allowed an input tax deduction for the VAT portion of a bad debt.[200] An input tax deduction is only granted for supplies made to non-taxable persons or where a credit note has been issued to a taxable person.[201] Any payment recovered by the taxable person after the adjustment is deemed to be a taxable supply.[202]

Ireland permits a deduction in respect of the VAT on a bad debt when all reasonable steps to recover the bad debt have been undertaken but no consideration has been received. [203] Where a credit for a bad debt is claimed, a credit note must be issued by the supplier.

All comparable jurisdictions provide a relief for bad debts. Differences arise in respect of what qualifies as a bad debt and the requirement to issue a credit note. All jurisdictions require the repayment of any input tax claimed in respect of a bad debt to the extent that the debt is subsequently recovered.

We suggest that the supplier should be allowed to claim an input tax deduction equal to the GST portion of the bad debt. Should the supplier recover any amount treated as bad debt after deducting the input tax, the GST amount relating to the recovered amount should be considered

[195] New Zealand GST Act, § 26(2).
[196] Singapore GST Act, § 19(12).
[197] Singapore GST Act, § 19(12A).
[198] Malaysia GST Act, § 58(1).
[199] Malaysia GST Act, § 58(3).
[200] IMF Law, § 30.
[201] IMF Law, § 30(5).
[202] IMF Law, § 30(4).
[203] Irish VAT Regulation 10.

as output tax. The approach of Ireland and the IMF of issuing a credit note for a bad debt creates a good paper trail and should be considered leading practice. Further, this will require the customer to apply the general rules relating to credit notes and thus correct the input tax originally deducted with no payment having been made (see 3.D.6 and 3.D.9).

3.D.8 Refund of Excess Input Tax

Overview of Concept

As discussed above in section 3.D.4 in respect of the calculation of tax payable, where during a taxable period the amount of deductible input tax exceeds the attributable output tax, the excess input tax amount should be refunded to the taxable person in accordance with the refund of excess tax rules.

Given that GST is intended to be a business neutral tax, taxable persons should be entitled to a refund of the excess input tax. Thus, provisions that address the refunding of any excess GST are required.

Providing rules in respect of the refund of GST also promotes certainty for taxable persons.

Leading Practice

The refund provision should be drafted to include the following:

- Where during a taxable period the amount of input tax exceeds the amount of output tax, the excess of input tax should be refunded to the taxable person.
- Payment of the refundable amount should be made by the tax authority within a certain number of working days after the return was received by the tax authority.
- The Secretary should have the power to withhold any refundable amount to offset against unpaid taxes, any amount under investigation, or where there are outstanding returns.

Discussion

The New Zealand GST Act allows the tax authority to apply any excess of input tax to other tax debts owed by the registered person.[204]If the registered person has no other tax debts and the Commissioner is satisfied that the amount of the GST refund is correct, then the tax authority must pay the refund within 15 working days of receiving the registered person's return where the registered person is a New Zealand resident.

The Commissioner can withhold any refund where the amount refundable is under investigation or where there are outstanding returns.

In Singapore, the tax authority must refund any excess input tax within a period equivalent to the prescribed taxable period after the return to which the payment relates is received by the tax authority.[205]Consequently, a registered person whose prescribed taxable period is on a quarterly

[204] New Zealand GST Act, § 46.
[205] Singapore GST Act, § 19(5); Singapore GST Regulations, regulation 63.

basis will get a refund within 3 months from the date the return was submitted. In addition, the tax authority is entitled to hold over the whole or any part of an input tax credit to a subsequent period.[206]

As with New Zealand, a GST refund may be withheld and applied against other unpaid taxes.

In Malaysia, if the amount of input tax exceeds the amount of output tax in a taxable period, the balance will be refunded.[207] The refund will be made within 14 working days after the return to which the refund relates is received in the case of online submission and 28 working days after the return to which the refund relates is received in the case of manual submission.[208] However, any refundable amount may be held over to be credited to any following or subsequent taxable period either on the taxable person's request or on any direction given by the tax authority.[209] The tax authority may also withhold any refund payment to offset unpaid taxes.[210]

Under the IMF Model Law, excess input tax must first be carried forward and the taxable person must be in a refund position for three consecutive taxable periods before the taxable person can claim the refund.[211] The refund must be made within 2 months of the claim being made.

Ireland is similar to the above regimes but requires the filing of a separate refund claim for the refund to be issued.[212]

Granting a refund of excess tax is considered business friendly and promotes the neutrality and fairness of the tax. The GST law should thus authorize refunds for taxable persons who are in a refund position during a given taxable period.

The refund should be paid out within a short timeframe after receipt of the return. This will reduce any cash flow impact on businesses that are in regular refund position. The taxable person should not be required to file a separate claim for the issuance of the refund in order to promote simplicity and efficiency. However, the tax authority should have the power to retain a refund where an investigation or audit is commenced or where the taxable person has outstanding returns. Further, where a taxable person has other tax debts, the refund should first be applied in satisfaction of those debts prior to issuance.

3.D.9 Tax Invoices, Credit Notes, and Debit Notes

Overview of Concept

A tax invoice is a document issued by a taxable person who makes a taxable supply that records the details of the supply and the amount of GST charged.

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[206] Singapore GST Act, § 19(6).
[207] Malaysia GST Act, § 38(3).
[208] Malaysia, GST Guide for Input Tax Credit, at 37.
[209] Malaysia GST Act, § 38(4).
[210] Malaysia GST Act, § 45.
[211] IMF Model VAT Law of New Vatopia, art. 45.
[212] Irish VAT law, regulation 36.

Credit notes and debit notes are documents that evidence the adjustment of the value of a previously made supply following the issuance of a tax invoice.

In an invoice-based GST system, these documents create a valuable audit trail for enforcement purposes. Further, without holding a valid tax invoice, purchasers are generally unable to claim credits for any input tax incurred on their expenses. This provides a valuable control within the supply chain, creating an element of self enforcement.

Consequently, GST laws generally outline the situations where these document must be issued and what form they should take.

Leading Practice

The tax invoice provision should be drafted to include the following:

- Registered persons should be required to issue a tax invoice for taxable supplies within a specified number of days after the delivery or making available of the goods or the completion of the performance of the services.
- A "tax invoice" should contain at least the following information:
  - The words "tax invoice" listed on prominent place;
  - Name, address, and GST number of the registered person making the supply;
  - Name, address and GST number (if registered) of the recipient to whom the supply is made (if the value of the supply is greater than US$1,000);
  - Invoice date;
  - Sequential number of the invoice;
  - The nature of the supply made (type of supply, type of goods or services, and quantity of goods or extent of service);
  - The amount of payment for the supply (excluding GST); and
  - The amount of GST.
  - The total amount, including GST.
- A registered person is required to issue a tax credit note or tax debit note when:
  - there is a change in the consideration due on a supply; or
  - when the supply is cancelled.
- Registered persons should be required to issue a tax credit note or tax debit note within a specified number of days after the change in the consideration due on a supply occurs, in case of bad debts, or when the supply is cancelled.
- A "tax credit note" or "tax debit note" should contain at least the following information:
  - the words "credit note" or "debit note" in a prominent place;
  - the name, address, and GST registration number of the registered person making the supply;
  - the name, address and GST Registration of the recipient of the supply (if registered);
  - the date on which the credit or debit note is issued;
  - Sequential number of the credit or debit note;
  - the value of the supply shown on the tax invoice, the correct amount of the value of the supply, the difference between those two amounts, and the tax charged that relates to that difference;

- a brief explanation of the circumstances giving rise to the issuing of the credit or debit note; and
- the number and date of the original tax invoice.

- A tax invoice, tax credit note, or tax debit note may be issued in electronic form provided the registered person can ascertain the authenticity of origin, the integrity of content, and the legibility of the document.

Discussion

Tax Invoice

In New Zealand, a registered person who makes a taxable supply of more than NZD 50 must provide the purchaser with a tax invoice if the purchaser requests one.[213]The tax invoice must then be issued within 28 days of the request.[214] Under New Zealand law there is a difference between an "invoice,"[215]which triggers time of supply and is simply any document which notifies an obligation to make payment and a "tax invoice,"[216]which is an invoice that meets certain requirements and allows a registered person to claim an input tax credit.

Tax invoices must contain the information set out below.

In New Zealand, a valid tax invoice must contain the following information:[217]

- the words "tax invoice" in a prominent place;
- the name and registration number of the supplier;
- the date it was issued;
- a description of the goods and services supplied;
- the consideration for the supply;
- the name and address of the recipient;
- the quantity or volume of the goods and services supplied; and
- either the total amount of the GST charged, the price before GST and the price with GST, or if the GST charged is a fraction of the price, the price and a statement that it includes GST.

Tax invoices may be issued in paper or electronic form. There is no prescribed format. In addition to tax invoices, there are special types of tax invoices in the following situations:

- the consideration for the supply does not exceed NZD 1,000 (and is not a zero-rated supply) –this is referred to as a "simplified tax invoice;"

[213] New Zealand GST Act, § 24.
[214] New Zealand GST Act, § 24(1).
[215] New Zealand GST Act, § 2.
[216] New Zealand GST Act, § 24.
[217] New Zealand GST Act, § 24(3).

- the supply is of second-hand goods – this is referred to as a "second-hand goods tax invoice," a buyer-created tax invoice; and
- shared tax invoices for groups.

Singapore requires a registered taxable person making a taxable supply to a taxable person to provide the latter with a tax invoice.[218] The tax invoice must be issued within 30 days of the time of supply. As with New Zealand, no tax invoice needs to be issued for zero-rated supplies, exempt supplies, or deemed supplies. There is also no need to issue tax invoices to non-GST registered persons.

However, unlike New Zealand, the Singapore GST Act requires a receipt to be issued for every taxable supply made, unless a tax invoice has already been issued.[219]Consequently, at least a receipt must be issued to a non-GST registered person. Tax invoices may be issued in paper or electronic form. There is no prescribed format.

In Singapore, a valid tax invoice must contain the following information:[220]

- the words "tax invoice" in a prominent place;
- an identifying number;
- the date of issue of the invoice;
- the name, address and registration number of the supplier;
- the name and address of the person to whom the goods or services are supplied;
- a description sufficient to identify the goods or services supplied and the type of supply;
- for each description, the quantity of the goods or the extent of the services and the amount payable, excluding tax;
- any cash discount offered;
- the total amount payable excluding tax, the rate of tax and the total tax chargeable shown as a separate amount; and
- the total amount payable including the total tax chargeable.

In addition, Singapore has the following types of special types of invoices:

- "self-billing" arrangement in which the customer may issue a tax invoice on behalf of his supplier and forward a copy of the tax invoice to the supplier;221 and
- "simplified invoices" when the amount payable on the tax invoice, including the tax, does not exceed SGD 1,000.[222]

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[218] Singapore GST Act, § 41(1); Singapore GST Regulations, regulation 10.
[219] Singapore GST Act, § 44;
[220] Singapore GST Regulations, regulation 11.
[221] Singapore GST Regulations, regulation 10(4).
[222] Singapore GST Regulations, regulation 13.

In Malaysia, every registered person who makes taxable supply of goods and services is required to issue a tax invoice.[223]Tax invoices must be issued within 21 days from the time of supply.[224]However, no tax invoice needs to be issued for zero-rated supplies, deemed supplies, or supplies under a special scheme under the GST Act. Tax invoices may be issued in paper or electronic form. There is no prescribed format.

In Malaysia, a valid tax invoice must contain the following information:[225]

- the words "tax invoice" in a prominent place;
- the tax invoice serial number;
- the date of issuance of the tax invoice;
- the name, address, and identification number of the supplier;
- the name and address to whom goods or services are supplied;
- a description sufficient to identify the goods or services supplied;
- for each description, distinguish the type of supply for zero rate; standard rate and exempt, the quantity of the goods or the extent of the services supplied and the amount payable, excluding tax;
- any discount offered;
- the total amount payable excluding tax, the rate of tax and the total tax chargeable to be shown separately;
- the total amount payable inclusive of the total tax chargeable; and
- any amount disclosed must be expressed in Malaysian Ringgit.

In addition, Malaysia has the following types of special types of invoices:

- self-billed invoice;
- simplified invoices; and
- invoice or statement of sales by auctioneer.

Under the IMF Model Law, a taxable person is required to issue a tax invoice for taxable supplies to another taxable person.[226] If 60 days after the date of supply the recipient does not receive a tax invoice, the recipient may request the supplier to issue such an invoice.[227] No tax invoice must be issued if the total consideration for the taxable supply is in cash and does not exceed a certain amount.[228] The IMF Model VAT Law does not address the format under which invoices should be issued.

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[223] Malaysia GST Act, § 33.
[224] Malaysia GST Guide, Tax Invoice and Record Keeping (DRAFT), at 3.
[225]Malaysia GST Act, Schedule IV.
[226] IMF Model Law, § 32.
[227] IMF Model Law, § 32(5).
[228] IMF Model Law, § 32(2).

Under the IMF Model Law, a valid tax invoice must contain the following information:[229]

- the words "tax invoice" in a prominent place;
- the name, address, and VAT registration number of the registered person making the supply;
- for a supply to a registered recipient, the name, address, and VAT registration number of the recipient of the supply;
- the individualized serial number and the date on which the tax invoice is issued;
- a description of the goods or services supplied;
- the quantity or volume of the goods or services supplied; and
- the total amount of the tax charged, the consideration for the supply, and the consideration including tax.

In Ireland, a taxable person who makes a taxable supply to another taxable person, a public body, or a person carrying on an exempted activity is required to issue a tax invoice. A simplified invoice may be issued if the amount of the invoice is not greater than €100, or when commercial, technical or administrative practices in a particular business sector make it difficult to comply with general invoicing requirements. The invoice must be issued within 15 days of the time of supply.[230]

The VAT invoice issued must show:

- the date of issue of the invoice;
- a sequential number, based on one or more series, which uniquely identifies the invoice;
- the full name, address and the registration number of the person who supplied the goods or services to which the invoice relates;
- the full name and address of the person to whom the goods or services were supplied;
- in the case of a reverse charge an indication that a reverse charge applies;
- the quantity and nature of the goods supplied or the extent and nature of the services rendered;
- the date on which the goods or services were supplied or, in the case of early payment prior to the completion of the supply, the date on which the payment on account was made, in so far as that date differs from the date of issue of the invoice;
- in respect of the goods or services supplied:
  - the unite price exclusive of VAT;
  - any discounts or price reductions not included in the unit price; and

[229] Singapore GST Regulations, regulation 11.
[230] Irish VAT Act, §§ 66-73.

- the consideration exclusive of VAT.
- in respect of the goods or services supplied, other than reverse charge supplies:
  - the consideration exclusive of tax for each rate (including zero-rate) of VAT; and
  - the rate of VAT chargeable.
- the VAT payable in respect of the supply.

Tax invoices may be issued in paper or electronic form (Ireland provides specific rules for issuing invoices in electronic format).

In addition, Ireland has special types of invoices including for:

- self-billed invoice;
- simplified invoices; and
- margin scheme.

All comparable jurisdictions require the issuance of an invoice. In most cases, formal tax invoices are only required where supplies are made to registered persons. However, due to the risk of fraud and evasion in Puerto Rico, tax invoices should be issued for all taxable supplies, irrespective of the nature of the recipient of the supply. As with all the comparable jurisdictions, prescriptive requirements for the content of a tax invoice should be included within the legislation. The only simplification should be for supplies of a value not greater than $1,000, in which case the invoice should not be required to contain the name, address and GST number (if registered) of the recipient to whom the supply is made. This exception should address most retail sales and thus reduce the compliance burden.

The GST leading practice approach departs from the current SUT system, under which a merchant is responsible to issue any receipt, invoice, ticket, or other evidence of sale.[231] However, the current SUT does not provide for invoicing requirements as the invoice does not constitute the principal mechanism to combat tax fraud and avoidance. Rather, the SUT puts an emphasis on the importance of exemption certificates such as the reseller certificates. Due to the input tax deduction mechanism (see 3.D.5), the requirement to issue valid tax invoices should create a more reliable paper trail of all transactions subject to GST and ensure to a certain extent that the tax is self-enforced by all taxable persons.

Tax Credit Note and Tax Debit Note

In New Zealand, where a tax invoice shows an incorrect GST amount, the supplier must issue a credit or debit note to the recipient.[232] A credit or debit note must be issued when:

- a supply of goods and services has been cancelled;
- the nature of that supply of goods and services has been fundamentally varied or altered;

[231] PRIRC § 4020.05(b).
[232] New Zealand GST Act, § 25.

- the previously agreed consideration for that supply of goods and services has been altered(whether due to the offer of a discount or otherwise); or
- the goods and services or part of those goods and services supplied have been returned to the supplier.

And

- the supplier has provided a tax invoice in relation to that supply and as a result of any one or more of the above events:
  - the amount shown on the tax invoice as GST charged on that supply is incorrect; or
  - the supplier has submitted a return in relation to the taxable period for which output tax on that supply is attributable and, as a result of any one or more of the above events, has accounted for an incorrect amount of output tax on that supply.

For a registered recipient, that adjustment must be made if the price has decreased and the recipient has been issued with a credit note, but is optional if the price has increased and the recipient has been issued with a debit note.[233]The tax authority retains discretion to determine that a credit or debit note need not be issued, or need not contain any of the requirements in circumstances where it is impracticable.

A valid tax credit note or tax debit note must contain the following information:[234]

- the words "credit note" or "debit note" in a prominent place;
- the name and registration number of the supplier;
- the date it was issued;
- the name and address of the recipient;
- the amount of consideration for that supply contained in the tax invoice, the correct amount of consideration, the difference between those two amounts, and the tax charged in respect of that supply; and
- a brief explanation of the circumstances giving rise to the issuing of the credit or debit note.

The Singapore GST Act does not define the situations when a credit note is to be used except where there is a change in the rate of GST and the supplier has to issue the tax invoice to reflect the new rate.[235] In practice, the Singapore tax authority recognizes that a credit note should be issued when:[236]

[233]K. Holmes, *New Zealand - Corporate Taxation* sec. 13., Country Analyses IBFD.
[234] New Zealand GST Act, § 25(3).
[235] Singapore GST Regulations, regulation 12.
[236]D. Kaur, *Singapore - Corporate Taxation* sec. 13., Country Analyses IBFD.

- correcting a genuine mistake (e.g., goods invoiced as standard-rated which should have been exempt or zero rated);
- the supply did not take place;
- charges are partly or fully waived before/after delivery of the goods;
- goods or services are accepted, but terms of the contract are not fully met (e.g., sub-standard goods are accepted by the customer at a reduced price);
- goods are returned or services are not accepted; or
- goods and services are supplied for an unconfirmed consideration.

The GST Act does not address tax debit notes.

In Singapore, credit notes should contain the number and date of the original tax invoice to which the credit note relates, in addition to the following particulars:

- an identifying number (e.g., a serial number);
- the date of issue;
- the name, address and GST registration number of the supplier;
- the customer's name and address;
- the reason for the credit – for example, "returned goods;"
- a description sufficient to identify the goods and services for which credit is being allowed;
- the quantity and amount credited for each description;
- the total amount credited, excluding tax;
- the rate and amount of tax credited; and
- the total amount credited, including tax.

In Malaysia, the GST Act provides the requirement for the issuance of credit and debit notes in respect of a supply.[237] The consideration for a particular supply can only be altered by means of a credit or debit note.[238]Where there is any such change in the consideration, the person making or receiving the supply, as the case may be, shall within twenty-one days (21 days)after any such change or events, or within such longer period as the Director General may allow, issue a credit note or debit note.[239] The issuance of credit and debit notes by the registered person occurs when there is a change in the consideration due on a supply including a change in the rate of tax or a change in the descriptions of the zero-rated or exempt supply or a cancellation of the supply.

In Malaysia, a valid tax credit or debit note must contain the following information:[240]

[237] Malaysia GST Act, § 35.
[238] Malaysia GST Act, § 35.
[239] Malaysia GST Guide, Tax Invoice and Record Keeping (DRAFT), at 24.
[240] Malaysia GST Guide, Tax Invoice and Record Keeping (DRAFT), at 26.

- the words "credit note" or "debit note" in a prominent place;
- the serial number;
- the date of issuance;
- the name, address, and identification number of the supplier;
- the name and address to whom goods or services are supplied;
- the reasons for its issue;
- description of the goods and services;
- the quantity and amount for each supply;
- the total amount payable excluding tax,
- the rate of tax and the total tax chargeable; and
- the number and date of the original tax invoice.

Under the IMF Model Law, a valid credit or debit note must be issued when the amount shown as tax charged in the tax invoice exceeds the tax properly chargeable in respect of the supply.[241] Only where a supplier issues a tax credit note to rectify the output tax charged to a recipient, the additional tax specified in the tax credit note is treated as output tax payable by the recipient in respect of a taxable supply made by the recipient in the tax period in which the tax credit note is received.[242]In addition, a taxable person is required to issue a debit note where the tax properly chargeable in respect of the supply exceeds the amount shown as tax charged in a tax invoice.[243] Where a registered person issues a tax debit note to rectify the output tax charged to a registered recipient, the additional tax specified in the tax debit note is deemed to be input tax payable by the registered recipient in the tax period in which the tax debit note is received.[244]

Under the IMF Model Law, a valid tax invoice must contain the following information:[245]

- the words "tax credit note" or "tax debit note" in a prominent place;
- the name, address, and VAT registration number of the registered person making the supply;
- the name, address, and VAT registration number of the recipient of the supply;
- the date on which the credit or debit note is issued;
- the value of the supply shown on the tax invoice, the correct amount of the value of the supply, the difference between those two amounts, and the tax charged that relates to that difference;

[241] IMF Model Law, § 33(1).
[242] IMF Model Law, § 29(7).
[243] IMF Model Law, § 33(3).
[244] IMF Model Law, § 29(5).
[245] IMF Model Law, Schedule IV.

- a brief explanation of the circumstances giving rise to the issuing of the credit or debit note; and
- information sufficient to identify the taxable supply to which credit or debit note relates.

The Irish VAT Act requires taxable persons to issue credit and debit notes when, after issuance of an invoice, the consideration stated in the invoice is increased or reduced, or a discount is allowed.[246] Where there is any such change in the consideration, the person making or receiving the supply, as the case may be, shall within fifteen (15 days) after any such change or events issue a credit note or debit note. In Ireland a debit note is considered as an additional invoice and thus follows the same invoicing requirements. The credit note must show:

- the date of issue of the note;
- a number, which uniquely identifies the note;
- the full name, address and VAT registration number of the person issuing the note;
- the full name, address and VAT registration number of the person to whom the note is being issued;
- in the case of a supply to a person who is registered for value-added tax in another EU Member State, the person's VAT identification number in that Member State;
- the reason why the note is being issued and a cross-reference to the invoice which was issued for the supply in respect of which the consideration was reduced;
- the amount of the consideration, exclusive of tax, in respect of which the note is being issued; and
- the rate or rates of tax in force when the related invoice was issued and the amount of tax at each rate as appropriate to the consideration shown on the note (other than where the reverse charge applied on the transaction).

In order to avoid fraud, GST adjustments relating to post sale adjustments should only be permitted where a valid tax credit note or tax debit note is issued. The GST law should thus indicate clearly in which situations registered persons are required to issue tax credit notes and tax debit notes. For simplicity purposes, tax credit and debit notes should be issued when there is a change in the consideration due on a supply or when the supply is cancelled. For efficiency and certainty purposes, the GST law should require registered person to issue a tax credit note or tax debit note within a certain timeframe after the changed occurred.

[246] Irish VAT Act, §§ 66-73.

Appendix D: Goods and Services Tax Special Cases

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1.A Special Cases

1.A.1 Grouping

Overview of concept

Under a GST, each person carrying on a taxable activity is required to register for GST and comply with the GST law. However, some countries allow closely related entities to form a GST group whereby all members of a GST Group will be considered as a single taxable person for GST purposes. This mechanism is generally designed to reduce the compliance burden by requiring the group as a whole to file a single return rather than having each entity file a separate return.

Where a GST group is formed, one entity designated as the group's representative files returns on behalf of the group that includes all transactions made and received by group members. In addition, because all members of a GST group are considered to constitute a single taxable person, transactions between GST group members are ignored for GST purposes. This has a consequential beneficial effect of removing any cash flow burden that may arise from accounting for GST on such supplies.[247]

Caution is required to be exercised when drafting rules in respect of GST grouping to ensure the operation of the GST is not adversely affected. Specifically, input tax credits incurred by a group member related to the making of exempt supplies to another group member should not be recoverable based on the taxable supplies made by the group as a whole. This issue is addressed in different ways by jurisdictions having implemented a GST grouping provision and are discussed below.

Leading Practice

The GST law should include a GST grouping provision, which should include the following:

- Two or more taxable persons established in Puerto Rico may apply to the authority to form a GST group provided that:
  - there is an element of common control between members (based on existing commercial and income tax concepts);
  - each member must make 100% taxable supplies (incidental exempt supplies should be ignored for the calculation of this percentage).
- If all the conditions for a GST group are met:
  - one member of the group should be designated as the GST group representative;
  - all transactions between group members should be deemed outside the scope of GST.
- All members of a GST group are jointly and severally liable for the payment of the tax.
- Where a member of the GST group no longer meets the common control requirement, it should be excluded from the GST group effective from the end of the taxable period in which the requirement ceased to be met.

[247] *Improving VAT/GST – Designing a Simple and Fraud-Proof Tax System*, at 17.1.4, IBFD (2014).

Discussion

In New Zealand, GST grouping is permitted provided that (1) all companies are registered persons for GST purposes; (2) there is a 66% common ownership among the members of the GST group; (3) all companies make collectively taxable supplies to non-group members that amount to at least 7 5% of their total supplies made to non-group members; (4) group members account for GST on the same basis (payments or invoice), and (5) group members have the same taxable periods.[248] Individuals, partnerships, trusts, and non-resident entities may join a GST group where certain control tests are satisfied. Where a GST group is formed, one company must be nominated as the "representative member" of the group. It is the representative member which is deemed to carry on all the taxable activities of the group members, and make and receive all supplies made by and to group members. Each individual member is deemed not to carry on that taxable activity or individually make or receive supplies for GST purposes. The representative member is responsible for filing GST returns and paying GST to the tax authority. However, each group member remains jointly and severally liable for the GST liability of the group.

In Singapore, GST Grouping is also permitted provided there is an element of common control over the members of the GST group.[249]Group registration is available to two or more taxable persons, each of whom must possess at least one of the following attributes:

- the taxable person is resident in Singapore or has a business establishment in Singapore;
- the taxable person has an annual turnover of SGD 1 million or more;
- the taxable person has issued shares which are listed on a securities exchange established in or outside Singapore;
- the taxable person is a subsidiary of a body corporate that satisfies the conditions above; or
- the taxable person is financed by an entity that satisfies the conditions above.

In addition, the taxable person must meet at least one of the following control requirements: (1) one taxable person controls each of the other taxable persons, (2) one person (whether a body corporate or an individual) controls all of the taxable persons; or (3) two or more individuals carrying on a business in partnership control all of the taxable persons.[250]

Furthermore, similar to New Zealand, the tax authority also requires each member of the proposed group to be individually registered for GST and can refuse an application for the protection of revenue.

In contrast to New Zealand, the above requirements are more restrictive and there is no threshold requirement in respect of taxable versus exempt supplies. Nonetheless, the effects of GST grouping are the same as New Zealand.

[248] New Zealand GST Act, § 55.
[249] Singapore GST Act, § 30; Singapore GST Regulations, regulation 4.
[250] Singapore GST Act, § 30; Singapore GST Regulations, regulation 4.

The Malaysian GST Act allows group registration for two or more companies provided the following conditions are met:[251]

- Each company must be making wholly taxable supplies. However, where a company is making incidental exempt supplies, the company is also allowed to be a member of the group (cf. New Zealand with a 75% taxable supplies threshold and Singapore with no threshold);
- Each company must be individually GST registered before they can register as a group (similar to New Zealand and Singapore);
- One company must have controlling power over the other companies within the group (similar to New Zealand and Singapore).

Generally, a company is deemed to have control over another company if the first company holds directly, or indirectly, through subsidiaries, more than 50% of the issued share capital of the second mentioned company. A company is deemed to be a subsidiary of another company if that company holds more than 50% of the share capital of the first mentioned company.

In contrast to New Zealand and Singapore, individuals or partnerships are not eligible to be a member of a group. However, companies controlled by individuals or partnerships may register as a group. Again, in contrast to New Zealand and Singapore, foreign companies which are not established in Malaysia cannot become members of a group. However, for the purpose of eligibility for group registration, their subsidiaries or registered branches in Malaysia can be considered as members of a group.[252]

The consequences of GST grouping in Malaysia are the same as in New Zealand and Singapore.

The IMF Model Law does not include any specific provisions for groups.

Ireland also permits the formation of a VAT group by two or more persons closely bound by financial, economic and organizational links.[253] Companies are treated as being "closely linked" if one owns 50 percent or more of the share capital of the other, or one owns 50 percent or more of the voting power of another, or one has power to appoint 50 percent or more of the board of the other.[254] Similar to Malaysia, only Irish established entities may be members of a group. Unlike in the other comparable jurisdictions, the Irish tax authority may deem a person to be a member of a VAT group and also has authority to cancel the registration of such groups.[255]

The effects of VAT grouping in Ireland are the same as in the other comparable jurisdictions. However, the VAT group provisions do not apply in the case of the supply of immovable goods by a group member to another group member.

Based on comparable jurisdictions, it is leading practice to include GST grouping provisions within the GST law to help ease the compliance burden for closely related entities. Common characteristics of GST grouping provisions include:

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[251] Malaysia GST Act, § 27; Malaysia GST Guide, GST Registration Guide (DRAFT), at 17.
[252] Malaysia GST Guide, GST Registration Guide (DRAFT), at 17.
[253] Irish VAT Act, § 15.
[254] O. Maher, Ireland - Value Added Tax, Topical Analyses IBFD.
[255] Irish VAT Act, § 15.

- There is an element of common control between members;
- A representative member is appointed to file GST returns on behalf of the group;
- All members of the GST group remain jointly and severally liable for the payment of GST;
- Intra-group supplies are disregarded for GST purposes; and
- All supplies made to and by group members are deemed to be made to and by the group as a whole.

Differences arise in respect of how jurisdictions approach the following:

- Definition of common control;
- Whether group members are required to be established in a jurisdiction; and
- Whether group members are allowed to make exempt supplies.

In the case of Puerto Rico, the definition of common control should follow existing commercial and income tax concepts to ensure consistency.

In respect of allowing non-resident entities to be group members, there are contrasting approaches between the comparable jurisdictions. While New Zealand and Singapore authorize, to a certain extent, non-residents as members of GST groups, such an option is not available in Malaysia and Ireland. In the context of creating a simple and easily administrable GST, only authorizing established entities to be members of a GST group would be the preferable approach.

In order to address the potential over-deductibility of input tax that might arise from the forming of a GST group where exempt supplies are disregarded by virtue of the grouping provisions, the comparable jurisdictions have taken different approaches.

New Zealand imposes certain thresholds for carrying on taxable supplies therefore restricting entities that make significant exempt supplies from joining GST groups. Malaysia takes a more strict approach with only permitting GST grouping for members who make 100% taxable supplies. Ireland and Singapore have no restrictions. As such in Ireland, VAT grouping is commonly used to mitigate VAT costs arising from a group member making exempt supplies (e.g., in the finance or insurance industry).

Puerto Rico should follow the Malaysian approach with GST grouping only being permitted for taxable persons who make 100% taxable supplies (rather than the New Zealand approach which would require complex threshold computations), regardless of their status (i.e., corporations, individuals, partnerships, branches) which are established in Puerto Rico in order to avoid any GST tax planning opportunities.

The GST law should also state that where a taxable person no longer meets the common control requirement, the taxable person should be excluded from the GST group. However, the taxable person should remain jointly and severally liable for any GST payable during the taxable periods in which it was a member.

1.A.2 Branches and divisions

Overview of concept

Branches and divisions are not separate legal persons from their head offices. As such, GST regimes generally treat branches and divisions and their head offices as single taxable persons. Consequently, any transactions between head offices and branches are disregarded for GST purposes.

However, some countries allow or require branches and divisions to be regarded as separate taxable persons for two reasons:

- Allowing separate GST registrations for a head office and a branch can address compliance concerns where the head office and the branch operate separate accounting systems and in practice, despite the fact that they constitute one legal entity, are managed and operated as two distinct establishments. In such cases, requiring the filing of a single GST return may be overly burdensome for the taxable person.

- Where there are cross border supplies between a head office and a branch and GST is not fully recoverable by the recipient (i.e., where the recipient branch makes exempt supplies) the neutrality of a GST can be compromised where that head office - branch transaction is disregarded for GST purposes. As such, some jurisdictions deem cross-border supplies between head offices and branches to be a supply for GST purposes.

Leading Practice

The GST law should include a provision regarding branches and divisions, which should include the following:

- Where a taxable person carries out its taxable activity in branches or divisions, the taxable person is deemed to be a single taxable person.
- However, a taxable person carrying out its activity in branches or divisions should be authorized to apply for any such branch or division to be registered as a separate taxable person if:
  - o The branch or division has an independent system of accounting, and
  - o The branch or division can be separately identified by reference to the nature of the activities carried on or the location of the branch or division.
- Where a taxable person carries out taxable activities both inside and outside Puerto Rico through branches or divisions:
  - o Each head office, branch, or division established overseas should be treated as a separate person;
  - o All head offices, branches, or divisions established in Puerto Rico should be treated as a single person.

Discussion

New Zealand allows taxable persons carrying out their activity in branches or divisions to apply for any such branches or divisions to be registered as separate taxable persons where those branches or divisions have an independent system of accounting and can be separately identified by reference to the nature of the activities carried on or by the location of the branch or division.[256]

[256] New Zealand GST Act, § 56.

In addition, the GST Act treats the offshore branch or head office of a company and its head office or branch in New Zealand as separate persons to ensure there is no avoidance of any GST liabilities arising from cross border transactions, as described in the Overview of Concept section above.[257]Consequently, transactions between a resident head office and a non-resident branch will be treated as subject to the GST regime.

Singapore does not have any special provisions with regard to the treatment of transactions between a branch and its head office for GST. Consequently, where a branch has transactions with an overseas head office, the branch and the head office are considered as the same legal entity and thus there is no supply for GST purposes.[258] However, similar to New Zealand, an application can be made to register each division separately where (1) it is likely to cause real difficulty for the taxable person to submit a single return in respect of all the divisions; (2) each division maintains an independent system of accounting; and (3) each division is separately identifiable by reference to the nature of the activities carries on by or the location of the division.[259]

Malaysia takes a similar approach to Singapore and New Zealand authorizing the separate registration of branches and divisions under similar conditions.[260] In addition, for a separate branch or division registration, Malaysia requires that the taxable person and all the branches or divisions make wholly taxable supplies; the taxable person is not a member of a GST group; and each branch or division has the same taxable period. Once registered, all branches and divisions must charge and account for GST even though an individual branch or division may not have a turnover that exceeds RM500,000 (i.e., the registration threshold).

Under the IMF Model Law, where a taxable person carries out its taxable activity in branches or divisions, the taxable person is deemed to be a single person.[261] Consequently, transactions between head offices and branches are not subject to VAT. The law also authorizes taxable persons to apply for a separate registration for branches and divisions where the branch or division maintains an independent system of accounting and can be separately identified by the nature of its activities or its location (similar to New Zealand).[262]

The Irish VAT Act does not contain any specific provision regarding branches and divisions. However, under EU VAT case law, and in contrast to New Zealand, supplies of services between branches and head offices must be disregarded, even in cross border situations, because the transaction is within the same legal entity.[263] However, this does not apply to cross border supplies of services where a branch is a member of a VAT group.[264]

All comparable jurisdictions, except Ireland, contain special provisions regarding the separate registration of branches and divisions under certain circumstances. However, New Zealand is the

[257] New Zealand GST Act, § 56B.
[258]*See e.g.*, Improving VAT/GST – Designing a Simple and Fraud-Proof Tax System, at 12.2.2.
[259]Singapore GST Regulation, regulation 7.
[260] Malaysia GST Act, § 30(2).
[261] IMF Model Law, § 56(1).
[262] IMF Model Law, § 56(3).
[263] Court of Justice of the European Union, Case C-210/04 *FCE Bank plc.*
[264]Court of Justice of the European Union, Case C-7/13, *Skandia America Corporation.*

only jurisdiction which deems cross border transactions between a head office and a branch to be a supply for GST purposes.

The GST Law may, similar to the IMF, clarify that where a business operates its taxable activity in branches or divisions, such branches or divisions should be considered carrying out the activity as a single taxable person. Consequently, all transactions between a head office, division, or branch will be disregarded for GST purposes. Such an approach provides certainty.

Based on the comparable jurisdictions, it is leading practice to allow a separate registration for branches or divisions where the branch or division maintains an independent system of accounting and can be separately identified by the nature of its activities or its location. Additional conditions such as those imposed by the Malaysian GST Act may be included, but is likely to add complexity to a provision deemed to provide flexibility to the law.

Finally, the GST law, should similar to New Zealand, deem cross-border transactions between head offices and branches to be supplies between two separate taxable persons for GST purposes. This provision will aid in maintaining the neutrality of the tax and mitigate avoidance opportunities.

1.A.3 Groups of persons/unincorporated bodies/partnerships

Overview of concept

Groups of persons, unincorporated bodies, and partnerships are often considered "pass-through entities" for income tax purposes, whereby partners or members of these entities are directly liable for tax. Applying the same principles for GST purposes may result in administrative and compliance complexities because each partner would be required to register for GST and special rules would be required for the artificial splitting of the supply between partners and the issuance of invoices. Consequently, GST laws generally introduce a mechanism that recognizes these entities as single taxable persons for GST purposes.[265] This will treat these entities as making or receiving all relevant supplies rather than supplies being made to or by each partner.

Leading Practice

The GST law should include a provision regarding groups of persons, unincorporated bodies, and partnerships, which should include the following:

- Where a group of persons, unincorporated body, or partnership carries on taxable activity, the group of persons, unincorporated body, or partnership is required to register for GST purposes in accordance with the registration rules.
- Members of the group of persons, unincorporated body, or partnership should not be registered for GST purposes except where they carry out a separate taxable activity to that carried out by the group of persons, unincorporated body, or partnership, of which they are a member.
- All supplies to and by members of the body are deemed to be made by or to the body and not the individual members.

[265] David Williams, *Tax Law Design and Drafting*, Chapter 6 Value Added Tax, Volume 1; International Monetary Fund, 1996.

- All members of the group of persons, unincorporated body, or partnership are jointly and severally liable for any tax due.
- A person is required to notify the authority when he or she is no longer a member of the group of persons, unincorporated body, or partnership.
- The liability of a member will cease at the end of the taxable period in which he or she notified the authority that he or she is no longer a member of the group of person, unincorporated body, or partnership.

Discussion

Under the New Zealand GST Act, a "person" includes a company, an unincorporated body of persons, a public authority, or a local authority.[266] Consequently, any unincorporated body is subject to the general registration rules.[267] Where an unincorporated body of persons, including a partnership, joint venture or trustees of a trust, carrying on a taxable activity is registered for GST, the individual members of the unincorporated body are not themselves liable (or able) to register in respect of that taxable activity.[268] All supplies made or received in respect of the taxable activity carried on by the body are deemed to be made by or to the body and not the individual members. Changes in membership do not have any effect for the purposes of the GST Act. Each member of the unincorporated body is jointly and severally liable for the GST of the body for taxable periods in which they were members, even if they are no longer a member of the body.[269]

Singapore, Malaysia and the IMF adopt a similar approach to New Zealand.[270]

Ireland does not separately address the case of groups of persons, unincorporated bodies, and partnerships, which are thus subject to the general rules.

All comparable jurisdictions, except Ireland, adopt a specific provision regarding groups of persons, unincorporated bodies, and partnerships. New Zealand's approach, which is followed by Singapore, Malaysia, and the IMF, thus constitutes leading practice. Consequently, the GST law should provide for the following in respect of groups of persons, unincorporated bodies, and partnerships:

- Require that groups of persons, unincorporated bodies, and partnerships register for GST rather than the individual members;
- Consider all supplies to and by members of the body are deemed to be made by and to the body and not the individual members;
- Require a member to register separately where it performs a separate taxable activity;
- Hold jointly and severally liable all members for all taxes due; and
- Require a member to notify the tax authority where it is no longer a member of the body.

[266] New Zealand GST Act, § 2.
[267] *See* Supra 3.C.
[268] New Zealand GST Act, § 57(2).
[269] New Zealand GST Act, § 57(3).
[270] Singapore GST Act, § 31 and 32, Malaysia GST Act, § 28, IMF Model Law, § 57.

1.A.4 Agents

Overview of concept

Where a supply of goods or services involves an agency relationship, generally the supply is made by or to the principal and not the agent. GST rules generally follow this principal. However, there may be situations where the agent does not reveal that there is an agency or declines to reveal the identity of the principal (e.g., undisclosed agent).[271] The general operation of the GST rules whereby the supplier is required to issue an invoice to the customer would potentially disrupt this commercial arrangement. As such, where an agent is acting in its own name but for and on behalf of a principal, many GST jurisdictions deem a buy/sell transaction to occur between the agent and the principal for GST purposes and GST purposes only.

Leading Practice

The GST law should include a provision regarding agents, which should include the following:

- When goods or services are supplied to or by a disclosed agent acting on behalf of a principal, the supply should be deemed to be made to or by the principal and not the agent.
- When goods or services are supplied through an undisclosed agent acting in its own name, the supply should be treated as a supply to the agent and as a supply by the agent.

Discussion

In New Zealand, where a person (the "agent") is authorized by another person (the "principal") to act, represent and/or enter into legally binding agreements with third parties on behalf of the principal, any supplies made by the agent pursuant to the agency relationship are deemed to be made by the principal and not the agent.[272]

However, a principal and their agent can agree in writing that a supply via the agent can be treated as two supplies – a supply of goods and services by the principal to the agent and a supply by the agent to the recipient.

Even in the event of no such agreement, an agent can issue a tax invoice for the supply as if it made the supply and can request a supplier to issue a tax invoice to the agent as if it received the supply. In such cases, tax invoices cannot also be issued by and to the principal, respectively.[273]

Similarly, where a registered person makes a taxable supply of goods or services to an agent, that supply is deemed to be made to the principal for GST purposes and not the agent.[274]

[271] David Williams, Tax Law Design and Drafting, Chapter 6 Value Added Tax, Volume 1; International Monetary Fund, 1996 at p. 27.
[272] New Zealand GST Act, § 60(1).
[273] New Zealand GST Act, § 60(1) and (2).
[274] New Zealand GST Act, § 60(2).

Singapore has a similar approach to New Zealand. A supply of goods or services through an agent who acts in his own name can be treated both as a supply to the agent and as a supply by the agent.[275]

Malaysia is also similar to New Zealand in that when goods or services are supplied to or by the agent acting on behalf of a principal, the supply will be deemed as made to or by the principal and not the agent.[276]

However, where goods or services are supplied through an agent acting in his own name, the supply is treated as a supply to the agent and as a supply by the agent.[277]

The IMF adopts a similar approach to New Zealand in relation to invoicing but does not have a provision for deeming a supply to occur to and by the agent.[278]

Ireland takes a similar approach to agents as Malaysia where the agent is acting in its own name. Where an agent acts in an undisclosed capacity (i.e., in its own name, but on behalf of a principal), any sales of goods and/or services through him are deemed to constitute a supply of those goods and services to and simultaneously by the agent.[279]

Where an agent is a disclosed agent (i.e., in the name and on behalf of the principal), any supply of goods or service takes place directly between the principal and the third party.

All comparable jurisdictions include specific provisions regarding transactions performed through agents. Differences arise in respect of whether the legislation includes a provision confirming whether a supply through a disclosed agent is made to or by the principal (New Zealand and Malaysia), a provision deeming a buy/sell to occur where the supply is made through an undisclosed agent (Ireland and Malaysia), a provision providing the option for a deemed buy/sell (New Zealand and Singapore), and a provision allowing agents to issue invoices in their own name even in the absence of a buy/sell (New Zealand and the IMF).

For clarity purposes the GST law should state that where a supply is made through a disclosed agent the supply is made to or by the principal and not the agent. The GST law should also state that where supplies are made through an undisclosed agent there should be two distinct supplies: one by the agent and the other one to the agent. Such an approach is preferable as it avoids any difficulties for the third party to identify the principal where the principal's name is not disclosed for the purposes of issuing GST compliant invoices.

1.A.5 Going concerns

Overview of concept

Normally, the sale of the assets of a GST registered business should be subject to GST (unless an exemption or zero rate applies). However, when all assets constituting a business are

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[275] Singapore GST Act, § 33(4).
[276] Malaysia GST Act, § 65(1) and 65(2).
[277] Malaysia GST Act, § 65(3).
[278] IMF Model Law, § 86(1).
[279] Irish VAT Act, §§ 19(b) and 22(1).

transferred and that business is to be carried on by the purchaser, the cash flow burden arising from the purchaser having to pre finance the GST in respect of the purchase while awaiting the processing of an input tax claim can be unduly burdensome. Consequently, many jurisdictions provide a relief mechanism in the case of a transfer of a business as a going concern for GST purposes (TOGC), where specific conditions are met.

