**COMMENTS OF THE PUERTO RICO MANUFACTURERS ASSOCIATION ON FEDERAL TAX REFORM AND PUERTO RICO**

Members of Congress and the President's Administration are considering various proposals to reform the US corporate international tax system. The eventual agreed-upon reform should not harm business and jobs in Puerto Rico; rather, the tax reform should be viewed as an opportunity to bring investment and jobs back from abroad to Puerto Rico as well as other areas of the US.

Federal tax reform should recognize that --

- Puerto Rico is a territory of the United States, Puerto Ricans are US citizens and thus Puerto Rican jobs are American jobs.
- The territory is underdeveloped in comparison to the States and the District of Columbia with an unemployment rate of 14% much higher than the States and DC.
- Manufacturing is a much greater percentage of Puerto Rico's economy, 42 % of its GDP and tax-base than it is of the States, where it is only 12% GDP, and DC.
- Puerto Rico has lost over 50% of its manufacturing jobs in recent years, many to foreign locations. This is a much more severe loss than in the States and DC.
- Unemployment in Puerto Rico has resulted in the movement of many Puerto Ricans to the States and DC. Out migration was estimated at 300,000 by the Census Bureau between 2000 and 2010. It has continued since then.
- Puerto Rico is a foreign jurisdiction for the IRS and is thus treated differently than the States and DC in Federal tax law. However, it operates within the US tax system.
- Federal tax law played a major role in Puerto Rico's industrialization and is relied upon by companies and Puerto Rico for maintaining investment jobs and attracting investment to the territory.
- Some Federal tax reform proposals would jeopardize manufacturing investment and jobs in Puerto Rico and make it difficult for the territory to compete with other locations.
- Provisions should be included in Federal tax reform to prevent adverse impacts on Puerto Rico's economy and, instead, should incorporate measures to strengthen its capacity to compete with foreign jurisdictions.

**Background**

Puerto Rico's treatment in Federal tax legislation-- corporate and individual --is complex. Some provisions have been extended to the territory and others have not. Most pertinent for corporate tax reform is that the Puerto Rico income of companies organized in the States or DC is taxable but Puerto Rico subsidiaries of US Shareholders fare Controlled Foreign Corporations and, as is the case of all CFCs, such entities operate in foreign countries with taxation only if income is received or deemed received by parent companies in the States and DC. All pay employment and are liable for some other taxes.

A special tax exemption for corporate income from U.S. territories was enacted in 1921 to enable American companies to compete with foreign companies in the American islands distant from the States and DC in low-cost regions of the world. When industrial incentives enacted by Puerto Rico in 1948 were added to the Federal exemption and the inclusion of Puerto Rico in the customs territory of the U.S., the islands economy was transformed from an agrarian one to one largely dependent upon manufacturing and the income gap between the territory and the States and DC started to close.

The exemption was revised into a 100% tax credit in 1976 with the expressed purpose of creating jobs in Puerto Rico. It was reformed in 1993 into two credits to more closely link tax benefits to Puerto Rico's economy but it was sunset in 1996, with a ten year transition period expiring at the end of 2005. A prime reason for the repeal, according to the Joint Committee on Taxation, was so that there would not be a greater incentive to locate manufacturing in Puerto Rico than in the States.

At the same time, however, replacement measures to benefit Puerto Rico's underdeveloped economy were not taken and it has not been able to benefit from tax benefits for underdeveloped communities in the States. The Domestic Production Deduction was extended in 2006 but only on a temporary basis. The refundable Child Credit was extended but only for workers with three or more children.