Leading Practice

The GST law should include a provision regarding the GST treatment of a transfer of a business as a going concern, which should include the following:

- The transfer of a business as a going concern may qualify as a zero-rated transaction.
- A supply may be treated as a going concern provided that all the following conditions are met:
    - There should be a transfer of all goods and services necessary for the continued operation of a business or part of business;
    - If only part of the business is transferred, then that part of the business should be capable of separate operation;
    - The transferee should be a registered person; and
    - The transferor and transferee should agree in writing that the supply is a going concern.

Discussion

In New Zealand, "going concern" is defined as a supply of a taxable activity, or of a part of a taxable activity where that part is capable of separate operation, where all of the goods and services that are necessary for the continued operation of that taxable activity, or that part of a taxable activity, are supplied to the recipient; and the supplier carries on, or is to carry on, that taxable activity or that part of a taxable activity upto the time of its transfer to the recipient.[280] The supply of a "going-concern" is explicitly treated as a taxable supply, but is zero-rated for GST purposes if:[281]

- the supplier and the GST registered recipient agree, in writing, that the supply is to be a supply of a going concern; and
- the supplier and the GST registered recipient intend that the supply is of a taxable activity, or part of a taxable activity, that is capable of being carried on as a going concern by the recipient.

Singapore also provides a special rule for TOGC, but takes a different approach to that of New Zealand. A transfer of a going concern is neither a supply of goods nor a supply of services, thus taking the transfer outside of the scope of the tax.[282]Any input tax incurred in relation to the TOGC remains deductible for both transferor and transferee.[283] The transferee who receives such a transfer of assets shall be deemed to have incurred input tax on the value of the assets supplied to him, and to have deducted such deemed input tax from any output tax due from him on the day the supply is made. This is to facilitate any subsequent change of use adjustments.

[280] New Zealand GST Act, § 2.
[281] New Zealand GST Act, § 11(1)(m).
[282]Goods and Services Tax (Excluded Transactions) Order.
[283] Inland Revenue Authority of Singapore, E-Tax Guide – Transfer of Business as a Going Concern, p. 6.

In order for a supply to qualify as TOGC, the following conditions must be met:

- the supply of assets is made in relation to a transfer of the business or part thereof to the transferee;
- the assets to be transferred must be intended for use by the transferee in carrying on the same kind of business as the transferor. For example, the transferor acquiring a rental business should continue with the transferred tenancies and not terminate them so as to put the immovable property to another use;
- in the case where only part of the business is transferred, that part must be capable of being operated independently;
- the business or part thereof must be a going concern at the time of the transfer;
- the transferee must be a GST registered taxable person at the time of the transfer; and
- both the transferor and transferee must maintain sufficient records on the transferred assets.

Singapore also has additional requirements where the transferee is a member of a GST group.

Malaysia takes a similar approach to Singapore.[284]Under the Malaysian GST Act, the transfer of a business can be considered as a transfer of going concern if:

- the transferor is a taxable person;
- the transferee is a taxable person or will be a taxable person after the transfer of business;
- the transfer of the business must be accompanied by a transfer of business assets that will be used to carry on the same kind of business; and
- if only part of the business is transferred, then that part of the business must be able to operate separately.

The IMF takes a similar approach to New Zealand as the transfer of a business as a going concern is also a zero-rated transaction.[285] There is a transfer of going concern where:[286]

- all the goods and services necessary for the continued operation of that taxable activity or part of a taxable activity are supplied to the transferee; and
- the transferor carries on, or is carrying on, that taxable activity or that part of a taxable activity up to the time of its transfer to the transferee.

In Ireland, similar to Singapore and Malaysia, the transfer of ownership of goods and intangible assets such as goodwill, in connection with the transfer of a business or part thereof to another person is deemed not to be a supply of goods.[287]The current legislation does not expressly state that it is necessary that the business be sold as a going concern. It states that the transferred assets should constitute an undertaking, or part of an undertaking, capable of being operated on an independent basis.

All comparable jurisdictions include a specific TOGC provision for the reasons discussed above in the Overview of Concept section.

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[284] Malaysia GST Act, Third Schedule.
[285] IMF Model Law, Schedule I.
[286] IMF Model Law, §§ 4(2) and (3).
[287] Irish VAT Act, §§ 20(2)(c) and 26.

While New Zealand and the IMF consider a TOGC as a zero-rated transaction, Singapore, Malaysia, and Ireland consider the transfer of a going concern to be out of scope of GST. However, the ultimate effect is the same for all jurisdictions.

The GST law should identify what types of transactions qualify as going concerns. All comparable jurisdictions take similar approaches with regard to the conditions that should be met to treat the transfer of a business as a TOGC. Therefore, based on the comparable jurisdictions a transfer of a business should be treated as a TOGC and subject to GST relief where the following conditions are met:

- There should be a transfer of all goods and services necessary for the continued operation of a business or part of business;
- If only part of the business is transferred, then that part of the business should be capable of separate operation;
- The transferee should be a registered person; and
- The transferor and transferee should agree in writing that the supply is a going concern.

The New Zealand approach of electing to treat this type of transaction as zero-rated is preferred, rather than making it a mandatory treatment, as determining whether all requirements for such treatment are met can be problematic. For certainty purposes, it is advisable that the parties agree in advance that the transfer qualifies as a going concern.

1.A.6 Vouchers

Overview of concept

Vouchers, stamps, coupons, tokens and similar items ("vouchers") are generally instruments which give the holder a right to goods or services, or to receive a discount or rebate in relation to a supply of goods or services.[288]

Vouchers create unique challenges from a GST perspective as a voucher is generally involved in two transactions:

1. The supply of the voucher itself (which could be free or for consideration);
2. The redemption of the voucher for goods or services.

The question that arises from a GST perspective is whether to tax the issuance of the voucher or the redemption of the voucher. In order to provide certainty and ensure there is no double taxation or non-taxation, special rules are generally required for the GST treatment of vouchers.

Further, issues can arise in respect of how the value of the transaction should be determined. For example, vouchers may be sold for less than their redemption value or they may be sold through a supply chain involving many parties with each party making a profit on their respective sales. Finally, vouchers could be issued for a specific good or service or for multiple types of

[288] Proposal for a COUNCIL DIRECTIVE amending Directive 2006/112/EC on the common system of value added tax, as regards the treatment of vouchers, 10/5/2012 at page 2.

goods or services that may have different GST treatments, therefore creating issues with determining the correct treatment if the voucher is to be taxed upon issuance.

Leading Practice

The GST law should include a provision regarding the GST treatment of vouchers, which should include the following:

- The issuance of a voucher, stamp, coupon, or token against consideration should not be considered a supply of goods or services if the consideration received for the voucher, stamp, coupon, or token is less than, or equal to, the face value of the voucher, stamp, coupon, or token.
- In cases where the consideration received for the issuance of the voucher, stamp, coupon, or token exceeds the face value of the voucher, stamp, coupon, or token:
    - GST should be applicable at the time of the supply of the voucher, stamp, coupon, or token;
    - The taxable amount should correspond to the difference between the consideration received and the face value of the voucher, stamp, coupon, or token.
- The supplier of goods and services should be required to include in the valuation of the goods and services supplied the value of the voucher, stamp, coupon, or token redeemed.

The above leading practice addresses the basic application of the GST law to the issuance and redemption of vouchers. The treatment of vouchers is an extremely complex area from a GST perspective. During the drafting of the GST law, special attention should be given to the following more complex matters:

- reimbursements where the issuer of the voucher is a different person from the person accepting the voucher and any associated GST adjustments;
- the treatment of markups made by resellers in the supply chain;
- loyalty programs and discount vouchers; and
- distinction between vouchers and payment instruments.

When drafting the law relating to vouchers, reference should be made to the current European Commission discussion on VAT reform in respect to vouchers.[289]

Discussion

In New Zealand, the issue or sale of a token, stamp, or voucher is treated as a supply of goods and services, other than those issued for no consideration.[290]

To prevent a double imposition of GST, the following are not treated as a supply of goods and services:[291]

- goods and services supplied pursuant to the redemption of the token, stamp or voucher; and

[289] Proposal for a COUNCIL DIRECTIVE amending Directive 2006/112/EC on the common system of value added tax, as regards the treatment of vouchers

[290] New Zealand GST Act, § 5(11E).

[291] New Zealand GST Act, § 5(11EA) and (11F).

- the supply of a token, stamp, or voucher by a registered person to another registered person, who subsequently issues or sells the token, stamp, or voucher (unless the first mentioned registered person is the person who actually supplies the goods and services upon the redemption of the token, stamp, or voucher).

However, if the voucher has a face value and it is not practical for the supplier to treat the issue or sale of the token, stamp, or voucher as a taxable supply, then the supplier may treat the redemption of the voucher as the supply of goods and services, rather than the issue of the voucher.[292]

A situation where it may be impractical to treat the supply of the voucher as a taxable supply includes one in which the supplier of the voucher and the supplier of the underlying goods or services may be different. If the issuer of the voucher and the supplier of the goods and services upon redemption of the voucher are different persons, then the issuer and the supplier must agree to this GST treatment.[293]

This elective GST treatment cannot apply to the extent that the consideration received for the supply is more than the face value of the tokens, stamps or vouchers.

Singapore takes a different approach and differentiates between multi-redemption vouchers (MRV) and non-multi-redemption vouchers (Non-MRV).[294] However, the Singapore GST law does not use these terms, rather they are terms that have been adopted by the tax administration to assist with the application of the GST rules to vouchers.

Section 35A of the Singapore GST Act provides the Minister with the authority to set rules relating to the taxation of vouchers via the regulations.

Where any voucher is supplied by an issuer for consideration that is equal to or less than the value of the voucher, the supply of the voucher is disregarded for GST purposes.[295] Where the consideration exceeds the value of the voucher, GST is payable on that excess.[296]

For vouchers that are wholly redeemed on a single occasion, GST may be accounted for (at the option of the taxable person) on the value of the voucher or the amount of the consideration received for the voucher (where the consideration received is less than the value of the voucher). If the consideration received for the voucher was equal to, or more than, the value of the voucher, GST must be accounted for on the value of the voucher.[297]

For vouchers that are partially redeemed on more than one occasion, the value of the supply on each such occasion is as follows:[298]

- where the consideration received by the issuer for the voucher was less than the value

[292] New Zealand GST Act, § 5(11G).
[293] New Zealand GST Act, § 5(11G) and (GA).
[294] Inland Revenue Authority of Singapore, IRAS e-Tax Guide – GST Treatment of Vouchers: Sale and Redemption, at 6 (Jan. 15, 2010).
[295] Singapore GST Regulations, Regulation 93B(1)
[296] Singapore GST Regulations, Regulation 93B(2)
[297] Singapore GST Regulations, Regulation 93C(1)
[298] Singapore GST Regulations, Regulation 93C(2)

of the voucher, either of the following at the option of the taxable person:

- o the portion of the value of the voucher being redeemed on that occasion; or
- o the amount of that consideration that is proportional to the value of the voucher being redeemed on that occasion;

- where the consideration received by the issuer for the voucher was equal to or more than the value of the voucher, the portion of the value of the voucher being redeemed on that occasion.

There are also specific rules for accounting for GST on unredeemed vouchers.[299]

Taxable persons can elect to be subject to different rules, upon approval of the Comptroller, to account for GST at the time the voucher is issued.[300] The Comptroller has fairly broad powers in determining what conditions need to be met in order to be subject to these different rules.

The Singapore Tax authority has interpreted these rules as follows.[301]

	Multi-Redemption Voucher ("MRV")	**Non-Multi-Redemption Voucher ("Non-MRV")**
Sale of voucher	Must be sold for a consideration	Need not be sold for a consideration
Types of goods and/or services that can be redeemed	Can be used to redeem a range of goods and/or services. No reference is made to any particular goods and/or services to be redeemed.	Can be used to redeem only specific goods and/or services. Reference is made to the specific goods and/or services to be redeemed.
GST Treatment	Sale of voucher and redemption of goods and/or services are treated as 2 separate supplies. (a) When voucher is sold i. at or below specified value, no GST needs to be accounted for. ii. Above specified value, GST has to be accounted for on the excess payment received. (b) When voucher is redeemed GST has to be accounted for on the value of the redeemed goods and/or services plus any additional payment received.	Sale of voucher and redemption of goods and/or services is treated as a single supply. (a) When voucher is sold GST is to be accounted for at the earlier of when the payment is received or when an invoice is issued. (b) When voucher is redeemed No further GST is accountable unless additional payment is received. If additional payment is received, GST is accountable on that payment amount.
Examples	$10 shopping vouchers, stored value cards, prepaid gaming and galling cards.	Free vouchers, discount vouchers, voucher for a spa treatment and parking coupons.

299 Singapore GST Regulations, Regulation 93D.

300 Singapore GST Regulations, Regulation 93E.

301 Inland Revenue Authority of Singapore, IRAS e-Tax Guide, GST Treatment of Vouchers, 31 December 2013, at p. 1.

Singapore also has specific rules addressing the supply of vouchers by intermediaries and how to account for the margin made by the intermediary on the resale of those vouchers.[302]

The Malaysian law is drafted in a simpler manner in respect of the treatment of vouchers. It simply states that where a right to receive goods or services for a monetary value stated on any token, stamp (other than postage stamp) or voucher is granted for a consideration, the consideration shall be disregarded except to the extent, if any, it exceeds the monetary value.[303]

The tax authority's application of this rule differentiates between monetary and non-monetary vouchers. Monetary vouchers are those vouchers with a face value while non-monetary vouchers are vouchers that entitle the bearer to a specific good or service mentioned in the voucher.[304]

GST is only chargeable on the issue of a monetary voucher to the extent the consideration for the voucher exceeds the value of the voucher. GST is payable when the voucher is redeemed for goods or services.

For non-monetary vouchers, if the non-monetary voucher is issued for consideration, GST is applicable at the time of the supply. However, if the issuance of voucher is for no consideration, there is a distinction between whether the voucher relates to goods or services. If the voucher relates to services, GST is only applicable when the voucher is redeemed. If the voucher relates to goods, then the Malaysian gift rules apply – only if the value of the goods to which the voucher relates is more than RM500 is the issuance of the voucher subject to GST.[305]

The IMF Model Law was followed by the Malaysian law. The wording of the principal provision governing the treatment of vouchers is the same.[306]However, this does not apply to prepaid phone cards.

If the issuance of a voucher results in a taxable supply, the supply takes place when the voucher is issued.[307] The valuation of the taxable supply is in this case equal to the amount by which the consideration exceeds the monetary value of the voucher.[308] Where a voucher is issued without consideration, the supplier of goods or services is required to include the value of voucher in the value of goods and services supplied when the voucher is redeemed.[309]

In Ireland, the sale of vouchers or telephone cards, and similar items (other than vouchers or telephone cards sold to and by taxable persons with a view to their re-sale) is not liable to tax except where, and to the extent that, the consideration paid exceeds the redeemable value.[310]

Where a taxable person supplies a coupon, stamp, telephone card, token, or voucher, which has a redeemable value, to a taxable person with a view to resale, and the supplier promises to

302 Singapore GST Regulations, Regulation 93F.
303 Malaysian GST Law, Third Schedule. §3
304 Malaysia, GST Tax Guide on Retailing, at 25.
305 Malaysia, GST Tax Guide on Retailing, at 28.
306 IMF Model Law, §4(19).
307 IMF Model Law, § 10(11).
308 IMF Model Law, § 13(10).
309 IMF Model Law, § 13(11).
310 Irish VAT Act, § 43.

subsequently accept that coupon, stamp, telephone card, token or voucher at its redeemable value in full or part payment of the price of goods or services, the supply is treated as a taxable sale. When such coupon, stamp, telephone card, token or voucher is used in payment or part payment of the price of goods or services, its redeemable value is disregarded for tax calculation purposes.[311]As such, where vouchers are issued through a multi-stage supply chain, vouchers are taxed on issuance.

Finally, where a supplier sells a voucher to a buyer at a discount and promises to subsequently accept that voucher at its face value in full or part payment of the price of goods purchased by a customer who was not the buyer of the voucher, and who does not normally know the actual price at which the voucher was sold by the supplier, the consideration represented by the voucher shall, subject to regulations (if any), be the sum actually received by the supplier on the sale of the voucher.

The GST treatment of vouchers is a complex area. It is therefore necessary for the GST law to provide simple and clear rules regarding vouchers in order to avoid any double or non-taxation of the transaction. The comparable jurisdictions take various approaches towards vouchers and, as such, a leading practice cannot be readily determined.

New Zealand's approach departs largely from the approach of the other jurisdictions as vouchers are subject to GST upon issue. This approach can be impractical and therefore New Zealand includes an exception to this rule such as situations when the issuer of the voucher is not the supplier of the goods or services.

All other jurisdictions identify (at least to a certain extent) that the moment of redemption should be the time of supply. This approach should be preferred as it avoids the impracticalities of the New Zealand approach. Singapore and Malaysia consider the type of voucher (i.e., MRV or non-MRV and Monetary or non-Monetary) to determine the tax treatment. While this approach takes into consideration various business models, it adds complexity to the GST law, which should be avoided when introducing a new type of tax. The IMF and, to a lesser degree, the Irish approach constitute a simpler approach with regards to vouchers: (1) vouchers are subject to GST at the moment of redemption regardless of their nature; and (2) only to the extent that the consideration received exceeds the monetary value of the voucher GST is applicable at the moment of sale on the differential amount. This approach first avoids any discussion regarding the specific type of voucher and any issues regarding whether the issuer of the voucher is also the supplier of goods and services. It also covers situations in which the issuer of a voucher receives consideration for the issuance of the voucher.

1.A.7 Gambling

Overview of concept

Gambling constitutes a specific challenge for the design of a GST law as it is necessary to determine if there is a supply in the first instance and, if there is a supply, when the supply

[311] Irish VAT Act, § 43.

takes places for GST purposes and on what value the GST should be levied. Due to these complexities, historically, gambling fell into the exempt supplies category. However, many of the more modern GST regimes have developed mechanisms to effectively bring gambling within the scope of GST.

Leading Practice

The GST law should include a provision regarding the GST treatment of gambling activities, which should include the following:

- The placing of any amount by a person with another person for betting, sweepstakes, lotteries, gaming machines, or games of chance should be a supply of services by the person operating the betting, sweepstakes, lotteries, gaming machines, or games of chance.
- The time of the supply should be determined as follows:
    - Casino gambling: when the casino count takes place;
    - Slot machines: when the money is removed from the machine;
    - Horse racing and other sports betting: when the bet is received;
    - Prize draws and lotteries: when the draw takes place.
- The value of the supply should be:
    - the amount paid for participating in the betting, sweepstakes, lotteries, gaming machines, or games of chance less.
    - any amount of money payable to any person participating successfully in the betting, sweepstakes, lotteries, gaming machines, or games of chance;
- Any negative value shall be treated as nil for the purpose of the current taxable period and be allowed to be carried forward to a subsequent taxable period.

Discussion

In New Zealand, payments in relation to the following are treated as payments for a supply of services by the person organizing the gambling or betting: racing or sports betting, participation in gambling or prize competitions, and casino gambling.[312]

Where there is a deemed supply by a racing board, the time of supply is deemed to occur when and to the extent that any amount of money is dealt with by the board.[313] For gambling or prize competitions, other than casino gambling, the time of supply occurs when the draw is made.[314] However, this rule does not apply to an instant game played by way of a machine (i.e., slot machines). In that case, the time of supply is deemed to occur when the coin or token is taken from the machine by the supplier.[315] For casino gambling, the time of supply occurs at the time of the "casino count."[316]

The value of the supply of services for racing betting or sports betting is the amount received by the New Zealand Racing Board plus the return of bets laid off by the New Zealand Racing Board less the sum of refunds and winning dividends.[317] The value of the supply of services for equalizer

[312] New Zealand GST Act, § 5(8) to (11C).
[313] New Zealand GST Act, § 9(2)(d).
[314] New Zealand GST Act, § 9(2)(e).
[315] New Zealand GST Act, § 9(2)(f).
[316] New Zealand GST Act, § 9(2)(g).
[317] New Zealand GST Act, § 10(12).

betting is the amount received by a racing club. For gambling and prize competitions, other than casino gambling, the value of the supply is the total consideration paid in money by a recipient to participate in gambling to a supplier less the total amount of prizes paid in money by the supplier.[318] If the gambling is in a casino venue, then the value is the amount of money paid to the casino for a chip, as commission, or to otherwise participate in gambling less any amount paid out by the casino as winnings.[319]

Singapore includes a separate section for betting, sweepstakes, lotteries and gaming under the Special Cases part of the legislation. This section states that the Minister may, by regulations, make provisions modifying the GST rules for transactions involving betting, sweepstakes, lotteries, fruit machines or gaming.[320]

Part XIII of the Singapore GST regulations addresses betting and gaming. The Singapore GST regulations state that where any person pays an amount in money to participate in any transaction involving betting, sweepstakes, lotteries, fruit machines or games of chance, the amount of money so paid shall be treated as consideration for a supply of services to him.[321]

For any gambling supply made outside of a casino, the tax base is equal to the amount paid for participating in the gambling transaction less any amount of money payable to any person participating successfully in the gambling.[322]

In respect of casinos, a casino operator shall be treated as having made a taxable supply of services when a person pays an amount in money to a casino operator as a bet received and accepted by the casino operator as a wager on any game where the casino operator is a party to a wager; or to participate in any game where the casino operator is not a party to a wager but the game is conducted by on the premises of the casino operator.[323]

Casino supplies are deemed to be made at the end of the prescribed taxable period in respect of which the net win from that supply is included in determining the gross gaming revenue of the casino operator.[324]

The tax base is calculated based on the same principles as for gambling supplies made outside of a casino. In addition, the regulation provides special rules for complementary chips or coupons given by the casino operator and bad debts resulting from gambling supplies. Further, any casino loss maybe carried forward and offset against the supplies made in a subsequent period (i.e., where amounts paid out exceed amounts received).[325]

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[318] New Zealand GST Act, § 10(14).
[319] New Zealand GST Act, § 10(15A).
[320] Singapore GST Act, § 35.
[321] Singapore GST Regulations, regulation 91.
[322] Singapore GST Regulations, regulation 91-91B.
[323] Singapore GST Regulations, regulation 92C.
[324] Singapore GST Regulations, regulation 92C.
[325] Singapore GST Regulations, regulation 92E.

Finally, the GST Act provides that any betting, sweepstake, and lottery duties must be included in the value of the gambling supply.[326]

Malaysia adopts a similar position as New Zealand and Singapore in determining the value of the betting and gaming supplies. According to the Third Schedule of the GST Act, the value of taxable supplies of services made by a person licensed under any written law involving betting sweepstakes, lotteries, gaming machines or games of chance must be the amount received by the supplier less any winnings paid out to the betting participants.

The GST Regulations provide further details on the time of supply of gambling and similar activities:[327]

- Where there is a supply of services involving number forecasting, lottery and a game of chance, the time of supply is at the time when the numbers are drawn.
- Where there is a supply of services involving sweepstakes, the time of supply is at the time when the race is taking place.
- Where there is a supply of services by gaming machine, the time of supply is at the time when collection is removed from the machine, or at the time when transaction is recorded by the machine; or
- Where there is a supply of services involving casino betting, the time of supply is on the last day of the taxable period in which the supply takes place.

Under the IMF Model Law, the placing of a bet by a person with another person operating a game of chance is a deemed to be a supply of services by the person operating the game of chance.[328] The time of supply for games of chance is subject to the general rules; i.e., earliest of performance of service, date of invoice, or payment.[329] However, if the supply for consideration in money is received by the supplier by means of a machine, meter, or other device operated by coin, note, or token, the time of supply occurs when the coin, note, or token is taken from the machine, meter, or other device by or on behalf of the supplier.[330] The value of a supply of games of chance is the amount received in respect of the bet, reduced by an amount equal to the tax fraction multiplied by the amount received in respect of the bet.[331] Unlike the other jurisdictions discussed above with value the supply as being net of any payments made to winning gamblers or participants, the IMF Model Law allows a specific input tax deduction for payments as a prize or winnings.[332]

Ireland departs from the approach followed by all the other comparable jurisdictions and exempts gambling and lotteries.[333]

Based on the comparable jurisdictions, leading practice is to tax gambling transactions. Therefore, the Irish approach should be excluded. Specific valuation rules and time of supply rules should

[326] Singapore GST Act, Third Schedule.
[327] Malaysia GST Regulations, Regulation 13.
[328] IMF Model Law, §4(9).
[329] IMF Model Law, §10(1).
[330] IMF Model Law, §10(7).
[331] IMF Model Law, §13(15).
[332] IMF Model Law, § 27(d).

[333] Irish VAT Act, Schedule 1.

be adopted to reduce the compliance burden associated with calculating GST on a per supply basis.

1.A.8 Non-resident GST refunds

Overview of concept

There may be situations where non-resident taxable persons who are not GST registered, nor are required to be GST registered, in a jurisdiction incur GST in that jurisdiction. Such GST costs can arise in a number of ways, including:

- Employees traveling to that jurisdiction and incurring GST on hotel, rental cars and other travel expenses;
- The non-resident imports goods into the jurisdiction and incurs import GST;
- The non-resident is charged GST by a resident supplier (e.g., services related to land in Puerto Rico).

Countries adopt various approaches to address such GST incurred by foreign entities, including:

- Providing simplified refund procedures to allow these entities to recover any GST incurred where that non-resident taxable person would have been entitled to recover the GST if it was operating its business in that country (e.g., European Union);
- Allowing the non-resident to register for GST and file returns to recover the GST incurred where that non-resident taxable person would have been entitled to recover the GST if it was operating its business in that country (e.g., Australia and New Zealand);
- Not permitting the recovery of the GST incurred unless the non-resident taxable person is making supplies subject to GST in that country (e.g., Singapore).

The general rationale for allowing non-resident businesses to recover GST incurred on costs is that GST should not be a cost to business; it is a tax on final consumption.

Many jurisdictions that allow GST refunds to non-resident businesses often place certain limitations on those refunds. For example, refunds may not be permitted unless the business's country of residence also provides refunds to non-resident business or refunds may not be permitted in respect of goods or services consumed in the country, such as food and accommodation.

Another situation giving rise to non-residents incurring GST is that of purchases made by tourists.

Many jurisdictions allow tourists to recover GST incurred on purchases made in the jurisdiction provided the purchases are removed from the country when the tourist leaves the country. The rationale behind such an approach is that GST should only apply to goods or services consumed in the GST jurisdiction. If a tourist purchases a souvenir to take back to their home country, consumption of that good arguably occurs in the tourist's home country.

Leading Practice

The GST law should include a provision regarding non-resident GST Refunds, which should include the following:

- Non-resident taxable persons, which are not registered under the general registration rules, that incur GST in Puerto Rico on purchases of goods and services for their taxable activity abroad may be permitted to register for GST and claim a refund of input GST under the following conditions:
    - Registration:
        - The non-resident is registered for a consumption tax similar to Puerto Rico's GST or carries out an activity that would cause the non-resident to be registered for GST if the activity was carried out in Puerto Rico;
        - The non-resident does not carry on or intend to carry on a taxable activity in Puerto Rico;
        - The non-resident does not sell goods or services that it can reasonably foresee will be received by an unregistered person in Puerto Rico.
    - Refund of input GST:
        - A non-resident registered for GST under the above conditions should be required to file a GST return on a calendar quarter basis;
        - Any amount of input GST that during a calendar quarter does not exceed a certain dollar value threshold should be carried forward to the next calendar quarter;
        - Any amount of GST during a calendar quarter that exceeds a certain dollar value threshold should be refunded to the non-resident within a prescribed number of days following the day the GST return was filed.

The GST law should also provide a refund of GST for tourists visiting Puerto Rico who purchase goods in Puerto Rico during their stay which they subsequently take back to their home countries.

Discussion

Refunds for non-resident businesses

In New Zealand, a non-resident can voluntarily register for GST even where the non-resident does not make taxable supplies in New Zealand.[334] A non-resident may only register if the following conditions are met:

- The non-resident is likely to claim an input tax deduction of more than NZD 500 in the first taxable period after registration;
- The non-resident is registered for a consumption tax in its country or carries out an activity that would cause him to be GST registered if the activity was carried out in New Zealand;
- The non-resident does not carry on or intend to carry on a taxable activity in New Zealand;
- The non-resident does not perform services that it can reasonably foresee will be received by an unregistered person in New Zealand; and
- The non-resident is not and does not intend to become a member of a group of companies that carries on a taxable activity in New Zealand.

GST is refunded within 90 working days of receiving the registered person's return.[335]

[334] New Zealand GST Act, § 54B.

[335] New Zealand GST Act, § 46.

In order to facilitate the claiming of a refund under the law, special rules are included in the section addressing the calculation of tax payable to allow the non-resident to claim GST that has been incurred despite the fact this it is not making supplies subject to New Zealand GST.[336]

Malaysia, Singapore and the IMF do not have general non-resident refund rules. Singapore has a limited refund rule for GST incurred on the importation of goods, subject to certain conditions.[337]

Ireland has a simplified regime for non-resident business to claim VAT incurred in Ireland. This regime does not involve the non-resident registering for VAT but allows the non-resident to file a refund claim by supplying certain required supporting documentation.[338] The VAT incurred must relate to the business carried on by the non-resident and the non-resident must not be making supplies of goods or services in Ireland.

In order to promote fairness and neutrality of the tax, the GST law should allow non-residents to recover input GST where is it incurred for the purposes of its business activity, if that activity would be taxable if carried on in Puerto Rico. For Puerto Rico, the New Zealand approach of requiring the non-resident to register for GST is preferable over the simplified approach of Ireland, in order to reduce the opportunity for fraud.

Tourist refunds

All comparable jurisdictions, except New Zealand, allow to a certain extent a refund of GST paid by tourists on purchases of goods made in the jurisdiction during their stay, which they bring back to their jurisdictions.

In order to maintain Puerto Rico's competitiveness in the tourism sector, GST refunds for goods purchased by tourists that are removed from Puerto Rico upon the tourist's departure should be provided.

1.B General Provisions

1.B.1 Document retention

Overview of concept

In order to facilitate the efficient assessment and enforcement of the tax by the tax authorities, the GST law should prescribe document retention rules. The provision should describe what type of documents should be retained, for how long, where and in what format (e.g., electronic or hard copy). Special rules should be included in the GST law as documents supporting GST positions taken can differ from those documents used for income tax assessment purposes. For example, there may be certain GST specific regimes, or transactions with a greater GST risk that require specific types of documents to be maintained (e.g., import documentation, documentation relating to transfers of going concerns, GST invoices and adjustment notes).

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[336] New Zealand GST Act, § 20.
[337] Singapore GST Act,§ 33A.
[338] Irish VAT Act, § 102.

Consideration should be given to the compliance burden and associated costs placed on taxable persons with regard to record storage and this should be balanced against the tax risk, as well as the statute of limitations relating to tax reassessments.

The rules should also address tax authority access to the records.

Leading Practice

The document retention rules should be drafted to include the following:

- All taxable persons must maintain the following records:
    - All original invoices, credit notes, and debit notes received;
    - Copies of all invoices, credit notes, and debit notes issued;
    - Customs documentation relating to the import and exports; and
    - Business and accounting records (e.g., contracts, sales and purchase registers. Books, bank statements).
- The records must be retained for a certain defined period of years from the end of the taxable period to which they relate. The number of years should be consistent with other tax and accounting rules in Puerto Rico.
- Records may be kept in a foreign jurisdiction upon tax authority approval or subject to certain guidelines such as accessibility.
- Records may be kept in electronic format provided that there are controls to guarantee the authenticity of the origin of the documents and maintain the integrity of the content of the document.
- The taxable person must be able to produce any requested records to the tax authority within a reasonable timeframe.

Discussion

Under the New Zealand GST Act, a GST registered person must keep records that are sufficient to enable ready ascertainment by the tax authority of that person's liability to tax for a period of at least seven years after the end of the taxable period to which they relate.[339]

The law provides a non-exclusive list of records that should be kept, including books of account recording receipts or payment or income or expenditure, vouchers, bank statements, invoices, tax invoices, credit notes, debit notes, receipts, and such other documents necessary to verify the entries in the books of account.[340]

Those records should contain at least (1) a record of all goods and services supplied by or to that registered person allowing the Commissioner to identify the goods and services, and the suppliers or the their agents; (2) the charts and codes of account, the accounting instruction manuals, and the system and program documentation; and (3) any special list required to be prepared under the GST Act.

The New Zealand GST Act also includes special record keeping rules in relation to certain supplies of land, and powers for the Commissioner to extend the record keeping period for an additional three years if the taxpayer is under audit or will likely be under audit.

[339] New Zealand GST Act, § 75(3).
[340] New Zealand GST Act, § 75(1).

The records must be maintained in New Zealand unless the registered person has been authorized by the Commissioner to keep the records outside of New Zealand.[341]

In Singapore, every taxable person is required to keep the following records for a period of five years from the end of the prescribed accounting period to which the record relates: (1) business and accounting records; (2) copies of all tax invoices and receipts issued by the taxable person; (3) tax invoices received by the taxable person; (4) documentation relating to importations and exportations by the taxable person; and (5) all credit notes, debit notes or other documents which evidence an increase or decrease in consideration that are received, and copies of all such documents issued by the taxable person.[342] The records can be kept in electronic format.

The Comptroller has the power to prescribe additional record keeping requirements by regulation.

In Malaysia, every taxable person is required to keep full and true records of all transactions which may affect his liability to tax including (1) all records of goods and services supplied by or to that taxable person including tax invoices, invoices, receipts, debit notes, credit notes, and export declaration forms; (2) all records of importation of goods; and (3) all other records required by the tax authority.[343] The records must be kept in Malaysia, unless record storage outside of Malaysia has been approved, and must be kept for a period of seven years.[344] The records can be kept in electronic format provided that the original document was an electronic document.[345]

Under the IMF Model Law, every taxable person is required to maintain in the jurisdiction (1) original tax invoices, tax credit notes, and tax debit notes received by the person; (2) a copy of all tax invoices, tax credit notes, and tax debit notes issued by the person; (3) customs documentation relating to imports and exports by the person; (4) accounting records relating to taxable activities carried on in the jurisdiction; and (5) any other records prescribed by regulations.[346] Records must be retained for six years after the end of the taxable period to which they relate.[347] The law defines records as meaning accounting records, accounts, books, computer-stored information, or any other document.[348]

The Irish VAT Act provides that every taxable person must, in accordance with regulations, keep full and true records of all transactions which affect or may affect his liability to tax and entitlement to deductibility for a period of six years from the date of the last transaction to which they refer.[349]

The basic records to be maintained by businesses (large and small) are essentially the same and, in brief, include invoices, credit notes, debit notes, receipts, books, bank statements or other

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[341] New Zealand GST Act, § 75(3BA)(b).
[342] Singapore GST Act, § 46(1).
[343] Malaysia GST Act, § 36(1).
[344] Malaysia GST Act, § 36(2).
[345] Malaysia GST Act, § 36(3).
[346] IMF Model Law, § 61(1).
[347] IMF Model Law, § 61(2).
[348] IMF Model Law, § 60.
[349] Irish VAT Act, § 84(1).

documentation that relates to the supply of goods or services, importation or intra-community acquisition of goods.

The Irish VAT Act is much more prescriptive than the other jurisdictions and also includes specific record keeping rules for certain types of transactions that have a special treatment under the Irish VAT Act.[350]

All comparable jurisdictions include a specific provision detailing the recordkeeping requirements for GST purposes. The common theme of these rules is that all records that enable the tax authority to validate the tax position taken by the taxable person must be kept for a certain period, varying between five and seven years.

Based on the comparable jurisdictions, it is leading practice to include specific record keeping rules in the GST law which will facilitate the inclusion of GST specific record keeping rules relating to GST specific regimes, where required. Taxable persons should be required to keep all invoices, credit and debit notes relating to input and output transactions. In addition, taxable persons should also keep customs documentation relating to import and export transactions performed. Finally, taxable persons should be required to maintain accounting records.

The length of time records should be maintained should be in line with other tax and accounting rules in Puerto Rico.

In order to minimize compliance costs, taxable persons should be permitted to maintain records electronically and in a foreign jurisdiction, subject to the tax authority's approval or guidelines.

1.B.2 Currency

Overview of concept

Transactions with non-resident businesses may occur in foreign currencies. Exchange rate variations may thus create valuation distortions between the value of the supply at the time of supply and when the supply is reported.

Further, where domestic transactions between businesses are conducted in a foreign currency, if the supplier uses a different exchange rate to that of the purchaser, there can be a variance between the output tax reported by the supplier and the input tax claimed by the purchaser, potentially resulting in a cost to the government.

GST laws thus generally include a provision dealing with foreign currency transactions.

Leading Practice

[350] Irish VAT Regulations, regulation 27.

The currency rule should be drafted as a separate provision and include the following:

- All amounts under the GST law should be expressed in US dollars with the exchange rate applicable at the time of supply used for currency conversion.
- A power for the tax authority to determine other currency conversion methods that may ease the administrative burden of the taxable person.

Discussion

In New Zealand, for transactions under the NZ GST Act, all amounts of money must be expressed in New Zealand dollars.[351] As such, GST invoices are required to be issued in New Zealand dollars, thus ensuring that the output tax reported by the supplier is the same as the input tax claimed by the purchaser. The exchange rate should be the prevailing rate at the time of supply.

In Singapore, where a value is expressed in a currency other than Singapore dollars, it must be converted into Singapore dollars at the prevailing selling rate at the time of supply.[352] The Comptroller can also publish rates of exchange that may be used or determine other accepted methods for currency conversion. The use of alternative methods is generally subject to Comptroller approval.

Malaysia adopts a similar approach to Singapore.[353] The use of the following exchange rates corresponding to the time of supply is acceptable:

- In the case of domestic transactions, the use of daily exchange rates (buying, selling or average of the two) of any bank operating in Malaysia.
- In the case of the importation of goods, conversion of foreign currency should be at the exchange rates published by Customs which are updated every week.[354]

Under the IMF Model Law, all amounts of money are to be expressed in the local currency.[355] If an amount is expressed in a foreign currency, the amounts must be converted at the exchange rate determined in the customs act for imports and at the exchange rate applying at the time the amount is taken into account under the Act – effectively the time of supply.[356]

Ireland requires that the amount of VAT included on a tax invoice must be expressed in Euros.[357] Where a currency other than Euro is used, it must be converted into Euro. The exchange rate to be used must be:[358]

- The latest selling rate recorded by the Central Bank of Ireland or the European Central Bank for the currency in question at the time the tax becomes due, if no agreement has been reached with the Revenue as to the basis for determining the exchange rate;
- If there is an agreement with the Revenue for a method to be used in determining the exchange rate, the exchange rate under that method.

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[351] New Zealand GST Act, § 77.
[352] Singapore GST Act, Schedule 3, §11(1)
[353] Malaysia GST Act, Third Schedule – Value of Supply of Goods or Services.
[354] Malaysia GST Guide, Tax Invoice and Record Keeping (DRAFT), at 24.
[355] IMF Model Law, § 83(1).
[356] IMF Model Law, § 83(2).
[357] Irish VAT Regulations, regulation 10.
[358] Irish VAT Act, § 37(4).

All comparable jurisdictions include a specific provision in respect of currency conversion in order to provide certainty in respect of how foreign currencies are to be converted and to ensure there are no mismatches between what output tax is paid by a supplier and what input tax is claimed by a purchaser. Given the compliance burden associated with monitoring foreign exchange rates, some jurisdictions allow the use of methods other than daily exchange rates (e.g., mid-month or month end rates, rates to be renewed every three months). These concessions are usually provided as an administrative relief and not included under the law, other than providing the tax authority with the power to prescribe other methods.

The location of the currency provision within the law also varies with some jurisdictions including the provision with the valuation sections (Singapore, Malaysia and Ireland) and others having a separate currency provision (New Zealand and the IMF).

Leading practice would be to include a currency provision to avoid the issues discussed above. For simplicity it should be included as a separate provision, similar to the IMF and New Zealand law. All amounts under the GST law should be expressed in US dollars with the exchange rate applicable at the time of supply used for currency conversion. The section should also include a power for the tax authority to determine other currency conversion methods that may ease the administrative burden of the taxable person.

1.B.3 Language

Overview of concept

In order to facilitate the administration of the tax, GST laws generally provide that records must be maintained in the local language. Some jurisdictions allow records to be maintained in another language provided that a translation can be made readily available upon the request of the tax authority. Such a provision is especially important for non-resident taxable persons that may not use the language commonly spoken in the GST jurisdiction in their day to day accounting system.

Leading Practice

The language provision should be drafted to include the following:

- Records should be maintained in Spanish or English.
- Taxable persons may apply to the tax authority for permission to maintain records in a language other than Spanish or English.

Discussion

In New Zealand, the Tax Administration Act requires that records to be kept in English. However, the tax authority may approve records to be kept in a foreign language upon request.[359]

Singapore and Ireland do not include any specific requirement regarding language in their legislation.

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[359] NZ GST Act, § 75(3BA)

In Malaysia, all records regarding the supply of goods and services must be kept in Bahasa Malaysia or in the English language.[360]

The IMF Model Law states that where records are not kept in the national language, the Commissioner may require the person keeping the record to provide, at that person's expense, a translation into the national language by a translator approved by the Commissioner.[361]

The Malaysian approach to require recordkeeping in a specific language should not be followed as it may be impractical for non-residents, especially those only registered for GST refund purposes. The IMF and New Zealand provide the leading practice in respect of language requirements, with the IMF being less stringent than New Zealand by not requiring the taxable person to obtain prior approval to keep the records in another language but by requiring a translation of the documents upon the tax authority's request.

In order to provide some control over the languages that are acceptable for record keeping, the law should require the records be maintained in Spanish or English language. Should a taxable person wish to maintain records in another language, the taxable person should apply to the tax authority for such permission. Approval of such applications should be dependent upon the language and whether the tax authority is satisfied that translated documents could be provided by the taxable person in a timely manner.

1.B.4 Additional issues to consider

Enactment of the tax and supplies spanning rate and rule changes

The enactment of the tax and supplies spanning rate or rule changes may affect agreements or contracts that span the enactment, rate, or rule change. GST laws may change over time to adapt to the revenue needs of the government or to address social issues. The changes generally involve rate increases or decrease, or changes in the treatment of particular types of supplies (e.g., change the treatment from taxable to exempt or vice versa). Therefore, GST laws generally provide for specific rules dealing with the transition period between old and new rules.

Secondhand goods

Taxable persons selling secondhand goods are required to charge GST their sales like any other taxable person. However, where they acquire those secondhand goods from non-registered persons, GST is likely to be imbedded in the cost of that acquisition as a result of the GST that was paid by the non-registered person on the initial acquisition of the good. In order to prevent GST being levied twice on the same good, jurisdictions adopt different approaches. One approach is to apply a margin scheme for such dealers in secondhand goods so that only the margin is subject to GST. Another approach is to allow a notional input tax credit on the acquisition of the second hand goods from non-registered persons. The GST law should include rules governing sales and purchases of second hand goods.

[360] Malaysia GST Act, § 36(2)(b).
[361] IMF Model Law, § 63.

Domestic Reverse Charge

Some countries apply the reverse charge mechanism on certain limited domestic transactions either to avoid additional administrative burden on taxable persons (e.g., cash flow burden arising from high value domestic transactions) or to combat tax fraud and evasion (e.g., in industries where refund fraud is more likely). Introducing a domestic reverse charge results in the recipient of the supply accounting for both the input and output tax on the transaction, therefore eliminating any cash flow burden arising from the transaction for the parties involved and any risk of a fraudulent refund payment being made by the tax authority. Consideration should be given as to whether any industries in Puerto Rico would warrant such treatment.

Agents for non-resident principals

Many jurisdictions have specific rules around agents being liable for the GST payment and compliance obligations of non-resident principals. Some jurisdictions require the appointment of a fiscal representative at the time of the registration of the non-resident, while others include a deeming provision within the law which states that an agent carrying on an activity for and on behalf of a non-resident is liable for the non-resident's GST obligations. Consideration should be given as to whether Puerto Rico should adopt a similar approach.

Electronically supplied services by non-residents

"Electronically supplied services" (ESS) are generally services that are:

- Delivered over the Internet or an electronic network (in other words reliant on the Internet or similar network for its provision);
- Heavily dependent on information technology for their supply (in other words the service is essentially automated, involving minimal human intervention and in the absence of information technology does not have viability).

Examples of ESS include digital books, downloaded music and videos, webhosting, online storage, software, apps, etc.

Most GST jurisdictions do not tax services supplied by an overseas supplier to an end customer over the internet if the supplier has no presence in that jurisdiction. However, there are special rules in the EU, Switzerland, Norway, Iceland, South Africa, and Ghana that require the providers of electronically supplied services to account for GST on sales to private consumers and non-taxable entities (e.g. public schools) in these territories (collectively B2C supplies), regardless of the absence of any local presence. B2B supplies are generally not subject to these special rules.

The rationale behind this approach is that it creates a level playing field for domestic suppliers of such services and non-resident suppliers given that the consumer can generally obtain such services from anywhere in the world with relative ease. Puerto Rico should consider the application of such a regime.

Appendix E: Goods and Services Tax Exemptions

Appendix E: GST Systems and Exemptions

A universally applicable broad based flat rate GST will be regressive. There are two ways to redress regressivity. The first, adopted by most modern regimes, is through transfer payments to select taxpayers to mitigate the impact of the tax on "necessities." The second, used principally by early adopters, is to provide exemptions or special rates for designated goods or services. Best practice indicates exemptions should be kept to a minimum to reduce the complexity of the administration of the tax.

This paper focuses on the issues associated with GST exemptions noted in our deliverable entitled "Analysis of Current Tax Structure and Optional Tax Strategies." It provides examples of some of the challenges faced by GST regimes that have chosen to use exemptions to address regressivity.

Overview

A single rate, broad based system is preferred because:

- It lowers cost of collection (administration costs for the government and compliance costs for businesses).There are no disputes over which rates should apply to which goods and services nor is there any incentive to fraudulently apply an incorrect rate. Further, accounting processes are simplified because only one rate is required to be tracked.
- A single rate avoids exemption creep and creating political vulnerability from businesses requesting to benefit from a lower rate.
- It eliminates the potential disruption of consumer choices that may arise where multiple rates may create an incentive to purchase lower rated goods and services.
- It minimizes the situations where suppliers will be making exempt supplies and therefore have an incentive to self-supply or vertically integrate because GST charged by third parties is not recoverable.
- It reduces the number of entities that will be making both taxable and exempt supplies requiring them to track and apportion the GST charged on business inputs to ensure only GST related to taxable supplies is recovered. This apportionment is difficult to achieve accurately and disputes can arise between the taxpayers and tax authority regarding the methods used to apportion input tax credits.

In 2007, Copenhagen Economics undertook a study on the application of reduced VAT rates in the European Union.[362]The study found empirical evidence indicating that compliance costs associated with lower VAT rates can be sizeable. It further found that differences in VAT rates between similar products may give rise to a substantial number of administrative and legal conflicts about the proper classification of specific goods.

[362] Copenhagen Economics, *Study on reduced VAT applied to goods and services in the Member States of the European Union*, 21 June 2007.

Collection costs are difficult to estimate and data is hard to come by. However, one clear implication of the evidence from developed economies is that the collection costs associated with GST are likely to be significantly affected by the design of the tax.[363] A broad based, single rate tax with a high registration threshold and few exemptions will have relatively low collection costs.

Evidence from New Zealand has shown that while precise administrative costs of GST may be difficult to ascertain, those costs are lowered if a broad based, low rate version of the tax is introduced. New Zealand's GST has had one major policy review since its enactment in 1986, which produced no recommended structural change. The Inland Revenue Department, responsible for most of the legislative work on GST, has the time of just 1½ professional policy staff dedicated to GST out of a total tax policy complement of 45. The key point is the New Zealand GST regime has been low cost from an administrative perspective. This is generally attributed to the twin policy pillars of comprehensive coverage and a single domestic rate.[364]

The study also observed that due to the substantial economic consequences of activities being classified with different VAT rates, businesses and tax authorities are constantly disputing borderline cases. In Sweden, such disputes constitute roughly 1/5 of all cases referred to their tax tribunal, and consuming, conservatively estimated, real resources in the public and private sector of almost US$100 million (Swedish Government, 2005).[365]

The Study also found that even very detailed guidance on the appropriate VAT rates to be applied on each potential food-like product will not prevent a large number of borderline cases being disputed between businesses and tax authorities because having different VAT treatments for goods and services can create considerable incentives for traders to obtain a lower rate for a specific good or service.[366]

Ultimately, the Study found that the income distributional effects of differentiated VAT rates are modest, particularly in countries with a relatively equal distribution of income, relative to the resulting compliance costs and distortions of consumer choice. For countries with less comprehensive transfer systems and more unequal distribution of incomes, the effects are larger. However, in both cases the Study argued that more targeted transfer systems and reduced compliance costs could be attained at lower costs to society.[367]

The Study stressed the need to consider alternatives to lower VAT rates to accomplish the desired policy goals. Targeted subsidies may have smaller mechanical revenue loss and a higher effectiveness.[368]

[363] Ebrill et al, *The Modern VAT*, International Monetary Fund, 2001.
[364] Ian Dickson and David White, *Tax Design Insights from the New Zealand Goods and Services Tax Model*, Working Paper Series, Work Paper No. 60, Victoria University of Wellington, Apr.2008, p. 7.
[365] Copenhagen Economics, *Study on reduced VAT applied to goods and services in the Member States of the European Union*, 21 June 2007 at p.53.
[366] Copenhagen Economics, *Study on reduced VAT applied to goods and services in the Member States of the European Union*, 21 June 2007 at p.71 and 78.
[367] Copenhagen Economics, *Study on reduced VAT applied to goods and services in the Member States of the European Union*, 21 June 2007 at p.84.
[368] Copenhagen Economics, *Study on reduced VAT applied to goods and services in the Member States of the European Union*, 21 June 2007 at p. 34.

Mechanical revenue loss arises where GST revenue foregone does not contribute to reaching the desired goal (e.g., GST exemption for food in order to improve the income distribution resulted in mechanical revenue loss because high income households will also benefit from lower GST).[369]

Exemptions and reduced rates can result in significant mechanical revenue loss. In New Zealand, the evidence available at the time suggested that while the bottom 20% of households allocated between 23% and 29% of their budgets to food, the top two deciles spent between 7% and 10% of their budgets on food. However, overall, upper income households spent twice as much as low-income households. Of every NZ$100 spent on food in New Zealand, the least well off spent NZ$6.50, whereas the most well off spent NZ$12. Taxing all food thus made revenue available to redistribute and supplement the income of the poor via other means.[370]

The OECD arrived at the same conclusions in its bi-annual analysis of consumption taxes.[371] The OECD observes that while most countries implement reduced rates and exemptions in order to alleviate the tax burden on low-income households, the benefits are greater for the better off resulting in tax expenditure producing a result that is unlikely to be in line with the original intention.

Given Puerto Rico's current administrative capabilities, a single rate, broad based system would be the best option.

Specific Country Experience - Food

Food exemptions create significant issues in determining whether particular food items fall within the exemption. Further, extensive tax authority guidance is required to help with this classification of food. Even with such guidance, there are often significant economic incentives for taxable persons to push the boundaries of those exemptions and dispute borderline cases.

Also, the exemption of certain food items results in foregone revenue that could be redistributed more effectively. Some of the issues faced by some jurisdictions that have chosen to exempt food are discussed below.

In the UK, basic food products for human consumption are zero rated and Her Majesty's Revenue and Customs ("HMRC") provides complex guidance detailing all the exceptions to zero-rating in the VAT law.

There are a number of exclusions from this treatment, including:

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[369] Copenhagen Economics, *Study on reduced VAT applied to goods and services in the Member States of the European Union*, 21 June 2007 at p. 6

[370] Ian Dickson and David White, *Tax Design Insights from the New Zealand Goods and Services Tax Model*, Working Paper Series, Work Paper No. 60, Victoria University of Wellington, Apr. 2008, p. 6.

[371] OECD, Consumption Tax Trends 2012: VAT/GST and Excise Rates, Trends and Administration Issues.

- Cold items taken away may be zero-rated in certain circumstances while certain hot food items taken away are standard rated.
- Confectionery is standard rated.
- A supply of food in the course of catering is standard rated.
- Certain beverages are standard rated.

With these exclusions come a number of classification and interpretation issues:

- *Hot vs. Cold takeaway food items*

  In the UK, cold items taken away may be zero-rated in certain circumstances while certain hot food items taken away are standard rated. Disputes have arisen in respect of why food items may be hot when taken away (i.e., are they specifically sold for consumption whilst hot or are they sold hot for another reason?).

  One dispute related to the sale of hot bagels which HMRC sought to tax at the standard VAT rate. However, the taxable person successfully argued that the reason why the bagels were hot when taken away was that they needed to be toasted to create a crunchy interior rather than for consumption whilst hot.[372]

  Another dispute related to heated ciabatta. HMRC argued that the purpose of heating the ciabatta was for the customer to consume the food hot and therefore it should be standard rated. However, the UK VAT Tribunal agreed with the taxable person's argument that the ciabatta was heated to maintain optimum freshness and to create appealing aroma in the shop. The taxable person further argued that it had no interest in, nor control over, the temperature at which the customer chose to consume the product.

- *Confectionery vs. Basic Foodstuffs*

  In the UK, confectionary is standard rated while basic foodstuffs are zero-rated. There have been many disputes of the classification of confectionary resulting in a number of complex tests developed by the courts.

  The courts have found that confectionery is generally held as being any food normally eaten with the fingers and made by a cooking process (other than baking) which contains a substantial amount of sugar or sweetening agent.[373] Further, the courts consider the view of the purchaser, appearance, size, ingredients, manufacturing process, taste, texture, packaging and marketing are relevant.[374]

  These types of tests can obviously be very subjective, giving rise to further disputes as to classification of certain food products.

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[372] *The Great American Bagel Factory Ltd* (VTD 17018) (TVC 29.58).
[373] *Popcorn House Ltd* [1968] 4 All ER 782.
[374] *C & E Commrs v Ferrero UK Ltd*, CA [1997] STC 881 (TVC 29.136).

- *Catering*

  The treatment of the supply of food in the course of catering has also been the subject of many disputes.

  A supply of food and drink in the course of catering is standard rated. Catering is characterized as a supply involving a significant element of service or the supply of food is for 'on premises' consumption.

  Many of the disputes have centered around what should be considered a "significant element of service."

  Disputes have also arisen in respect of whether the food is supplied for "on premises" consumption. HMRC considers premises to be the areas controlled by the retailer or areas that have been specifically provided for the customer to consume the food purchased. Similar disputes have arisen in other countries, for example, where seats were provided by the European equivalent of a food truck vendor – does this constitute "on premises" consumption?

- *Drinks*

  The classification of beverages is particularly complex in the UK. Beverages are generally standard rated, with the following exceptions:

  - Tea, maté, herbal teas and similar products, and preparations and extracts thereof;
  - Cocoa, coffee and chicory and other roasted coffee substitutes, and preparations and extracts thereof; and
  - Milk and preparations and extracts thereof.

  Disputes have not only arisen in respect of whether a beverage falls within one of these exceptions but also whether a drink is a beverage or not.

  In respect of the former, the VAT tribunal found that as the drink contained over 50% milk extracts, the drink was able to be zero-rated, even though it did not appear to be a milk based drink.[375]

  In respect of the latter, complex tests have been developed through case law to determine whether a drink is a beverage.

  The court found in *Bioconcepts* that notwithstanding the Oxford English Dictionary definition of "beverage" meaning drink, it is not used in the sense of meaning all drinkable liquids. Its meaning in ordinary usage covers drinks that are commonly consumed. This concept of what is a commonly consumed beverage was characterized by the courts as:

  1. A liquid that is commonly consumed; and a liquid that is characteristically taken to;

[375] *Rivella (UK) Ltd* (VTD 16382) (TVC 29.175).

2. Increase bodily liquid levels;

3. To slake the thirst;

4. To fortify, or;

5. To give pleasure

These five points were adopted by HMRC as being the key factors in determining whether a product is a beverage. They were placed in HMRC guidance through Public Notice 701/14/02 Food (May 2002). Subsequent cases have cited the "Beverage Test" within the decision.

Each of these five points gives rise to its own complexities and interpretation. An example is in respect of increasing bodily fluids. In the case of Unilver Bestfoods UK Ltd the tribunal found that the high sugar content of "Vie Shots" had the effect of slowing the rate of absorption of the product. Vie Shots were therefore not considered suitable for quick hydration of body fluid levels.

Some of the tests are quite subjective, including the fortify and pleasure points. In respect of the fortify point, in the case of *Ocean Grown UK Ltd*, it was noted that to consider whether or not a beverage is fortifying, it is important to look at how the customer perceives the product and what the marketing literature says; it was felt that scientific research is irrelevant.

In Australia, basic food products are GST free. Australia has very comprehensive guidance on food, including an 88 page list of specific food items and their treatment. Further, they have a dedicated Food Classification Working Party to address GST and food issues.

Where a certain food item is not specifically listed, a taxable person needs to work through a complex flow chart to determine whether the food should be subject to GST. This flow-chart includes 12 steps, each giving rise to their own definitional issues.

Not only can disputes arise in respect of the classification of food, as noted in the UK examples, but they can also arise where exempted foods are sold with other products. Such a dispute arose in Australia in respect of a supplier of exempt food who included promotional items with the food, such as radios and alarm clocks. Even though the promotion items were marked as "free," the court held that the amount paid for the exempt food and the promotion item needed to be apportioned between the exempt food and the taxable promotional item.[376]

Where food classification disputes arise, complex analyses of the products are often required. Another Australian case considered whether a mini ciabatte was a cracker.[377] The judge went through the following analysis:

- the ingredients of Mini Ciabatte are substantially the same as those of a cracker;

[376] *Food Supplier and Commissioner of Taxation* [2007] AATA 1550.
[377] *Lansell House Pty Ltd v Commissioner or Taxation* [2010] FCA 329.

- the ratio of ingredients in Mini Ciabatte and crackers are substantially the same;
- the manufacturing processes are largely the same for Mini Ciabatte and crackers;
- both Mini Ciabatte and crackers can be produced using yeast and can include fermentation stages;
- the percentage of sugar as an ingredient of Mini Ciabatte is within the range specified for crackers;
- to the extent that the Italian origin of Mini Ciabatte is relevant, the evidence points towards the product being a cracker;
- Mini Ciabatte and crackers are put to the same use;
- Mini Ciabatte and crackers are displayed in supermarkets as comparable products;
- while the appellants market Mini Ciabatte as Italian flat bread, the supermarkets treat it and sell it either as a cracker or in the company of crackers and biscuits;
- the moisture content of dry flat bread such as Mini Ciabatte is quite low and similar to crackers;
- Mini Ciabatte has an elongated cell structure similar to that of a cracker;
- both Mini Ciabatte and crackers have a gluten network;
- the percentage of protein of Mini Ciabatte is within the range specified for crackers;
- Mini Ciabatte's appearance (size, weight, docking, saltiness and thinness) is like that of a cracker;
- Mini Ciabatte snaps or cracks like a cracker; and
- Mini Ciabatte's long shelf life points to it falling into the biscuit/cracker category.

The case was appealed. The taxable person emphasized in the appeal that the Mini Ciabatte was not a cracker on the basis that the water and yeast content of the mini ciabatte is outside the range of those for crackers.

In Ireland, basic food products are also generally zero-rated. However, certain items are specifically excluded from the zero rate (taxable at standard or reduced rate).

In 2007, Ireland had defined 2,500 subgroups of goods and services in order to implement a three-tier VAT system with standard (21.5 percent), reduced (13.5 percent) and zero rates. Food alone had 89 subgroups such that nuts are zero rated, while roasted nuts are standard rated, cold pizza is zero rated, and warm pizza is reduced rated in a take-away.[378]

Ireland, again, has similar classification issues as the UK. The Irish authorities have some interesting guidance on the classification of bakery products and food supplements.[379]

The supply of bakery products such as cakes, biscuits, bagels and croissants, being flour or egg based bakery products, is liable to VAT at the reduced rate of 13.5%. However, the supply of bread that meets a certain ingredient definition is liable to VAT at the zero rate. The ingredient definition of bread is very specific and although products, such as garlic bread, onion bread and fennel bread are marketed as bread, these products do not generally conform to the ingredient definition of bread and do not therefore qualify for the zero rate of VAT.

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[378] Copenhagen Economics, *Study on reduced VAT applied to goods and services in the Member States of the European Union*, 21 June 2007 at p. 12.
[379] Revenue eBrief No. 70/11.

In respect of food supplements, the zero rate applies to the following substances, whether they are marketed as food supplements or not, provided they are formulated to make good the potential shortfall from the nutrition required for a normal, healthy diet:

- Vitamins and minerals in solid form, such as capsules, tablets, pills or lozenges, intended for oral consumption without further preparation;
- Vitamins and minerals in liquid form intended for oral consumption without further preparation, but not including beverages such as high vitamin drinks; and
- Fish oils for oral consumption.

The following substances do not benefit from the zero rate, even if labeled and marketed as food supplements:

- Substances marketed specifically to improve sporting or physical performance, e.g., ergogenic aids;
- Substances marketed specifically for the purpose of bodily sculpture or weight reduction, e.g., slimming aids;
- Substances that, although consisting in whole or in part of ingredients regarded as food supplements, are marketed for use other than for human consumption, such as, liniments, ointments and rubs.
- Substances in the form of bars or sweets or any other form similar to confectionery;
- Beverages of any kind (including water), concentrates, crystals, essences, extracts, powders or other products for the preparation of beverages, unless they come within the scope of certain exceptions.

Specific Country Experience – Education

As with food, GST exemptions for education can give rise to disputes relating to the interpretations of the application of the exemptions resulting in significant administration costs for the government. Some of the issues faced by jurisdictions that have chosen to exempt education are described below.

In Australia, education is zero-rated (GST-Free in Australian terminology), along with associated field trips, course materials and certain boarding accommodation. Education includes:

a) a pre-school course; or
b) a primary course; or
c) a secondary course; or
d) a tertiary course; or
e) a special education course; or
f) an adult and community education course; or
g) an English language course for overseas students; or

h) a first aid or life-saving course; or
i) a professional or trade course; or
j) a tertiary residential college course.

The Australian Tax Office has issued a number of rulings to help taxpayers navigate the complexities around determining whether an education related service falls within the GST relief. Three of the rulings governing primary, secondary, tertiary and special education amount to 73 pages of examples of what is, and what is not, subject to GST.

For example, an amenities fee paid by students a university used for plant and equipment, buildings, lockers, childcare and parking facilities is not subject to GST while payments for using such facilities, such as parking, are subject to GST. However, at another college, students pay a $20 amenities fee but are given a photocopy card to the value of $20. This amenities' fee is subject to GST.

While Australia treats education as not subject to GST, the Australian Bureau of Statistics found that in 2009-10, while the wealthiest 20% of households spent 2.3% of their annual expenditure on primary and secondary school fees, the poorest 20% spent only 0.35%. This suggests that the taxation of education is not as regressive as one might think as wealthier households spend more of their income on education than poorer ones.

The European Union (EU) VAT Directive provides that member states shall exempt the provision of children's or young people's education, school or university education, vocational training or retraining, including the supply of services and of goods closely related thereto. Such goods and services need to be supplied by educational bodies governed by public law. In addition, tuition given privately by teachers and covering school or university education is also VAT exempt.

The provision has given rise to many disputes with regards the scope of the VAT exemption.

In Germany, for example, the tax authority considered that research activities performed by public sector higher education establishments fell into the provision of the VAT exemption for education. The Court of Justice of the European Union (ECJ) however held that only closely related activities to university education may fall under the VAT exemption. As making the research activity subject to VAT would not increase the cost of education, and because research activities performed by universities are not essential to the provision of university education, the ECJ held that research activities performed by universities are subject to VAT.[380]

Another dispute concerned what "school or university education" means. The ECJ held that the phrase is not limited only to education which leads to examinations for the purpose of obtaining qualifications or which provides training for the purpose of carrying out a professional or trade activity, but includes other activities which are taught in schools or universities in order to develop

[380] C-287/00, Commission v. Germany (Jun. 20, 2002).

pupils or students' knowledge and skills, provided that those activities are not purely recreational.[381]

In the UK, a private individual argued that the golf tuition he gave in his capacity as a director of a company must be exempt from VAT because the same tuition was exempt when he provided it as a partner in a partnership. The tribunal held that the VAT exemption is not applicable because the individual was not a body governed by public law or a body with similar objects having education as its aim.[382]

A golf club also argued that "green fees" should fall within the VAT exemption for education services. The issue is currently referred to the ECJ, which has to decide whether the VAT exemption requires that the scope of the exemption for services closely linked to sport education is restricted to membership fees. In such a case, "green fees," which merely constitute additional revenue for the club should not fall within the scope of the VAT exemption.[383]

Specific Country Experience – Healthcare

Healthcare exemptions face similar issues. Primarily in respect of what types of healthcare should be exempt and classification issues relating to whether a particular type of service falls within the exemption.

Defining the categories of exempt healthcare can be problematic. For example, should only services provided by registered health professionals (i.e., doctors and nurses) be exempt or should the exemption be extended to include all services intended to protect/maintain/restore the health of individuals. If the latter, should acupuncture be included but hypnotherapists, yoga and homeopathy be excluded?

In terms of medication, should only prescription drugs be exempt from GST or should certain "over the counter" drugs also be excluded? How should over the counter drugs be treated where they are prescribed by a doctor?

These types of issues create political pressure for exemption creep.

Even once a set of exempt categories has been determined, as with other exemptions, issues can arise in respect of whether a particular good or service falls within an exemption. For example, in Australia, "appropriate" dental treatment is not subject to GST. In order to help with interpreting the term "appropriate treatment", the Australian Tax Office has issued a ruling. An extract from this ruling is reproduced below to illustrate the complexity of such exemptions:[384]

> *"Appropriate treatment" also includes medical treatment of a preventative nature, for example, a periodic oral examination where there is no evidence of an ailment prior to attendance. However, this does not extend to the supply of services and*

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[381] C-473/08, Ingenieurburo Eurlitz (Jan. 28, 2010).
[382] MarcusWebb Golf Professional v. Her Majesty's Revenue and Customs, UK FTT 388.
[383] Bridport and West Dorset Golf club v. Commissioner of Her Majesty's Revenue and Customs, [2012] UKUT 272 (TCC).
[384] CR 2013/14 - Goods and services tax: goods and services supplied by dentists (20 February 2013).

goods in relation to customized mouth guards. Whilst a customized mouth guard is a device that may prevent or reduce damage sustained to the mouth and teeth in the event of an injury, it is not considered to be 'treatment' that is performed on a patient.

43. To be GST-free, the dental profession must accept that the service is necessary and acceptable treatment, taking into account the patient's individual circumstances.

44. Services provided in assessing a patient for insurance or litigation purposes, that is, medico-legal services, are not 'necessary for the appropriate treatment' of the patient and are not GST-free.

45. Services which are predominantly for the improvement of the appearance of the patient are also not 'necessary for the appropriate treatment' of the patient and therefore, are not GST-free.

46. Services that are intended to improve the health of the patient but which also comprise a 'cosmetic' component, for example, reconstruction of a badly damaged tooth, are 'necessary for the appropriate treatment' of the patient and are therefore, GST-free.

The EU VAT Directive provides that Member States should exempt the following services:

- hospital and medical care and closely related activities undertaken by bodies governed by public law or, under social conditions comparable with those applicable to bodies governed by public law, by hospitals, centers for medical treatment or diagnosis and other duly recognized establishments of a similar nature;
- the provision of medical care in the exercise of the medical and paramedical professions as defined by the Member State concerned;
- the provision of medical care in the exercise of the medical and paramedical professions as defined by the Member State concerned;
- the supply of human organs, blood and milk.

These provisions have been implemented in the 28 member states in various ways and resulted in abundant case law from both national courts as well as the ECJ.

The ECJ held that the VAT exemption applies to medical services consisting of:

- conducting medical examinations of individuals for employers or insurance companies,
- the taking of blood or other bodily samples to test for the presence of viruses, infections or other diseases on behalf of employers or insurers, or
- certification of medical fitness, for example, as to fitness to travel.

However, the VAT exemption does not apply to the following services:

- giving certificates as to a person's medical condition for purposes such as entitlement to a war pension,
- medical examinations conducted with a view to the preparation of an expert medical report regarding issues of liability and the quantification of damages for individuals contemplating personal injury litigation,
- the preparation of medical reports following examinations referred to in the previous indent and medical reports based on medical notes without conducting a medical examination,
- medical examinations conducted with a view to the preparation of expert medical reports regarding professional medical negligence for individuals contemplating litigation,
- The preparation of medical reports following examinations referred to in the previous incident and medical reports based on medical notes without conducting a medical examination.

In determining which services were subject to the VAT exemption and which should be taxable, the ECJ observed that only medical services effected for a purpose of protecting, including maintaining or restoring, human health should benefit from the exemption. The fact that other services whose aim is not to protect human health should be taxable does not increase the cost of healthcare.[385]

The ECJ also held that supplies of dental prostheses made by an intermediary who does not have the status of dentist or dental technician are not covered by the exemption.[386] However, the same supply would be exempt if performed by a dentist or dental technician.

A Danish taxpayer argued that the VAT exemption applies to the collection, transportation, analysis and storage of umbilical cord blood for possible future therapeutic use, when those services are supplied by a private stem cell bank which is officially authorized to handle stem cells from such blood. As stem cells are collected only to ensure that a particular resource will be available for medical treatment in the uncertain event that treatment becomes necessary but not, as such, to diagnose, treat or cure diseases or health disorders, the ECJ held that activities consisting in the dispatch of a kit for collecting blood from the umbilical cord of newborn children and in the testing and processing of that blood and, where appropriate, in the storage of stem cells are not VAT exempt.[387]

However, the ECJ held also that the removal of joint cartilage cells from biopsy cartilage material taken from a human being and their subsequent multiplication, with a view to reimplantation for

[385]C-307/01, D'Ambrumenil (Nov. 20, 2003).
[386]C-401/05, VDP Dental Laboratory (Dec. 14, 2006).
[387]C-86/09, Future Health Technologies (Jun 10, 2010).

therapeutic purposes, constitute the "provision of medical care," regardless of whether the cells obtained from the cell multiplication are intended for reimplantation in the donor or in another person.[388]

An Austrian court held that the services of practitioners of "mental suggestion" do not qualify for the exemption for medical care because practitioners of "mental suggestion" treat patients during individual therapeutic sessions by means of hypnosis and mental suggestion, and are not designated as paramedical professionals.[389]

According to a Swedish court, medical advice given by a certified nurse by telephone is not covered by the exemption for medical care because the nurse's advice is not based on physical examination of the patient and the nurse does not actually treat the patient.[390]

The Swedish tax authority considered that cosmetic and plastic surgery constituted medical care that is exempt from VAT and thus denied a taxpayer the input VAT recovery right on purchases made for this activity. The ECJ held that cosmetic and plastic surgery should be VAT exempt if those services are intended to diagnose, treat or cure diseases or health disorders or to protect, maintain or restore human health. The subjective understanding of the person who undergoes plastic surgery or a cosmetic treatment has of it is not in itself decisive in order to determine whether that intervention has a therapeutic purpose. It is also not sufficient that the surgery is performed by a qualified medical practitioner.[391]

A Dutch court observed that independent anesthesia assistants, who assist anesthesiologists during surgery in hospitals and clinics provide services that an essential part of the medical treatment of the patient. Therefore, the services provided by the independent anesthesia assistants should be VAT exempt.[392]

The UK tax authority considered that prescription glasses ordered through an online ordering procedure are subject to VAT as they constitute a distinct supply to the eye exam provided by a different optician or optometrist. The UK tribunal held that the supplies in question should be exempt because neutrality requires online suppliers be treated the same as brick and mortar suppliers of the same product.[393]

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[388]C-156/09, Verigen Transplantation Service International (Nov. 18, 2010).
[389]AT: Administrative Court (Verwaltungsgerichtshof), 29 July 2010, Case 2008/15/0291, Other Domestic Case Law IBFD.
[390]SE: Supreme Administrative Court (Högsta förvaltningsdomstolen), 9 Feb. 2011, Case 5772-10, Other Domestic Case Law IBFD.
[391]C-91/12, PFC Clinic (Mar. 21, 2013).
[392]NL: Court of Appeal (Gerechtshof) of Hertogenbosch, 4 Oct. 2013, Case 13/00538, Other Domestic Case Law IBFD.
[393]Prescription Eyewear v. HM Revenue and Customs, TC02759, [2013] UKFTT 357 (TC).

Act 20 & 22 Economic Impact Study

December 18, 2015

Estudios Técnicos Inc.

DEPARTMENT OF ECONOMIC DEVELOPMENT & COMMERCE

*The information provided is based on DDEC's CRM database of Act 22 Applications and Annual Reports. Data reflects all decrees approved as of 11/02/2015. It is important to note that database is self-reported and hence subject to inherent limitations in terms of potential human errors.

EXECUTIVE SUMMARY

During the past 25 years manufacturing employment in Puerto Rico has seen a consistent decline. During the same period, professional services employment increased almost continuously. This evidences Puerto Rico's transition to a service economy, even though manufacturing output, due to its high productivity gains, has remained the main contributor to Puerto Rico's GNP.

The economy's state calls for a wide ranging set of actions that will generate investment, stimulate productive activity and provide the basis for development of an advanced services sector with export potential. Both Law 20 and Law 22 address these needs by stimulating local production beyond domestic demand. In this respect, both incentive programs will contribute to a more robust service sector and thus, higher exports.

This report highlights Act 20 and Act 22 performance, particularly by providing a summary profile of current program beneficiaries along with detailed descriptions of their impact in the economy and potential impacts in a 10 year timeframe. The findings evidence the importance of maintaining both acts, since their positive effects are maximized when both laws are combined. Both pieces of legislation will continue to foster the development of Puerto Rico's service economy, increase the share of service export as a share of total exports, and ultimately run a service trade surplus of high-skill and high-paying services.

Currently Act 22 has added over $266 million in acquired real estate, and by 2020 grantees will have demanded close to $1,000 million in real estate investments. These investments will provide an injection of capital to the local construction industry. Moreover, the total value of individual expenditures of Act 22 grantees will reach over $830 million by 2024. Individual expenditures will provide for a wider tax base in Puerto Rico's economy.

Similarly, Act 20 has generated new economic activity by exporting services and increasing Puerto Rico's participation in the global economy. This Law has provided the greatest opportunity for technology transfer and spillover effects in the local economy. The analysis performed for this report shows that close to 20% of Act 20 decree holders are local companies and more than 33% export to destinations beyond the U.S. market. In terms of the current economic impact a total of 7,033 direct, indirect and induced jobs are generated by the incentive program. It is estimated that by 2024 close to 50,000 direct employment opportunities will be created. The study reveals that jobs created under this program have a salary above the Island's average employee compensation. Finally by 2024 Act 20 companies would have accumulated over $38.5 billion in gross revenue and paid over $800 million in corporate income taxes.

INTRODUCTION

Introduction

Since the end of World War II Puerto Rico has consistently maintained an economic development strategy which retains at its core, the attraction of foreign capital or foreign direct investment (FDI), with the aim of creating new economic activity. Such a strategy has been almost exclusively focused on new productive capacity in the form of capital-intensive manufacturing facilities. However, Puerto Rico's factor endowments have migrated from a traditional *maquiladora* (low-skill, labor surplus type of economy[1] to a high-skill post-industrial service economy. The pool of highly educated resources has allowed for the development of a domestic service provider class that has fueled the shift to a post-industrial economy[2]. These new service based ventures have been mainly dependent on internal demand. Hence, due to the decline in manufacturing activity and the increase in local service providers, Puerto Rico's service economy has maintained a trend which could eventually catch up with the traditional manufacturing economy in terms of its impact on the aggregate economy.

At the US level most states employ local policy tools to attract external investment. Puerto Rico, benefiting from its fiscal autonomy has employed fiscal policy tools to attract foreign capital and develop new economic activity. The main actors in this new scenario are fiscal policies that promote trade in services. Both Act 20 and Act 22 support movement in this direction.

The Department of Economic Development & Commerce (DDEC, for its Spanish acronym) is the agency responsible for Act 20 of 2012, known as the Law to Promote the Export of Services, as amended, and Act 22 of 2012, known as the Law to Encourage the Transfer of Individual Investors to Puerto Rico, as amended. Utilizing both laws, since 2013, one of the DDEC's main economic development strategies has focused on making Puerto Rico a top destination for business as well as an attractive location for establishing residence, for both high-profile individuals and companies.

Act 20-2012 seeks to provide the appropriate environment and opportunities to make Puerto Rico a center of international services, by encouraging local service providers to expand their business and services to clients located outside the Island, and persuading foreign service providers to relocate their operations to Puerto Rico. Act 22-2012 focuses on drawing new residents to Puerto Rico by providing a 100% exemption from Puerto Rico income taxes on all passive income realized or accrued after such individuals become bona fide residents of Puerto Rico.

Currently few policy tools have the advantages to combine a scheme similar to the previous FDI era, particularly with our current economic profile. That is, the ability to create a series of incentives that- when combined- allows creating new economic activity by moving beyond domestic demand and satisfying increasing international demand for Puerto Rican products and services. At the same time that it attracts new productive capacity into the

[1] For an original description of the concept of *labour surplus* see Lewis, W. A. *Economic Development with Unlimited Supplies of Labour*. Manchester School, 22, May: 139-191, (1954)

[2] For a recent definition of the term *post-industrialization* see D. Rodrik. *Premature Deindustrialization*, JFK School of Government, Harvard University (2015)

local economy, it strengthens local economic activity in Puerto Rico. The Island's challenge is to maximize the spillover effects from both, the export of services and the law 22 decree holders (grantees).

Act 20-2012 seeks to provide the appropriate environment and opportunities to make Puerto Rico a center of international services

Such policies have the effect to boost the competitiveness of firms established in Puerto Rico, vis-á-vis other U.S and international jurisdictions. These policies alone are not sufficient to pull Puerto Rico out of its recent economic malaise, yet, these measures, combined with adequate policy interventions that guarantee higher spillover effects (internal linkages) have a great potential to bootstrap economic development within a small, open and export oriented economy. Both pieces of legislation will continue to foster the development of Puerto Rico's service economy, increase the share of service export as a share of total exports, and ultimately run a service trade surplus of high-skill and high-paying services.

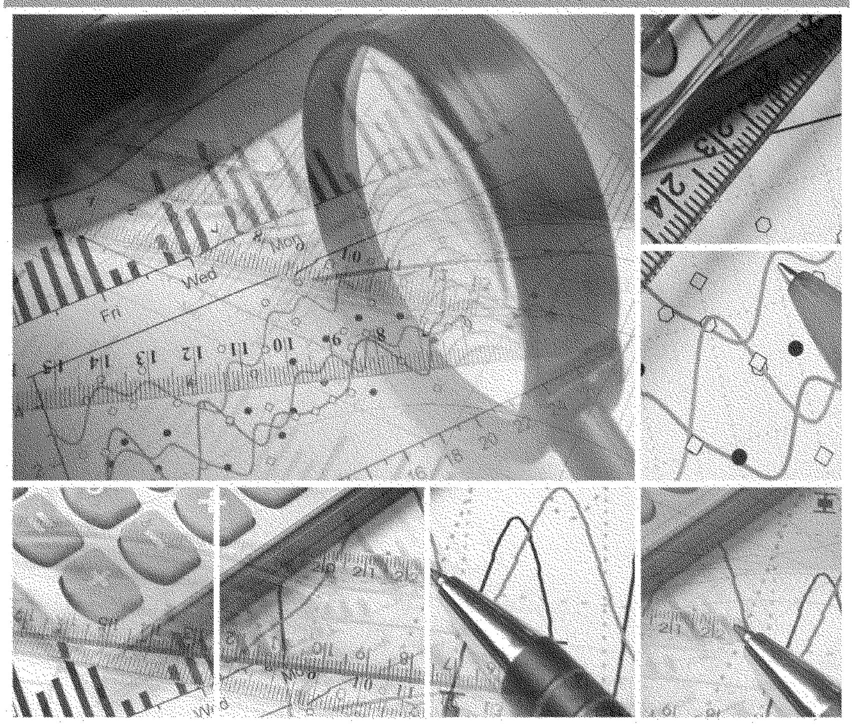
The effects of these policy tools cannot be observed individually. To maximize the potential of both laws, they must operate together. That is, the best scenario for these laws to operate is to use Act 22 as an incentive to import new capital and knowhow into the economy, and Act 20 as an export vehicle for both local and newly formed enterprises in the Island.

The newness of such instruments and their recent implementation means that any analysis of their impacts may well be premature, since it usually takes five or more years for substantial effects to be observed in the economy. Nevertheless, this report has been able to highlight several direct effects of these incentives, which are expected to continue increasing during the next few years. To measure the impact of these laws on Puerto Rico's economy, the DDEC commissioned Estudios Técnicos, Inc. to carry out an economic impact study

Moreover DDEC uses other policy tools which seek to complement the incentives offered by Act 20/22. These other laws provide tax incentives to promote the International Financial Entities ("IFEs") (Act 273-2012), and the International Insurers and Reinsurers Act, which establishes the legal basis for the International Insurance Center of Puerto Rico (Act 399-2004). Through Act 399, insurance companies can export and import insurance and services related to the insurance industry. While Act 273 seeks to make Puerto Rico an international banking and financial center by providing tax incentives for banking and financial services provided to clients outside of Puerto Rico. Law 73 of 2008 is the legislation that provides a wide range of incentives mainly related to manufacturing, but provided an initial basis for a transition from manufacturing to a service economy.

This document describes the methodology used to pursue the economic impact of tax incentive laws, the legal and economic background, data gathering procedures, economic impact analysis, economic impact forecasts and recommendations.

BACKGROUND



Legal Background

During 2012, two laws were enacted to promote the transfer of investors to Puerto Rico and to incentivize export of services from the Island. These laws have been known as Act 20 and Act 22. Even though both policy tools are administered by the DDEC and have been promoted together, their core tenets vary substantially.

Act 20-2012: Tax Incentives to Promote Export Services in Puerto Rico

This law applies to companies established in Puerto Rico that export services to jurisdictions outside the Island. Act 20-2012 arises from an analysis which demonstrated the comparative advantage of Puerto Rico in foreign markets. The Island's competitive edge is particularly strong in the provision of advanced services such as: information technology and communications, project management, financial services and business support services, among others.

This initiative provides substantial tax incentives for businesses that wish to establish or expand their operations by exporting services from Puerto Rico. Companies that hold an Act 20 decree will benefit from:

- 4% fixed income tax rate on export service activities.
- 3% fixed income tax rate in the case of services considered strategic and over ninety percent (90%) of all gross income of the entity that carries out the eligible business and its affiliated entities is derived from the provision of services for export.
- 100% tax exemption on distributions from earning and profits.
- 90% tax exemption from real and personal property taxes related to property used in eligible activities. Businesses who perform centralized management services, shared services and call centers benefit from 100% exemption.
- 60% tax exemption on municipal taxes (90% tax exemption if business operates within the municipalities of Vieques and Culebra).
- No federal taxes on Puerto Rico source income

To obtain a decree under Act 20, a person who has established or proposes to establish an eligible business in Puerto Rico, may request the benefits by filing the corresponding duly sworn application with the DDEC's Office of Industrial Tax Exemption (OITE).

The following are the activities eligible to receive benefits under the Act:

- Research and development
- Advertising and public relations
- Consulting services
- Creative industries
- Production of blueprints, architectural and engineering services, and project management
- Professional services such as legal, tax and accounting services
- Centralized management services
- Centers for electronic data processing
- Development of licensable computer software
- Voice and data telecommunications between persons located outside of Puerto Rico
- Call centers
- Shared services centers
- Storage and distribution centers
- Educational and training services

- Hospital and laboratory services
- Investment banking and other financial services
- Promoter services
- Commercial and mercantile distribution of products manufactured in Puerto Rico for jurisdictions outside Puerto Rico
- Assembly, bottling and packaging operations of products for export
- Marketing centers
- Trading companies

In terms of the effective period of the incentives, the law provides that once the service provider is officially granted the decree, tax rates will be secured for the 20 year term, irrespective of any changes in the applicable Puerto Rico tax laws. The decree may be eligible for a ten year extension.

To maintain accountability with respect to the performance of the program, most decree holders will annually file a report no later than thirty (30) days after the filing of the corresponding income tax return. This report shall contain data that shows compliance with the conditions set out in the decree for the immediately preceding taxable year, including average employment generated by the services covered by the decree and other performance measures.

Act 22-2012: Individual Investors Act

Act 22, as amended, provides significant incentives to individuals who decide to relocate to Puerto Rico, and establish their residence here. So far the incentives have attracted new capital investments in the real estate and financial sectors, although there have been investments in other sectors.

This Act applies to individuals, who have not been residents of Puerto Rico for the 6 year period[3] prior to January, 2012. To benefit from the law, the individual needs to become a bona fide Puerto Rico resident. For the purposes of the law, a resident of Puerto Rico means a person who is present for at least 183 days during any tax year[4]. All program participants from December 1st, 2015 and onwards will be required to acquire a residential property and a bank account in Puerto Rico[5].

Tax exemptions include:

- 100% tax exemption on interest and dividend income received by Resident Individual Investors during the Exemption Period. The exemption applies to all sources of such income.
- In the case of long-term capital gains, the Act provides for either a full Puerto Rico income tax exemption or a reduced tax rate of 5%, depending on meeting certain requirements
- No federal taxes on Puerto Rico source income

In order to benefit from the incentives provided in this Act, every Resident Individual Investor must request from the Secretary of Economic Development the issuance of a tax exemption decree pursuant to this Act, by filing a duly sworn application before OITE.

Once the individual is officially granted the incentives, such benefits become an agreement between the Government of Puerto Rico and the individual. The maximum

[3] Initially, when the Act was enacted, the required period was 15 years.

[4] IRS definition of bona fide resident. Act 22 has other requirements intended to guarantee that Puerto Rico is the principal place of residence for the resident individual investor.

[5] Per an amendment introduced in Act 187-2015.

term for the agreement ends in December, 2035.

Also, since the December 2014 amendment, every resident individual investor who holds a decree granted under this Act, shall file an annual report not later than April 15 of each year[6]. During 2013, the annual report was required as a condition in the decree, all decrees awarded prior to the enactment of this requirement, are not obliged to file the report. To assess the program's performance, annual reports contain data that reflects compliance with the conditions set out in the decree for the taxable year immediately preceding the date of filing.

Overall Methodology

The report's methodology uses a multivariate approach, which essentially entails the use of various research methods (including primary and secondary research) to gather data and validate results. An additional test for quality control identifies outliers and estimates margin of errors.

Data was initially gathered from DDEC's database system (which will be described below), data was then validated with DDEC personnel, and also measured against individual data points, gathered from interviews with Act 20/22 service providers and other key industry informants[7]. Yet, the main information source of the report relied on empirical evidence gathered from annual reports and decree applications.

To capture the complete spectrum of Act 20/22 information, ETI developed a hybrid approach which combined data from annual reports[8] (being the most accurate source of information) and complemented that data with information provided by decree holders (grantees) in the application form[9]. Hence, for all approved decrees with no annual reports, the information was obtained from the application form. In order to create a unified database of DDEC's applications and annual reports, information was validated, merged and standardized. Generally, applications will offer a wider set of data points, since applicants are required to provide financial, legal and operational information about their businesses and investments before a decree is granted.

It is important to note that not all fields under the annual report can be complemented with the applications. In some instances both data objects do not coincide. Therefore, some of the analyses in the report utilize the hybrid approach, and other will depend on the tendencies reflected in the applications or annual reports exclusively. This condition is

[6] A thirty (30) day extension may be granted.

[7] The data gathering sections provides a detailed description on both quantitative and qualitative data.

[8] Annual reports are considered more accurate data points since information is not estimated or expected, but rather is actual data from the previous taxable year.

[9] In some instances decree applicants provided yearly estimates on financial and economic performance indicators. Since data is not uniform among all decree numbers, ETI's analytical tools were programmed to look for data initially in the annual report, and secondly in the application form. This programming allowed for a complete integration of both databases, i.e. when data point was not available in the annual report the system traces a comparable data field in the application form. Overall this increases the accuracy of the estimates.

particularly relevant for Act 22 for which reports vary substantially from applications.

Economic Impact Methodology

To estimate the economic impact ETI developed a series of econometric tools that gauge employment, fiscal revenues, investment and consumer spending. As will be explained in each section of the report, every Act has its own set of procedures to determine the economic impact in Puerto Rico's economy. This is particularly important, since both laws are usually perceived as similar policy tools. However, in economic terms both Acts utilize different incentives and thus, produce different impacts in the economy.

The methodology employed for Act 20 follows the procedures used for an economic incentive program which targets businesses established in Puerto Rico and which plan to export services to other jurisdictions, including the U.S. This diverges from Act 22 which is focused on attracting foreign individual investors[10] and the diaspora, into the local economy.

There are several ways to measure the economic impact of export activities, yet, most of the analysis will focus on a few economic variables which have tangible effects in the economy such as sales volume, value added per GDP, wealth creation in the form of property values, personal income and job creation. All these measures (if positive) serve as proxies for improvements in the economy's well-being. Nonetheless, these estimates cannot be equated with a cost-benefit analysis[11], which will require a different methodological approach and its inconsequential for these type of incentive program. It is important to note that these measures are overlapping. Thus, when determining the aggregate economic impact, measures cannot be simply added.