There have been several consequences of the repeal, lack of tax incentives that apply in the States and DC, and other factors, such as free trade agreements, Federal environmental and labor laws, and the earlier closing of the gap between the standard of living for the U.S. citizens of Puerto Rico and citizens in the States and DC, and technology. The consequences include:

- Manufacturing jobs have decreased since 1997 by approximately 50% , a much deeper decline than in the States.
- Companies converted their Puerto Rico operations to become CFCs.
- Hundreds of thousands of Puerto Ricans have moved to the States. At 3.67 million the islands' population is about a quarter of a million smaller now than in 2006.
- The territory's labor force and participation in the job market has also shrunk, and the unemployment rate has increased. It is now 14.5%, compared with the national rate of 7.7 % and the highest rate in a State or DC of 9.6%.

Manufacturing job loss is a particular problem for Puerto Rico in comparison to the States because its economy is less developed and there are relatively fewer jobs in other sectors.

Still, manufacturing remains a major component of the economy:

- Manufacturing accounts for 42% ($40 billion) of Puerto Rico's GPD and 98% of its exports.
- It directly employs 75,300 people and indirectly is responsible for some 230,000 jobs – more than 27% of all employment in the territory.
- The islands' manufacturing sector provides more than 20% of the Commonwealth's fiscal income, paying in excess of $2 billion in local income taxes.

Considering that many of the tax reform initiatives being discussed purport to address what is perceived as abusive tax haven situations and to protect American jobs, it should be noted that Puerto Rico is not a foreign tax heaven. While it is a jurisdiction that offers local tax incentives, it operates under insular tax rules that are similar to U.S. tax regulations. The Puerto Rico Treasury Department has entered into exchange of information agreements with the Internal Revenue Service. Federal law enforcement applies as in the States and DC. It is not a center for paper companies but, instead, for actual manufacturing, which provides for American jobs.

**Issue and Comment**

In addition to the economic factors cited above, the fact is that the reform is being undertaken when Puerto Rico is still feeling the effects of a major contraction that began earlier than the US recession and persists to this day. Puerto Rico's economy has had six consecutive years of negative growth rates, becoming around 14% smaller at the end of fiscal 2012 that it was at the beginning of fiscal 2007.

The Reform should recognize the hybrid nature of the territory's current coverage in federal tax law, covered by some laws and not others, since it is a foreign tax jurisdiction. Its weak and fragile economy is constructed on this complex application of Federal tax law -- and the further intricacies of the islands' treatment under other Federal laws. Most that encumber companies with costs of doing business -- which do not apply to foreign competitive locations -- apply to Puerto Rico based firms. Some tax and program laws that provide economic opportunities, particularly for individuals, do not. A number of these are within the jurisdiction of the Committee on Ways and Means.

PRMA is confident that Federal tax reform goals are not to harm Puerto Rico's economy. It wants to make sure that Federal tax policy-makers recognize the hybrid nature of its treatment under current law and do not apply reforms designed with foreign locations in mind that would intentionally adversely affect manufacturing -- and, thus, the economy – of Puerto Rico.

Reform measures that are not accompanied by provisions that recognize the unique tax and needs of Puerto Rico -- even among the territories of the U.S. in addition to the States and DC -- could have an extremely negative impact upon Puerto Rico. Reform should include special provisions that recognize that Puerto Rico is part of the American political family, exempting it from provisions designed to discourage investment and jobs from going overseas and compensating for systematic changes with provisions to foster the growth of the territory's economy and jobs base.

The Puerto Rico Manufacturers Association (PRMA) represents nearly 1,200 companies employing over 300,000 persons. It includes the pharmaceutical, biotechnology, medical device, construction, information technology, communications, food production, financial services, education, aerospace, and other industries in Puerto Rico. However, it is based on the fundamental assumption concerning the central role of manufacturing in the economy and in supporting non- manufacturing sectors.

PRMA urges Federal officials to adopt international tax reform measures for the protection and creation of new and high-quality jobs for all Americans, greater investment in research and innovation, enhancement of the competitiveness of U.S. companies - and that these measures include appropriate provisions that recognize that Puerto Rico is American. The specific measures for Puerto Rico will depend upon the nature of the overall reforms but, by working together, we are certain that these goals, which clearly are in furtherance of a better future for the entire Nation, can be achieved.

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