On the other hand, the methodology used for determining the impact of foreign investment usually incorporates the economic literature of *Foreign Direct Investment* (FDI). This type of analysis centers on econometric tools at the aggregate national level with no particular consideration to individual investment efforts, which is the focus of Act 22. Thus, the methodology employed in this report combines the concept of FDI with a particular focus on individual private investments. The studies developed around individual private investment, such as those[12] regarding the US EB-5 Visa program[13] are

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[10] The term foreign investor should be exclusively equated to individuals with low linkages with the Island; subsequent amendments to the law changed from 15 to 6 years the amount of time an individual has to be living outside the Island in order to benefit from the incentives. These changes have provided greater opportunities to the diaspora of young professionals.

[11] Incentive programs such as Act 20/22 provide non-cash transfers via forgone income, with a marginal state investment in the institutional infrastructure already in place. Since both programs allow for the creation of new economic activity within the Island, and exogenous variables, such as changes in foreign markets, are not considered, a cost-benefit analysis has no practical application. A cost-benefit analysis entails a wider consideration of factors to determine net effects in the economy, i.e. societal and economic costs of economic activity created by the incentive programs and the benefits created within different areas of the economy. On a purely economic basis this could mean analyzing any potential displacement in already established economic activity.

[12] MIG, Inc., Economic Impacts of the EB-5 Immigration Program 2010-2011. June 7, 2013.

[13] The EB-5 Visa program was designed for foreign nationals willing to invest in the US (usually in the above-$500,000 range), and includes a variety of incentives for foreign investment, local purchasing of supplies, and catering to the U.S.A. market. An important difference with the Law 22 program, however, is that this visa program is not based upon

particularly relevant. It is important to note that several decree holders (grantees) have combined their incentives from Act 22, with those from Act 20, by moving their business operations to Puerto Rico. Yet, the methodology employed has standardized the data to guarantee that economic values are not double counted when these circumstances are present.

Variables such as employment, investment (mostly real estate), consumer spending and fiscal revenues[14], will be used to assess the overall impact in the economy. For salaried workers employed by the investors, a salary characteristic of their respective occupations (if available) will be imputed. Household spending for investors and their hired employees will also be estimated so as to determine consumption-based taxes and their spending-side impact upon the economy. It is important to point out that the economic impact of these investors goes beyond mere household spending, as these investors purchase vehicles, properties, other durable goods, and generate indirect economic activity as a result of these purchases. Whenever possible, these spending patterns will be taken into account in the estimation and forecasting analysis.

Economic multipliers will be used to determine direct, indirect, and induced employment produced by Act 20 businesses. These estimates will have an aggregate impact on GNP that can be determined using a labor input-share analysis upon the relevant industries. Additionally, population forecasts will be used to determine potential employment in the following years, as well as economic impact derived from their expectations.

A detailed description of the econometric methodology employed in the estimates will be explained in the *Forecasts section*

Data Gathering

Quantitative Data

To understand the sources of data available, interviews were conducted with personnel from the DDEC, OITE and the agency's information technology consultants. Currently, the DDEC has three sets of data related to Act 20 and Act 22 beneficiaries:

- Applications – All beneficiaries are required to submit an application requesting a decree that contains the most information. However, data must be analyzed as proposed or potential impacts estimated with no specific timeframe.
- Decrees – Is the agreement between the Commonwealth and the Act 20/Act22 beneficiary. Per DDEC's database, information is limited, but contains accurate data on the actual number of beneficiaries per program.
- Annual reports – An annual report constitutes the most accurate representation of recent economic activity of program beneficiaries; completeness, accuracy and uniformity of data was enhanced for the purposes of this report. Both Acts have different

tax incentives for the investors, their incentives a directly related to an immigration status.

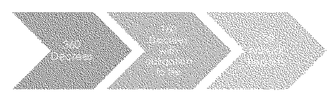
[14] Estimates of the tax revenue generated from personal income, and sales taxes

requirements in terms of annual reports. Act 20 requires annual reports to be filed 30 days after the tax return filing date. On the other hand, Act 22 reporting requirements will vary depending on the date of issuance of the decree. Act 22 decrees granted before mid-2013 are not required to submit annual reports.

Data was gathered using DDEC's web based system call CRM (a Customer Relationship Management tool created on Microsoft Dynamics). This platform is used by grantees to submit decree applications and also to submit their annual reports. Simultaneously, DDEC personnel use this tool to manage and monitor both programs. Estudios Técnicos' team was granted access to the system, so as to gather the necessary data to assess the economic impact of both programs. Additional efforts have been made to obtain data filed prior to the establishment of the platform. It is important to note that a migration process was undertaken at the DDEC prior to the development of CRM. This process transferred most of the information from hardcopy files into the web-based system. As described in the *addendum* some of the limitations inherent to the data are intrinsically related to this process. Thus, a great deal of emphasis was placed on obtaining high-quality data and developing adequate control measures.

Act 20 Statistics

As of November 2nd, 2015, there were 360 Act 20 decrees approved[15]. Out of the total approved decrees only 160 decrees had the responsibility to file an Annual Report due to their business' commencement of operation date. A total of 129 had submitted annual reports (complete) by the time of this report. To bridge the gap between available information from annual reports and the total number of decrees, data was also gathered from decree applications. The methodology further explains this procedure.



Act 22 Statistics

As of November 2, 2015, there were 574 Act 22 decrees approved. [16] According to DDEC's database, only 133 reports were presented for taxable year 2014. [17] The difference between decrees and annual reports is partially attributed to grantees which did not had the obligation to file due to amendments to the enabling Act and the time allowed in the decree to formally

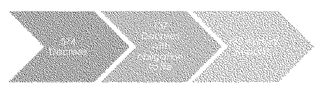
[15] Out of 360 decrees, only 160 were required to file an annual report for taxable year 2014, based on the commencement of operations date and according to the information provided by OITE. According to CRM, data obtained on November 2, 129 reports were presented for taxable year 2014. This amount excludes any canceled and incomplete reports, as well as 3 decrees which had annual reports with more than one status (i.e. filed + pending filing). As of November 2, of the 160 decrees that have the responsibility to file annual report for the taxable year 2014, 101 were filed. Also, another 28 reports were voluntarily filed. Voluntarily filed refers to those companies which had no obligation to file a report due to the commencement of operations date.

[16] Out of those 574, around 137 were required to file an annual report for taxable year 2014, according to the information provided by OITE.

[17] This amount excludes any canceled and incomplete reports, as well as 3 decrees which had annual reports with more than one status (i.e. filed + pending filing). Of the 137 decrees that have the responsibility to file annual report for the taxable year 2014, 75 were filed, as of November 2. Also, another 58 reports were voluntarily filed. Voluntarily filed refers to those companies which had no obligation to file a report due to the commencement of operations date.

establish residence in Puerto Rico. Furthermore, annual reports were adjusted to guarantee that decree holders with spouses were not double counted if both family members were decree holders. Also, reports were adjusted for decree holders which had both Act 20 and 22, and thus could have a potential double counting in the operational business analysis.

Regarding applications, there are several pending cases which are in transit to approved decrees. For instance, around 159 applications have been filed, but are not yet approved, and another 101 applications are in process in CRM, but have not been properly filed.



Data processing

To develop a uniform data set, information from applications, decrees and annual reports was generated using CRM. Reports (applications, decrees and annual reports) obtained from CRM provided all data, as self-reported by the grantee. These individual files were consolidated in order to gather the greatest amount of information for each case, using the decree/case number, used as the unique identifier.

Application forms and annual reports template capture multiple data fields. Yet, a set of data points which are relevant for assessing the economic impact of both laws was selected. During the data merge, some fields were included or excluded to guarantee consistency and/or minimize duplication. For instance, individuals under Act 22, whose spouses are also decree holders, and who have businesses with Act 20 decrees.

A preliminary analysis of CRM data demonstrated various limitations mostly due to incomplete data and lack of uniformity. For instance:

- Data is self-reported and thus cleanup was required.
- The forms, and systems used to capture the data have changed over the years, thus subject to submission date, different data fields are included.
- Since there are no required fields in the application and annual report templates, some information is missing in CRM.
- Data related to the service type, as well as other fields, required a standardization procedure. Partially due to the fact that the system does not provide a set of alternatives to choose from.

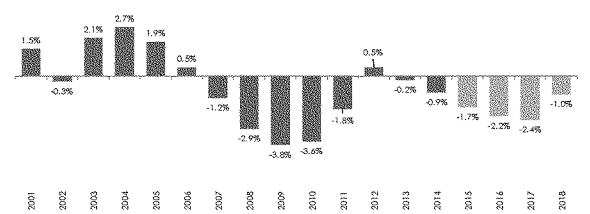
The report includes a section solely dedicated to the information gathered from applications and reports and how to develop adequate performance measures.

Economic Background

GNP and Economic Growth

With the exception of 2012, Puerto Rico hasn't registered positive economic growth since 2006. Given the fiscal situation, public spending is expected to see substantial declines in the coming years. The recession has begun to impact personal consumption, which for the first time since 2009 declined in 2014 (-2.6%). Estudios Técnicos has projected negative growth until the end of the decade. The Island currently faces reductions in Medicare and Affordable Care Act funds which could force the reduction of health benefits for many of the Island's elderly and low income residents.

Real and Forecasted GNP Growth
Fiscal Years 2001-2018

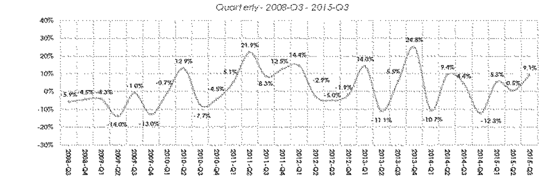


Sources: Puerto Rico Planning Board (2013). *Statistical Appendix – Table 1*. Forecasted Years by Estudios Técnicos, Inc. (January 23, 2015).

General Fund Net Revenues

In October of 2015 general fund revenues were 99.7% of estimated revenues. Even with the positive news regarding revenues the Department of the Treasury has revised its 2015 revenue estimate down by \$354 million. Revenues were higher in the first quarter of fiscal 2016, yet October reflected a 7.3% decline in revenue. The increase in the sales tax that went into effect on July 1st is expected to bring in an additional \$1,111.7 million in revenue to the General Fund.

Growth in Net Revenues to the General Fund
Quarterly - 2008-Q3 - 2015-Q3



Source: PR Department of Treasury (2015). *Net Revenues to the General Fund*. *Interannual growths.

Recent Fiscal Events

To address short-term liquidity problems, emergency cuts and self-financing measures had to be enacted. The greatest of these is a $400 million internal Tax Revenue Anticipation Notes (TRANs) issue, which will be purchased by SINOT, ACAA and the State Insurance Fund.

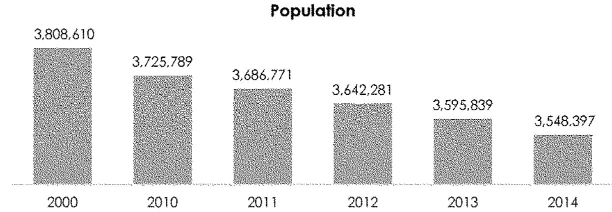
Other measures include delays on tax refund payments and payments to suppliers, reorganization of government agencies and restructuring their payment and service-providing processes, and privatization/suspension of AMA routes, including reducing Sunday services. For additional liquidity, an agreement is in process for the Retirement fund to pay their part of the retirement pensions owed in July and October directly, instead of these being paid by the General Fund.

Even with these measures the necessary liquidity needed for the first half of fiscal 2016 was not acquired. This has increased the risk of additional emergency measures being taken to address the lack of liquidity. These measures could have adverse effects on economic activity as they contemplate a full or partial government shutdown, a reduction of the working day for public employees, or default of further instruments.

Migration

Net Migration since 2010 reached over 200,000 people in 2014. According to the *Cumulative Estimates of the Components of Populations Change*, approximately 218,137 people migrated from Puerto Rico during the period from April 1, 2010 to July 1, 2014; 55,092 of which migrated during July 1, 2013 to July 1, 2014. The local population decreased 1.2% annually since 2010, reaching 3,548,397 inhabitants in 2014 – 177,392 persons fewer than the baseline Census estimate (3,725,789). The population estimates for 2012 and 2013 were also revised downward, to 3,642,281 and 3,595,839 persons, respectively.

Population

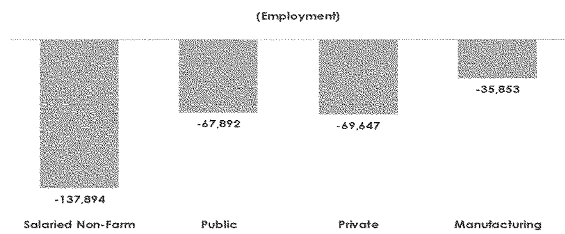


Sources: Census Bureau. Population. Population Census 2000 and 2010; Current population survey; Population

Labor Markets

Labor markets continue to downsize with the cumulative net loss of jobs reaching 137,894 employees between 2007 and 2015. Although salaried non-farm employment has increased since June on a year over year basis, the cumulative loss of jobs reached 67,892 in the public sector and 69,647 in the private sector. Of the private employment losses, approximately 50% of the accumulated losses were from manufacturing employees.

Accumulated loss in Employment by Sector
*2007-2015**



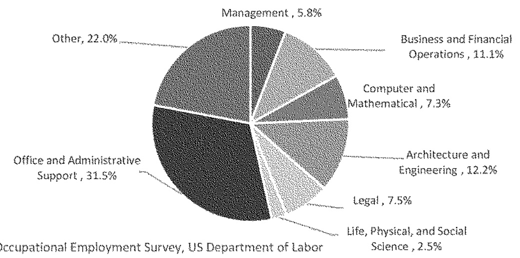
Source: PR Department of Labor and Human Resources (2015). Current Employment Statistics, Salaried non-farm employment (adjusted for stationality). *Until september

Occupation by Industry

Of particular importance is the employment in the technical services industry as many investors that take advantage of laws 20 & 22 belong to these occupations. Employment in this industry has increased between 2012 and 2014 by 6.4%, from 26,990 to 28,720. This increase could be reasonably attributed to the passage of Acts 20 & 22, since there few other policy measures specifically targeting these sectors. This is an impressive growth rate given the fact that total salaried non-farm has been declining as presented in the previous section.

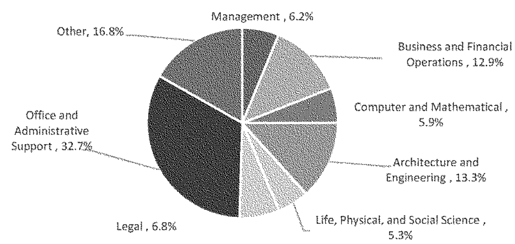
Office and administrative support has registered an increase, in 2014 it represented 32.7% of employment in the technical services industry up from 31.5% in 2012. Architecture and engineering, and business and financial operations have also slightly increased and represent the second and third occupation respectively.

Employment in Technical Services Industry
by Occupation 2012



Source: Occupational Employment Survey, US Department of Labor

Employment in Technical Services Industry
by Occupation 2014



Source: Occupational Employment Survey, US Department of Labor

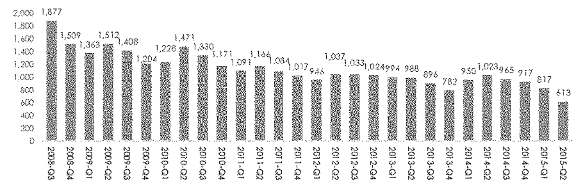
Construction Industry

Construction activity has remained in contraction or stagnant since 2008. In the second quarter of 2015 construction permits stood at 33% of their 2008-Q3 total. This decline in investment highlights the need for foreign investment in key sectors of Puerto Rico's economy.

In recent trends, following a short period of moderate growth, construction permits resumed their decline. Cement sales continued declining in inter-annual terms.

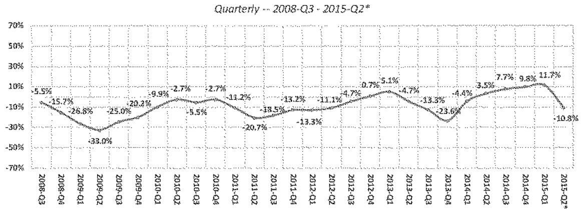
After a sustained increase in construction permits from 2014-Q2 to 2015-Q1, the number of construction permits decreased by 10.8% during the first two (2) months of 2015-Q2. Cement sales showed inter-annual declines of 11.9% in 2015-Q1 and of 5.4% in 2015-Q2.

Number of Construction Permits
Quat erly--2008-Q3 - 2015-Q2



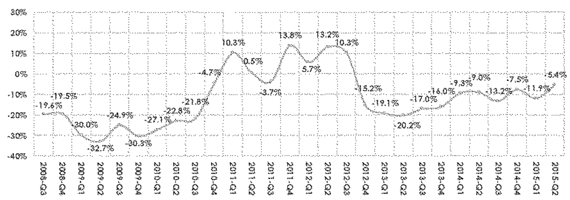
Source: PR Planning Board (2015). *Number of Construction Permits (total). *Up until May 2015.*

Growth in Number of Construction Permits
*Quarterly -- 2008-Q3 - 2015-Q2**



Source: PR Planning Board (2015). *Number of Construction Permits (total).* *Interannual growth of the first two (2) months of 2015-Q2. **Interannual growths.

Growth in Cement Sales
Quarterly-- 2008-Q3 - 2015-Q2



Source: PR Planning Board (2015). *Cement Sales (thousands of 94lb sacks).* *Interannual growths.

Gross Domestic Investment

Investment has declined in the past two years, and is now 29% or $559.4 million below the 2006 total. Gross domestic investment is projected to continue to fall in the coming years as public spending declines. This generates a need for foreign private investment to help mitigate the negative effects of budget cuts in the coming years. Acts 20 and 22 could be used as tools to attract foreign investment and generate local employment. Investors could also contribute to the general fund, as their economic activity would generate tax revenue.

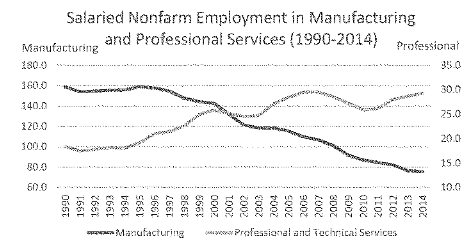
Gross Domestic Investment Growth

Sources: PR Planning Board (2014). Statistical Appendix.

The following sections present the current state of the professional and technical services sector. This is one of the main sectors affected by Act 20 and 22. Although this has been a traditionally small sector within the Puerto Rican economy, it has been one of the few that has registered growth in employment in the past years. The local economy is dominated by the manufacturing sector which represents 47% of the GDP. Yet, measures must be taken to diversify the economy and incentivize growth in sectors that have strong growth potential.

Employment in Key Economic Sectors

In the past 25 years manufacturing employment in Puerto Rico has seen a consistent decline. During the same period professional services employment increased almost continuously with the exception of the mid 2000s due in part to the beginning of the recession. Although employment has been growing in service industries, it has not been enough to compensate for the loss in the manufacturing sector. The graph below presents salaried nonfarm employment for the period between 1990 and 2014.

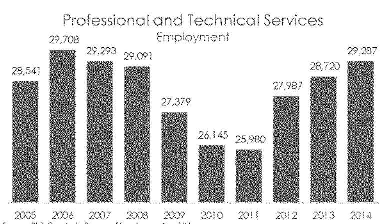


Source: PR Department of Labor and Human Resources, Salaried nonfarm employment.

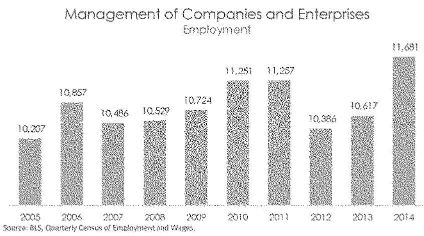
This represents a shift in the employment available in Puerto Rico, given that is one of the few sectors that has registered significant growth, it implies that this type of work should be promoted and incentivized. Act 20 and 22, when applied together, help attract individuals and businesses which help generate more employment in this growing sector. In the following sections the Professional and technical services sector as well as the management of companies and enterprises sector are presented. It is in these sectors that the majority of Act 20 and 22 beneficiaries should be classified.

Employment in Professional and Technical Services

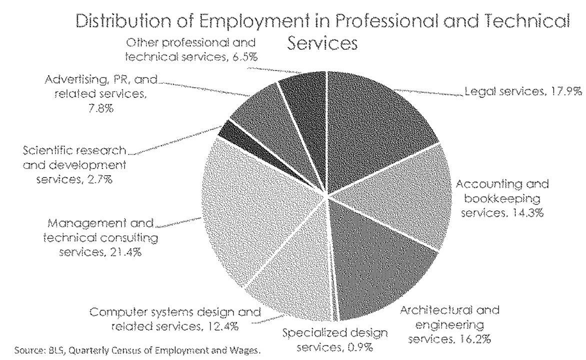
According to data from the Quarterly Census of Employment and Wages, employment in professional and technical services has been steadily increasing since 2011. In 2014 employment stood at 29,287, slightly below the 2006 high of 29,708 but 12.7% higher than in 2011. Employment in management of companies and Enterprises registered a 12.5% with respect to 2012, and in 2014 stood at 11,681. Professional services employment includes all services classified under NAICS sector 54 which includes: architectural, engineering, scientific, design, and publicity services among others.



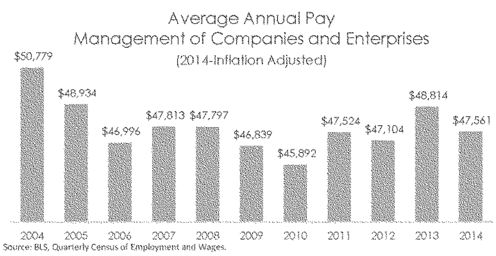
Source: BLS, Quarterly Census of Employment and Wages.



In 2014, employment in Professional and Technical services, concentrated primarily in management and technical consulting services with 21.4% of all sector employment. This was followed by legal services with 17.9% and architectural and engineering services with 16.2%. Computer systems design and related services is the only other classification to represent more than 10% of employment in the sector. As more beneficiaries of both acts arise, a small shift in the distribution of professional and technical services employment could be observed.

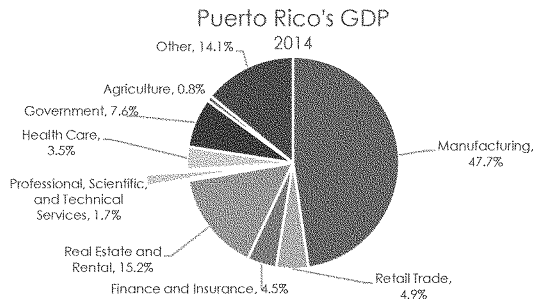


Wages in the professional and technical services sector have remained stagnant in the past decade, the lowest point coming in 2010 when the average annual salary was $37,905. The average pay presented in the following graph has been adjusted for inflation and is presented in 2014 dollars to facilitate the comparison between the years. To adjust for inflation, the Consumer Price Index for Puerto Rico was used. In 2014 the average pay was up to $39,416, this is around $2,300 below its 2004 high. The average annual pay for management of companies and enterprises in 2014 stood at $47,561, up from the 2010 low of $45,892. The average annual pay for management of companies and enterprises is also presented in 2014 dollars.



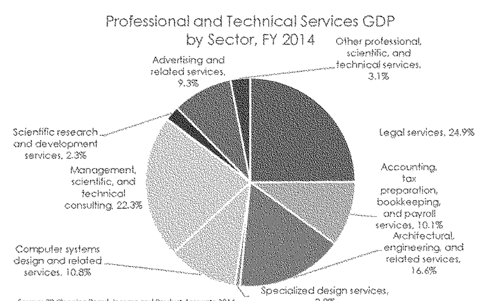
GDP by Sector

In 2014 professional and technical services GDP reached $1,783.1 million, which represents 1.7% of Puerto Rico's GDP. Manufacturing represents nearly half of the Commonwealth's GDP, this is followed by the real estate and rental sector with 15.2%, and the government with 7.6%.



Source: PR Planning Board, Income and Product Accounts 2014.

Legal services comprise 24.9% of the professional and technical services sector, followed by management, scientific, and technical consulting with 22.3%. Architectural, engineering, and relative services was the third biggest sector with 16.6% and computer systems design and relative services totaled 10.8%. The smallest sector reported was specialized design services. This is another distribution that could change in the coming years thanks to law 20 & 22.



Source: PR Planning Board, Income and Product Accounts 2014.

Summing up

The economy's state calls for a wide ranging set of actions that will generate investment, stimulate the construction sector and provide the basis for development of an advanced services sector with export potential. Both Law 20 and Law 22 address these needs. Although difficult to quantify a number of beneficiaries of both laws have begun programs to improve the Island's capabilities in activities such as programing, knowledge management and C& IT in general. This was made clear in a number of the interviews. The above overview of the economy and some of its main sectors is included to emphasize the need for initiatives that provide stimulus to investment and economic activity in general. The current outlook of the local economy requires actions which stimulate local production beyond domestic demand. In this respect, both incentive programs will contribute to a more robust service sector and thus, higher exports.

Data Analysis and Results for Act 20

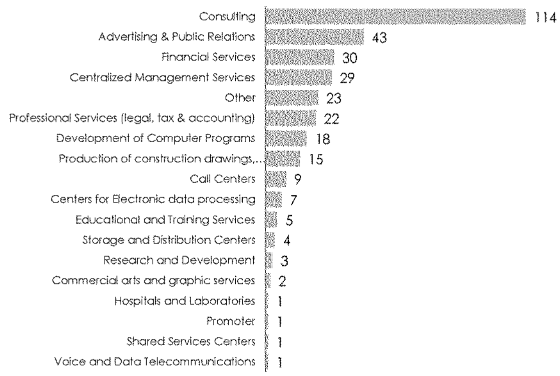
Since the validation of accuracy of the data reported to the DDEC, the conclusions of the study are solely based on reported data. However, appropriate distinctions have been placed when describing results based on proposed accomplishments as reported in applications, rather than actual accomplishments, as informed in annual reports.

Profile of Grantees

The analyses presented throughout the section are based on a total of 360 decrees for Act 20. Note: The total decree numbers do not take into account pending cases for 2015. Estimates from DDEC include close to 204 additional decrees from decree applications which are in the process of approval. Decrees by year will not add to the total, since 10 decrees didn't have an approval date.

Year	Decrees
2012	33
2013	47
2014	121
2015	149
Total	360

In terms of the structure, the report provides an initial description of the decrees and their particular annual reports, complemented with certain sets of information from the application form, originally submitted by each decree holder. As outlined in the data gathering section, certain caveats influence the results of this report, yet the data has been interpreted following a representative sample - type of approach- in which the annual reports that were gathered will be extrapolated to the universe of total annual reports.



* Only filed decree reported their main service type.

As noted in the above graph, most Act 20 companies selected Consulting as their main service type[18]. Nonetheless, a limited number of companies specified the type of consulting (i.e. economic, environmental, marketing, etc.). Of those who reported the type of consulting, most of them are related to financial services.

Advertising and Public Relations follows in second place when establishing the type of service. The number is relatively high due to the fact that these companies include several other services. When data is individually analyzed, only 11 companies are solely dedicated to advertising and public relations. The other 32 companies reported other business activities.

As noted in the graph, the services with the highest share are high-skill services in the areas of business, advertising, accounting, management and legal services. Production of computer programs is the 7th highest. These are usually associated with high value-added activities.

Due to the way the information is obtained from applicants there is no data field indicating if the company is a local business

[18] The number for Act 20 service type is estimated based on the percentage of type of service established in the annual report and application. Information was also validated using the main service type established in the decree. It is important to note that decree holders can select several service types and thus, one company could have multiple services. The company's main highest allocation for a particular service was used to determine the decree's main service.

or a recently established business from abroad. Applicants were asked to inform if they were performing eligible services in Puerto Rico prior to obtaining a decree[19]. If one assumes that a local business will most probably perform an eligible service in Puerto Rico prior to obtaining a decree, then, it could be argued that close to 20% of Act 20 grantees are local businesses and close to 80% of applicants are from other jurisdictions. This is only a proxy since there is a chance that foreign businesses could be performing eligible activities in Puerto Rico prior to a decree, among other plausible scenarios.

Based on the information provided in the annual reports, the following table illustrates the top export services destinations. Due to Puerto Rico's trade integration with the US more than half of exports are destined to the US market. The Dominican Republic and Mexico follow in second and third place respectively. Beyond the top 20 destinations below, others include: New Zealand, British Virgin Islands, Costa Rica, Trinidad & Tobago, Netherlands, Ecuador, Bermuda, France, Guatemala, Curacao, Japan, Taiwan, Denmark, Aruba, Tortola, Dubai, Argentina, Bahamas, South America, Estonia, Hong Kong, St. Kitts, St. Lucia, Antigua and Haiti. The results illustrate that almost 2/3 of the export market is concentrated in the USA, but the remaining 35% is wide spread around the world.

Top 20 Export Destinations

#	Export Destinations	Frequency of Export Destinations	Share
1	USA	238	65.9%
2	Dominican Republic	13	3.6%
3	Mexico	7	1.9%
4	United Kingdom	6	1.7%
5	Colombia	6	1.7%
6	Grand Cayman	6	1.7%
7	India	5	1.4%
8	Germany	5	1.4%
9	China	4	1.1%
10	Spain	4	1.1%
11	Venezuela	4	1.1%
12	Brazil	4	1.1%
13	USVI	3	0.8%
14	St. Marteen	3	0.8%
15	Australia	3	0.8%
16	Panama	3	0.8%
17	Canada	3	0.8%
18	Peru	3	0.8%
19	Russia	3	0.8%
20	Ireland	3	0.8%

Employment

Two of the main indicators of economic impact are total employment and investment, this is particularly relevant for Act 20 grantees since export services generate high-quality employment opportunities and generate high value-added investments. Using a hybrid approach (combining applications and annual reports) ETI estimated the average potential impact of Act 20 decrees. The information is segregated between eligible and non-eligible activities, yet, most of the results and analyses are based on the overall economic activities performed by the grantees. As highlighted in the following tables, Act 20 companies had a bigger share of eligible employees, thus, data suggest that most firms are a direct result of Act 20 incentives.

Using the hybrid approach, data shows that annual payroll averages close to $43,000 per

[19] Question per Act 20 Application: "Base Period Income (BPI) – Specify whether Applicant, Stockholder, Member or any Affiliated Entity or Predecessor Business (both as defined in the Act and the Regulations promulgated thereunder) is presently performing, or was performing, in Puerto Rico the eligible activities subject of this Application: "

job, and businesses had a total payroll of $137.2 million. When compared to Puerto Rico's average salary for all private and public sector jobs ($27,510), Act 20 companies almost double that figure. This salary level is closely related to the high value-added nature of services provided under the incentive program.

Payroll	Average Salary*
$137,185,589	$42,601

*Average salary for both eligible and non-eligible employment

Source: DDEC, Input-Output Matrix 2002

The Direct, indirect and induced employment generated by Act 20 companies account for a total of

7,033 jobs

The payroll figures represent close to 3,349 direct jobs that are generated by Act 20 companies. These direct jobs in turn, helped to generate 2,163 indirect jobs and 1,520 induced jobs. The Direct, indirect and induced employment [20] account for a total of 7,033 jobs. This estimation was carried out using the Input-Output Matrix for Puerto Rico (2002). Given the diversity of work offered by Law 20 beneficiaries the multipliers for the service sector were used to estimate the impact of employment.

Total Employment

Direct	Indirect	Induced	Total
3,349	2,163	1,520	7,033

Source: DDEC, Input-Output Matrix 2002

Out of the 3,349 jobs created, 40% corresponds to non-eligible activities which were performed by program participants. Such non-eligible activities are considered due to the inability to determine if a portion of Act 20 companies are dependent on their non-eligible activities to maintain their eligible activities. Therefore, the non-eligible components are assumed to arise as a result of the eligible work. That is, that non-eligible work is still taking place in Puerto Rico and exists due to Act 20, even if it doesn't reap the benefits of the law.

Estimated Impact of Law 20 Firms in Puerto Rico

Actuals and Averages of expected 3-year investment schedules, by concept

Number of Employees	3,349
Eligible	2,200
Non-Eligible	1,149

Following the profile for Act 20 companies – in which most grantees are performing consulting services - the services with the highest share of new employment opportunities are also concentrated in consulting services. Nonetheless, advertising and public relations, call centers, architectural and engineering services, accounting and management services, also account for a substantial share of employment. In terms of highest salaries per employee, Centers for Electronic data processing, financial services, development of computer programs and centralized management services, reflect the highest compensation. On the other end, call

[20] Basic definition of multipliers effect: Direct – refers to new economic activity directly linked to the incentive program. Indirect – refers to business growth in suppliers of program beneficiaries. Induced – additional spending in the economy as a consequence of direct and indirect businesses. i.e. additional spending from workers and payroll. (consumer expenditure) *The above assumes continuation of local inter-industry trade patterns and local flows of money.

centers provide the lowest salary per employee but holds the second largest portion of new employment opportunities.

If differences between service types are not considered, the average number of jobs per decree is close to 9.3 jobs. Based on information from applications and validated via interviews with local services providers and key industry informants, most of the contracting is done locally (87% of total employment is local), yet certain activities will have a higher propensity for local hiring, particularly if skill sets are less specialized. It is important to note that contrary to manufacturing incentives, the performance of Act 20 incentives cannot be measured only via employment creation, but rather on the long-term effect of technical knowhow - which spurs innovation - and the internationalization of the local service sector.

The average number of jobs per decree is close to

9.3 jobs

Law 20 Employment, Total Payroll and Average Payroll by Type of Eligible Economic Activity
2014

Type of Activity	Eligible Activities			Non Eligible			Total		
	Employment	Total Payroll	Payroll / Employment	Employment	Total Payroll	Payroll / Employment	Employment	Total Payroll	Payroll / Employment
Centers for Electronic data processing	34	$3,221,830	$95,935	---	---	---	34	$3,221,830	$95,935
Centralized Management Services	170	$10,391,987	$60,980	4	$1,142,777	$79,371	174	$11,534,763	$66,133
Financial Services	72	$4,686,259	$65,314	15	$790,880	$34,881	87	$5,477,138	$63,137
Development of Computer Programs	58	$3,147,283	$54,031	20	$1,447,361	$44,728	78	$4,594,644	$58,906
Professional Services such as legal tax and accounting	114	$4,053,118	$35,424	130	$9,094,302	$12,917	245	$13,147,420	$53,736
Consulting	434	$19,868,556	$45,806	513	$28,362,906	$49,826	946	$48,231,463	$50,971
Other	171	$7,636,650	$44,724	127	$6,992,436	$0	298	$14,629,086	$49,173
Production of construction drawings, architectural and engineering services and project management	124	$5,815,262	$46,897	62	$2,850,811	$126,865	186	$8,666,073	$46,654
Hospitals and Laboratories	2	$67,063	$44,709	---	---	---	2	$67,063	$44,709
Voice and Data Telecommunications	6	$161,750	$29,409	20	$883,383	$0	25	$1,045,133	$41,391
Commercial arts and graphic services	3	$90,016	$30,005	1	$71,601	$0	4	$161,617	$40,404
Research and Development	5	$185,450	$37,090	---	---	---	5	$185,450	$37,090
Promoter	---	---	---	8	$289,602	$60,073	8	$289,602	$36,200
Shared Services Centers*	3	$86,000	$34,400	---	---	---	3	$86,000	$34,400
Advertising and Public Relations	241	$8,908,728	$36,966	85	$1,794,199	$0	326	$10,702,927	$32,831
Educational and Training Services	19	$456,220	$24,012	1	$49,868	$0	20	$506,088	$24,992
Storage and Distribution Centers	21	$706,782	$33,260	61	$846,270	$0	82	$1,553,052	$18,882
Call Centers	595	$9,752,061	$16,390	103	$3,420,180	$89,424	698	$13,172,240	$18,865
Total	**2,071**	**$79,235,015**	**$38,259**	**1,149**	**$58,036,574**	**$50,500**	**3,220**	**$137,271,589**	**$42,628**

Source: Data provided by the PR Department of Economic Development (2015). *Imputed based on the application, as the only firm in this sector reported 0 payroll in the annual report. This imputation was not considered for the total estimates.

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Investment[21]

The results on initial investment show that most of the investment is concentrated in real estate and machinery and equipment. This is typical of businesses which are establishing new operations in the Island. This validates the fact that most businesses – as previously mentioned - are new foreign companies establishing their operations in Puerto Rico. If businesses were mostly local, one should expected less intensity in terms of real estate investments and equipment, particularly since local businesses can maximize their current real estate space and business operations. Furthermore, since these figures do not consider that businesses initially rent when entering a new market, bigger investment in real estate is to be expected as companies settle down in the ensuing years. As noted in the table, total investment is close to $143 million. This means that Puerto Rico's economy has benefited from an injection of productive capital of almost $70 million when real estate and machinery & equipment are add up. Is reasonable to expect a greater spillover effect to the local economy in both, the construction industry, and the equipment required for the type of businesses established.

Estimated Impact of Law 20 Firms in Puerto Rico

Actuals and Averages of expected 3-year investment schedules, by concept

Investment	$142,860,166
Real Estate	$30,960,811
Machinery & Equipment	$34,966,974
Other Assets[22]	$76,932,381

Total investment is close to
$143 million

Potential Income and Taxes

Act 20 companies have reported total revenues of almost $1.2 billion. The share of eligible and non-eligible activities follows the same tendency as in the payroll information. That is, total revenues from eligible activities are substantially higher than revenues from non-eligible activities. Again, data confirms that most companies are export oriented businesses benefiting from the incentives promulgated in the law; thus, it could be understood as a proxy for new economic activity.

Total revenues of almost
$1.2 billion

The table below shows that companies had an aggregate net income of $387 million of both eligible and non-eligible activities, which provides fiscal revenues of almost $34.3 million in the form of corporate income taxes. Even though financial data is limited,

[21] Average financial and operational estimates reported in 3-year projections combined with actual results from annual reports

[22] The way the information is compiled in the annual reports do not allow for a breakdown of which assets comprise the total figure of *Other Assets*.

the levels of net income against total revenues highlight a highly profitable group of businesses with a good chance to keep their operations running in the Island. That is to say, that data is not showing a sector in decay which may compromise future fiscal revenues from the incentives program.

While information for municipal tax paid was limited to annual reports, and no information is provided in applications, a simple linear estimate shows that almost $2,292,195 have been paid in municipal taxes[23].

Almost
$2,292,195
have been paid in municipal taxes

Companies operating under this scenario are expected to have wider spill-over effects in the local economy via outsourcing on local businesses and new potential ventures formed within the eligible services. This tendency provides a positive signaling to other local economic actors, which could tap into new foreign markets, not dependent on domestic demand.

Operating Information of Law 20 Firms

Actuals and averages of expected 3-year operational schedules

Total Revenues	$1,210,450,634
Eligible	$1,069,871,898
Non-Eligible	$140,578,736
Total Expenses	$788,751,495
Eligible	$718,827,049
Non-Eligible	$69,924,446
Corporate Income Tax Paid	$34,349,691
Eligible	$30,887,461
Non-Eligible	$3,462,230
Net Income	$387,349,447
Eligible	$320,157,388
Non-Eligible	$67,192,060

Other Fiscal Revenues

Being an incentive program focused on businesses, the biggest share of the total economic impact emanates from business activity, however, other areas of the local economy benefit from the revenues of these services. Among those one could highlight personal income tax from Act 20 employment and the sales tax from the consumption activity of such individuals. It is important to note that other sectors of the economy will also produce additional fiscal revenues, and these are subject to change depending on public policy.

Act 20 companies reported a total payroll of $137.1 million and an average salary of $42,301; with this salary employees would have paid an estimated individual income tax of $17.6 million annually, under the current tax system[24]. Services such as consulting, centralized management services, architectural and engineering services, and advertising and public relations paid the highest amount of individual income tax. These companies either have high salaries or a large total payroll.

[23] Act 20 has a special provision for municipal taxes which could be pushing down the total amount.

[24] Income tax paid was based on the 2014 income tax rates, with the first $20,000 being tax exempt.

Estimated individual income tax of
$17.6 million
annually

Following the previous analysis, half of the salary net of income tax was then multiplied by 7.0% to determine the SUT/VAT paid. This estimate is based on the fact that only around 50% of all consumption is subject to SUT/VAT. This totals $3.6 million on sales tax paid by the employment created under Act 20 beneficiaries.

$3.6 million
on sales tax

The table below summarizes the total fiscal contribution that is directly linked to Act 20. As noted in the table, Act 20 alone has generated close to $60 million in tax revenues. Almost 60% of all revenue is concentrated in direct business activity from corporate income taxes, however, since salaries from Act 20 businesses are relatively high, individual income tax represents close to 30% of all tax revenues.

Act 20 alone has generated close to
$60 million
in tax revenues

Potential Fiscal Revenues

Tax Revenue Estimate	Total Taxes
Corporate Income Taxes	$34,349,691
Income Taxes	$17,628,243
Sales Taxes	$3,555,070
Municipal Taxes	$2,292,195
Total	**$57,825,199**

Estimated Individual Income Tax Payable by Employees in Eligible and Non-Eligible Activities
2014

Type of Activity	Tax Payable in Eligible	Tax Payable in Non-Eligible	Total Individual Income Tax Payable
Consulting	$3,019,602	$4,082,829	$7,102,430
Production of construction drawings, architectural and engineering services and project management	$897,055	$2,060,941	$2,957,996
Call Centers	$0	$2,170,315	$2,170,315
Centralized Management Services	$1,982,518	$70,810	$2,053,328
Advertising and Public Relations	$1,145,092	$0	$1,145,092
Other	$1,142,495	$0	$1,142,495
Financial Services	$937,308	$63,454	$1,000,762
Centers for Electronic data processing	$778,081	$0	$778,081
Development of Computer Programs	$544,061	$132,168	$676,229
Professional Services such as legal tax and accounting	$499,549	$0	$499,549
Promoter	$0	$90,674	$90,674
Storage and Distribution Centers	$81,283	$0	$81,283
Educational and Training Services	$33,281	$0	$33,281
Research and Development	$23,913	$0	$23,913
Voice and Data Telecommunications	$13,790	$0	$13,790
Shared Services Centers*	$10,275	$0	$10,275
Hospitals and Laboratories	$10,031	$0	$10,031
Commercial arts and graphic services	$9,034	$0	$9,034
Total	**$11,127,367**	**$6,500,876**	**$17,628,243**

Sources: Data provided by the PR Department of Economic Development (2015). PR Treasury Department (2015).Income Tax 2014 Instructions. p. 16.

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Estimated Sales and Use Tax Payable by Employees in Eligible and Non-Eligible Activities
2014

Type of Activity	SUT Payable in Eligible	SUT Payable in Non-Eligible	Total SUT Payable
Consulting	$562,587	$810,712	$1,373,298
Other	$216,840	$233,477	$450,317
Professional Services such as legal tax and accounting	$118,654	$303,659	$422,312
Call Centers	$325,621	$41,733	$367,354
Advertising and Public Relations	$259,228	$59,908	$319,136
Centralized Management Services	$280,792	$35,793	$316,585
Production of construction drawings, architectural and engineering services and project management	$164,219	$26,374	$190,593
Financial Services	$125,177	$24,289	$149,466
Development of Computer Programs	$86,922	$43,914	$130,836
Centers for Electronic data processing	$81,597	$0	$81,597
Storage and Distribution Centers	$20,885	$28,257	$49,142
Voice and Data Telecommunications	$4,940	$29,496	$34,437
Educational and Training Services	$14,122	$1,665	$15,787
Promoter	$0	$6,642	$6,642
Research and Development	$5,394	$0	$5,394
Commercial arts and graphic services	$2,704	$2,391	$5,095
Shared Services Centers*	$2,528	$0	$2,528
Hospitals and Laboratories	$1,904	$0	$1,904
Total	**$1,948,493**	**$1,606,577**	**$3,555,070**

Sources: Data provided by the PR Department of Economic Development (2015). PR Treasury Department (2015).Rules for implementing the Dispostions of Subtitle D - Sales and Use Tax of Law 1 of January 31, 2011.* Value based on imputed payroll from application.

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Overall Impact in the Economy

As an incentive program that promotes the development of new export activity, Act 20 provides new dynamism to Puerto Rico's economy. Export activities, particularly in the service sector, have large positive externalities in the local economy. As presented in the section describing Puerto Rico's service economy, the service industry shows a growing tendency vis-a-vis manufacturing activity, and other sectors in the local economy.

In general, the service economy has high degree of mobility –less machinery/facilities and more human resources- and thus, allows for faster tangible effects in the economy. Moreover, the potential for new knowhow and its spillover effects can propel new economic activity. The fact that Act 20 companies are concentrated in high-value added services, with highly specialized skill sets, means that the local economy can participate in a more competitive market with potential technology transfers.

To what extent this is achieved will depend on Puerto Rico's capacity to develop strong linkages with foreign firms and propel local management to seek target markets beyond the domestic demand. As previously mentioned, contrary to manufacturing incentives, the performance of Act 20/22 incentives cannot be measured only via employment creation, but rather on the long-term effect of technical knowhow - which spurs innovation - and the internationalization of the local service sector.

As illustrated in the abovementioned results, Act 20 companies have directly created/retained over 3,000 jobs since their enactment. These jobs are predominantly high-skill and provide a direct link with foreign businesses and international markets. This exemplifies both, an opportunity to increase the local knowhow and also the potential internationalization of local businesses. Since Puerto Rico has an ample service economy, incentives are naturally in place for Act 20 businesses to capture local services and increase their productivity.

In terms of the effects in the Gross National Product (GNP), Act 20 economic impact in the form of revenues could represent close to 1% of Puerto Rico's GNP for 2014. Taking into account the limited time the incentive program has been in place, the total effect in GNP is relatively high when compared to other incentive programs such as the EB5 program in the USA[25].

Act 20 economic impact in the form of revenues could represent close to 1% of Puerto Rico's GNP for 2014

It is important to distinguish Act 20 from Act 22, particularly for the overall economic impact, since Act 20 provides a *level playing field* for all businesses within the Island while

[25] Several studies highlighting the effects of the EB-5 Program in the U.S. economy have estimated that the total economic impact of the program for a given year (2013) close to $3.58 billion or 0.02% of U.S. GDP. Contrary to the incentives programs in Puerto Rico, the EB-5 program has been in place since 1990's. *The Economic Impact and Contribution of the EB-5 Immigration Program* (2013). IIUSA, Invest in the USA. May, 2015, P.5; EB-5 Program: Successes, Challenges, and Opportunities for States and Localities (Sept. 2015) Bipartisan Policy Center, P.19; Total U.S. GDP figures from International Monetary Fund, Report for Selected Countries and Subjects.

Act 22 is directed to individuals. What could in turn have an effect on local businesses, is the fact that a more competitive market will require local service providers to increase their productivity. Additional policy tools will be required to create new market mechanisms that embed export services into the local ecosystem.

Data Analysis and Results for Act 22

Similar to the previous section, this analysis looks at the economic impact and benefits of law 22. However, the economic effects of Act 22 will vary from those of Act 20, mainly due to the incentive structure. Act 22 provides incentives for individual investors and Act 20 tax incentives for export companies.

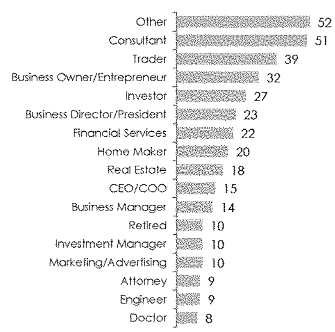
Grantee's Profile

As described in the data gathering section, for the purposes of this report, Act 22 has generated 573 approved decrees. The following figure illustrates the total number of decrees approved each year. At the time of the application a total of 344 grantees had a residence in Puerto Rico and 232 had a business established in the Island.

Year	Decrees
2012	18
2013	120
2014	262
2015	173
Total	**574**

Note: The total decree numbers do not take into account pending cases for 2015. Estimates from DDEC include close to 180 additional decrees from decree applications which are in the process of approval. Decrees by year will not add to the total since one decree did not had an approval date.

In terms of the main occupation identified by grantees, data shows that most grantees are consultants, traders within the financial industry, entrepreneurs and investors. Other occupations include attorneys, accountants, among others. Out of the total applications,



205 applicants did not state any current occupation.

To gauge the place of origin of decree holders the field of prior residence in the application was used as a proxy. Out of 573 decrees, 510 (89%) reported having their previous residence in the USA. The other 11% had previous residence in countries such as Venezuela, United Kingdom and Spain.

Country	Amount
USA	510
Venezuela	9
United Kingdom	6
Spain	3
US Virgin Islands	3
Uruguay	2
Dominican Republic	1
Canada	1
Hong Kong	1
Nevis	1
Brazil	1
Russia	1
BVI	1
Holland	1
Colombia	1
Italy	1
Monaco	1
Argentina	1
India	1
Unknown	27
Total	**573***

* Information on previous residence could not be obtain for all decree holders.

In terms of their distribution within the USA, most grantees come from Florida, followed by Texas, California, New York and Illinois. Yet, participants have come from all other states of the Union with the exception of Delaware, Hawaii, Maine, Mississippi and New Mexico.

State	Amount
Florida, USA	73
Texas USA	62
California, USA	61
New York, USA	53
Illinois USA	20
USVI	18
Nevada, USA	16
Georgia, USA	16
Connecticut, USA	15
USA	15
Massachusetts, USA	15
New Jersey, USA	15
Arizona, USA	13
Pennsylvania, USA	11
Texas, USA	11
Colorado, USA	10
Washington, USA	9
North Carolina, USA	7
Virginia, USA	7
Maryland, USA	7
Kentucky, USA	6
Utah, USA	5
Oregon, USA	5
Ohio, USA	5
Other	46
Total	**510**

Participants provided information of their main type of activity in their annual reports. As in Act 20, participants' main business (52.5%) is consulting and financial services. Centralized management services and advertising and public relations follow in order. The fact that participants of both programs have a similar profile with respect to their business activity, evidences that promotional efforts targeted the benefits of using both laws together. It is important to note that not all Act 22 grantees reported having a business, thus, absolute numbers will not match the total number of decrees.

Distribution of Reports by Type of Business

Consulting	32.2%
Financial Services	20.3%
Other	11.9%
Centralized Management Services	8.5%
Advertising and Public Relations	5.1%
Call Centers	3.4%
Hospitals and Laboratories	3.4%
Non-Service Industry	3.4%
Storage and Distribution Centers	3.4%
Development of Computer Programs	1.7%
Management	1.7%
Production of construction drawings, architectural and engineering services and project management	1.7%
Professional Services such as legal tax and accounting	1.7%
NA	1.7%

Act 22 Economic Impact

Being an individual investor program, Act 22 has a strong economic impact in local real estate investments. The case of Puerto Rico has been particularly relevant since at the time of the enactment of the law, Puerto Rico had an excess inventory of high-value properties which had a very limited market within the Island. Using the hybrid approach (combination of applications and annual reports) ETI was able to estimate several aggregate data points which can be used to estimate the economic impact of Act 22 beneficiaries.

Information from property values shows that close to $266 million have been invested in the local real estate market. The average property value ranged between $1.1 and $1.8 million. In terms of 1-year value of rent, estimates reflect a total of $7.1 million. As initial investors mature in the local market, it is expected they will make a transition to purchasing local real estate[26]. Moreover, with a subsequent amendment to the enabling Act[27], new investors are required to purchase a residential property within the Island.

This impact does not take into account other potential indirect effects of the program in

[26] Usually newcomers are more attracted to rental agreements due to the uncertainties experienced when entering a new market.

[27] Act 187-2015, "En las solicitudes de decretos que se radiquen a partir del 1 de diciembre de 2015, el Secretario requerirá a los solicitantes, como requisito indispensable para otorgar los decretos aquí establecidos, que el Individuo Residente Inversionista adquiera una propiedad residencial en Puerto Rico y que abra una cuenta personal o de negocio en un banco o cooperativa con presencia en Puerto Rico."

the economy, such as new businesses that have been created to provide services to Act 22 beneficiaries. Moreover, other potential investors have created new investments in the Island, betting on the new market that's been created due to these programs. This particular issue is partially measured in the data gathering section, under qualitative data and interviews to key industry informants.

Total Impact of Law 22 Individuals
Hybrid (Application and Report)

Planned Capital Investment	**$228,381,000**
Percentage of Individuals with Established Businesses in Puerto Rico	**52.29%**
Expected Employment from Business Activity	**2,483**
Total Net Worth:	
Unspecified	22.3%
Less than 10 million	66.4%
10 million to 50 million	9.9%
50 million to 100 million	1.2%
More than 100 million	0.2%
Percentage of Capital Estimated to be Transferred:	
Unspecified	39.5%
0% - 25%	17.9%
26% - 50%	10.6%
51% - 75%	9.1%
76% - 100%	15.7%
Other	7.1%
Total Value of Currently Purchased Properties	**$266,333,025**
1-year Value of Rent	**$7,145,856**
Percentage of Individuals Making Other Investments	**39.3%**

Based on the information provided by the program participants, close to 66% had a net worth of less than $10 million; only 10% had a net worth between $10 and $50 million. This means that their residential status in the island will create a bigger demand for consumer goods and services from local companies. Again, to maximize the economic benefits of this new capital, local businesses will need to adapt their services to the particulars needs of such a market. Furthermore, individual spending in terms of consumer goods will have an impact in terms of fiscal revenues, but also with local businesses providing such goods.

Act 22 Applications do not hold information on expected consumer spending, hence Annual Report data was used to determine total consumer spending from Act 22 decree holders[28]. The data from 133 annual reports totaled $17,884,645. The average spending per decree was used to estimate the total potential spending for all decree holders, this amounts to more than $73 million.

The total potential spending for all decree holders amounts to more than $73 million.

On the other hand, these individual investors could have bigger effects in the economy if they develop new business ventures within the Island. i.e. buying commercial facilities will have an impact in the economy, yet, injecting new capital improvements to those facilities could have a wider economic impact[29]. Act 22 grantees reported a total of $228 million in capital improvements[30] and 52% had businesses established in Puerto Rico[31].

Act 22 grantees reported a total of $228 million in capital improvements

The business activity of these individuals generate close to 2,483 new jobs within the Island. These direct jobs in turn, helped to generate 1,604 indirect jobs and 1,127 induced jobs. The direct, indirect and induced employment[32] accounts for a total of 5,214 jobs. This estimation was carried out using the Input-Output Matrix for Puerto Rico (2002). Given the diversity of work offered by

[28] Out of 574 decrees only 133 submitted annual reports in 2014. These annual reports had a particular field named "money spent in Puerto Rico".

[29] Construction for instance, has a high degree of *embeddedness* in terms of local intra-industry links.

[30] The initial estimate of $214 million, excluded potential duplication from couples and Act 22 individuals which had an Act 20 decree. The exclusion intended to minimize any overestimation as a result of couples which reported the same capital investments, under different decree numbers; and also Act 22 individuals which planned capital investments for their Act 20 business. After further analysis, the information was individually analyzed to determine which couples had non-related capital investments and thus must be included in the final amount of total capital investments. Information was gathered directly from Act 22 applications. This data field is not included in the Act 22 Annual Report.

[31] This fact is further validated in the data, since 40% of grantees reported making other investments in Puerto Rico.

[32] Basic definition of multipliers effect: Direct – refers to new economic activity directly linked to the incentive program. Indirect – refers to business growth in suppliers of program beneficiaries. Induced – additional spending in the economy as a consequence of direct and indirect businesses. i.e. additional spending from workers and payroll. (consumer expenditure) *The above assumes continuation of local inter-industry trade patterns and local flows of money.

Law 22 beneficiaries the multipliers for the service sector were used to estimate the impact of employment.

The direct, indirect and induced employment accounts for a total of 5,214 jobs

It is important to note that these jobs do not include employment generated by the consumption of services demanded by the household, such as domestic work or other incidental services required by a homeowner.

The above employment figures represent jobs directly created by the Act 22 individuals and which exclude any potential overlapping with Act 20 jobs from individuals which hold decrees from both acts.

Total Employment

Direct	Indirect	Induced	Total
2,483	1,604	1,127	**5,214**

Source: DDEC, Input-Output Matrix 2002

Qualitative Data

To supplement the data obtained from Act 20/22 decrees (applications and annual reports), several interviews were conducted with business leaders who have played key roles in the implementation and execution of these programs. This section is particularly relevant, as not all the direct effects of the incentives programs can be captured by DDEC reporting requirements for decree holders.

In terms of the profile of the informants, it was very diverse, and included consulting firms, real estate companies, financial institutions and non-decree holders with local investments. Some informants provided robust data on current and future investments and others provided insights on new ventures developed as a result of these programs, including the creation of new divisions and hiring new personnel to deal with the new clientele.

Information obtained from the consultations consists of data related to the general Act 20/22 decree holders' profile, their investments in Puerto Rico, and other facts concerning the overall impact of these laws.

In general, most of the interviewees agree that both laws have a positive impact in the Island's economy and contribute to develop new investment opportunities. Moreover, informants agreed that both, Acts 20 and 22, play an important role in marketing the Island as an investment location in U.S. and international markets. Nonetheless, some informants recommended the government to consider enacting additional policy measures that guarantee a level playing field, for both local and foreign investors.

As specified by informants, the highest influx of Act 20 and Act 22 applications was between the second semester of 2014 and the first semester of 2015. In their opinion, a decline in the number of persons interested in benefitting from these laws occurred during mid-2015, mostly due to the uncertainty arising from Puerto Rico's fragile fiscal situation.

Informants stated that Act 22 participants have very diverse profiles, not only in terms of net worth, but in terms of occupations and interests. Not all decree holders are "super rich" as traditionally perceived, and they come from multiple cultural backgrounds and world regions. Mostly they are knowledgeable, highly educated individuals, who demand highly skilled services and high scale consumer products. This has generated an increase in the demand for specific products and services, particularly, organic products, high-end restaurants, concierge services, healthcare related services, among others. This in turn could cause the emergence of new businesses in the Island to satisfy the demand of this sector. Also, since most Act 20/22 decree holders move to Puerto Rico with their families, there has been an increase in the enrollment in local private educational institutions and other complementary services.

Other Economic Effects

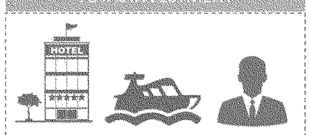
According to the interviewees, one of the main areas of impact is the commercial and residential real estate sector. Participants mentioned that Act 22 played an important role, particularly in the case of high-end projects in distress, both in completing projects and in selling units. This has been the case, not only with decree holders, but also with private investors who have been attracted to Puerto Rico since the enactment of this Law, even though they are not benefiting from it directly.

Act 22 investors were initially more interested in renting properties rather than buying. This trend changed since mid-2014, when there was a noticeable increase in real estate sales. Information provided by agents confirmed that most Act 22 grantees who are buying homes in Puerto Rico, are acquiring real estate properties in San Juan (Condado Area), Dorado and Humacao (Palmas del Mar).Similarly, most renters are also located in San Juan's Condado Area and Dorado.

In terms of residential real estate, they are mostly concentrated in Dorado, Humacao, Rio Grande and San Juan. Total investment in residential real estate exceeds $150 million. The average property value is around $1.5 million. Furthermore, major investors- who are not decree holders, but which are indirectly incentivized by both programs, were interviewed. An investor reported initial investments of $76.6 million for the purchase of a residential apartment building, commercial spaces and adjacent lots in San Juan. An additional $44.7 million in capital expenditures has been invested to finance the construction and renovations of the residential apartment complex and its commercial premises.

Total investment in residential real estate exceeds
$150 million

TOTAL INVESTMENT



The acquisition, remodeling and improvement of hotels, office buildings, marinas, as well as partnerships with local businesses, have generated a total investment of **$125 million** as a result of Act 22.

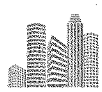
As to commercial properties, the biggest real estate firms in Puerto Rico move around $40 to $50 million a year in transactions related to Act 20/22 investors. The acquisition, remodeling and improvement of hotels, office buildings, marinas, as well as partnerships with local businesses, have generated a total investment of $125 million as a result of Act 22. Informants indicated that, besides acquisition price, most entrepreneurs are planning to make additional investments in the properties acquired within the Island. The development of these commercial properties has also created direct jobs in administration and customer service, as well as construction jobs. Moreover, non-decree holders have also acquired commercial properties for a total approximate investment of $650 million.

COMMERCIAL PROPERTIES INVESTMENT

Approximate investment of $650 million

Some particular investments include a marina for $50.2 million and an additional $10.6 in renovations of the infrastructure. Some key informants have already awarded contracts for further commercial developments within the Island which total over $112 million for the following three years.

FURTHER COMMERCIAL DEVELOPMENTS



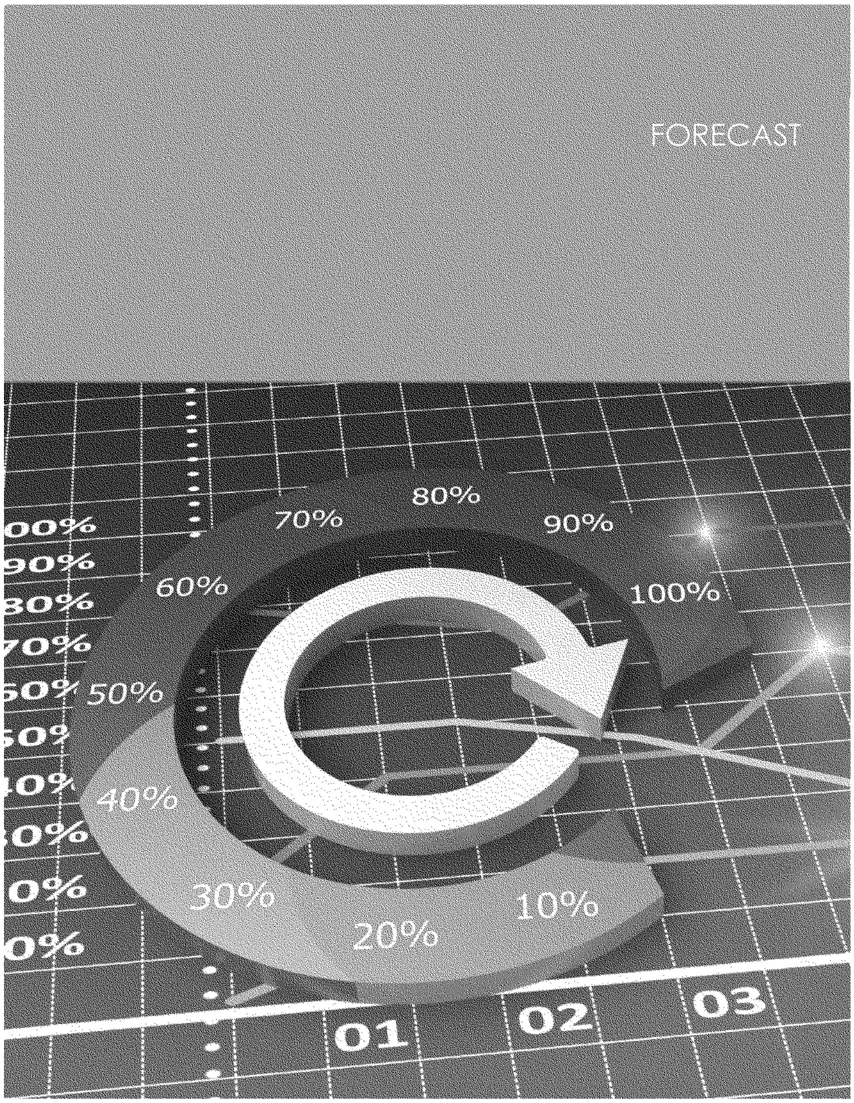
total over $112 million for the following three years.

Related to Act 20, interviewees stated that most participants are foreign companies that established offices in Puerto Rico to export services from the Island. These businesses are mostly engaged in financial, technological and consulting services. According to the informants, their profile has changed since the enactment of the Law in 2012. During 2013, most Act 20 companies were leasing small office spaces; while in 2014-2015 most business in the technological industry, such as programmers, web designers, cloud hosting, web marketing, call centers, with 25 to 50 employees needed larger facilities to carry out their services.

FINANCIAL SERVICES

Act 20/22 decree holders have over 730 bank accounts in local banking institutions and some institutions reported having close to $100 million in deposits from these clients.

In terms of local financial services, Act 20/22 decree holders have over 730 bank accounts in local banking institutions and some institutions reported having close to $100 million in deposits from these clients. Individual investors have generated over $85 million in residential mortgages closings and used local baking services for investments of more than $5 million. Similarly, multiple credit cards have been granted and commercial credit lines of over $6 million are currently operating. Between 2014 and 2015 all these figures have experience an average growth of more than 80%.


FORECAST
70%
80%
90%
60%
100%
50%
40%
30%
20%
10%
01
02
03

10 Year Forecast for the Expected Number of Act 20 and Act 22 Decrees

Estimates are based on DDEC's database. Additional qualitative data was gathered for validation, including interviews with key informants. Only official data was used to develop aggregate figures of economic impact.

In order to estimate the potential long-term impact of Act 20 and Act 22 decrees, the potential trend in decree growth up to 2024 was estimated. This provides a reasonably conservative estimate of expected decree counts, based primarily on the behavior of the potential demand for these decrees and the cumulative effects of promotional activities.

Limitations

The information provided by the Department of Economic Development comprises four (4) years of decree approvals, which accumulate into 360 approved Act 20 decrees and 574 Act 22 decrees. However, the only "complete year" of available information in annual reports is 2014. Additionally, due to the incipient nature of the project, there is clearly not enough decree data to produce accurate forecasts for long periods based on extensive time series. [33] Finally, the potential results are greatly influenced by the agency resources involved in the programs: a significant change in these would heavily influence the outcome of the programs far beyond any statistical trend, and would not be explainable by the economic information of current applicants. Therefore, our forecasts hold a very "ceteris paribus" plausibility with limited statistical power, and should only be deemed as an assessment of plausible scenarios following particular trends.

To simplify the analysis, all future decrees were assumed to be for residents and firms from the main markets which comprised the profile of decree holders.

Theoretical Approach

Our forecasts took the approach of modeling the overall trend in the *potential base of applicants* for each Act, and deriving an estimated number of decrees from the parameters in said model. This potential base was defined as *the group of individuals having a shared set of determinant characteristics with the decree holders*. Potential decree holders are expected to be "drawn" from this potential base, i.e. *every applicant is assumed to come from this particular base (up to a margin of error)*.

[33] This refers to time series forecasts, which dynamically model the trend in decrees alongside other external factors and could produce a more reliable estimate of the decree count, particularly for such a long time span.

Proxies of the Potential Base

The potential base is not directly observable, but can be approximated by using a set of proxy variables. These proxies differ with respect to the original definition of potential base as defined above, but do serve as a parsimonious representation of it. Selecting the suitable proxies for each Act consisted of a multi-part process, involving 1) ranking the most important characteristics of the eligibility requirements in each Act, and 2) evaluating the available pools of related variables for which there exists a reasonable amount of data available. After several discussions and a consensus interpretation of the eligibility requirements, the following potential pools were identified:

1) **Establishments involved in Act 20 eligible activities**
   a. An establishment is defined by the US Census Bureau as "a business or industrial unit at a single physical location that produces or distributes goods or performs services" (US Census Bureau, 2015). The locational distinction is deemed important, as U.S. firms are able to take advantage of Puerto Rico' s Act 20 by locating a particular establishment in the island, not necessarily creating a new firm. Also, only the activities performed by establishments *located in the island* would be eligible for Act 20 benefits.
2) **Owners of housing units with high property value**
   a. A difficulty in determining the potential base of Act 22 decree holders was the extremely low response rate to the household income variable, which made income (as reported by participants) unviable as a defining characteristic of participants. Additionally, Act 22 decree holders do not need to generate a high-level income in order to partake in the benefits, which are vested upon *capital assets*.
   b. However, a variable which was reported by most decree holders was the property values which they intended to purchase in the island. The average value of primary properties purchased in Puerto Rico by Act 22 decree holders was 1.8 million, and the bracket of owner-occupied housing units containing this value was selected as the proxy. The reasoning was that *the characteristics of owners of high-value real estate in the US roughly mirror the characteristics of Act 22 decree holders, and hence are sufficiently correlated to the potential base to be used as a proxy.*

The next sections detail the data and forecasting methods used to extend the potential base of each Act into a long-term forecast up to 2024.

Description of the Data

The data used are yearly establishment counts from the US Census Bureau's *County Business Patterns* database.[34] This database contains information about employment, payroll and number of establishments for an administrative sample of establishments. This yearly establishment count differs from the *Economic Census* (also by the US Census Bureau), which is updated every five (5) years and includes an estimate of all establishments/firms in a particular geographical jurisdiction. The establishment data are classified using the *North American Industrial Classification System* (NAICS), with revisions also made every five (5) years.

Imputation of NAICS to Eligible Activities

Eligible activities are not classified by NAICS codes: hence, a suitable NAICS code was imputed in order to relate the establishment counts to each activity. The level of detail was kept up to 3-digit NAICS codes (industry subsectors), due to the following factors:

1) Eligible activities were already broad enough to be classified into more than 1 NAICS sub-sector, and even more if higher levels of detail were used; and
2) More detailed subsectors would not be disclosed if they contained a high level of firm concentration, or too low an employment/establishment count.

The following table presents the imputed NAICS codes for Act 20 eligible activities.

Imputation of NAICS Codes to Eligible Activities in Law 20

Eligible Activity	Imputed NAICS Codes (2012)		
Research and Development	541		
Advertising and Public Relations	541		
Consulting Services	541	523	524
Commercial Arts and Graphic Services	541		
Production of Blueprints, Architecture, Engineering & Project Management	561		
Professional Services	541		
Centralized Management Services	551		
Centers for Electronic Data Processing	518	519	541
Development of Computer Programs	511	541	
Voice and Data Telecommunications	517	519	513 and 514*
Call Centers	561		
Shared Services Center	541		
Storage and Distribution Centers	492	493	
Educational and Training Services	611		
Hospital and Laboratory Services	621	622	
Investment Banking and Other Financial Services	523	524	

Source: Law 20 of January 17 of 2012, Article 3. Codes selected by Estudios Técnicos, Inc. *These are the equivalent codes for these activities under the NAICS 1997 classification.

[34] An establishment is defined by the US Census Bureau as "a business or industrial unit at a single physical location that produces or distributes goods or performs services." See https://www.census.gov/glossary/#term_Establishment

Timespan of the Data

The sample time period used was 2000-2013, the latest year for which *County Business Patterns* data was available. The NAICS underwent several major revisions from 1997 through 2002, including the broadening of the Telecommunications sub-sectors and the introduction of several new classifications for older sectors. Hence, only three (3) years of NAICS 1997 data were included, which coincided with the turn of the century and the dot-com explosion – a major structural rift in the history of service exports. For these years, the NAICS 1997 codes which most closely coincided with the NAICS 2002 sectors (which already include the aforementioned changes) were used.

Forecasting Method

The technique involved forecasting the growth trend in the potential base using an Auto-Regressive model of lag 1 (known as an AR-1 process). This model was chosen following the approach given by Box and Jenkins (1970). The growth in number of establishments was projected for the 2014-2024 period – an 11 year span – due to the fact that the available information exists only up to 2013. The following table presents the estimates and margins of error for the model.

Actual and Forecasted Number of U.S. Establishments in Act 20 Eligible Activities

Year	Number of Establishments	Base Case Estimates		
		Base Growth	Margin of Error	Change
2000	1,954,123			
2001	1,987,145	1.69%	1.69%	33,880
2002	2,037,232	2.52%	2.52%	51,349
2003	2,058,809	1.06%	1.06%	21,806
2004	2,105,848	2.28%	2.28%	48,114
2005	2,149,599	2.08%	2.08%	44,660
2006	2,197,208	2.21%	2.21%	48,663
2007	2,249,030	2.36%	2.36%	53,044
2008	2,250,477	0.06%	0.06%	1,448
2009	2,237,191	-0.59%	-0.59%	-13,208
2010	2,247,083	0.44%	0.44%	9,936
2011	2,245,631	-0.06%	-0.06%	-1,451
2012	2,278,944	1.48%	1.48%	33,807
2013	2,298,852	0.87%	0.87%	20,082
2014	*2,324,096*	**1.10%**	*+/-1.475%*	*25,244*
2015	*2,351,839*	**1.19%**	*+/-1.603%*	*27,743*
2016	*2,380,871*	**1.23%**	*+/-1.625%*	*29,031*
2017	*2,410,672*	**1.25%**	*+/-1.629%*	*29,802*
2018	*2,441,025*	**1.26%**	*+/-1.630%*	*30,353*
2019	*2,471,836*	**1.26%**	*+/-1.630%*	*30,811*
2020	*2,503,069*	**1.26%**	*+/-1.630%*	*31,233*
2021	*2,534,712*	**1.26%**	*+/-1.630%*	*31,642*
2022	*2,566,760*	**1.26%**	*+/-1.630%*	*32,048*
2023	*2,599,216*	**1.26%**	*+/-1.630%*	*32,456*
2024	*2,632,083*	**1.26%**	*+/-1.630%*	*32,868*

Sources: US Census Bureau (2015), *County Business Patterns* – 2000 to 2013. Forecasts by Estudios Técnicos, Inc. (2015). Margins of error are based upon a 90% prediction interval.

This model did not consider exogenous factors which may affect the growth in number of establishments; it merely reflects the growth trend in the potential base. As can be seen, the margin of error actually *exceeds* the forecasted growth in the base case, owing to 1) the small amount of periodicity in the data (13 growth values) and 2) the large forecasting horizon, which basically doubles the size of the available data. However, this is a normal occurrence in models with such large time horizons (e.g. Hogarth & Makridakis, 1981).

Forecasts of the Act 22 Potential Base

Description of the Data

The data used are the counts of owner-occupied housing units in the U.S. valued above $1 million, according to the *American Community Survey 1-year Estimates*. Note that our deduplication method for decrees in the real-estate value made possible the correspondence of 1 homeowner to exactly 1 primary residence, since the Act 22 spouses' duplicated data was discounted in estimating the property value. Likewise, the value of owner-occupied housing units had a 1-1 correspondence with the primary residence, due to the occupation requirement of the estimated universe. Hence, the number of housing units (which is the variable provided by the Census data) can also be taken as the number of eligible homeowners (family or otherwise).

Timespan of the Data

The sample time period was 2005-2014, the latest year for which the *American Community Survey 1-Year Estimates* were available.

Forecasting Method

As with the Act 20 forecasting, the technique utilized followed the approach by Box and Jenkins (1973). Using the lag specification, an AR-1 model was also utilized to model the growth rate of new housing units. The forecasting period was 2015-2014 – a 10 year timespan. Mirroring the Act 20 forecast methodology, no exogenous factors were considered in the model, giving a trend-estimate of the growth in housing-units.

As can be seen in the following table, the number of data values available is of less size as the forecasting period (9 growth values vs 10 forecasted values). As a result, the mean predictions take their own forecasted values as exact in the calculation of the longer-term forecasts, without taking any actual data to weigh these estimates. This compounds the margin of error by the inherent uncertainty in taking the point estimate as given (see Sorjamaa, Hao, Reyhani, Ji & Lendasse, 2007). Note that this compounding is independent of the type of model used, since it comes as a result of the proxy characteristics.

Actual and Forecasted Number of Owner-Occupied Housing Units With Property Value Above $1 million

Year	Owner-Occupied Housing Units Valued Above $1 Million	Base Case Estimates		
		Base Growth	Margin of Error	Change
2005	1,488,414			
2006	1,826,113	22.7%		
2007	1,974,385	8.1%		
2008	2,024,287	2.5%		
2009	1,676,630	-17.2%		
2010	1,558,461	-7.0%		
2011	1,472,701	-5.5%		
2012	1,460,472	-0.8%		
2013	1,558,025	6.7%		
2014	1,770,990	13.7%		
2015	*1,967,569*	*11.1%*	*+/-15.431%*	*196,579*
2016	*2,154,329*	*9.5%*	*+/-18.205%*	*186,760*
2017	*2,337,132*	*8.5%*	*+/-19.182%*	*182,803*
2018	*2,520,722*	*7.9%*	*+/-19.552%*	*183,590*
2019	*2,708,793*	*7.5%*	*+/-19.695%*	*188,070*
2020	*2,904,208*	*7.2%*	*+/-19.751%*	*195,415*
2021	*3,109,233*	*7.1%*	*+/-19.773%*	*205,025*
2022	*3,325,725*	*7.0%*	*+/-19.781%*	*216,492*
2023	*3,555,278*	*6.9%*	*+/-19.784%*	*229,553*
2024	*3,799,328*	*6.9%*	*+/-19.786%*	*244,050*

Sources: American Community Survey 1-Year Estimates (2015). Value (Table B25075). Forecasts by Estudios Técnicos, Inc. (2015). Margins of error based upon a 90% prediction interval.

Obtaining Decree Estimates: The Static and Dynamic Capture Rates

After the potential base was forecasted, a formula for deriving the decree estimates was used. This formula made use of an assumption which requires the introduction of two (2) important terms:

1) The *static capture rate* (SCR) – also known as simply the *capture rate*, it is defined as the ratio of decrees to the potential base for a particular time period. An increase in the capture rate implies that the decrees represent a *larger* proportion of their potential base.
2) The *dynamic capture rate* (DCR) – it is defined as the change in decrees, as a percentage of the *change* in the potential base. It is a measurement of the velocity at which decrees increase with respect to the potential base. Changes in the DCR correspond to the *acceleration* in the capture rate, or variations in the speed at which new decrees increase.

The primary assumption used was that the DCR remains constant throughout the period, that is, decrees will be added at a constant rate from 2016 onwards. Although highly restrictive, the aforementioned implication is consistent with the idea that our forecasts model the exogenous demand trends only. *At any given time, the set of factors endogenous to the agency may significantly alter the velocity at which decrees are added, and thus violate the assumptions used in this forecast.*

The formula used to derive the number of decrees for each formula is $D_{t+1} = k\,(B_{t+1} - B_t) + D_t$, where k is a constant, B_t is the potential base at time t, and D_t is the number of decrees at time t. The parameter of interest is k, which was determined using the methods described below.

Scenarios for the Dynamic Capture Rate

Due to the lack of data in order to estimate k, a scenario approach was used instead.

We evaluated the empirical estimates of the DCR by year, which are presented in the tables below.

Estimation of the Dynamic Capture Rate for Act 20

Year	Change in Establishments	Change in Act 20 Decrees*	Dynamic Capture Rate (DCR) for Act 20
2012	33,807	35	0.1028%
2013	20,082	50	0.2477%
2014	25,522	124	0.4902%
2015**	28,074	295	1.0624%

Sources: Data provided by the PR Department of Economic Development for Act 20 decree holders, US Census Bureau (2015). *County Business Patterns – 2012 and 2013.* Forecasts by Estudios Técnicos, Inc. (2015). *There were 11 decrees whose date of approval was not included, which were split evenly between the four (4) years and added to the number of decree holders for each year. **2015 includes both the amount of decree holders as of February 2, 2015, and the number of non-canceled decree applications for 2015. This is due to the fact that the PR Department of Economic Development is currently accepting all applications as eligible decree holders.

Estimation of the Dynamic Capture Rate for Act 22

Year	Change in Home Owners	Change in Act 22 Decrees*	Dynamic Capture Rate (DCR) for Act 22
2012	-12,229	18	-0.1492%
2013	97,553	120	0.1233%
2014	212,965	262	0.1231%
2015**	196,579	318	0.1619%

Sources: Data provided by the PR Department of Economic Development for Act 20 decree holders. US Census Bureau (2015). *County Business Patterns – 2012 and 2013.* Forecasts by Estudios Técnicos, Inc. (2015). *There was 1 decree whose date of approval was not included in the data supplied, which was split evenly between the four (4) years and added to the number of decree holders for each year. **2015 includes both the amount of decree holders as of February 2, 2015, and the number of non-canceled decree applications for 2015. This is due to the fact that the PR Department of Economic Development is currently accepting all applications as eligible decree holders.

Using these estimates, the following scenarios were constructed for each Act:

1) **Base Scenario** – the DCR for the forecast period is the average of the DCR in the two (2) most recent years.
2) **Optimistic Scenario** – the DCR is the greater of the two (2) most recent years.
3) **Pessimistic Scenario** – the DCR is the lesser of the two (2) most recent years.

Due to the short time span since the Acts' approval, only the two (2) most recent years were used to construct each scenario. These years are more likely to reflect a realistic DCR as the decree programs have more maturity.

Results

The following tables present the forecasts from 2015 to 2024, according to each of the scenarios discussed.

Expected Trend in Act 22 Decrees, by Scenario

Year	Baseline (Average 2014-2015 DCR)	Optimistic (Best-Performing DCR)	Pessimistic (Worst-Performing DCR)
2015	719	719	719
2016	985	1,021	949
2017	1,246	1,317	1,174
2018	1,507	1,615	1,400
2019	1,775	1,919	1,632
2020	2,054	2,235	1,872
2021	2,346	2,567	2,125
2022	2,655	2,918	2,391
2023	2,982	3,289	2,674
2024	3,330	3,685	2,975

Sources: Data provided by the PR Department of Economic Development (2015). Forecasts by Estudios Técnicos, Inc. (2015). DCR = Dynamic Capture Rate – See Section __ for explanation.

Expected Trend in Act 20 Decrees, by Scenario

Year	Baseline (Average DCR)	Optimistic (Best-Performing DCR)	Pessimistic (Worst-Performing DCR)
2015	503	503	503
2016	728	811	645
2017	960	1,128	791
2018	1,195	1,451	940
2019	1,435	1,778	1,091
2020	1,677	2,110	1,244
2021	1,923	2,446	1,399
2022	2,171	2,786	1,557
2023	2,423	3,131	1,716
2024	2,679	3,480	1,877

Sources: Data provided by the PR Department of Economic Development (2015). Forecasts by Estudios Técnicos, Inc. (2015). DCR = Dynamic Capture Rate – See Section __ for explanation.

10 Year Forecast of the Economic Impact of Act 20 and Act 22

Obtaining the impact for Law 20 and 22 firms involved two (2) general steps: 1) measuring the individual footprint of each decree, and 2) establishing an appropriate dynamic for the behavior of each new entrant across time. The total impact is the aggregation of the decrees' dynamic footprint across the estimated time span.

General Assumptions

The following assumptions were held as true in both Act 20 and Act 22 forecasts:

1) As with the decree forecast, each new decree is assumed to be "captured" from a potential base of applicants, which is approximated via proxies.
2) The distribution of decrees by sector is dynamic, and will change over time according to the industrial/individual characteristics of each new entrant. Therefore, it cannot be held fixed across time.
3) Each new entrant behaves according to the general trend of the currently approved decrees with respect to employment and revenues. In other words, *outliers were not considered in any of the footprint estimates*.

The last assumption is important, since in more than one of the measured variables, a small set of outlying decrees represented a disproportionate amount of the total impact. We hold these values as probabilistically indistinguishable from 0, in that the base probability of new entrants with these characteristics, compounded over the considered time period, is basically 0.

Step 1: Measuring the Individual Footprint

The Trimmed Mean

The *trimmed mean* served as the primary estimate for the footprint of evaluated variables. A *trimmed mean* Σ with trim factor $\phi \in [0,50]$ is an average which excludes the top ϕ percent of the highest-valued half of the data, and the bottom ϕ percent of the lowest-valued half of the data. The trimmed mean serves to remove outliers from the estimates, thus providing a more robust estimate when compared with the regular mean. With the exception of non-eligible employment, all trimmed means used a trim factor of 5%. Due to the small sample size in non-eligible employment, the trimmed mean for this variable used a trim factor of 2.5%.

The following tables present the estimated decree footprint for each of the considered variables, using the data from the hybrid-approach datasets discussed in previous estimates.

Estimates of the Act 20 Tax Decree Footprint
Trimmed Means

Employment by Decree	
Eligible Activities	2.7
Non-eligible Activities*	0.6
Average Wages Paid per Employee	
Eligible Activities	$39,735
Non-eligible Activities	$56,578
Gross Income by Decree	
Eligible Activities	$1,925,337
Non-eligible Activities	$225,865
Corporate Income Tax Paid by Decree	
Eligible Activities	$39,785
Non-eligible Activities	$5,687

Sources: Data provided by the PR Department of Economic Development (2015). Estimates by Estudios Técnicos, Inc. (2015). All estimates in this table are trimmed means. *The trim factor is 5% for all variables, excluding employment in non-eligible activities, which has a trim factor of 2.5%.

Estimates of the Act 22 Tax Decree Footprint
Trimmed Means

Money Spent in Puerto Rico (Excluding Rent and Mortgage)	$101,802
Employment	1.8
Property Value	$1,022,733
Rent Payment (12-Year Value)	$33,347

Sources: Data provided by the PR Department of Economic Development (2015). Estimates by Estudios Técnicos, Inc. (2015). Trimmed means were used for all variables in this table, with a trim factor of 5%.

Step 2: Establishing Behavioral Dynamics

While the forecasting process involved only characteristics of the potential pools and obtaining an estimated number of decrees, the impact measurement involves additional assumptions regarding the long-term behavior of each decree. Due to the heterogeneity in the types of decrees, these were evaluated in a multi-generation approach which is detailed in the following subsections.

Act 20

Each year, a specified number of entrants is added to the already active decrees. We refer to this number as a *generation* of decrees. All generations follow a specified 10-year behavior regarding their economic footprint; however, they begin said pattern at different starting years, and thus each generation contributes a different amount per year. The specified behavior is as follows:

1) Introduce the establishment with α_1 employees, and hire β_1 employees for three (3) more years (not necessarily in sequence);
2) Generate α_2 in yearly gross income;
3) Produce α_3 in payroll per year; and
4) Pay α_4 percent of the gross income in corporate income taxes.

This pattern was generated for both eligible and non-eligible activities, with each type of activity differing in its starting values. As no assumption regarding the distribution of decrees was made for each year, each generation originally had the same starting parameters for its corresponding eligible and non-eligible activities. To address this, three (3) sources of exogenous variation were introduced:

1) The starting value for each decree's yearly revenue was updated according to growth in the US real GDP for the imputed NAICS sectors of the potential base.
   a. A 10-year trend forecast of real GDP growth in the US was made using ARIMA models. The resulting forecasted growths were then applied to the base revenue footprint of each decree during its respective entrance year.
   b. The data used for the forecast was the *Value Added by Industry* table from the Bureau of Economic Analysis, from 1997 to 2014. Some sectors were excluded from the estimate, as these tables did not hold the required levels of NAICS detail to include all categories, even at the general levels used for the imputation.
2) The average wage paid in eligible activities was updated each year according to Puerto Rico's wage growth in the imputed NAICS sectors, assuming that the decree holders will maintain the PR wage scale when hiring workers.
   a. A 10-year trend forecast of quarterly wage growth and employment in eligible activities was made using ARIMA models, and the resulting growth in the average wage was applied to the base wage.
   b. The data was retrieved from the *Quarterly Census of Employment and Wages*, a quarterly dataset compiled by the Bureau of Labor Statistics, from January 2001 to June 2015. Non-disclosed values at differing levels of detail in NAICS sectors were imputed using the either last known disclosed value for each series, or the value such that the annual averages coincide with the reported statistic, if said averages were available.
3) The average wage paid in non-eligible activities was updated yearly according to Puerto Rico's overall growth in quarterly wages.
   a. The same treatment as with the previous series was given to this forecast. The data used was obtained from the same source as the forecast for eligible activities.

The following tables present the forecasted growths for GDP and average wages in eligible and non-eligible activities. As can be seen, the margin of error is very wide for the average wage forecasts, due to compounded uncertainty for both wage and employment growths. This is particularly the case in eligible activities due to the additional imputation procedures which had to be made for non-disclosed data.

Forecasts & Actual Values of Real GDP Growth in the Potential Base of Eligible Activities (United States)

Year	Estimate (in billions)	Margin of Error	Growth
1997	$2,695		
1998	$2,830		5.0%
1999	$2,963		4.7%
2000	$3,087		4.2%
2001	$3,241		5.0%
2002	$3,313		2.2%
2003	$3,405		2.8%
2004	$3,553		4.3%
2005	$3,723		4.8%
2006	$3,855		3.5%
2007	$3,913		1.5%
2008	$3,943		0.8%
2009	$3,780		-4.1%
2010	$3,886		2.8%
2011	$3,980		2.4%
2012	$4,112		3.3%
2013	$4,177		1.6%
2014	$4,331		3.7%
2015	$4,469	+/-148	3.2%
2016	$4,604	+/-161	3.0%
2017	*$4,741*	*+/-167*	*3.0%*
2018	*$4,881*	*+/-172*	*2.95%*
2019	*$5,025*	*+/-177*	*2.95%*
2020	*$5,173*	*+/-183*	*2.94%*
2021	*$5,325*	*+/-188*	*2.94%*
2022	*$5,482*	*+/-194*	*2.94%*
2023	*$5,643*	*+/-199*	*2.94%*
2024	*$5,809*	*+/-205*	*2.94%*

Sources: US Bureau of Economic Analysis (2015). *GDP by Industry - Value Added - 1997 to 2014.* Forecasts by Estudios Técnicos, Inc. (2015). Note: Some sectors were not included in the forecasts, due to there not being enough detail in the GDP tables used to be included.

Forecasts & Actual Values of Real GDP Growth in the Potential Base of Non-eligible Activities (United States)

Year	Estimate (in billions)	Margin of Error	Growth
1997	$11,035		
1998	$11,526		4.4%
1999	$12,066		4.7%
2000	$12,560		4.1%
2001	$12,682		1.0%
2002	$12,909		1.8%
2003	$13,271		2.8%
2004	$13,773		3.8%
2005	$14,234		3.3%
2006	$14,614		2.7%
2007	$14,874		1.8%
2008	$14,830		-0.3%
2009	$14,419		-2.8%
2010	$14,784		2.5%
2011	$15,021		1.6%
2012	$15,355		2.2%
2013	$15,583		1.5%
2014	$15,962		2.4%
2015	$16,355	+/-459	2.5%
2016	$16,753	+/-527	2.4%
2017	*$17,158*	*+/-555*	*2.4%*
2018	*$17,572*	*+/-572*	*2.41%*
2019	*$17,995*	*+/-586*	*2.41%*
2020	*$18,428*	*+/-601*	*2.41%*
2021	*$18,871*	*+/-615*	*2.40%*
2022	*$19,324*	*+/-630*	*2.40%*
2023	*$19,789*	*+/-645*	*2.40%*
2024	*$20,264*	*+/-661*	*2.40%*

Sources: US Bureau of Economic Analysis (2015). *GDP by Industry - Value Added - 1997 to 2014*. Forecasts by Estudios Técnicos, Inc. (2015).

Forecasts & Actual Values of Average Wage in the Potential Base of Act 20 Eligible Activities (Puerto Rico)

Year	Base Value	Margin of Error	Growth
2001	$21,478		
2002	$21,990		2.4%
2003	$22,289		1.4%
2004	$23,078		3.5%
2005	$23,895		3.5%
2006	$24,849		4.0%
2007	$25,729		3.5%
2008	$27,168		5.6%
2009	$27,622		1.7%
2010	$28,275		2.4%
2011	$28,595		1.1%
2012	$28,852		0.9%
2013	$28,951		0.3%
2014	$29,629		2.3%
*2015**	*$30,396*	*+/-118,545*	*2.6%*
2016	*$30,667*	*+/-154,499*	*0.89%*
2017	*$30,936*	*+/-198,838*	*0.88%*
2018	*$31,207*	*+/-234,149*	*0.88%*
2019	*$31,480*	*+/-263,242*	*0.88%*
2020	*$31,755*	*+/-288,153*	*0.87%*
2021	*$32,033*	*+/-309,997*	*0.87%*
2022	*$32,312*	*+/-329,472*	*0.87%*
2023	*$32,594*	*+/-347,051*	*0.87%*
2024	*$32,879*	*+/-363,073*	*0.87%*

Sources: US Bureau of Labor Statistics (2015). *Quarterly Census of Employment and Wages*. Note: Wage and Employment data was imputed for some sectors, due to differing periods of data collection and/or nondisclosure at certain levels of detail. The imputation procedure was to use a fixed value which balanced the annual averages with the monthly available data, or the last current value if no other available data was needed. *The last two (2) quarters of 2015 were forecasted.

Forecasts & Actual Values of Average Wage in the Potential Base of Act 20 Non-eligible Activities (Puerto Rico)

Year	Base Value	Margin of Error	Growth
2001	$19,162		
2002	$19,842		3.5%
2003	$20,318		2.4%
2004	$20,871		2.7%
2005	$21,523		3.1%
2006	$22,215		3.2%
2007	$23,145		4.2%
2008	$24,055		3.9%
2009	$24,516		1.9%
2010	$24,813		1.2%
2011	$25,036		0.9%
2012	$25,195		0.6%
2013	$25,284		0.4%
2014	$25,593		1.2%
*2015**	*$26,156*	*+/-83,321*	*2.2%*
2016	*$26,376*	*+/-81,463*	*0.84%*
2017	*$26,630*	*+/-81,714*	*0.96%*
2018	*$26,919*	*+/-83,612*	*1.08%*
2019	*$27,242*	*+/-86,396*	*1.20%*
2020	*$27,603*	*+/-89,850*	*1.32%*
2021	*$28,001*	*+/-93,878*	*1.44%*
2022	*$28,438*	*+/-98,430*	*1.56%*
2023	*$28,916*	*+/-103,478*	*1.68%*
2024	*$29,437*	*+/-109,005*	*1.80%*

Sources: US Bureau of Labor Statistics (2015). *Quarterly Census of Employment and Wages*. Forecasts by Estudios Técnicos, Inc. (2015). *The last two (2) quarters of 2015 were forecasted.

The increment in average size by year for the three periods was determined by calculating the trimmed mean of employment by decree for each proposed year, and using it as an estimate of the growth in employment size per decree holder during the hiring stage of each generation. The following table presents these calculations. Note that 126 Act 20 decrees did not specify a date of commencement.

Trimmed Mean of Proposed Full-Time Employees per Act 20 Decree - Eligible Activities

Year of Proposal	Employment by Decree	Growth
Entrance	2.0	
First Year	3.9	93.5%
Second Year	4.8	23.6%
Third Year	5.4	13.2%

Source: Data provided by the PR Department of Economic Development. All estimates of employment were trimmed means, with trim factor of 5%.

Trimmed Mean of Proposed Full-Time Employees per Act 20 Decree - Non-eligible Activities

Year of Proposal	Employment by Decree	Growth
Entrance	1.3	
First Year	1.2	-6.6%
Second Year	1.3	7.7%
Third Year	1.6	25.5%

Source: Data provided by the PR Department of Economic Development. All estimates of employment were trimmed means, with trim factor of 2.5%.

Continuing Impact of Existing Decree Holders
Existing decree holders were also incorporated in the projection, since they also contributed to the economic impact for the forecast period. We assumed that these decrees were previous generations of decrees, which were at a particular stage in their employment, gross income, tax and payroll growth. Therefore, *the starting values used for existing Act 20 decree holders were the corresponding average values for their particular economic stage.*

To impute their employment contribution, they were first classified by year of approval, and assumed to follow a 3-year hiring window with the previous characteristics. Decrees approved in 2012 were assumed to be in their final hiring stage, decrees approved in 2013 were in their second hiring year, and so on. Calculated impacts which fell into the specified time period were also incorporated to the projections.

Act 22

The following assumptions about future decree holders were made in order to produce the estimates:

1) Each decree holder made only one (1) purchase of a primary residence during the 10-year period;
2) In the case of renters, each decree holder maintained the acquired rent contract from his/her entrance year to the end of the estimated timespan;
3) The hiring stage of each decree holder was reduced from three (3) years to two (2), as there is no employment requirement for approval, in contrast to the Act 20 decree holders;
4) For the same reason, the employment estimates were weighed by the proportion of Act 22 decrees expected to generate employment, contrary to the Act 20 methodology where this proportion was assumed to be 100%; and
5) Each decree holder is assumed to spend the reported footprint of money spent in Puerto Rico from his/her entrance year to the end of the period.

Estimates of purchased real estate were calculated by multiplying the estimated real estate footprint by the number of entrants each year. Rent estimates were calculated by accumulating the yearly rent value of each generation from the date of entrance to the end of the ten-year period. The same methodology was used for the estimate of money spent in Puerto Rico. Finally, the employment created was estimated following the approach of the Law 20 forecasts. The average growth in the employment footprint was approximated by calculating the growth in average employment per decree, distributed by the effective date of the decree (for income purposes).

Trimmed Mean of Employment per Decree, by Effective Date for Income Purposes

Year	Employment by Decree	Growth
2012	2.1	
2013	0.9	-58.5%
2014	3.1	250.5%
2015	1.9	-37.5%

Source: Data provided by the PR Department of Economic Development (2015). All estimates of employment by decree were trimmed means, with a trim factor of 2.5%.

Continuing Impact of Existing Decree Holders

As with Act 20, the existing Act 22 decree holders were assumed to exert a continuing impact throughout the 2015-2024 period, and thus were incorporated into the overall impact. The methodology mirrors that for Act 20.

Results

Act 20

The following tables show the results under the base scenario of Act 20 decrees added by year. Over the 10-year period from 2015 to 2024, a total of 2,351 additional decrees are expected to be added. These are expected to generate an average of 4,237 employees per year, or a total of 44,656 new employees. Of this total, 38,073 employees would be in eligible activities, and 6,583 would be in non-eligible activities.

The gross income generated by these decree holders would amount to an additional $3,810.5 million per year, for a total of $38,510 million of new corporate income added over the 10-year period. The accumulated corporate income tax paid throughout the period would amount to $808.9 million.

Projected Impact of Law 20 Decrees -- 2015 to 2019

Concept	2014 (Actual)	2015	2016	2017	2018	2019	5-Year Accumulated Impact (2015-2019)
Employment Generated by Year	**1,769**	**2,282**	**3,612**	**4,918**	**5,844**	**5,280**	**21,936**
Eligible Activities	1,277	1,802	2,793	4,061	5,058	4,572	18,286
Non-Eligible Activities	492	480	820	857	785	708	3,650
Gross Income Generated by Year (in millions)	**$896.0**	**$1,133.9**	**$1,710.2**	**$2,320.9**	**$2,962.3**	**$3,634.9**	**$11,762.2**
Eligible Activities	$824.6	$968.4	$1,431.7	$1,919.9	$2,430.7	$2,963.4	$9,714.2
Non-Eligible Activities	$71.4	$165.5	$278.5	$400.9	$531.6	$671.5	$2,048.0
Corporate Income Tax Paid by Year (in millions)	**$26.6**	**$24.2**	**$36.6**	**$49.8**	**$63.6**	**$78.1**	**$252.3**
Eligible Activities	$24.7	$20.0	$29.6	$39.7	$50.2	$61.2	$200.7
Non-Eligible Activities	$2.0	$4.2	$7.0	$10.1	$13.4	$16.9	$51.6
Payroll Generated by Year (in millions)	**$78.5**	**$106.4**	**$162.8**	**$241.8**	**$335.4**	**$360.2**	**$1,206.6**
Eligible Activities	$50.7	$87.7	$134.4	$202.7	$284.8	$306.0	$1,015.5
Non-Eligible Activities	$27.8	$18.7	$28.4	$39.1	$50.7	$54.2	$191.1

Sources: Data provided by the PR Department of Economic Development (2015). Estimates by Estudios Técnicos, Inc. (2015). *Is the number of applications in progress for this year, which are assumed will obtain a decree.

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Projected Impact of Law 20 Decrees -- 2020 to 2024

Concept	2020	2021	2022	2023	2024	Accumulated Impact (2020-2024)	Grand Total (2015-2024)
Employment Generated by Year	**1,525**	**4,726**	**5,335**	**5,495**	**5,639**	**22,720**	**44,656**
Eligible Activities	1,267	4,118	4,665	4,805	4,932	19,787	38,073
Non-Eligible Activities	258	608	670	690	708	2,933	6,583
Gross Income Generated by Year (in millions)	$3,932.4	$4,574.7	$5,242.5	$5,936.5	$6,657.4	**$26,343.3**	**$38,105.5**
Eligible Activities	$3,525.7	$4,102.7	$4,702.9	$5,327.0	$5,975.6	$23,634.0	$33,348.2
Non-Eligible Activities	$406.7	$472.0	$539.5	$609.4	$681.7	$2,709.3	$4,757.3
Corporate Income Tax Paid by Year	$83.1	$96.7	$110.8	$125.4	$140.6	**$556.6**	**$808.9**
Eligible Activities	$72.9	$84.8	$97.2	$110.1	$123.5	$488.4	$689.1
Non-Eligible Activities	$10.2	$11.9	$13.6	$15.3	$17.2	$68.2	$119.8
Payroll Generated by Year (in millions)	$368.1	$375.4	$382.5	$389.5	$396.8	**$1,912.3**	**$3,118.9**
Eligible Activities	$312.5	$318.3	$323.9	$329.4	$335.0	$1,619.1	$2,634.6
Non-Eligible Activities	$55.7	$57.1	$58.6	$60.1	$61.8	$293.2	$484.3

Sources: Data provided by the PR Department of Economic Development (2015). Forecasts by Estudios Técnicos, Inc. (2015).

Act 22

The following tables present the economic impact of Act 22 Decrees. Act 22 Decrees are expected to produce an average of 1,195 jobs per year, for a total of 11,945 jobs added over the 2015-2024 period. The value of real estate purchased by Act 22 decree holders could be of up to $1.7 billion, depending on the available inventory. Their 1-year value of rent payments could ascend to $832.7 million as well.

Forecasted Impact of Law 22

Concept	2015*	2016	2017	2018	2019	Accumulated Impact (2015-2019)
Employment Generated by Year	964	1,341	1,481	1,083	1,079	5,948
Value of Real Estate Purchased by Year (in millions)	$319.6	$139.8	$136.8	$137.4	$140.8	$874.4
1-Year Value of Rent Paid, by Year (in millions)	$14.0	$18.3	$22.6	$26.8	$31.2	$112.9
Money Spent in Puerto Rico, by Year (in millions)	$63.1	$67.5	$71.7	$75.9	$80.3	$358.5

Sources: Data provided by the PR Department of Economic Development (2015). Forecasts by Estudios Técnicos, Inc. (2015). *Corresponds to the number of applications in progress, which are assumed will obtain a decree.

Forecasted Impact of Law 22

Concept	2020	2021	2022	2023	2024	Accumulated Impact (2020-2024)	Grand Total (2015-2024)
Employment Generated by Year	1,098	1,135	1,188	1,251	1,325	5,997	11,945
Value of Real Estate Purchased by Year (in millions)	$146.3	$153.5	$162.0	$171.8	$182.7	$816.3	$1,690.6
1-Year Value of Rent Paid, by Year (in millions)	$35.7	$40.4	$45.4	$50.7	$56.4	$228.6	$341.5
Money Spent in Puerto Rico, by Year (in millions)	$84.8	$89.5	$94.5	$99.9	$105.5	$474.2	$832.7

Sources: Data provided by the PR Department of Economic Development (2015). Forecasts by Estudios Técnicos, Inc. (2015). *Corresponds to the number of applications in progress, which are assumed will obtain a decree.

Conclusions

Act 20 companies are mainly exporting to the USA but are also engaging in business relationships with countries around the world. This has potential spillover effects in Puerto Rico's local economy, particularly in providing know-how of international markets, so that other local services providers could move beyond internal demand.

In the long-run, maintaining both policy tools could render strong yields for the local economy, particularly if the local government and service providers are able to capture the spillover effects of these grantees. Moreover, having incentives to develop the service sector will enable Puerto Rico to absorb the economic activity generated by more robust service sectors. In contrast with the previous development strategy, which focused on manufacturing, incentivizing the service sector -even through the injection of foreign capital- will bring about stronger economic growth. That is, the entry barriers to the service economy are much lower than that of manufacturing and technology transfer is almost a natural condition of the knowledge economy.

Given the short period of time since enactment, one should expect the biggest returns once a healthy critical mass has been reached.

Recommendations

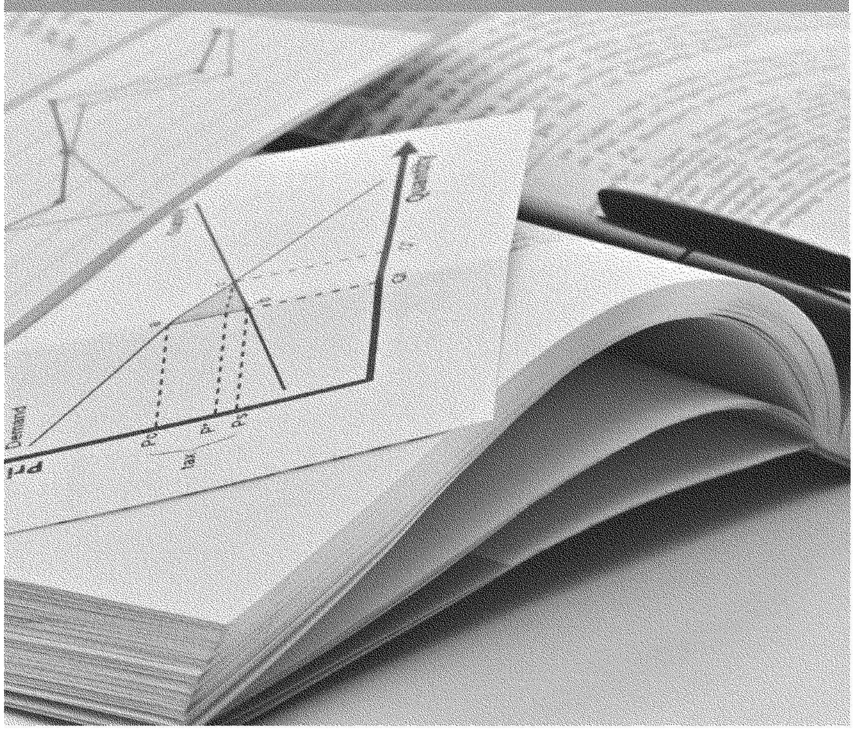
In terms of policy, the DDEC should consider establishing thresholds related to employment and investment requirements and for Act 20 and Act 22. This will contribute to the achievement of the Department's objective in terms of economic impact.

Promotional efforts should also focus on incentivizing local firms to obtain these types of decrees. Due to the many structural inefficiencies in the island, the benefits of tax alleviation to local firms are bound to be greater in comparison to foreign firms. The low entry requirement should be maintained for local firms, in order to increase the incentives effectiveness.

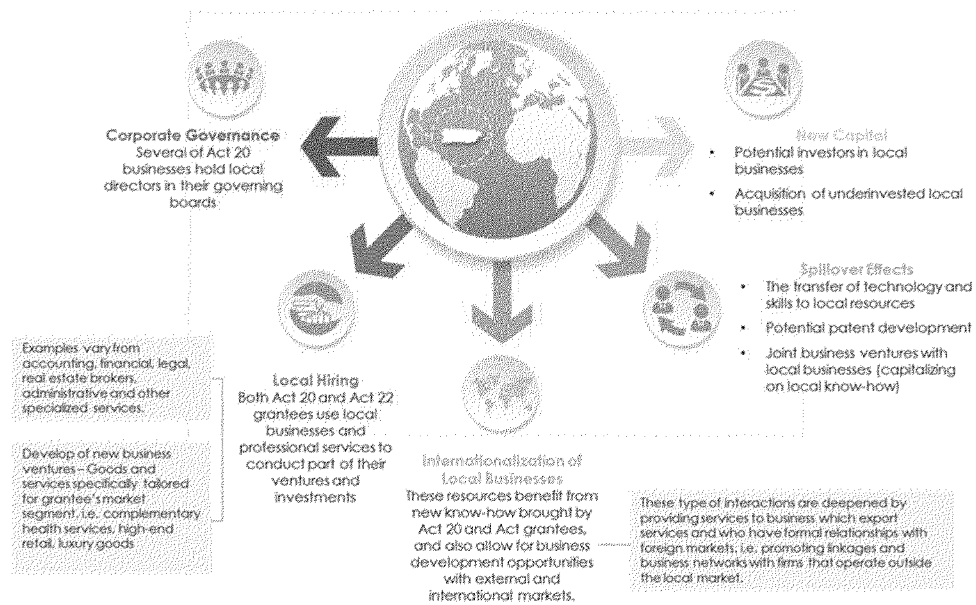
These laws, specifically Law 20, should be seen as part of a broader framework of developing local start-ups in these eligible activities. A grant program for incubating/accelerating local Act 20 firms could be considered, in order to promote a larger local base of these types of firms.

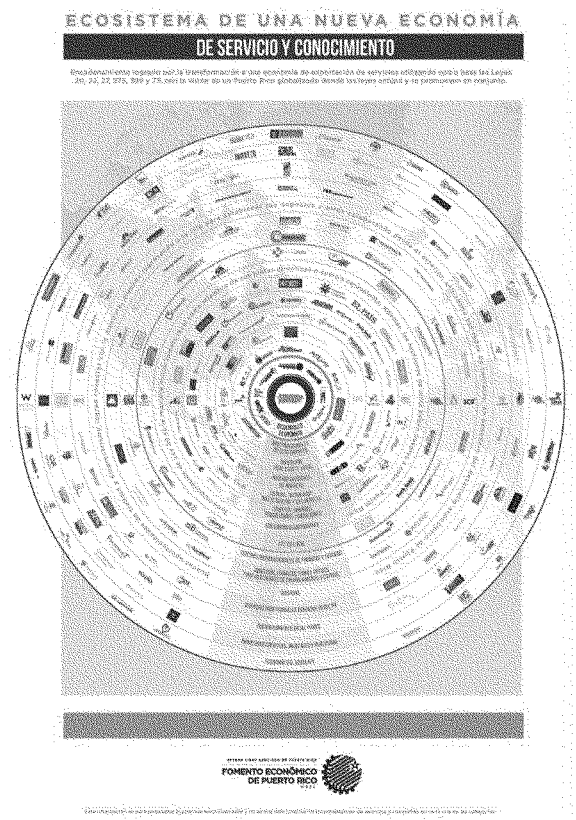
For Act 22 decree holders, an investment requirement in conformity with the development of Act 20 firms or other types of enterprises should be included. The objective of Act 22 should be to incentivize the arrival of foreign entrepreneurs towards Act 20 eligible activities or some other type of investment; this objective must be enforced by appropriate requirements which promote investment and growth in the local economy.

APPENDIX



Internal Linkages of Act 20 and Act 22





This information is for illustration purposes only. Actual number of participants may vary. Source: DDEC.

DDEC Management Forecasts and Estimates

The purpose of forecasting is to make predictions, or inferences regarding future characteristics given a representation of reality in a fixed state. There exist various types of forecasting techniques, with a wide variation in sophistication. This section compares the approach used by Estudios Técnicos, Inc. (ETI) with an extrapolation approach by the PR Department of Economic Development (DDEC, by its Spanish acronym), based upon certain assumptions regarding decree holders.

There is no single "correct" approach to a forecasting, and the actual accuracy of a forecast can only be determined by the empirical forecast error. As neither method used statistical approaches to directly estimate the economic impact, estimates of forecast error do not exist. Hence, only the reasonability of the estimates can be evaluated, based upon the current historical experience.

The DDEC Approach

The DDEC used a series of internal assumptions with respect to the growth rate in upcoming years up to 2022. These assumptions were then applied to the historical trend in decrees, to derive the economic impact estimates. The following assumptions were used:

Act 20 Assumptions

1) From 2016 through 2018, the number of approved Act 20 decrees is expected to double; from 2019 to 2022, it is expected to grow by 10% each year.
2) Each new Act 20 decree holder will pay $250,000 in taxes for 2016, and will increase this amount by $125,000 until reaching $1 million in 2022.
3) Each Act 20 decree holder will begin with twelve (12) employees in 2016; for the following years, each new generation of decrees will increase this employment footprint by six (6) new employees, until reaching 50 employees per decree in 2022.
    a. In other words, each new decree holder will have an employment footprint 6 units greater than the previous year.

Act 22 Assumptions

1) From 2016 onwards, Act 22 approved decrees will increase at a rate of 50%.
2) Each new Act 22 decree holder will pay $25,000 in taxes for 2016, and will annually increase in $4,167 until attaining $50,000 in 2022.
3) Each new decree will generate (3) jobs throughout the period.

Limitations with the DDEC Approach – Act 20

1) The assumed growth is extremely sensitive to forecast errors. For example, the assumption of 100% growth, or yearly doubling of Act 20 decree numbers, was based upon the average growth from 2013-2015.
    a. For the employment and revenue estimates, this margin of error is compounded by the error margin in the decree footprint. For example, if the decree footprint in

employment grew by 5 employees each year instead of the expected 6, there would be a discrepancy of 65,929 employees.

2) When using the hybrid-approach dataset by Estudios Técnicos, Inc., it is readily seen that the average Act 20 employment per decree for the 3-year period (without discounting outliers) is approximately 1.8 employees per decree per year; yet the DDEC forecast begins at 12.
    a. The efficient scale for production in the service industry is not a constant function of time, but responds to technological, cost and market considerations. (contrast with manufacturing)
3) In 2022 alone, DDEC forecasts that 3,701 new Act 20 decree holders will produce 50 employees each, for a total job creation of approximately 185,000 employees. This implies that Act 20 firms alone would be able to produce as many jobs in one year as the entire retail sector in the island. The 610,934 cumulative employment estimate would double the size of the private sector in the island.
    a. Important to take into account that relocation costs are much higher for larger establishments than for smaller ones. Also one has to take into account the available inventories of capital, real estate, infrastructure, permits or additional services that such large establishments may require.

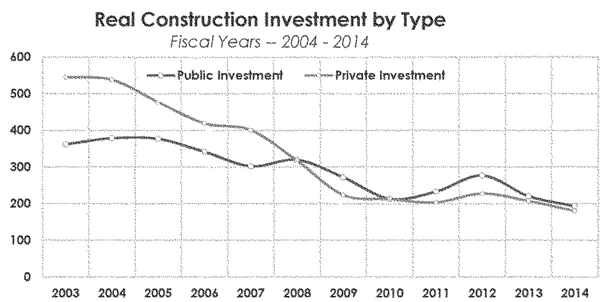
Limitations with the DDEC Approach – Act 22

1) As with the Act 20 forecasts, the total number is extremely sensitive to the growth assumption; a 5% increase would imply 3,353 more decrees are added at the end of the period, or 19.7% more than originally forecasted.
2) In 2022 alone, DDEC forecasts that 6,031 new Act 22 decree holders will produce 3 employees each, for a total job creation of approximately 18,094 employees.
3) Even in the empirical record, there exists more Act 22 decree holders than Act 20 decree holders, with an average growth of 251% -- or tripling every year. However, the current Act 22 forecasts present a lower number of Act 22 decree holders than in Act 20, contrary to current experience.
    a. If we followed the same methodology as with Act 20, there would be an accumulated 99,000 decrees from 2016 through 2022 alone. This highlights the explosiveness of the Act 20 estimates, i.e. the methodology is highly sensitive to specific values in order to produce reasonable estimates.

Puerto Rico's capital investment vis-à-vis Act 20 & Act 22 incentives

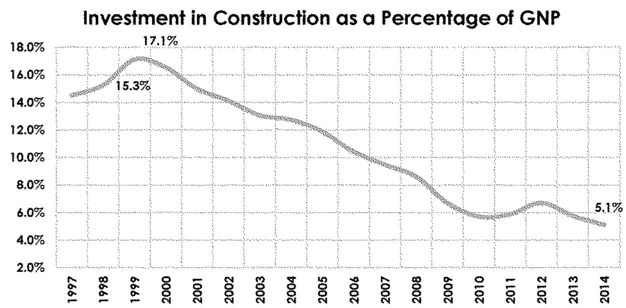
For the past years Puerto Rico has experienced a continued reduction in capital investments. As reflected in the National Accounts, Gross Domestic Fix Investment has been declining since 2005. Reduction in capital investment, particularly when adjusted by inflation and ignoring specific outliers such as ARRA funds, has been sustained for the past decade. In Puerto Rico more than half of all capital investment was attributed to the construction industry, however, due to the economic contraction experienced since 2006, now construction represents close to 39% of all investment. If construction investment was further broken down, housing construction will reflect a steep fall. The total investment in housing construction for 2014 represents 30% of the total housing construction of 2005.

The graph below highlights the reduction in construction investment from 2005 to 2014.



The investment in construction has reduced close to 5.7% annually since 2006, which contrasts with a 2.2% annual increase in the previous 7 years. Moreover, one of the main challenges for the local economy is to increase capital investments which usually bootstrap additional productive ventures. In 2005 investment in construction as a percentage of GNP represented close to 11.9%, yet, in 2014 such figure only amounts to 5.1%.

The graph below illustrates the downward trend of investments in construction as a percentage of GNP.



Act 20 and Act 22 Investments constituted a change in direction in the downward trend in capital investments. Due to the limited time these incentives have been in effect, aggregate change may not be reflected in the national accounts. Total investment in construction totaled $3,534 million in 2014, out of these, private construction represented $1,849 million (50% of total construction). Furthermore, since 2014 total investment in construction is close to $2,000 million less than 2003 construction levels of investment.

Act 20 and Act 22 provide the enabling factors for creating new capital investments in the economy. By importing new capital, the economy has captured capital inflows which will add to the total investment figures in the following years. Taking into account the forecasts presented in the study, by 2020 Act 22 grantees will have demanded close to $1,000 million in real estate investments (primarily housing) which will provide an injection of capital to the construction industry. Moreover, Act 22 grantees reported planned capital investments of $228 million up to 2015. If this trend continues, the local economy should expect a boost in total investment from the private sector in the following years.

Status of the applications

The following table describes the various stages or status of the applications and/or reports in CRM.

Application/Report Status in CRM	Description
Cancelled	The applicant cancelled an application/report in the system. Change of Status in CRM occurs automatically.
Incomplete Application	The user has created an application/report using the Platform and is still in process. The application has not been submitted for OITE's approval. Change of Status in CRM occurs automatically
Incomplete Application	Once the application/report has been filled and required documents have been uploaded, except for the sworn statement. Application/report maintains the same status.
Submitted Online	Platform user submits the application in CRM with all required appendix for OICTE's review. Change of Status in CRM occurs automatically.
Complete Application	Once OETI reviews the application, and determines it is complete, the status is change to Complete Application by the user. The applicant receives a notification to proceed with the sworn statement.
Pending Filing	The applicant submits the sworn application in the supporting documents screen in the Platform. The application is identified as Pending Filing. Filing fees must be paid to OETI, for the case to be considered filed. Change of Status in CRM occurs automatically.
Filed	The applicant paid the filing fees. OETI's personnel make a manual change and identifies the status in CMR as Filed. This step begins the application approval period in CRM.

Additional References

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Nombre
ABBOT BIOTECHNOLOGY LTD/ABBVIE BIOTECHNOLOGY LTD
ABBOTT DIAGNOSTICS INT'L LTD
ABBOTT HEALTHCARE PUERTO RICO LTD
ABBOTT PHARMACEUTICALS PR LTD/ABBVIE LTD
AMGEN MFG LTD
AMO PUERTO RICO MFG INC
BARD SHANNON LTD
BASF AGROCHEMICAL PRODUCTS BV/BASF AGROCHEMICAL PRODUCTS BV PR BR
BAXTER HEALTHCARE SA
BECTON DICKINSON CARIBE LTD
BRISTOL MYERS SQUIBB HOLDINGS PHARM
BRISTOL-MYERS SQUIBB MFG CO
COOPERVISION CARIBBEAN CORP/OCULAR SCIENCES CARIBBEAN CORP/OCULAR SCIENCES CAYMAN ISLANDS CORP
CORANGE INT'L LTD/ROCHE OPERATIONS LTD
CUTLER HAMMER ELECTRICAL CO
DUPONT AGRICULTURAL CARIBE INDUSTRI
DUPONT ELECTRONICS MICROCIRCUITS IN
ETHICON LLC
ETHICON LLC/JANSSEN ORTHO LLC
GUIDANT PUERTO RICO BV
HAMILTON SUNDSTRAND DE PUERTO RICO
HEWLETT PACKARD CARIBE BV LLC
IPR PHARMACEUTICALS INC
JANSSEN CILAG MFG LLC
KNOLL LLC/KNOLL LLC B V
LILLY DEL CARIBE INC
MCNEIL HEALTHCARE LLC
MEDTRONIC PUERTO RICO OPERATIONS CO
MICROSOFT OPERATIONS PR LLC
MSD INT'L GMBH PR BRANCH LLC
ORTHO BIOLOGICS LLC
PFIZER PHARMACEUTICALS LLC
ST JUDE MEDICAL PUERTO RICO LLC
STRYKER PR LTD
U S S C PUERTO RICO INC
WARNER CHILCOTT CO INC/WARNER CHILCOTT CO LLC
ZIMMER MFG B V

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Questions from Ranking Member Maria Cantwell

Question 1: Looking at the short term crisis we face, both the Administration and the Governor have outlined their approaches to a recovery plan which are similar, and feature:

- extension of Chapter 9 bankruptcy coverage;
- correcting the disparity in healthcare treatment;
- establishing an oversight mechanism; and
- extending investment incentives, such as the Earned Income Tax credit.

These elements track closely to what you concluded in your testimony, but I'd like to give you an opportunity to comment on both of these plans and how you think they could be improved?

Answer: In our view, the proposal put forward by the Obama administration is a good and positive first step in the process of developing a coherent Federal policy for Puerto Rico. That being said, we must point out that we still need to see the specific details of each of the proposals in order to provide a more informed opinion to the Committee.

Second, the policy package announced by the Administration does not address Puerto Rico's short-term liquidity situation. According to information provided by the Government Development Bank of Puerto Rico, the Commonwealth faces maturities in excess of $1.2 billion between December 1, 2015 and January 31, 2016. As I mentioned in my testimony this is the most pressing issue that Puerto Rico faces in the short-term.

If the cash flow projections made by Conway MacKenzie are valid and accurate, then Puerto Rico will not have enough cash on hand to meet all its obligations as soon as December of this year.[1] In that event, in the absence of either (1) access to an emergency liquidity facility or (2) forbearance from bondholders, the probability of a disorderly default is quite high, because the current administration has already stated its firm intention to keep essential government operations running and Puerto Rico cannot avail itself of relief under Chapter 9 of the U.S. Bankruptcy Code.

Given the short time window, the policy options at the federal level boil down to (1) providing short-term financing to Puerto Rico to avoid a default or (2) enacting "fast-track" legislation extending the application of Chapter 9 to Puerto Rico. So far, both the U.S. Treasury and the Federal Reserve Bank of New York (which has jurisdiction over financial institutions in Puerto Rico) have been reluctant to provide any kind of short-term financing to the government of Puerto Rico that could be characterized as a "bailout".

Third, the Administration's proposal could be improved in several ways. For example, Puerto Rico is currently treated quite unfairly under the Medicare program. Some policy

[1] Conway MacKenzie, *Commonwealth of Puerto Rico Liquidity Update*, August 25, 2015.

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recommendations that have been put forth by the Commonwealth, Senator Schumer (S. 1961), and Rep. Velázquez (D-NY) to address this issue include, among others, the following:

- **Establish automatic enrollment into Part B for residents of Puerto Rico**

  Unlike states and the other territories, Puerto Rico residents who are Medicare-eligible are not automatically enrolled into Medicare Part B. Instead of an "opt-out" enrollment process, Puerto Rico residents have to "opt-in" to Medicare Part B coverage. This leads to some eligible beneficiaries going without Part B over the long run due to late enrollment penalties, and has resulted in a Medicare Part B participation rate that is reportedly well below the national average. This, in turn, can place fiscal pressure on the Commonwealth government and/or safety net health care providers because they have to provide services that would otherwise be covered by Part B. Automatic enrollment could instead apply to Puerto Rico residents.

- **Make Puerto Rico residents eligible for Medicare Part D Low Income Subsidy**

  Residents in Puerto Rico and other territories are not eligible for Medicare Part D's Low Income Subsidy (LIS). The LIS could be expanded to make such residents eligible, which could reduce fiscal pressures on Puerto Rico's Medicaid program (to the extent that Puerto Rico is providing some drug assistance now) as well as make drug coverage more affordable for low-income Medicare beneficiaries in Puerto Rico. (This could be applied to other territories as well.)

- **Modify Medicare DSH payments for Puerto Rico hospitals**

  Medicare Disproportionate Share Hospital payments are based, in part, on the share of patients on SSI, but residents of Puerto Rico and the territories are not eligible for SSI except for the N. Marianas Islands (though they may still be eligible for financial assistance under pre-SSI block grants that go to those territories). The formula could be modified to instead take into account Part A beneficiaries enrolled in those territorial programs. This proposal would presumably increase existing DSH payments going to hospitals in Puerto Rico.

Another issue that could be included is Puerto Rico's treatment under the U.S. coastwise shipping laws, most notably the Jones Act of 1920. We understand this is a thorny and complicated issue, but granting a partial exemption to allow Puerto Rico to use non-U.S. flag vessels to import natural gas from the United States would help Puerto Rico to significantly lower its energy costs.

Finally, the Administration's proposal does not address the issue of long-term growth in Puerto Rico. We will take up that issue in our answer to Question 6.

Question 2: Looking at the longer term, on page four of your testimony you highlight the role that the decline in investment has had in Puerto Rico's economic decline over the

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past 10 years. In addition to the extension of the Earned Income Tax Credit (EITC) that you recommended, what other longer-term investment strategies do you recommend?

Answer: In this respect I would say that the ball is on Puerto Rico's side of the court. The island's government needs to establish a series of horizontal policies that cut across and provide support to a defined set of productive sectors.

Some of those policies are: (1) cracking down on government corruption; (2) significantly improving Puerto Rico's Byzantine and unduly opaque financial reporting; (3) reforming an unnecessarily complicated permitting and licensing system that stifles innovation; (4) undertaking affirmative actions to materially lower energy and other costs of doing business in the island; and (5) substantially improving Puerto Rico educational standards, among others.

For example, in terms of the permitting system, the chart on the next page depicts the permitting process for a typical real estate development in Puerto Rico circa 2006.[2] As evidenced by the chart, the current permitting process was not designed to promote or incentivize new investment.

[2] Steven J. Davis and Luis Rivera Batiz, "The Climate for Business Development and Employment Growth" in *The Economy of Puerto Rico: Restoring Growth*, Susan M. Collins, Barry P. Bosworth, and Miguel A. Soto-Class eds., (Brookings Institution Press: Washington, DC, 2006), p. 294.

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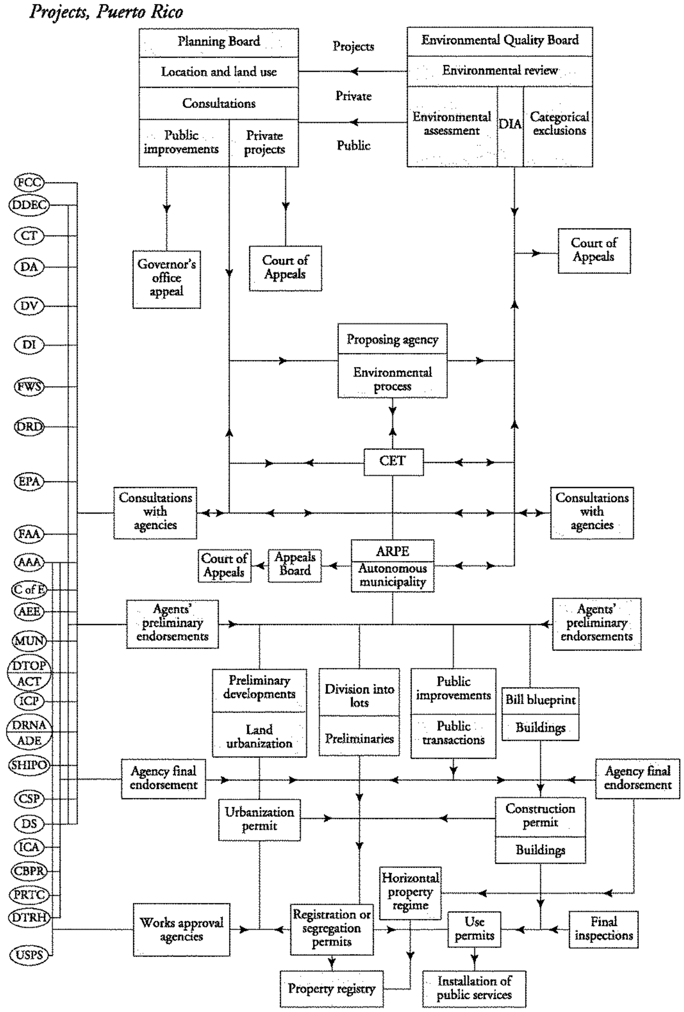
Figure 6-4. *Permitting Process for Construction and Real Estate Development Projects, Puerto Rico*



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Puerto Rico also needs to modernize its labor laws and regulations, most of which were developed for a predominantly industrial economy that no longer exists (the United States also needs to address this issue by the way). The problem is how to protect workers in an economy were full-time employment with a single employer for thirty or forty years is no longer the norm, while (1) providing more flexibility to workers who want more control over the time they dedicate to work as well as more power to decide what projects they work on, and (2) avoiding abuses by employers (wage theft, shift changes on short notice, etc.) In this regard Denmark has developed some interesting policies that could prove useful in the case of Puerto Rico (but perhaps not so much in the case of the mainland states).

Finally, as I mentioned in my testimony, Puerto Rico needs to develop and implement a new industrial policy, broadly defined, to attract new investment to the island.

On the Federal side, the Department of Commerce, in consultation with the Departments of Energy and the National Science Foundation, could establish a Center for Manufacturing Innovation in Puerto Rico. Such Center would be part of the National Network for Manufacturing Innovation under the National Institute of Standards and Technology Act.

Question 3: You concluded by stating your belief that any new economic strategy "is bound to fail if it ignores the fact that Puerto Rico has reached the limits of its development within the constraints imposed by its subordinate political status." Political status is not the immediate topic of this hearing, but it is certainly relevant to this committee's jurisdiction.

> I would appreciate your thoughts on what Puerto Rico's economic strategy and economic outlook would be under different status options – such as a State, as an independent Caribbean nation, or as a sovereign state in free association with the United States in a relationship that is similar to the U.S. relationship with the Pacific island nations of: The Federated States of Micronesia, Palau and the Republic of the Marshall Islands.

Answer: This is an extremely difficult question to answer because of the enormous amount of economic and political variables that would be affected by a change in political status either to statehood or to some form of sovereignty.[3] The table on page seven sets forth some of the most important variables that could be affected by a change in political status.

[3] The Congressional Budget Office analyzed this issue twenty-five years ago. See, Congressional Budget Office, *Potential Economic Impacts of Changes in Puerto Rico's Status Under S. 712*, April 1990; and more recently with respect to statehood, see United States General Accountability Office, *Puerto Rico: Information on How Statehood Would Potentially Affect Selected Federal Programs and Revenue Sources*, GAO-14-31, (March 2014).

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First, it is important to note that the current crisis has clearly highlighted Puerto Rico's lack of economic and political powers to address it. Neither a sovereign country nor a state of the union, Puerto Rico has no authority to negotiate international treaties, no access to emergency financing from multilateral institutions, no monetary policy instruments, limited fiscal policy tools, nominal representation in Congress, and the U.S. Supreme Court has determined it is constitutionally permissible for Congress to discriminate against Puerto Rico in the application of federal programs as long as there exists a "rational basis" for doing so. Thus being neither fish nor fowl in terms of the U.S. Constitutional order, Puerto Rico lives in a state of permanent limbo.

In terms of statehood the principal advantages would be (1) full representation in Congress to protect Puerto Rico's interests; (2) equal treatment under all federal programs; and (3) the elimination of the "Puerto Rico premium" that some U.S. companies and entrepreneurs require to invest in Puerto Rico given its ambiguous political status.

In terms of independence or sovereign free association, the principal advantages would be (1) the ability to execute an independent monetary policy; (2) the authority to negotiate international treaties; (3) access to and representation in international organizations; and (4) the political power to establish economic and political institutions that are specifically designed to address Puerto Rico's problems.

Finally, we note that while a change in political status would provide Puerto Rico with a set of policy tools it currently lacks, a change in status, in and by itself, is no guarantee that those policy tools would be used wisely. There are wealthy as well as poor states of the Union, just as there are wealthy and poor independent countries. Therefore, the eventual economic impact of any changes to Puerto Rico's political status would depend, to a large extent, on the economic policies adopted *ex post*.

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570 BOSWORTH/COLLINS

Table 10-1. *Strengths and Concerns for Puerto Rican Growth*

Factor	*Strength*	*Concern or constraint*
Macroeconomic	Stable currency Low inflation	Fiscal difficulties High and rising debt Lack of transparency No monetary independence
Openness	Access to U.S. markets, including financial markets Free flow of labor and capital Participant in U.S. open trade regime with rest of world Potential gateway to Latin American countries	U.S. law and treaties not designed for or by Puerto Rico Jones Act restrictions on trade with United States Exports poorly diversified
Institutions and business climate	Financial system Access to mainland FDIC regulation of banks Legal system (including U.S. protection of intellectual property rights) U.S. social safety net	Complex and inconsistent tax policies Difficult regulatory procedures Political seesaw and policy uncertainty Poor incentive structure of transfer programs U.S. minimum wage U.S. dependency issues
Physical and human capital	High educational attainment English-speaking workforce Strong infrastructure for the region	Low investment, especially in the 1980s Concerns about school quality Weaknesses of the infrastructure compared with United States and Ireland Environmental degradation?

Source: The Economy of Puerto Rico: Restoring Growth, p. 570.

Question 4: Some members have expressed a concern that extending the full coverage of Chapter 9 of the Bankruptcy Code to Puerto Rico would unfairly impact average Americans who have pensions that are invested in Puerto Rico bonds. However, it is my understanding that pension funds have not held Puerto Rico debt since it was downgraded below investment grade because pension funds are required to sell such low-rated debt.

> Is that correct, or would extending Chapter 9 authority to Puerto Rico unfairly impact the pensions of average Americans?

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Answer: We do not have first hand knowledge about the exposure of U.S. pension funds to Puerto Rico debt. However, we note that total U.S. pension assets (public and private, defined benefit and defined contribution, and including IRAs) amounted to approximately $22.1 trillion in 2014.[4]

Thus, even if we assume *arguendo* that *all* $72 billion of Puerto Rico debt was held by U.S. pension funds, Puerto Rico debt would amount to only 0.32% of all U.S. pension assets. In the unlikely event that Puerto Rico simultaneously defaulted or restructured all its outstanding debt, the impact on the value of U.S. pension assets, *assuming U.S. pension funds are adequately diversified*, would therefore be marginal or insignificant and would be barely noticed, even to the third decimal place.

Question 5: Currently, the U.S. Treasury has a Puerto Rico Working Group that is providing technical assistance to the Puerto Rico Government. In addition, the Governor is recommending the establishment of a local Control Board to implement elements of his 5-year plan.

> Do you have any suggestions on ways that the local Control Board and the Treasury Working Group could be brought more closely together in partnership to better assure positive outcomes?

Answer: This is really a political economy problem. On the one hand, if the Treasury Working Group takes over the fiscal oversight function completely it may suffer from a lack of legitimacy and representation. On the other hand, the proposed Commonwealth's Control Board, as structured right now, may suffer from a lack of credibility with the capital markets and, it may fail, due to political pressures, to impose adequate accountability standards on other agencies of the Puerto Rican government. The problem therefore is to identify the proper tradeoff between these two options.

In this case we recommend the Committee analyze the option of establishing a fiscal council with representatives from both the Federal and the Commonwealth governments and from the private sector. According to the International Monetary Fund:

> Fiscal councils are independent public institutions aimed at promoting sustainable public finances through various functions, including public assessments of fiscal plans and performance, and the evaluation or provision of macroeconomic and budgetary forecasts. By fostering transparency and promoting a culture of stability, they can raise reputational and electoral costs of undesirable policies and broken commitments.[5]

[4] Towers Watson, *Global Pension Assets Study 2015*, February 2015, p. 6.
[5] International Monetary Fund, *The Functions and Impact of Fiscal Councils*, IMF Policy Paper, July 16, 2013, p. 1.

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These councils have been used, with mixed success to be honest, in several countries to stabilize government finances and oversee the implementation of fiscal and economic reforms.

Question 6: On page 5 of your testimony, you mention the Center for a New Economy's work with experts at Columbia, Brown, MIT, Brookings and others to develop a medium- to long-term industrial policy for Puerto Rico.

> Can you outline the general approach that this research is taking and when you expect that a formal paper resulting from this work could be made available to the Committee?

Answer: What Puerto Rico needs the most is to grow its economy. Short-term fixes will not work and short sightedness by the government on matters pertaining to economic development is partly to blame for our current situation. It is important to understand that the comparable situation here is not that of a two-year business cycle. A more realistic time horizon for registering significant economic gains in a country could be up to 10 years.

Crafting development and growth strategies is an endeavor best suited to academics and economic development experts. It should also stem from a country dialogue process to insure legitimacy and sustained acceptance by civil society. A project like this is already underway and led by CNE. The project is identified as the *Roundtable for a New Economy*, and in it, CNE and its partners —Professor Joseph Stiglitz and the Initiative for Policy Dialogue at Columbia University (IPD), the Brookings Institution (BI), and the Watson Institute for International Studies and Public Affairs at Brown University— aim to create a transformation agenda based on well-thought policy solutions that command the support of a broad group of key stakeholders. This novel project combines top-notch research and civic engagement to transcend the current juncture and restructure the island's outdated economic model.

Unique in resources, structure and processes, this bold initiative will inspire first-class actionable research and policy making as the foundation for a series of dialogues that will engage a wide swath of Puerto Rican stakeholders in considering, discussing, crafting and implementing the optimal policy solutions to current challenges. We are working within a three-year time horizon to produce and divulge specific research products and policy proposals, but are currently accelerating the project's timeline due to the urgency of Puerto Rico's situation.

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Question for the Record Submitted to Mr. Fetter

Question from Ranking Member Maria Cantwell

Question: What can the Federal Government do to encourage PREPA's interest in and commitment to the adoption of new technologies, modernize its equipment, and make its operations more efficient?

Answer:

a) The Aguirre Offshore Gasport is a linchpin project for moving Puerto Rico from heavy reliance on oil toward liquefied natural gas (http://en.aguirreoffshoregasport.com/).

The project has received approval from the Federal Energy Regulatory Commission but is awaiting a decision on its loan guarantee proposal filed by PREPA at the US Department of Energy, which would help finance construction and operation of the project.

I expect as PREPA proposes additional infrastructure improvements, DOE loan guarantees would be most beneficial.

b) PREPA is facing environmental mandates that will be costly and difficult to meet. I know delay with regard to environmental issues is controversial, but if the Environmental Protection Agency is willing to meet with PREPA and discuss possible strategies, that might help the utility to improve its efficiencies.

c) I believe the Congress or the Executive Branch could help facilitate PREPA and/or the Energy Commission tapping the knowledge base held by individuals at NARUC, EEI, AGA, NGSA, APPA, FERC, etc. as well as retired former utility industry and regulatory leaders, either at no cost or the small cost of travel expenses.

d) It is my understanding that relief from the Jones Act could assist PREPA in cutting costs with regard to maritime trade.

October 16, 2015

Hon. Lisa Murkowski
Chair, US Senate Committee on Energy and Natural Resources
304 Dirksen Senate Building
Washington, DC 20510 Via Fax: (202) 224-6163

Cc: Hon. Maria Cantwell

Re.: Puerto Rico
October 22, 2015

Dear Senator Murkowski:

On behalf of the Alliance for Free Association (ALAS), we hereby submit our comments for the hearing of reference on Puerto Rico's economy, debt, and options for Congress in moving forward. ALAS, as you may know, is a relatively newcomer to the Puerto Rico political landscape. It is a civil society organization, which got it first taste of politics in the 2012 status plebiscite, representing the option of "ELA Soberano" (Free Association). Though it is a new group, some of our members have been around politics for decades and have witnessed numerous hearings in Congress, which have resulted in no movement forward. Hopefully, this time we will see the forward movement we all desire and expect.

An expedited comment on the topics to be reviewed: (1) The economy has been at a standstill since 2006, as a result of the termination of Section 936 of the IRS code, which provided a potent tax incentive exclusively to subsidiaries of US companies established on the island; (2) The $72 billion debt, which rose to this level by senseless decision making by all parties involved or related in the issuing of debt; and (3) The options are many and they may be short, medium, and long range. But the one option that we all can't continue to kick down the road is the decolonization of Puerto Rico. That is to such extent part and parcel of the essence of the problem that it needs to be operationalized promptly: this is "non-negotiable"

The Economy

The definite downturn of our economy did not result from the real estate bubble bursting in 2008. That event added to the indisputable fatal blow to our economy, the elimination of Section 936 without any commensurate adjustments. Section 936 used to generate significant deposits to our banks for financing in other economic sectors, good paying jobs for our people, and funds to advance US foreign policy in Central America and the Caribbean as per the US *Caribbean Basin Initiative* (CBI). A congressional creation in 1976, Section 936 brought many benefits to our economy. However, it was phased-out and eventually terminated by Congress. By such action Congress contributed to inflicting a fatal blow to the economy of Puerto Rico.

The Debt

Many actors are to blame for the enormous amount of debt a small island like Puerto Rico has accumulated. Irresponsible administrators, issuing agencies, brokers, crediting agencies, as well as Congress. Keep in mind that Puerto Rico is a US territory subject to the plenary powers of the US Congress under the territorial clause of the US Constitution (Article IV, Section 3) and as such the island lacks the traditional tools sovereign countries enjoy and utilize to face fiscal or economic turmoil. The government of Puerto Rico has requested assistance from the US government. The White House has offered technical advice thru the Treasury Department, many meetings, and a lukewarm endorsement to the inclusion of Puerto Rico in Chapter 9 (federal bankruptcy law). Congress has done nothing, aside from introducing bills to include our public corporations under Chapter 9 of the laws of Bankruptcy. It has failed to fashion an economic relief package in the nature of the one conceded to the US automotive industry, by either purchasing our debt and/or offering federal guarantees to new debt. Congress has to remember its total political responsibility over Puerto Rico. Consequently, Congress has the authority to fashion whatever remedy it may see fit to help Puerto Rico out of this malady, particularly when it is responsible, in no small measure, for contributing, with its legal limitations on Puerto Rico's autonomy, to the chaotic economic situation we are presently living.

Options

There are many options which Congress could consider, short of taking the daily chores of directly governing the island. But, in order to do that, you need to have the courage to take bold and decisive action:

Short term

1. Repeal or eliminate the applicability of the 1920 Jones Act (PL 66-261 as amended) to Puerto Rico, also known as the US maritime or shipping law, which holds our people hostage to the regulatory scheme which limits our

freedom in our maritime transportation with the US. This would equate Puerto Rico with other US territories, which are exempt from the 1920 Jones Act, such as the Virgin Islands, the Marianas Islands, American Samoa and Guam.[1] According to the PR Senate Report to Senate Resolution 237, the Jones Act has cost Puerto Rico more than $ 29,000 billion from 1971 to 2012. Without question, a repeal of the application of the Jones Act to Puerto Rico shall provide a much-needed relief to our beat up consumer, who presently pays the highest sales tax under the US flag (11.5%) and who also earns less than their fellow citizens in the 50 states.[2] Needless to tell you, Puerto Rico also suffers from the highest poverty rate under US jurisdiction, with around 47% of our population earning below the US poverty rate. Mississippi stands at 22% as of 2014.

2. Making the foreign tax credit permanent at 10% for either type of tax that Puerto Rico chooses to impose to its foreign US corporations operating on the island. This would enable Puerto Rico to receive a steady stream of tax revenue without the concern of whether the US Department of Treasury will permit or not the credit to the US corporations operating on the island.
3. Amend the current Free Trade Agreements to accelerate the entry of Puerto Rico products into the foreign countries subject to the Free Trade Agreements. And in NAFTA, provide the same consideration to Puerto Rican rum that is provided to the bourbon crafted in the states or to the tequila of Mexico or whiskey of Canada. Also, make permanent the cover over of the rum excise tax paid by Puerto Rican rum into the US Treasury at the full level, and limit (the government of Puerto Rico) the pass through to the private rum producing companies in the island. Exempt Puerto Rico from any future tax legislation to impose a tax to US controlled foreign corporations.
4. Provide full health benefits to our people residing on the island under US federal programs to which we contribute (Medicaid and Medicare).
5. Consider extending the Suplemental Security Income (SSI) to our old , disabled , and blind people many of whom live in extreme poverty.

Medium Term

This committee needs to bite the bullet and provide Puerto Ricans with a real opportunity to decide our political future. Not by appropriating funds for an educational campaign for a local plebiscite. But rather, by telling us what political options is Congress willing

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[1] Guam has a partial exemption.

[2] Medium household income in Puerto Rico in 2014 was $23,168.00, and in the poorest state of the Union, Mississippi, it was $36,919.00.

to consider besides independence. It is mind-boggling how the US, the great promoter of freedom in the world, continues to keep Puerto Rico and other jurisdictions under the claws of colonialism. We want this issue resolved tomorrow. Puerto Ricans has held several plebiscites; has asked the United Nations for assistance in our struggle to end the present colonial relationship with the US; besides, foreign countries and other international organizations have called for the decolonization of Puerto Rico.

As recently as in 2012, the last locally sponsored plebiscite was held, because Congress has evaded the issue since the late 1950's. In the 2012 local plebiscite, 54% of the voters rejected the present colonial status. They said NO to the Commonwealth, which has, since 1952, been colonial and subordinated to US sovereign powers in its very nature. Since the early 1900's, the essence of our political subordination to Congress as a non-incorporated territory has not changed, other than the adoption of a Constitution in 1952 (amended by Congress). The Insular cases decided by the US Supreme Court said clearly that as a non-incorporated territory, Puerto Rico is not part of the US; our US citizenship since 1917 did not entitled Puerto Ricans living on the island to full citizenship rights because the US Constitution accords full rights to citizens residing in any of the 50 states. The US citizens of the island lack full participation on nutritional assistance; are held to a cap on Medicaid; are treated different under Medicare, though we pay the same Medicare tax as citizens residing in the 50 states; there is no SSI for our disabled, blind , and old people. This is the consequence of the US Supreme Court decision ruling that we could be treated differently because Puerto Rico is a territory, a colonial possession, in other words.

So, please bite the bullet and tell us what political options are actually available to Puerto Rico. Be candid, as New Zealand was during the 1960's to its colonial territories of the Cook Islands and Niue. Let us decide fair and square what kind of relationship we want to have with the US. How difficult can it be? New Zealand told quite frankly to the islanders that they had to choose between independence and free association because integration to New Zealand was not desirable nor planned for those islands.

Tells us whether statehood is or not viable for Puerto Rico. Tell us if we can build a Free Association relationship similar to the one the United States has with several jurisdictions in the Pacific Ocean. Tell us. It is that simple. As you well know, the lack of a clear policy declaration by Congress, has deluded many Puerto Ricans to expect the concession of federal statehood within the United States, i.e, incorporation. As long as many Puerto Ricans support statehood (even though the condition of non-incorporated overseas territory means that Puerto Rico "was not intended to become a state") there will not be a clear majority for Free Association or for Independence, the net result being the continuation of a Commonwealth relationship that has been rejected by 54% of our voters as recently as 2012, i.e. has lost democratic legitimacy. We still suppose that you sincerely believe in democracy: so please show it through actions, not just words, in the case of Puerto Rico. You may declare a thousand times that you recognize Puerto Rico´s right to self-determination. However, as long as you entertain false hopes in the Puerto Rico statehood movement in the sense that federal statehood is viable for Puerto Rico by the lack of a clear policy established by Congress, your words and commitments to democracy and to respecting self-determination for Puerto Rico are undone by Congress's inaction regarding Puerto Rico. As you see, this is so because such inaction and inattention by Congress, leads to a stalemate in Puerto Rican politics as long as pro-statehood Puerto Ricans continue to be deluded to believe that statehood is a real option for Puerto Rican society under present distressful economic and social conditions.

It is time to end the one-way street of Congress mandating statutory rules and Puerto Rico simply obeying. In our view, this is no longer acceptable by the Western democratic world and runs counter to the spirit of the twenty-first century.

Long Term

Transition to the next relationship, which we believe and expect to be a mutually convenient Free Association Treaty with the US, allowing Puerto Ricans to maintain a close relationship with the United States including the retention of free access to the United States by Puerto Ricans and to Puerto Rico by US residents, as well as the retention of the same type of US citizenship that Puerto Ricans have had since 1917, which, nowadays, is in no way incompatible with a Puerto Rican citizenship for matters regarding the Puerto Rican sovereign state created by the sovereign expression of the Puerto Rican people and by such Treaty of Free Association with the United States.

These are the comments of *ALAS* as we move forward. Thank you.

For the ALAS Executive Committee,

Gladys Escalona, PHD.
Ex-Chancellor University of Puerto Rico at Río Piedras

Sen. José A. Ortiz-Daliot, Esq. (PDP- 2001-2004)

Juan R. Fernández, PHD
Ex- Chancellor, University of Puerto Rico at Río Piedras

Ángel Israel Rivera Ortiz, PHD. Senior Professor of Political Science
University of Puerto Rico at Río Piedras

Enrique Vázquez-Quintana, MD
Ex-Secretary of Health, Cabinet of Governor Rosselló

Statement of Luis E. Bacó, Esq.*
Hearing on "Puerto Rico: Economy, Debt, and Options for Congress"
Senate Committee on Energy and Natural Resources
October 22, 2015

Madam Chairman Murkowski, Ranking Minority Member Cantwell, and Members of the Committee:

Thank you for holding this hearing on Puerto Rico's "economy, debt, and options for Congress," and for the opportunity to submit a statement on this vitally important matter for the nearly 3.5 million fellow U.S. citizens residing on the Island and the 5.2 million residing in the states of the Union.

The fact that there are less than 3.5 million U.S. citizens residing in Puerto Rico today constitutes, in itself, the most powerful indication of the magnitude of the crisis before us. The population of Puerto Rico, which had been steadily growing since at least the 1700's, has dramatically drifted downward in the last decade, but even more so during recent years. The nearly 9 percent decrease in population from 3.8 million in 2000 to 3.5 million in 2014 represents the first sustained decline since U.S. census-taking began in the early 20th century. Puerto Ricans are leaving their beloved but financially troubled island for the U.S. mainland in the largest numbers since the Great Migration that followed World War II. They are relocating to the states in extraordinary numbers, which, as U.S. citizens, they can do for the price of a one-way plane ticket. As a matter of fact, since this Committee's last hearing on Puerto Rico's political status in August of 2013, more than 100,000 Puerto Ricans have moved to the states and, unless immediate and dramatic measures are implemented, both locally and at the federal level, this exodus to the states will further increase in the future. The Census Bureau, for one, has projected that the island's population loss will continue through at least 2050, estimating that Puerto Rico's population will be less than 3 million by then.

The undisputed fact, and primary cause of this exodus, is that the great U.S. colonial experiment in the Caribbean has blatantly failed. The U.S. Congress has held hearings on the subject; the President's Task Force on Puerto Rico's Status has hosted forums in Washington and San Juan; and the Obama Administration is said to be providing "technical advice and assistance" to the local government. National media coverage on the crisis and the local government's default has been unprecedented. By now, the Washington establishment is, or should be, fully aware of Puerto Rico's historic financial collapse. And yet, one thing seems patently and frustratingly clear: to this day, the Executive and Legislative Branches of the federal government have reacted to the territory's predicament with the bureaucratic equivalent to Clark Gable's infamous "Frankly, my dear, I don't give a damn." In short, there's been much talk but little, if any, substantive action.

Given that so much has already been said about Puerto Rico's economy and debt, I will instead focus my statement on the options before Congress while proposing a road map that could lead to resolving the long-standing political and economic dilemmas before us once and for all.

First, Congress needs to finally recognize that the root cause of Puerto Rico's crisis is the island's territorial relationship with the U.S., a subject that is well within the jurisdiction of this Committee. The fact is that Puerto Rico's current territorial status does not provide the island with the necessary tools to overcome, by itself, the current financial crisis. It is also true that Puerto Rico's current territorial status was never intended to be permanent in nature, but rather a transitional accommodation towards eventual Statehood or Independence. For decades, however, the federal government has stood by silently, perpetuating with its inaction this congressionally imposed hybrid and discriminatory political and economic model – or as President Ronald Reagan once said, Puerto Rico's "historically unnatural status." Washington's blatant procrastination regarding the island remains unaltered to this day, even after the people of Puerto Rico overwhelmingly and unequivocally voted to withdraw their consent to the current territorial relationship in November of 2012. This Committee held hearings on this very issue back on August 1, 2013 but, as usual, no action followed.

The fact that this colonial experiment has resulted in Puerto Rico becoming the poster child for underdevelopment should come as no surprise, as any political or economic model founded on the basis of citizen inequality is doomed to fail miserably. And fail miserably it has... As Resident Commissioner Pedro Pierluisi indicated during a September 29, 2015 Senate Finance Committee hearing on the financial and economic challenges in Puerto Rico, "Congress should not expect the island to have a first class economy if it treats Puerto Ricans as second class citizens." Furthermore, were it not for federal welfare handouts, economic stratagems such as Section 936 of the Internal Revenue Code, and other short-term, improvised and makeshift measures, Puerto Rico's economy would have collapsed long ago and in an even more dramatic manner.

Thus, the federal government, as one of the main culprits of this unprecedented crisis, has a moral, political, and juridical obligation to intervene immediately. Why? A currently debated topic can provide some insight: when news first broke out on the depth of Puerto Rico's $73 billion debt problem, one of the local government's initial reactions was to call on Congress to amend the U.S. bankruptcy laws so as to make available to the island's public corporations the benefits of bankruptcy protection, a protective mechanism that is available to government entities in the 50 states, and which had been available to Puerto Rico until Congress amended the statute back in 1984. Uncharacteristically, this proposal has received almost unanimous support across the island's political spectrum, but remains languishing in Congress. Efforts by the Puerto Rico Legislature to enact a similar law locally resulted in the federal courts ruling that such statute was unconstitutional as it was preempted by federal law, leaving Puerto Rico, as is often the case, between "a rock and a hard place." This is just one, yet very recent, example of the territorial relationship's severe shortcomings.

And this, Madam Chairman and Members of the Committee, exemplifies the real problem: U.S. citizens in the 21st century that continue being discriminated against solely because of their place of residence and an absolute denial of the most elemental right in a democracy: the right to political representation. Those unfamiliar with Puerto Rico's 117 year-old colonial dilemma should know that, although Puerto Ricans have been American citizens since 1917 and have valiantly served in every single war and conflict the U.S. has been involved in ever since, they are barred from voting for the President and from electing a proportionate congressional delegation which, given the island's population, would include no less than five members in the U.S. House of Representatives and the requisite two senators in this Chamber. Thus, Puerto Rico has a very limited capacity to use the federal political process to pursue its interests, which is the essence of our democratic system of government. Simply stated, the island's territorial status cannot be reconciled with the principles of self-determination, voting rights, democracy, and equality that the U.S. promotes all over the world, sometimes with the use of force, but fails to apply domestically in the case of Puerto Rico.

Further, Puerto Ricans on the island are treated unequally in, or even totally excluded from, most federal programs, which essentially makes them, as stated before, second-class citizens of the U.S. The disparities that Puerto Rico faces in many federal programs, especially when their impact is considered cumulatively, have been devastating, not only to the U.S. citizens residing in the territory, but also to Puerto Rico's economy and fiscal well-being. These inequities are harmful to Puerto Rico's economy because billions of dollars in federal funding are lost every year, money that would have otherwise been available to be spent and invested. They are also detrimental to Puerto Rico's fiscal condition because the local government is obliged to spend or borrow money to compensate for the shortfall in federal support, exacerbating deficits and debt. Lastly, these disparities contribute to Puerto Rico's demographic disaster by compromising the quality of life of Puerto Ricans and, in many instances, forcing them to move to the U.S. mainland, where—unlike in Puerto Rico—they are entitled to equal treatment under all federal programs.

The fact that we are still having this discussion in our nation, the greatest democracy that the world has ever known, is both unconscionable and shameful. Congress needs to stop procrastinating and start living up to its historical and constitutional responsibilities. Specifically, Congress should consider the following initiatives:

- Formally respond and act upon the democratic will of the people of Puerto Rico as expressed in the 2012 Plebiscite on Puerto Rico's status, the results of which have embarked the island on an irreversible path towards Statehood. Enactment of H.R. 727, introduced by Resident Commissioner Pedro Pierluisi with 110 House cosponsors but no Senate companion bill, would be a good starting point. Holding hearings is not good enough. We've had hundreds of them over the years with absolutely no result. The time to act is long overdue.

- Begin a gradual phasing-in of equal treatment in all federal programs where the U.S. citizens of Puerto Rico are currently being discriminated against when compared to their fellow citizens in the states. These include, but are not limited to, Medicaid, Medicare, the Earned Income Tax Credit (EITC), the Child Tax Credit (CTC), Veterans' TRICARE, Supplemental Security Income (SSI), Temporary Assistance for Needy Families (TANF), the Supplemental Nutrition Assistance Program (SNAP), and the Low Income Home Energy Assistance Program (LIHEAP). Urgent attention should be given to the Medicaid and Medicare funding and provider-reimbursement disparities given the impending health care fiscal cliff that would completely devastate Puerto Rico's health delivery system and result in the exodus of many thousands more, particularly seniors and the medically-indigent, to the states.

- Pass H.R. 870 and S. 1774, granting Puerto Rico with state-like treatment under Chapter 9 of the U.S. Bankruptcy Code, as it had been before 1984.

- Ensure that Puerto Rican veterans are treated equally with their counterparts in the states. If our brave men and women – who, by the way, are not even allowed to vote for their Commander-in-Chief – were equal during their service in times of war, they should be equal upon their return home in times of peace.

- Work with the Administration to provide Puerto Rico with a temporary and/or partial exemption from the Jones Act cabotage laws as a way to incentivize the island's economy. This would not be inconsistent with Statehood, as other states, including Alaska and Hawaii, are seeking similar remedies.

- Institute a policy where Puerto Rico would be granted state-like treatment in all future legislation enacted by Congress. Every effort must be made to close, and not enhance, the ever-growing gap between Puerto Rico and the states. The ultimate policy goal should always be to seek equality for all U.S. citizens, regardless of their place of birth or residence.

- Consider the establishment of a *Puerto Rico Federal Advisory Board*, whose members would be appointed by Congress and the Administration, to provide recommendations, oversight, and technical assistance to the local government in areas such as federal fund administration, access to federal grant programs, debt restructuring, and budgetary matters. Said board should be strictly advisory in nature and report periodically to Congress and the White House.

- Make the full Rum Cover Over reimbursement to Puerto Rico permanent, as it was prior to 1984, instead of having it partially subjected to the unpredictable enactment, or lack thereof, of *Tax Extenders* legislation.

- Enact comprehensive legislation that would put Puerto Rico on a path towards energy self-sufficiency, as an economic development and job creating tool as well as an environmental sustainability initiative that could serve as an example nationwide and in the Caribbean region.

- Enact comprehensive legislation addressing Puerto Rico's recurring drought issues, using as basis S. 1894, *The California Emergency Drought Relief Act* introduced by Senators Feinstein and Boxer, particularly those provisions pertaining to the availability of assistance to drought-stricken communities and farmers, desalinization and other technologies, water storage and reservoir capacity, water recycling, and conservation.

While the aforementioned constitute specific steps that Congress could take to alleviate the plight of 3.5 million of its own citizens, it is by no means intended to suggest that the federal government is solely to blame for this crisis. On the contrary, local administrations in Puerto Rico, who must be adjudicated their proportionate share of the responsibility for the current fiscal crisis, for years have also "buried their heads in the sand," resorting to a sort of "wait until tomorrow" attitude where political expediency and improvisation have become the practical tools of economic policy. In simple language, they have been paying their credit card debts with other credit cards, until the time has come when they are realizing that the debt payment exceeds receipts, and there are no more credit cards. This should not come as a surprise in a pseudo-socialist economic model where close to 33 percent of all employment is in government, and emphasis is on government supremacy over the private sector.

In summary, Congress, which is vested by the Constitution with nearly unlimited power over its territories, needs to live up to its responsibilities and finally recognize that the only way to resolve Puerto Rico's long-standing fiscal, economic, and political woes is to end, once and for all, the island's discriminatory territorial status. In so doing, Congress must act upon the democratic will of the island's electorate, which overwhelmingly voted in 2012 to reject the current territorial relationship and in favor of Puerto Rico becoming the 51st state of our great Union. In the meantime, years of procrastination and improvisation must be replaced by the proactive implementation of realistic and permanent pro-growth economic policies based upon the sacred principles of citizen equality and political empowerment.

Madam Chairman and Distinguished Members of the Committee, 2017 will mark the centennial of the granting of U.S. citizenship to Puerto Ricans. The U.S. citizens of Puerto Rico are proud of being Americans and cherish their citizenship, but have become increasingly tired of the many inconsequential hearings, panels, forums, workshops, and task forces. For too long, the primary focus has been on treating the patient's symptoms rather than the actual disease. Gone are the days where we could remain silent and still, unfairly relegating and passing on to our sons, daughters, and future generations the tough decisions that we must make today. The time for action is long overdue. The 3.5 million U.S. citizens of Puerto Rico and our nation deserve no less.

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[*] Luis E. Bacó is a Capital Member at the Puerto Rico-based McConnell Valdés Law Firm and heads the Firm's Washington, D.C. office. He previously served as Chief of Staff to Congressman Luis G. Fortuño in the U.S. House of Representatives, Counsel in the McDermott, Will & Emery International Law Firm, Deputy Executive Director of the Puerto Rico Federal Affairs Administration, and Deputy Chief of Staff and Legislative Director to Congressman Carlos Romero-Barceló in the U.S House of Representatives.

INDUSTRIALES
PUERTO RICO
MANUFACTURA ■ SERVICIO ■ COMPETITIVIDAD ■

October 22, 2015

The Honorable Lisa Murkowski
Chairman
Committee on Energy and Natural Resources
U.S. Senate
304 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Maria Cantwell
Ranking Member
Committee on Energy and Natural Resources
U.S. Senate
304 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Murkowski and Ranking Member Cantwell:

The attached letter is to convey the views of the Competitiveness and Sustainable Economy Institute of Puerto Rico (CSEIPR) and the Puerto Rico Manufacturers Association (PRMA) on the important topics being examined today by the Senate Committee on Energy and Natural Resources at its oversight hearing entitled "Puerto Rico: economy, debt, and options for Congress." I ask that you make this letter a part of the formal hearing record.

The CSEIPR is a recently incorporated non-profit organization aimed at conducting educational activities, coordinate expert data gathering, studies and analysis that foster the socio-economic wellbeing of Puerto Rico.

The Puerto Rico Manufacturers Association is a private, voluntary, non-profit organization established in 1928 with the purpose of uniting all Puerto Rico's manufacturers and service industries into a strong and effective body in order to further their mutual interests as they relate to the private and public sectors of the Commonwealth of Puerto Rico.

Both organization, in alliance with other Puerto Rico organizations are conducting studies and preparing for the intervention processes at the Puerto Rico Energy Commission, which is the focus of our communication to you given the present urgent nature of the Puerto Rico Energy Reform processes.

Sincerely,

Tomas J. Torres
Presidente, PRMA Energy Committee

cc: The Honorable Alejandro García Padilla, Governor of Puerto Rico
The Honorable Pedro R. Pierluisi, Resident Commissioner from Puerto Rico, U.S. House of Representatives

October 21, 2015

Senator Lisa Murkowski
United States Senate
Committee on Energy and Natural Resources
709 Hart Senate Office Building
Washington, D.C. 20510-0203

Honorable Senator Murkowski:

The subject of energy reform is considered one of the top three areas of opportunities by Puerto Rico's private sector; our local government as stated in the Krueger Report; and the US government as stated in the White House Task Force on PR report, to positively impact renewed economic growth for Puerto Rico.

Pursuant to this opportunity, and the need by US government as well as Puerto Rico institutional debt-holder investors to see Puerto Rico's government and private sector leadership enact well planned, pro-growth, responsible structural economic reforms, in October 2014 a Memorandum of Understanding (MOU) between the US Department of Energy (DOE) and the Government of Puerto Rico was signed, including these objectives:

> *"This Memorandum of Understanding (MOU) is intended to provide a framework for an ongoing Commonwealth-wide effort to realize Puerto Rico's vision for a modern, sustainable, energy infrastructure. The work under the MOU will maintain the current public support for long-term action that is widely recognized as necessary to a sustainable energy sector in Puerto Rico, in part by ensuring that a broad array of stakeholders is able to shape the direction and outcome of this transformation. This includes pursuing policies, technologies, deployment strategies, and financing approaches tailored to Puerto Rico's needs relating to: energy efficiency in the private and public sectors; renewable energy; alternate fuels; electric transmission and distribution systems; energy storage; alternative fuel vehicles and other forms of clean transportation; and institutional capacity".*

Notwithstanding, after a good commencement organized through the DOE's Energy Transition Initiative, where the local participating non-governmental organizations defined an initial objective along with DOE and our state energy office representatives (focused on the Puerto Rico's electrical system reform), meetings and further progress ceased.

Another important issue we ask you and the US congressional leadership to urgently consider is related to Section 9. of the HR- 83, Consolidated and Further Continuing Appropriations Act, 2015. Section 9. titled "Study of electric rates in the insular areas" requires the following actions with regards to Puerto Rico energy reform needs and opportunities:

- "not later than 180 days after the date of enactment of this Act, the Secretary shall, within the Empowering Insular Communities activity, establish a team of technical, policy, and financial experts— (1) to develop an energy action plan addressing the energy needs of each of the insular areas and Freely Associated States; and (2) to assist each of the insular areas and Freely Associated States in implementing such plan"

- As indicated in the act:
  - The term "insular areas" means American Samoa, the Commonwealth of the Northern Mariana Islands, Puerto Rico, Guam, and the Virgin Islands.
  - The term "Secretary" means the Secretary of the Department of Interior (DOI).

To date, no action has been taken by the agency, and we know of no real efforts that may enable effective collaboration between the DOI's mandate and the DOE's MOU execution towards the common goal of achieving reduced energy costs through better use of indigenous energy resources in Puerto Rico's energy reform.

The ongoing debt restructuring process of the financially distressed Puerto Rico Electrical Power Authority (PREPA) includes the PREPA June 1st Report and July 22nd 2015 Public Disclosure cost structure as follows: Fuel- 8.1¢; Purchased Power- 5.1¢; Operation and Maintenance- 8.6¢; Capital Improvement- 1.4¢; Debt Service- 6.1¢; for a **Total Energy Cost of 29.2¢/KWh.**

Simple analysis of PREPA proposed costs indicate unsustainable electrical energy rates for local businesses and rate-payers in general and offer no hope for renewed economic growth for PR. As an example, the Operation and Maintenance cost segment of 8.6¢/KWh is equivalent to the Average Energy Rate for the West South Central US. Region for July 2015 of 8.62¢/KWh; while 6.1¢/KWh allocated for the Debt Service is comparable to the West South Central US. Region Industrial Energy Rate for July 2015 of 5.69¢/KWh.

The present artificially low average rates of around 21¢/KWh – though still twice US average rates – results from our public utilities financial non-compliance and the very low oil prices on which two thirds of our obsolete thermal generation fleet rely. The PREPA restructuring officer recently disclosed an estimated deficit of 7.9 ¢/KWh, with regards to the current rate and PREPA's current cost structure. The officer has publicly stated for "all to share the burden" of the proposed debt restructuring alluding to rate-payers suffering an up to 4¢/KWh increase.

Forty eight percent (48%) of Puerto Rico's GDP results directly from its manufacturing sector. When other related primary sectors of our local economy are considered, a total of approximately 70% of our GDP has relied and still relies on competitive electrical energy rates similar to other industrial island economies.

Puerto Rico has endured a more than doubling of its energy cost since year 2000, with severe decreases in energy consumption, as well as growing manifestations of economic and social ills such as increasing migration, government deficits and massive loss of investment. Energy rates increased from 9.22 ¢/KWh in residential, 12.19 ¢/KWh in commercial and 9.58 ¢/KWh in the industrial sector during FY 2000 to 23.51 ¢/KWh in residential, 24.17 ¢/KWh commercial, and 20.60 ¢/KWh in the industrial sector during FY 2015. At the same time, energy consumption has seen a significant decrease of 15.3% in the past 10 years from 20,507.4 mmKWh in FY 2005 to 17,280.1 mmKWh during FY 2015; including a severe decrease in the industrial sector of 44.09% in 10 years from 4,177.4 mmKWh in FY 2005 to 2,335.6 mmKWh during FY 2015.

The above turmoil in the electrical energy sector has resulted in a significant decrease of 7% in our GDP, at constant value, from $11.379 Billion on 2005 to $10,581 Billion in 2014. Intervention by the federal government along with Puerto Rico's private sector leadership and local government are required to address and correct the current obstacles to energy reform, with specific attention to these four main areas of intervention:

- Urgently reactivate existing MOU with the DOE providing vigorous strategic and tactical consulting support for intervention by local NGO's in the ongoing Integrated Resources Plan (IRP) review at the Puerto Rico Energy Commission (PREC), and subsequent Rate Case analysis.

- Urgent compliance by the DOI with HR- 83, specifically focusing resources on needed studies and system modeling, as part of the local government MOU with DOE which promised active participation by our private sector to jointly plan for the lowest Base Energy Cost possible pursuant to the IRP Review Process.

- Amend the law with the exclusion of Puerto Rico in the federal Bankruptcy Code of 1984, specifically as it relates to the orderly reorganization of our public corporations and municipalities.

- DOE financial guarantees that lower the costs of competitive fuel and power purchase suppliers as part of the system re-structuring towards a sustainable energy system.

Senator Murkowski, prompt solutions to the unsustainably high energy costs and resulting general economic distress in Puerto Rico cannot be achieved without a prompt congressional and federal government intervention.

Sincerely,

José E. Rossi	Carlos Rivera	Tomas Torres
President	President	President, Energy Committee
Instituto de Competitividad y Sostenibilidad de P. R.	P. R. Manufacturers Association	P. R. Manufacturers Association
ICSE		INDUSTRIALES PUERTO RICO

XC: The Honorable Maria Cantwell, Ranking Member Committee on Energy and Natural Resources
Files

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"Puerto Rico: Economy, Debt and Options for Congress"
October 22, 2015
SD-366

To: Committee on Energy & Natural Resources
304 Dirksen Senate Building, Washington, DC 20510

Hi!

First, I will like you to consider me "A Friend of the Senate"

Second, It would be a grave mistake to include Puerto Rico in the Bankruptcies protection laws as the other states of the union at this moment.

The basics is that this territory has a "Socialist Designed Form of Government" With this socialist attitudes the government of PR has being acquiring and inventing new ways to grow and grow and grow by acquiring existing industries as Merchant Shipping Lines, Telephone companies, Water and Electric utilities, Workmen compensation Insurances, Internet services, etc.

At the same time, by creating laws or by driving away competition, this socialist form of government establish monopolies that hinder and drive away private enterprises and investments.

Although I can sound to be partisan I have no choice other than establish as a fact that the actual political party, the (Popular Democratic Party) has a greater amount of responsibility in this Socialist business like way to govern.

When the other major party, the New Progressive Party, has been in power and have tried to sell, close, downsize or dispose of any government department or office, powerful forces from Workers Unions, the Univ. of PR, Teachers Associations, Environmentalist groups, Print and Electronic media, and Churches, Etc. unleash powerful and emotional strikes, pickets, riots, acts of violence and psychological pressures that makes the government (NPP) to back up their plans of making a better and more efficient government. When violence erupt, very few actors face charges and never, never get jail terms.

Unfortunately, the same NPP has a lot of blame because an "unofficial" but open policy of this party in the last 40 years is to appease the protestors many time without getting anything in return. Nor a compromise or even a "happy medium".

Actually, the actual PR government do not want and refuse to close offices, layoff employees, sell assets or cut expenses. This government just want to stay as big as it is now.

a. Should the local government be in the Broadcast business with TV & Radio stations?

b. Should it have commercial offices in Peru, Ecuador, Colombia, Kissimmee, NY, that also acts like embassies of a foreign country?

c. Should it be in the Higher Education business with a University with 11 branches in different towns with a budged of $1.2 Billions annually?

d. Should the government be in the business of Education with over 1,300 Government Schools?

e. Should it be in the Insurance business with a Workers Compensation Insurance monopoly "that force" all employers to subscribe in order to maintain an artificial payroll and several luxury big empty buildings?

f. Should it be in the Water business with another monopoly made by Law?

g. Should it be in the Electric business by avoiding or slowing competition?

An inclusion in the bankruptcy laws will "De Facto" maintain all this Big Government intact. With the time, and if finances gets better, they will go back to basic to do exactly the same things and at the first opportunity they will go to the market to ask for more loaned money for they to use and others to pay.

By allowing Puerto Rico to enjoy the US bankruptcy laws it will impede the opportunity to get rid of many government departments, agencies and offices like the Electric and Water Authorities that "claim they provide services" but the reality is that "the services" they provide are services needed to solve situations created by laws and regulations by the very same government.

The city of New York has one mayor for 8 Millions residents. Puerto Rico has 78 mayors with a population of 3.5 Millions. Some of these mayors makes more salary than Mr. Bill de Blasio.

It also has 120 government agencies. When a new government get in power they immediately hire 120 very well paid new directors with undisclosed amount of "people of trust", "Assistants" and "Assessors". **See Exhibits #1 & #2**

In summary, this Socialist form of government make everything more complicate in order to keep a big bureaucratic and complicate way to do businesses. But the government is a 4 year monopoly so many politicians don't care too much to make life easier for the citizens until new elections approach. After elections passed, things will go back to basics.

Political accountability could be a lot better if elections could be held every two years instead of four or Legislators could be elected for four years in mid-term elections apart and separate of administrative elective positions. This will diminish the "winner takes it all" attitude that prevail when an opposition party sweep an elections.

In summary:
1. Any kind of help from Congress should be tied up to lower the amount of employees and government agencies under the average of other states based in population.

2. Parity in Medicaid, Social Security and other federal programs should be welcome as long as they are tied to lower the amount of government agencies.

3. Don't let this Banana Republic sort of government to survive as it is now.
This socialist form of government needs to be overhauled to be a facilitator not an obstacle to free enterprise, private businesses and economic development. Bankruptcy is just a way to keep this Big government intact.

Pensions Funds

Pension funds financial problems is a very big problem for all our nation. But the solution is simple and it is at hand. Just put a mandatory "CAP" in all pensions funds. You are not telling the amount of the "cap" that should be discretionary to each Fund. The Social Security do have a "CAP". These caps could be evaluated and adjusted every two years.

"No laws or regulations of Pension Funds should be written, on purpose or by accident, in a way that it will destroy the good will objectives of its own purposes".

What this means is that: Pension Funds were created in "Good Will" to give financial support to bonafide members of a class in their golden years. **It was not created to enrich or provide Lavish Styles of Living to a Few** when the immense majority of that same class receive a very low income that many times do not provide enough for ordinary daily expenses.

While many pensioners receive a very low amount of money like $600 or $800 per month some others receive quantities with absurds amounts as 6, 7, even 10 thousands dollars per month for life.

As an example. The 9 Puerto Rico Supreme Court judges have to retire when they get to 70yrs old and will receive their full salary for the rest of their lives. If they die, the widow will keep receiving the same income for also the rest of her life independent of her age. While our nation has 9 Judges for 320 Millions Puerto Rico has 9 judges for only 3.5 Millions.

No wonder Puerto Rico is in Bankrupt. It would be interesting to learn if these pensions are or are not exempted from taxes because the territorial government do not make available this kind of information. :-)

To secure the financial health of all Pension Funds in our Nation (and in the world that will probably copy it) a "CAP" should be a standard requirement. This three letters words "CAP", will solve all Pension Fund blues in our nation forever.

US Virgin Islands

1. If Puerto Rico become a state of the Union, provisions should be established to include the US Virgin Islands together as one. The official name of the new state should be "The Great State of Puerto Rico/USVI" and as soon as the Virgin islanders approve such a move, if they want to approve such a move, the two US Senators of Puerto Rico will represent both territories and the Congressperson that will represent the north-east of Puerto Rico, Culebra and Vieques will also represent Saint John, Saint Thomas and Saint Croix.

English Language

Any action by Congress from now on should address the fact that "the use of the English language to teach in Government Schools is De facto prohibited" but not in private schools where politicians and the ruling classes send their children.

Since 1948 until today, yes, until today, the use of the English language to teach is prohibited in all Government schools in the territory. What is in control of the government is in control of the politicians and many times the representatives of the people represent their political parties over the needs of the people they should represent.

In 1991, then governor Hernandez Colon sent two bills to the Legislature. The first in May was labeled "The Spanish Only Law" This one was adamantly opposed by the minority of the New Progressive Party and it was derogate with Law No.1 of 1993.

In August 28 of that same year 1991, he sent another bill. This one to convert into law the Administrative Order of then Secretary of Education, Mariano Villaronga (1948) that prohibited the "Use of the English language to teach" in the 1,300 schools of the government. The majority of the PPD and the minority of the NPP voted in favor with only one abstention making "a Law" the administrative order of 1948.

Since that year, in government schools no classes of Mathematics, Science and Social Studies can be provided in English and the books for those classes got to be in Spanish. Even the English classes are conducted "in Spanish" because many English teachers do not master the language.

Native English speakers teachers are not found in any classroom in Puerto Rico Government schools demonstrating the discrimination against our other brothers and sisters teachers from others states. The Department discriminate subtlety against American teachers in this American territory of the US. Clearly this do not happen in private schools where the politicians send their children.

In government schools at the elementary level, you can hear children singing children songs "in Spanish" but never songs "in English". Clearly all "No Child Left Behind" laws, regulations and appropriations and not even the US Constitution apply to this US territory. Are we citizens of a foreign country?

That's why its important that all additional help from Congress be tied up to specific "Affirmative Actions" to demonstrate that local politicians can be re-educated to behave themselves in favor of the people they claim to represent.

Truly Yours

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#1

UPR Scientists Discover new Element "Governmentium"

By: The San Juan Star staff
January 4, 2001

Rio Piedras (UPI) - The Science Department of the University of Puerto Rico, Rio Piedras campus, has just announced the discovery of the heaviest element yet known to science. The new element has been named "**Governmentium Portorricensis**."

Governmentium Portorricensis has one neutron, 12 assistant neutrons, 75 deputy neutrons, and 224 assistant deputy neutrons, giving it an atomic mass of 312. These 312 particles are held together by forces called morons, which are surrounded by vast quantities of slowgoing-like particles called peons.

Since Governmentium Portorricensis has no electrons, it is inert. However, it can be detected, as it impedes every reaction with which it comes into contact.

A small amount of Governmentium Portorricensis causes any reaction to take over 4 days to complete, when it would normally take less than a second.

Governmentium Portorricensis has a normal half-life of four years; it does not decay, but instead undergoes a reorganization in which a portion of the assistant neutrons and deputy neutrons exchange places.

In fact, Governmentium Portorricensis mass will actually increase over time, since each re-organization will cause more morons to become neutrons forming isotopes.

This characteristic of moron-promotion leads some scientists to believe that Governmentium Portorricensis is formed whenever morons reach a certain quantity in concentration. This hypothetical quantity is referred to as "critical morass."

When catalyzed with money, **Governmentium Portorricensis** becomes Gabinetum, an element which radiates just as much energy since it has 1/2 as many peons but twice as many morons.

#2

The San Juan Star Sunday, March 5, 2000 31

'Holy wars' can't be controlled or stopped

ALEX MALDONADO

Commentary

The first time I met Gov. Pedro Rosselló was back in 1991 at the New Progressive Party headquarters in Santurce. It was, I thought, an important meeting. I accompanied a group of engineers from North Carolina and Puerto Rico that wanted to build and operate a private electric power plant in Mayagüez.

It was important because we had, we believed, one major argument in favor of this plant. It was imperative that Puerto Rico begin to reduce its almost 100 percent dependence on oil for all its energy. In fact, it was crazy that it had not already done so. Back in 1974-75, Puerto Rico was nearly devastated by the OPEC oil embargo. Back then, the government should have vowed "never again!"

This plant would not burn oil. But that was also the problem. It would burn coal. And this had begun to create controversy in Mayagüez and throughout the island.

The mission was not to ask Rosselló to favor the plant. It was to ask him to allow the many Puerto Rican and United States regulatory agencies to study and determine if the plant would be clean and if it would meet all the local and federal environmental laws.

This plant, the engineers said, would be much cleaner than any of the existing government plants, but don't take our word for it. If the new plant failed to get any one of the many United States or Puerto Rico government permits, it would simply not be built.

It was, of course, a reasonable request. And the meeting with Rosselló, everyone agreed, went very well. The young NPP candidate for governor did not say much, but seemed to listen intently. He was, after all, a medical doctor, and had the image of not being the typical político. Although he did not commit himself to anything, everyone left the meeting thinking that he would not interfere with the permitting process.

It was a shock and a major disappointment, when in January of 1992, the firm, Cogentrix, received word that Rosselló had held a press conference in Mayagüez, surrounded by local NPP and environmental group leaders opposed to the plant. Rosselló came out against the plant, and promised that if elected, he would kill it. He got elected, and he did. The monumental campaign of false information and fear had won.

To listen to the opposition, one had to believe that the real purpose of the plant was not to produce electricity, but to poison the people of Mayagüez. It was a plant built to produce black clouds of contamination. Like the poor Romans of ancient Pompey, the people would be buried and suffocated by the tons of ash coming out of the plant's chimneys.

If the ash did not get you, the acid rain would. The people would begin to see the paint peel off their cars and homes before they started dropping dead like flies. Everything green would become a wasteland and everything in the sea would be poisoned by the water discharging from the plant.

But there was still more. If any person managed to survive in Mayagüez, he or she faced the horrible slow death of the cancer caused by the electric power lines coming from the plant.

All of this was false. But the campaign took on a life of its own. There was no way to stop it, or even slow it down. By November, the North Carolina firm had been totally demonized. There seemed not to be a single political leader, of any party, that could resist coming out against the plant.

Then there was the media. I recall in particular the newscasts on one major TV station: every time the firm was mentioned, the viewers were treated to images of a real wasteland that looked like Hiroshima after the atomic bomb.

But why is this important today?

For one reason, because Puerto Rico is suffering again from a big increase in the price of oil. OPEC began last year to reduce production. Today, the entire world consumes 77 million barrels a day, but production is only 75 million. The result, of course, is that the price has gone up sharply — by mid-week, up to $31 a barrel.

There is hope that on March 27, OPEC will decide to begin to increase production. But any increase in the price of oil hits Puerto Rico quick and hard. The increase is passed on directly to the consumers of electricity. Of course, the cost of gasoline has shot up. Even a small increase means hundreds of millions of dollars that leave the island economy.

Now, a decade later, Puerto Rico will have a coal burning plant. By the year 2002, the private Applied Energy Systems plant should be producing some 450 megawatts of electricity. In Guayanilla, a plant using natural gas has begun operations.

But a decade has been lost needlessly. If the Mayagüez plant had not been killed, Puerto Rico would be in a better position today to meet the current oil crisis.

But there is something else in all this. For a Puerto Rico today caught in the terrible Vieques mess, there is a big lesson.

One likes to think that in this world, truth, facts, reality will, in the end, triumph over falsehood and demagoguery. But those of us who lived through the Mayagüez battle saw first hand something else. We saw how easy it is for falsehood and demagoguery to win.

Once the critical mass of public hysteria is reached, enflamed by a potent mix of political irresponsibility with passionate bias in the media, there is no force that can resist it.

The big lesson is this: never start a jihad, a Holy War, in Puerto Rico. Be it against a successful power plant company from North Carolina that believed that it could invest on this island, or against the Navy. For once you start it, you can't control it, let alone end it.

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Jose Calderon, President, Hispanic Federation
Written Testimony
United States Senate Committee on Energy and Natural Resources
"Hearing on Puerto Rico: economy, debt, and options for Congress"
October 22, 2015

Chairman Murkowski, Ranking Member Cantwell, and distinguished members of the Committee on Energy and Natural Resources thank you for the opportunity to provide testimony on the crisis facing Puerto Rico.

My name is Jose Calderon. I am the President of the Hispanic Federation. Hispanic Federation is the nation's premier Latino membership organization with a mission to advance and empower the Hispanic community locally and nationally. For over 25 years, Hispanic Federation has provided critical nonprofit capacity-building grants, launched innovative community programs and led public advocacy efforts in the areas of education, health, immigration, economic empowerment, civic engagement, civil rights and the environment. Through its network of nearly 100 affiliated community-based organizations, HF reaches thousands of Hispanics each year including a large number of Puerto Ricans living on the mainland.

Recently, Hispanic Federation has been helping to lead efforts to support Puerto Rico and its 3.5 million U.S. citizens, along with an extensive coalition of Latino, labor, environmental, health and economic justice advocates from across the nation. With our partners, we have organized press conferences in several cities from Hartford to Orlando, collected signatures on a White House petition calling for the President to respond to the crisis and organizing a congressional briefing to inform our nation's leaders about the situation on the island. Two weeks ago we released a briefing paper, *Puerto Rico's Economic Crisis: Overview and Recommendations for Action* in which we lay out Hispanic Federation's strong belief that the federal government bears a social, moral and economic responsibility to directly address the Puerto Rican debt crisis.

The ramifications of the island's economic crisis have been far reaching: One hundred and fifty public schools have already been shuttered in the last five years. Puerto Rico has increased the retirement age and required heftier pension fund contributions from public sector workers. And more pain is coming. Puerto Rico passed a budget for the fiscal year beginning July 1, 2015 that increased the sales and use tax from 7 percent to 11.5 percent and reduced pubic investment by $674 million.

Severe current and future government budget cuts threaten to undermine the already tenuous economic situation of hundreds of thousands of Puerto Ricans on the island. And there is good chance that the crisis will be increasingly felt in many U.S. states, through potential pension asset losses and a growing reliance on local social services by those who migrate to the U.S. In short, Puerto Rico's near-calamitous economic crisis, if left to fester, will almost certainly reverberate far beyond the geographic limits of the island.

The reasons behind the island's current economic woes are complex, with plenty of blame to go around: poor budget practices by the island, federal funding shortfalls and tax policies that hamper economic growth, predatory lending by hedge funds, and the complicated and oft unjust relationship between the U.S. and Puerto Rico, to name just a few. There are also wider forces to blame, such as the Great Recession, outmigration from the island, and escalating energy and health care costs.

Setting the stage for the crisis were stagnant economic conditions in Puerto Rico over the past 10-15 years, brought about by the elimination of Section 936 of the Internal Revenue Code. Section 936 encouraged mainland companies to locate on the island. Unfortunately, when the tax breaks were eliminated by Congress, these companies moved out. The Great Recession of 2008 compounded this stagnation, leaving almost half the island's residents in poverty and unemployed. Forced to seek economic opportunity, hundreds of thousands of Puerto Ricans moved stateside to places like Florida, draining the island's tax base which funds basic public services.

However, structural economic inequalities – in part driven by Federal policies – date back long before the recent decline. A prime example is the burdensome costs of transporting goods created by the U.S. Jones Act, which has increased shipping costs by billions over many decades. In effect, the law requires every car, food item or other product that enters or leaves Puerto Rico to be carried on a more-expensive U.S.-flagged vessel. If a foreign-flagged ship enters the island, high taxes and customs fees essentially double the price of transported goods.

Puerto Rico also faces growing costs to its public services. The electricity system led by the Puerto Rico Electric Power Authority (PREPA) is more than $8 billion in debt. A recent deal to restructure the debt still leaves the systemic challenge of reducing sky-high energy costs to homeowners and businesses from the outdated and unhealthy use of fossil fuels, as opposed to cleaner, renewable energy systems.

Federal healthcare funding inequities have also contributed to the ongoing crisis. Approximately 60% of the island's population is enrolled in Medicaid or Medicare, both which face an uncertain future due in part to an archaic capping of federal contributions which was imposed upon Puerto Rico. As a result, healthcare costs represent an estimated $25 billion of its $72 billion debt.

Declining tax revenue forced risky borrowing to keep public utilities and local government running, which in turn generated massive debt because of predatory interest rates aimed at creating a big fiscal windfall for hedge funds looking to make a fast buck at the island's expense. In fact, these same hedge fund interests were backers of changes in the island's constitution that mandated the local government to first pay debt relief before continuing to fund schools, energy and other vital public services.

Unfortunately, these measures will only help to exacerbate the current vicious cycle of outmigration, with the only certainty being that more pain for Puerto Rico is in store in the near future. Below are more details regarding the main causes of the island's financial troubles, focusing on labor force decline, the health care crisis, and debt and debt service costs.

The depth and scope of Puerto Rico's economic crisis has forced leaders on the island to make difficult and painful choices. The Commonwealth has already laid off over 30,000 employees, raised utility and college tuition prices, raised taxes, cut public health and pension benefits, closed schools, and raised the retirement age. On September 8th, the Governor announced a new round of austerity measures that calls for additional cuts to social services, layoffs and reductions in job protections. Meanwhile, Puerto Rico is also bracing for a health care crisis with federal funds rapidly diminishing and no clear plan on how to keep island residents covered in the coming years.

Puerto Rico is considering reforms to all aspects of its economy and governance, including taxes, labor laws and administrative practices. Negotiations are underway to explore debt restructuring and other options, but financial interests are resisting payment reductions. Meanwhile, there are estimates that this year's $5 billion principal and interest payments alone would require $1,400 in increased tax levies for every resident of the island, roughly 9% of per-capita income. Unfortunately, Puerto Rico does not have the cash flow or tax base to make anything close to the required payments.

Despite these cuts and the pain they're causing millions of American citizens on the island, the same hedge fund interests who urged the Commonwealth to continue to unwisely borrow well beyond its means are now calling for further severe austerity and privatization measures to protect their financial windfall. The IMF's "Krueger Plan" perfectly encapsulates this thinking with its severe budget cuts and related proposals calling for even more massive school closures and wage reductions.

While there will undoubtedly be further fiscal pain for the families of Puerto Rico, we do not believe the island can or should cut its way through this crisis. Further reductions to government services and pensions threaten to undermine the Puerto Rican economy so deeply that it may take generations to recover. Any realistic solution must instead include reasonable debt restructuring and relief, immediate federal investment and reforms, and a long-term economic growth and diversification strategy that will create living-wage jobs, grow small businesses, improve infrastructure and provide opportunities for local residents.

President Obama and Congress cannot stand on the sidelines when it comes to Puerto Rico. Elected officials and civil servants in both the executive and legislative branches have a legal and moral obligation to support Puerto Rico in its time of dire need. Over 3.5 million U.S. citizens are counting on them to act immediately to help the island get through this fiscal crisis and on a path to economic recovery. Below are select key actions the Federal Government can undertake to offer resources and enact reforms to assist Puerto Rico through this fiscal and economic crisis.

- Bankruptcy Protection: Congress should pass legislation granting Puerto Rico the right to declare Chapter 9 bankruptcy or another orderly and fair alternative in order to renegotiate the debt and establish a fair repayment plan. See Puerto Rico Chapter 9 Uniformity Act-H.R. 870, introduced by Representative Pedro Pierluisi (D-PR) and Senators Richard Blumenthal (D-CT) and Charles Schumer (D-NY).
- Debt Renegotiation & Relief: President Obama should convene a Working Group on Financial Markets to bring all parties to the table in order to negotiate a fair debt repayment and relief deal. In doing so, the President could sit down with all relevant stakeholders and explore a Federal Reserve loan or any other bridge or gap financing options for the Commonwealth of Puerto Rico. In addition, the President should exercise his authority to convene both the Government of Puerto Rico and its creditors, and urge the parties to find an orderly negotiated resolution of this crisis in order to avoid further costs to the vulnerable residents and populations in Puerto Rico.
- Health Care: Congress should bolster Puerto Rico's health care safety net by passing legislation that will eliminate the annual Medicaid/Mi Salud funding cap on Puerto Rico in favor of funding based on FMAP per-capita income. Congress should include all U.S. territories in this legislation. Congress

should also improve the formula for the Medicare Disproportionate Share Hospital Program, reduce by 50% the fee on insurers in the territories, and establish a floor for Medicare payments. In the interim, the President should establish a multi-billion dollar health care program as has been done in some states to ensure vital health care services continue past 2017, when existing funds will run out. See Improving the Treatment of the U.S. Territories Under Federal Health Programs Act of 2015 - H.R. 2635 introduced by Representative Pedro Pierluisi (D-PR).

- Energy and the Environment: President Obama should direct the Department of Energy (DOE) and Environmental Protection Agency (EPA) to engage in a full review and collaborative analysis of all federal policies and programs that apply to Puerto Rico in the areas of clean energy generation and environmental cleanup. This will ensure the development of a comprehensive policy plan that addresses the energy, clean environment, safety and health needs of Puerto Rico, including the cleanup of toxic sites within the island municipalities of Vieques and Culebra.
- Jones Act: The President should grant a temporary waiver and Congress should pass legislation that amends the costly shipping mandates dictated by the Jones Act, which unfairly increases the prices of imports and exports to and from Puerto Rico. Any funds from foreign-vessel fees should also be directed to the Puerto Rico Treasury.
- Tax Policy: Following the loss of Section 936 tax incentives, the Federal Government should institute tax policies that foster economically-diverse and living-wage job creation. President Obama should also support local government implementation of an Earned Income Tax Credit (EITC) that rewards work and supplements earnings to low-income workers in Puerto Rico.
- Federal Policy & Funding Formula Assessment: There should be a full Administration and Congressional review of all federal policies that apply (or not) to the Commonwealth of Puerto Rico. This review should seek to eliminate or reduce the impact of federal policies that put the island at an economic disadvantage, as well as look for ways to expand access to Federal investments and programs.

Puerto Rico and its citizens are inextricably intertwined with the United States by history, emigration and economics. Puerto Ricans, both on the island and stateside, have fought valiantly in every war since World War I, and its citizens have contributed to this nation in innumerable ways. Its diaspora – five million strong, still intimately connected to the island – are a visible presence in communities throughout the fifty States of the Union. Just as significantly, three out of every four municipal funds in the country hold Puerto Rico's bonds.

Because of these intimate interconnections, what affects Puerto Rico affects the U.S. The fact that Puerto Rico faces the worst economic crisis in more than a century should be of the highest concern to all Americans. If Puerto Rico is forced to enact even more draconian cuts to its budget, the island will almost certainly spiral into an even deeper crisis. Given the interpenetration of the Puerto Rican population and economy with the U.S., this will have incalculable repercussions on communities, towns and cities stateside.

The time to debate or assign blame is past, as is any hope that the U.S. could avoid economic fallout from this crisis. The real question is, do we have the will to act in order to ameliorate its very worst effects?

To do so, we urge the Administration and Congress to resist calls by hedge funds to force more cuts to social services. We urge Congress to give Puerto Rico the ability to file for bankruptcy protection and to pass legislation rectifying economic inequities including the Jones Act and Mi Salud. We urge the President to call for a full federal agency review of policies that are economically harmful to Puerto Rico, including health care reimbursement, and convene his Working Group on Financial Markets to develop an in-depth debt relief, repayment, and investment plan to stabilize the island's economy.

We urge the Congress to take strong, substantive and constructive action that stabilizes Puerto Rico and protects the livelihoods of 3.5 million American citizens living on the island.

Thank you for your time and consideration.

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Statement for the record of the Natural Resources Committee of the U.S. Senate October 22, 2015

THE TIME FOR EQUALITY and REPARATION IS NOW!

The beginning of this American Paradox, the political limbo of a U.S. territory, started in the office of newspaper publisher and tycoon William Randolph Hearst. With his control of newspapers in San Francisco and New York Hearst was competing for influence and circulation with another newspaper tycoon Joseph Pulitzer, owner of the New World. Their competition was fierce and promoted the publishing of unfounded and false stories to incite public opinions in promoting their business interests and political policies objectives.

Hearst was the prime mover of the Spanish American War of 1898. He used his papers in every conceivable way to spark the war against Spain. Hesent Frederic Remington, an artist hired by Hearst to provide illustrations to accompany a series of articles on the Cuban Revolution,soon became bored with seemingly peaceful Cuba and wired Hearst on January 1897: "Everything is quiet. There is no trouble. There will be no war. I wish to return." To which Hearst's alleged reply was: "Please remain. You furnish the pictures and I'll furnish the war." Then, the war ship Maine was blown by a massive "unknown" explosion in Havana harbor and the Spanish American War began. It was a short war. It started in April and ended on December 10, 1898 with the signing of the Treaty of Versailles. Spain sold the Philippines for $20 millions; Cuba became a protectorate and Puerto Rico and Guam were ceded to the United States.

The treaty gave the United States Congress absolute control of the new territories. After 2 years of military governors Puerto Rico was given civilian control of the governments with the Foraker Act and in 1917 the Jones Act granted American citizenship. During the first 25 years the United States Supreme Court issued a series of opinions in the so called Insular Cases in which the citizens living in Puerto Rico were labelled "aliens" "not fit for the Anglo-Saxon culture" and through judicial fiat legalized segregation and discrimination. Francis Torres writing for the Brown University Political review said: "The recent memory of the Civil War and Reconstruction led some to believe that the relationship between Americans and the peoples of these new territories would be based upon the newly established concept of political equality between racial groups on the mainland. However, these notions were thrown out the window in the wake of popular social Darwinism and the nationalistic mythos of Manifest Destiny. Under this ideological framework, American views of their new subject populations leaned towards the paternalistic and racist."

It is true that Puerto Rico was an abandoned and neglected colony by the decaying and powerless metropolis of Spain. When the United States assumed control of Puerto Rico roads, schools, hospital, the University of Puerto Rico and many other infrastructure and public works were built to begin a process of social, economic and political development. The overwhelming majority of the citizens of Puerto Rico lived under abismal levels of misery and poverty. Just take a photographic tour of the pictures in the National Archive of that time period. http://www.archive.gov

Nevertheless since the granting of citizenship American citizens in Puerto Rico have contributed to our Nation in many forms and ways. Let's see the most outstanding:

1- More than 275,000 have served with dignity and honor defending liberty democracy in all major conflicts of the 20th and 21st century. Thousands have given their lives for the causes of democracy and liberty denied to them.

2- Puerto Rico is among the 20th purchaser of U.S. goods and services in the World creating hundreds of thousands of jobs in all the states of the union.

3- Puerto Rico pays more Federal taxes than Alaska, Vermont, Montana, Maine, North Dakota and Wyoming. Despite this fact that American citizens paid 100% of the Social Security taxes they are discriminated by Congress denying the application of certain benefits. Congress has extended 100% applicability of all Social Security benefits to Americans abroad and to those retired in independent republics like Costa Rica. Taxation without representation? See The Economist: http://www.economist.com/blogs/dailychart/2011/08/americas-fiscal-union

4- American citizens from Puerto Rico have enriched the diversity of American culture in show business, movies, literature, sports and in all aspects of the human experience. Examples of this contributors are: José Ferrer; Rita Moreno, Benicio del Toro, tennis player Gigi Fernandez, baseball stars like Roberto Clemente, Peruchín Cepeda and many others.

5- There are five millions American citizens from Puerto Rican ancestry living in all of the 50 states of the union and generating billions of dollars to the American economy. Since the granting of the so called "estado libre asociado" free associated state in 1952 more than 2.3 millions have departed seeking the American dream.

6- Dozens of Air Force, Naval and Army facilities in an Island 100 miles by 35 miles, including use of two populated islands with live target practice and multiple intelligence gathering & listening posts.

The other side of the coin:

1- Since conquering Puerto Rico, the United States government, particularly Congress, established an apartheid and segregated policies towards American citizens residing in Puerto Rico. Federal laws provides full benefits to Americans living in the states and a different standard in the territory. For example, supplemental social security is paid to American citizens residing in the Republic of Costa Rica by an act of Congress.

2- American citizens serving in the U.S. Armed Forces were segregated in the same manner African Americans were. They were also discriminated in promotions within the ranks of the armed forces.

3- During the 1930s the Rockefeller Foundation funded a program under the management of U.S. Army Colonel Cornelius P. Rhoads, an oncologist and pathologist. He experimented with Puerto Ricans, using cancerous cells to find "a cure" for this deadly disease. He wrote a letter to a colleague of his in Boston by the name Fred W. Stewart and this is what he said about PuertoRicans: "They are beyond doubt the dirtiest, laziest, most degenerate and thievish race of men ever inhabiting this sphere. It makes you sick to inhabit the same island with them. They are even lower than Italians."

4-Federal court system and law enforcement agencies are been used to persecute enemies of the colonial regime with the sole objective of maintaining the status quo.

5-American citizens residing in the territory are forced to use American ships for importation and exportation of goods and services.

6-Since 1952 the United States have adopted the disgraceful policy that Puerto Rico "solved" it's political status with the adoption of the territorial constitution (Law 600) approved by the U.S. Congress. This policy denied American citizens the right for a self determination process guaranteed by United Nations Resolution 1541-XV.

On July 25, 1979 the Carter Administration, pressed by Puerto Ricans who supported his candidacy in 1976, ignored the pressures from The White House and the State Department and crossed the street into the United Nations to denounce the colonial nature of the "commonwealth status!" As a direct result the White House issued the Alternative Future Presidential Executive Order. This was the beginning of a path to be followed by future presidents to maneuver the status question into abridge to nowhere. But it was a beginning on the end of "commonwealth" colonial status. It was also the 1st time that the presidency made an official policy statement "guaranteeing" the right self-determination to choose between independence, statehood or the so called commonwealth.

President George H.W. Bush issued a memorandum on November 30, 1992, to heads of executive departments and agencies establishing the current relationship between the Federal Government and the commonwealth of Puerto Rico. This memorandum directs all Federal departments, agencies, and officials to treat Puerto Rico administratively as if it were a State insofar as doing so would not disrupt Federal programs or operations.

On December23, 2000, President William J. Clinton signed executive Order 13183, which established the President's Task Force on Puerto Rico's Status and the rules for its membership. This executive Order outlines the policy and functions of the Task Force in identifying the options for Puerto Rico's future status and the process for realizing an option. On April 30, 2001, President George W. Bush amended executive Order 13183, extending the deadline for the Task Force to forward a report to the President until August 2001.

President George W. Bush signed an additional amendment to executive Order 13183 on December 3, 2003, which established the TaskForce co-chairs and instructed the Task Force to issue reports as needed, but no less than once every two years.

President Barack Obama validated the Executive Order en a Task Force was re-appointed an issued a report.The Obama Administration Inter Agency Committee on Puerto Rico clearly stated that Puerto Rico's economic quagmire is tied to it's political status. On March 11, 2011 it released its report and the first recommendation made was the following:

"The Task Force recommends that all relevant parties—the President, Congress, and the leadership and people of Puerto Rico—work to ensure that Puerto Ricans are able to express their will about status options and have that will acted upon by the end of 2012 or soon thereafter." Obama in multiple letters to the colonial governor and political leader said "is to to you to decide. You vote and I will act."

All of these carefully planned intervention by presidents from Carter to Obama, even though they are better than nothing, were hollow policies initiatives with great sound bytes and lip service labels! There more things "change"... the more they remain the same.

Soon there after on November 6, 2012 the People of Puerto Rico in a historical plebiscite voted on two questions:

1- Whether to remain a colonial territory under the "commonwealth status." For the first time in its history the People spoke clearly with 54 per cent rejecting the present non incorporated colonial territory. So the United States has a territory that has rejected the colonial status and does not have the consent of the governed.

2- The second question asked the People's preference in favor of independence, statehood (political equality) or free association. The People again expressed their preference by voting for statehood with 61 per cent of the vote. We voted two and half years ago. Even though, President Obama issued the Lexington Doctrine of Nation building first for his second term PuertoRico is seating in the back of the bus. Washington through its web of control and "persuasive perversions" maintains out of the political discussion agenda the issue of the right of self determination of 3.6 millions American citizens. This is no longer benign neglect of a Nation sequestering the final destiny of a People. It is gross negligence and violations of the Charter of the United National, the United States' Constitution and the right to pursue its final status.

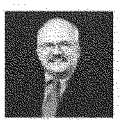
The present crisis facing the territory is a massive un-payable public debt together with high unemployment, real estate deflation, the largest non performing loans portfolios of all colonial banks in recorded history and a massive population exodus. Today PuertoRico is the place in all of the Americas with the highest cost of living and taxes. Maintaining a policy of passivity and non intervention, while the Island's family structure is dismembered by the massive population exodus, is a crime against humanity!

The U.S. Census projected that by 2050 the population of Puerto Rico will decrease to 2.3 millions. The same amount when "commonwealth" and the Constitution were adopted in 1952. The number of American citizens leaving the Island for 2015 is estimated at 80,000. The tax base and government revenues is shrinking fast. Jet Blue has expanded their flights from the Island to Florida, Georgia, North Carolina, Virginia, Pennsylvania, Ohio and New Jersey. All

"battle ground states!" Therefore if Washington does not react PuertoRicans will abandon a bankrupt and nearly empty archipelago to the United States.
The Gallup Organization made two polls in Puerto Rico in 1990 and 1991 and asked the American citizens living in the territory, what would they do if the Island was granted Independence or Free Association (Associated Republic). Ninety two per cent (92%) said that they would move to the United States. This is not surprising. Polls made by Frank Luntz for the campaign for Governor of Dr. Pedro J. Rosselló revealed that ***97% treasured their American citizenship the most. So, those states that PuertoRicans love the most should be prepared for the tidal wave of population from the territory to a neighborhood near you.***

The United States owes the People of Puerto Rico reparations for all its colonial abuses and for extending it's regime of apartheid and segregation for 117 years. Giving us billions in welfare and subsidies programs is not a substitute for our right to be equal. We have paid a very high price of 117 years of colonial rule. There is an admission bill introduced by Resident Commissioner Pedro J. Pierluisi to sponsor Federal plebiscite asking for a vote on statehood yes or no. That's the democratic path to follow to resolve this American Paradox! Latin America, the Caribbean and the World are watching how the United States treats this issue affecting the lives of 3.6 millions American citizens of Hispanic origin. It will reveal if the United States has changed its policies of force and imperialism and has truly become a beacon of democracy, liberty and equality. Passivity is not an option

The reparation is to grant political equality and end the racist, segregated and apartheid colonial territory to American citizens that pays more Federal taxes than 6 states of the Union; to the thousands of American citizens who gave the ultimate sacrifice defending democracy and freedom and to the 275,000 who have served and are serving with honor and distinction in the U.S. Armed Forces. There is no liberty if there is no EQUALITY! Dismembering the People of Puerto Rico with a benign neglect policy is a crime against humanity. The time to act is now. History will judge the decision makers. Equality is the soul of freedom. Denying it is a human right violation!



Franklin Délano López is a former United Press International and The Associated Press journalist. He served as National Field Coordinator of the Carter-Mondale Presidential Campaign in 1976. He was the first elected State Democratic Chairman of the Democratic Party pf Puerto Rico. He was National Director for Ethnic Affairs of the Carter Mondale Campaign in 1980. He was a member of the 1st Circuit Court Nominating Panel; the National Small Business Presidential Commission and member of the transition team of three U.S. Presidents.

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ASOCIACIÓN DE HOSPITALES DE PUERTO RICO

Statement of the Puerto Rico Hospital Association

By Mr. Jaime Plá Cortés, Executive President

For the Hearing Record

Senate Committee on Energy and Natural Resources
"Hearing on Puerto Rico: economy, debt, and options for Congress"

October 22, 2015

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Chairman Murkowski, Ranking Member Cantwell and distinguished Members of the Senate Energy & Natural Resources Committee, thank you for the opportunity to provide this Statement for the Record on behalf of the Puerto Rico Hospital Association. Our organization represents the 69 hospitals serving approximately 3.6 million U.S. Citizens residing in the U.S. Territory of Puerto Rico; a population larger than twenty States. Our Hospitals employ approximate 50,000 health professionals and represent the centerpiece of 20% of Puerto Rico's GDP.

Notably, we are particularly proud that not only was our organization founded in 1942 but we are the home of the America's oldest continuously operated hospital: El Hospital La Concepcion of San German, founded in 1524. Many of our Hospital Systems have served our U.S. Territory prior to the granting of U.S. Citizenship in 1917.

We appreciate the interest of the Committee in the current state of Puerto Rico's economy as well as the fiscal crisis facing our local government and its institutions. Unfortunately, our island's weak economy, high level of poverty, record unemployment and troubled government finances are contributing to the challenges we face in managing a health care system designed to provide the best quality care for the U.S. Citizens we serve each and every day.

Frankly, we face a larger challenge as we work to deliver quality health care. Our Medicaid funding is capped and our treatment under Medicare is significantly less than that received by identical stateside hospitals. However, we are expected to deliver the same level of quality care for our Citizens and visitors as that provided by our sister stateside institutions.

The Government of Puerto Rico is behind in its Medicaid reimbursements to the tune of at least $200 million today. Since 43% of our local population is living in poverty every one of our member hospitals serves Medicaid patients. This combined with our lesser Medicare reimbursement levels has put an incredible strain on the operations of every hospital. We also note that 20% of our island's population is Medicare eligible. However, Medicare represents 40% of the utilization of our hospitals.

We recently surveyed our member hospitals and found that over the past twelve months almost every institution has been forced to scale back operations in some way due to the Government of Puerto Rico's delayed Medicaid payments due to the inability to obtain an additional line of credit through the Government Development Bank. This reduction in services has resulted in employee cutbacks and reduced hours impacting thousands of employees, with many hospitals reducing beds, closing floors and eliminating specialized services as well as an additional delay in payment of bills and payroll. One hospital has already closed its doors after the local government owned electrical utility cut off its electricity service due to late payment of bills.

The facts show that Puerto Rico's hospital system is in a crisis due to the combination of the government's delay in reimbursing its medical providers and the secondary treatment our hospitals receive under Medicare. We are struggling to maintain our staff and see many of our experienced doctors, nurses and other health professionals recruited away with offers of better compensation by stateside hospitals. In fact, official census data suggests Puerto Rico loses on average one doctor a day.

You've noted in your opening statements as well as through comments by individual Members during this hearing that you wish to focus on solutions that can have a meaningful impact on the U.S. Citizens residing in Puerto Rico. While there are many areas in health care where the disparity in treatment under Medicare can be identified, my intent with this statement is to ask your attention to the initiatives where Congress can make a difference in the short term. In fact, each of these initiatives addresses a fairness issue resulting from disparate treatment of Puerto Rico hospitals. These are our priorities:

ISSUE#1: MEDICARE'S IPPS SINGLES OUT PUERTO RICO'S HOSPITALS

The federal government reimburses hospitals who admit Medicare patients for inpatient care under a system known as the Inpatient Prospective Payment System, or IPPS. The IPPS payment is intended to cover the costs that a reasonably efficient hospital would incur in furnishing high quality care.

The current IPPS results in the federal government reimbursing Puerto Rico hospitals that treat Medicare patients a lower amount than hospitals in the 50 states and other Territories. Puerto Rico's hospitals are not paid the same base rate as identical hospitals in the states, resulting in these hospitals receiving lower payments than identical hospitals elsewhere receive per discharged patient. This is because hospitals in Puerto Rico do not receive a base rate based on 100% of the national average operating and capital costs associated with running a hospital. Instead, they receive a base rate based on 75 percent. When combined with the disparity in the Medicare Wage Index administered by CMS, Puerto Rico hospitals only receive 52% of the reimbursement given to identical hospitals elsewhere.

Puerto Rico's hospitals are the only U.S. hospitals treated under the IPPS in this fashion. Even the other Territories are not treated this way. We ask your support for correcting this disparity when the Senate Finance Committee considers appropriate legislation. We believe identical hospitals should be treated equally as they work to serve Medicare patients, provide quality care and remain financially stable. It's a fundamental issue of fairness.

There is no principled basis to treat Puerto Rico hospitals under the Medicare IPPS as Puerto Rico residents pay the Medicare payroll tax just like their fellow citizens in the 50 states and District of Columbia. This disparate treatment significantly hampers Puerto Rico's hospitals' goal of providing the highest quality care for almost 3.6 million U.S. citizens; a population larger than 20 States.

Legislation to address IPPS for Puerto Rico is offered by Senator Schumer and other Members, as part of a broader package of reforms is included in S. 1961. This legislation would eliminate this disparity and treat Puerto Rico's hospitals under the IPPS the same as identical hospitals elsewhere. This solution has been endorsed by both the American Hospital Association and the Puerto Rico Hospital Association.

ISSUE #2: INCLUDE PUERTO RICO HOSPITALS IN THE HITECT ACT

The Health Information Technology for Economic and Clinical Health (HITECH) Act was enacted in 2009. The goal of the HITECH Act is to advance the design, development and operation of a nationwide health information infrastructure that promotes the electronic use and exchange of information. Doctors and hospitals are encouraged to use electronic health records (EHR), so, patient care is improved, medical errors are curtailed and lower health care delivery costs.

To promote the adoption of EHRs, the HITECH Act authorizes bonus payments under both Medicare and Medicaid for eligible doctors and hospitals that become "meaningful users" of certified EHR systems. The Medicare incentive program consists of both "carrots" and "sticks" in that physicians and hospitals will be penalized if they fail to adopt EHR technology by a certain date.

Unfortunately, apparently due to a drafting error, the final HITECH legislation omitted Puerto Rico hospitals from the Medicare component of the incentive program. The current law makes Puerto Rico physicians eligible for both the Medicaid and Medicare payments and Puerto Rico's hospitals are eligible for the Medicaid bonus payments, yet our hospitals were omitted from the Medicare provision, which is likely attributed to the definition of an eligible hospital as a "subsection (d) hospital", an acute care hospital located in the fifty states or District of Columbia. The proposed amendment would simply add for purposes of this Act the inclusion of subsection (d) hospitals in Puerto Rico, thus putting Puerto Rico hospitals on parity with those in the States.

This inadvertent exclusion significantly hampers Puerto Rico's hospitals' efforts to adopt EHR systems putting at stake a vital modernization initiative.

Unfortunately, only Puerto Rico was excluded from the program by a drafting error.

Bi-partisan legislation known as the Puerto Rico Hospital HITECH Amendments Act of 2015 to correct this oversight has been introduced in the Senate, S. 1602, by Senators Menendez, Nelson and Rubio. Both the Puerto Rico Hospital Association and the American Hospital Association (AHA) has endorsed this fix.

We also noted during the hearing the comments of one witness who justified disparate treatment of Puerto Rico under Medicare with a two pointed argument. First, it was said that health care funding levels should not be considered as part of an economic development strategy. Second, it was noted while workers in Puerto Rico pay taxes into the Medicare system, they do not all typically pay Federal income tax. We respond by noting that Congress has made it a policy priority to ensure access for quality health care for all American regardless of whether they are rich or poor. If U.S. Citizens do not believe they can obtain quality health care in Puerto Rico, they then as U.S. Citizens have the right to find that quality health care elsewhere within the United States.

We do not ask for a bailout and never have. However, we ask for fair treatment and note that equal treatment for all American Citizens is a guiding principle for our great Nation. Parity is a fair request.

Mr. Chairman, Ranking Member Cantwell and Members of the Energy & Natural Resources Committee, our health care system is in a crisis. We have offered a set of priorities and ask to work with you to ensure fair treatment for all U.S. Citizens when it comes to health care. These priorities deserve prompt action and are solutions within your Committee's jurisdiction and we look forward to working with you.

Thank you for the opportunity to share our statement with you.

Below is a Forbes op-ed by Rosselló set to run at 6am ET tomorrow

A New Path Forward for Puerto Rico
By Ricardo Rosselló

Another hearing will be held today on the fiscal crisis of Puerto Rico; this time by the Senate Energy and Natural Resources Committee. Washington seems intent on figuring out what the Federal government should do to help the island's government pay its public debt of over $70 billion dollars. Yet, despite all of the attention Congress is not addressing the root cause of the problem. The debt is just the symptom of the problem. The real underlying issue is the island government's addiction to spending – a habit which produces $6 billion dollar deficits per year and a government centered economic model which leads to stunted growth. To put it into perspective, even if the island completely defaulted on its roughly $3 billion dollar per year debt service payments, this still does not address half of the deficit problem.

This is what scares financial markets and undermines the credibility of the government. This is why there are several other jurisdictions that have much higher debt to GDP ratios than Puerto Rico and still have better credit ratings than the island.

Defaulting on the debt or deferring payment for several years as Governor Alejandro Garcia-Padilla has proposed as a renegotiation strategy would clearly only aggravate the island's credibility problem. Investors would have a hard time believing they will eventually get paid and, in the end, the government would have a bigger future debt service burden.

To address the real challenges Puerto Rico faces, I propose a new path forward for Puerto Rico; one that begins with the basic premise that the Puerto Rican government can and should pay its debts and that it does not need any type of bailout from Washington to meet the responsibilities it has assumed.

The new path I propose calls for three specific strategies: first, we must once and for all dismantle the current government apparatus that is costly and ineffective; second, we should simultaneously implement real and strong free market reforms that open up our economy and lead to robust growth and job creation; and third, a new independent mechanism should be created to manage the debt, based on a collaboration between the government of Puerto Rico and the Federal government, in order to restore investor confidence and allow the island's government to regain access to the financial markets.

We should start by creating a new government structure that significantly reduces the cost and enhances its function. The current structure allows for 118 agencies in the executive branch, at a price tag of $21.8 billion per year. All of the services provided by these agencies, 340 in total, must be reassessed to determine if some of them can be consolidated, delegated to the private sector, and which ones are simply not necessary. The strategy could provide up to a 70% reduction in the government's sprawling administrative structure. We can achieve this through a few key steps. First, making the government a single employer, so that it can allocate human resources where they are most needed and avoiding layoffs. Second, implementing a zero-based budgeting approach, where all government expenses have to be justified to show that they are truly necessary and meet the needs of the citizens and where expenditures are strictly scrutinized to avoid waste. Third, using technology to transform the government's processes to be efficient and transparent in order to ensure accountability and continuous improvement.

Puerto Rico must also articulate and implement an economic development model based on the principles of global competitiveness and sustainability that will enable the private sector to lead this recovery. The complexity and cost of doing business in Puerto Rico must be dramatically reduced by utilizing technology to streamline government processes, updating our antiquated labor laws to support a modern and dynamic economy, partnering with the private sector to reduce our dependence on oil as a primary fuel source to generate electricity, and reducing the cost of basic infrastructure services.

Partnering with the private sector also means taking small bets on economic activities that leverage Puerto Rico's geographic, cultural, and human capital assets, in order to accelerate the expansion of the visitor economy, the export of knowledge-based services, and entrepreneurial innovation and R&D.

Puerto Rico must begin to restore investor confidence by being completely transparent and truthful about its financial condition – including the release of audited financial statements - and its negotiations with bondholders. In order to overcome the damage already done to the government's credibility, an independent third-party, namely the Federal IRS, should collaborate with the territory government and oversee the efficient collection of income and other tax revenues.

Puerto Rico's public corporations, which represent an important component of the island's total debt burden, each have provisions for the case of default but would benefit from embarking on a formal path towards the establishment of public-private partnerships for appropriate aspects of their operations, including the necessary provisions for the management of their debt burdens. More than the short-term restructuring of the upcoming debt-service payments, it's these public-private partnerships that will provide long-term repayment guarantees to bondholders and most important, a much needed reduction in the cost and improvement in the quality and accessibility of basic infrastructure services to the island's residents and businesses.

While all these measures combined will ensure that Puerto Rico puts its house in order, there is one more thing that Washington must do, and which is absolutely necessary for Puerto Rico to fully develop economically: put the island on a path towards full incorporation and statehood.

Puerto Rico will continue to lack a stable business climate that attracts investors under the current territorial status. Its uneven patchwork of state and federal laws -some federal laws apply, other do not- confuses many investors and dissuades them for putting their money to work on the island. They do not know if they are dealing with a foreign country or a U.S. state. Many go to Puerto Rico seeking the economic advantages and guarantees that the U.S. government provides, only to find out that certain key federal rules do not apply to the island.

The time has come for Puerto Rico to embark on a bold transformation. A new path forward is needed today to finally implode that antiquated state centered model that still exists in Puerto Rico and build a thriving economy, open to private investment and able to create good paying jobs for the people of the island.

Ricardo Rosselló is a scientist, researcher and college professor at the Metropolitan University of Puerto Rico, and is a candidate for governor of Puerto Rico.

U.S. Army Lieutenant Colonel (R) Armando M. Santos: Vice-President, Council of Soldiers and Veterans of Puerto Rico

Opening Statement before the U.S. Senate Committee on Energy & Natural Resources – Hearing on Puerto Rico: Economy, Debt and Options for Congress

October 22, 2015

Honorable Chairman, Ranking Member and distinguished committee members I would like to thanks you for the opportunity to address the committee in relation to Puerto Rico's economy, debt and options for Congress and its effects on Veterans and their Families. I am honored to representing one hundred eighty thousand Veterans, Service members and about three hundred fifty thousand dependents living in the beautiful island of Puerto Rico. In essences, our veteran community and their dependents represent on or about 17 percent of our population.

I am here today, to advocate for the Veterans and for those who believe that Puerto Rico must join the union by becoming the 51st state of United States of America. I dream for a secured future for my Family, for Veterans and their Families and for generations to come. In the meantime I do invite you to represent us while we deal with the unfinished business of American Democracy. Please join me to end colonialism in Puerto Rico, work a plan to set the conditions to improve the economy and to **transform Puerto Rico in the Capital of and for the Americas**. (Emphasis added)

Economy

I have met with Veterans from VFW, American Legion and Vietnam Vets just to mention some of them, to discuss the Commonwealth of Puerto Rico (CPR) economy. We have concluded that Puerto Rico is not equipped with the tools to stay relevant and responsive before the ongoing and fast-pace globalization. Moreover, Puerto Rico's economy is not aligned with our nation economy, it is not comparable. Simple, you do no take a four cylinder car to compete in a NASCAR Race. No matter how many concessions or privileges the CPR may receive from Congress, the colonial system will impede growth and prosperity. If Puerto Rico's economy were growing, we would be much better positioned to address its fiscal crisis and might have avoided it altogether.

Moreover, the negative effects of Puerto Rico's economy have caught the Veterans and their Families in the impact area. The 45% of Puerto Rico's population live under the federal poverty line. Due to the lack of accurate statistics about Veterans, we can say that Veterans are under the same percentage as well. What would happened if we allow the economy to continue its free fall? What would be the negative effects in the VA-Hospital? What would be the new demand if a significant amount of veterans are forced to request more VA benefits?

Secretary McDonald said on July 22, 2015 before the House Committee on Veterans Affairs that "to meet growing requirements next year, VA needs the adequate funding the President's 2016 budget request. However, the House proposed$1.4 billion reduction means

$688 million less for Veterans Medical Care – meaning as many as 70,000 Veterans may not receive medical care". It is well known, that Puerto Rico is the first on line for federal cuts and last on line to receive any funding increase.

In addition, the Veterans employment rate is on or around 43 percent. There is a significant percentage of Veterans that are not counted in the work force. The question is why? What are they doing to support their self and their Families? What is the status of the Jobs for Vets Program? Who is monitoring these actions at a federal level? What is the status of the programs designed to advance Veterans opportunities in the business field?

Debt

Puerto Rico's $72 billion debt is more than 100 percent of its gross national product (GNP). This debt does not take into account of another $35 billion in unfunded pension liabilities, which also need to be considered. Confronting this massive debt will require difficult political decisions.

Current Administration led by Governor Garcia Padilla said the he is not going to pay the constitutional debt. We, Service members, Veterans and Families do not support such decision. We are men and women who embrace values, so we as community do support Puerto Rico's debt must be paid, period. I urge you to help and assist Puerto Rico to pay its debt, which is the right way to do.

Options for Congress

The economic prosperity was one of the most powerful argument used during the admission campaigns of the 37 admitted states. The promise of rapid economic development was one of the more powerful arguments used by the statehood advocates. It appealed to everyone, regardless of class. For the poor, the prospect of a general redistribution of wealth was a powerful reason for joining the statehood crusade. For the growing middle class and the rich, statehood offered multiple economic opportunities.

At the nation scene, the President and Congress also used as a supporting argument for admission the "loyalty" to the Union demonstrated by Vermont, Maine, West Virginia, Alaska and Hawaii. We – Puertorricans – are loyal and proud citizens, let leave no question about it. We have gave our lives and blood fighting in every conflict since 1917, that's a fact.

Closing

I do invite you to join me to ensure the Federal Government does not break the promises made to American Veterans and their Families. We loyally served, traumatically bled, and shed sad tears as we fought hard to protect all of us.