

WASHINGTON OFFICE:
1213 LONGWORTH HOUSE OFFICE BUILDING
(202) 225-2615 FAX: (202) 225-2154

Congress of the United States
House of Representatives
Washington, DC 20515-5401

SAN JUAN OFFICE:
157 AVENIDA DE LA CONSTITUCIÓN
ANTIGUO EDIFICIO DE MEDICINA TROPICAL
ALA DE ENFERMERIA 2DO PISO
SAN JUAN, PUERTO RICO 00901
(787) 723-6333 FAX: (787) 729-7738

January 8, 2014

The Hon. Max Baucus
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Hon. Orrin G. Hatch
Ranking Member
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Baucus and Ranking Member Hatch:

On November 19, 2013, Chairman Baucus released a staff discussion draft of legislation to reform the taxation of corporate income attributed to operations outside of the 50 states and the District of Columbia. This includes corporate income attributed to the U.S. territory I represent, Puerto Rico; to the four other U.S. territories; and to foreign jurisdictions. A summary of the staff discussion draft, under the heading "Unaddressed Issues and Requests for Comments," states: "The staff discussion draft does not separately address the taxation of foreign subsidiaries doing business in the U.S. territories. Comments are requested regarding the appropriate scope of U.S. taxation of such territory operations in light of the changes proposed in the staff discussion draft."

Given that, in the absence of legislative provisions regarding the taxation of controlled foreign corporations (CFCs) in the territories, they would be taxed in the same manner as CFCs in foreign jurisdictions, I write to provide a comment on this issue. I have held numerous conversations about this matter with your counterparts on the House Committee on Ways and Means, Chairman Dave Camp and Ranking Member Sander Levin, as well as with senior officials in the Obama Administration. I look forward to discussing this important subject in more detail with you and your staffs as the effort to enact comprehensive tax reform moves forward.

My first point is the most fundamental. As the staff discussion draft explains, an important purpose of reforming the current international business tax system is to "promote U.S. growth and job creation," to "reduce incentives for U.S. companies to move jobs or the entire company overseas," and to "make the U.S. more attractive and competitive for multinationals to invest and create jobs." As you know, while Puerto Rico and the other territories are treated as "international" for some (though by no means all) purposes under the Internal Revenue Code, the territories are U.S. jurisdictions, home to millions of U.S. citizens. Jobs in the U.S. territories are

American jobs. The laudable goal of tax reform—to encourage investment and employment in the United States—will not be fully achieved if provisions are included in the legislation that have the effect of discouraging job-creating investment in Puerto Rico and the other territories. Tax reform should seek to foster economic opportunities in the American territories to the same degree and extent that it seeks to promote those opportunities in the states.

Puerto Rico and the other territories face severe economic and fiscal challenges. For at least four decades, Puerto Rico's economic performance has been far worse than any state according to every indicator, and the gap between Puerto Rico and the states is widening, not narrowing. The November 2013 unemployment rate in Puerto Rico was 14.7 percent, which is 7.7 percent above the U.S. national average. In December, Moody's Investors Service placed Puerto Rico's general obligation and other bonds—which the three main credit rating agencies have rated one notch above junk status—on review for downgrade. The Puerto Rico Government Development Bank's Economic Activity Index (GDB-EAI)—a useful tool for evaluating the overall health of the territory's economy—was 5.7 percent lower in November 2013 than in November 2012, and the cumulative Fiscal Year 2014 GDB-EAI (July-November) was about 5.3 percent below the corresponding period in 2012. In November, in a clear sign of the gravity of the situation, the White House assigned an inter-agency team to work with the government of Puerto Rico to “strengthen Puerto Rico's fiscal situation and economic outlook.” Primarily because of the lack of economic opportunities in Puerto Rico, island residents are leaving in staggering numbers for the states. Between 2004 and 2013, the territory's population fell from 3,826,878 to 3,615,086—a loss of 211,792 individuals or 5.5 percent. As the Committee considers provisions related to Puerto Rico for inclusion in tax reform legislation, I respectfully ask that you bear in mind that, in economic and demographic terms, Puerto Rico is in an extraordinarily delicate and deteriorating condition.

Forty years of empirical evidence establishes, beyond any doubt, that Puerto Rico's economic problems are inextricably linked to its political status. As a territory, Puerto Rico is treated unequally under, or excluded entirely from, key federal spending and tax credit programs, most of which are within the jurisdiction of your Committee. This disparate treatment is the principal reason why Puerto Rico's economy has consistently struggled, regardless of who holds power in Washington or San Juan. I support statehood for Puerto Rico, and do so in meaningful part because history shows that every territory that joins the Union experiences a substantial increase in its economic activity and standard of living. Statehood is the only status that will enable Puerto Rico, on an enduring basis, to reduce unemployment, attract investment, retain talent, promote growth, and manage our deficits and debt. A November 2012 referendum on the island demonstrated that a majority of my constituents oppose the current territory status and that there are now more people in Puerto Rico who support statehood than who support any other status option, including the current status. To honor this democratic vote, and to most effectively assist the economic development of Puerto Rico, I respectfully urge the Committee, as part of

comprehensive tax reform, to provide for the equal treatment of Puerto Rico under the refundable Child Tax Credit program and to extend to Puerto Rico the refundable Earned Income Tax Credit program. I also request that the Committee take separate legislative action to treat Puerto Rico equally in Medicare, the Temporary Assistance for Needy Families (TANF) program, Supplemental Security Income (SSI), and Medicaid.

My hope and expectation is that Puerto Rico will soon become a full and equal member of the American family, that island residents and corporations will be treated in the same manner as their counterparts in the states under all federal spending and tax programs, and that local leaders will no longer need to seek special treatment under federal law in order to encourage companies to invest and create jobs in Puerto Rico. Until that day arrives, however, I believe that it is appropriate for Congress to enact tax provisions that are tailored for Puerto Rico and the other U.S. territories, given that the territories are treated in unequal fashion under many federal programs; that territory residents will continue to relocate to the states if there are not sufficient economic opportunities available to them at home; and that these are American—not foreign—jurisdictions. But a caveat is in order. In the past, federal legislation to exempt territory income from corporate taxation has arguably done more to benefit companies than to benefit Puerto Rico, so it is important that any provision included in corporate tax reform legislation be designed to promote job creation or other measurable contributions to the island's economic development. I trust that you, your counterparts on Ways and Means, and the Obama Administration fully share this objective.

If the Committee, notwithstanding the arguments I have made, is inclined to treat foreign subsidiaries doing business in Puerto Rico and the other U.S. territories in more or less the same fashion as foreign subsidiaries doing business in foreign jurisdictions, I ask the Committee—at a minimum—to adopt the following proposal, which I believe would be fair and beneficial.

As background, although there are meaningful differences between the various business tax proposals in Chairman Baucus' staff discussion draft and the proposals contained in the discussion draft released by Chairman Camp in October 2011, both drafts seek to ensure that reform does not result in base erosion—that is, does not encourage U.S. companies to shift an even greater share of their production to low tax “foreign” jurisdictions. Therefore, both chairmen have made proposals under which the United States would impose a tax on certain profits of CFCs operating in jurisdictions where the local tax is below a certain minimum rate. In the event that a foreign jurisdiction raises its rate to the minimum level, the U.S. would not impose this levy. In effect, this could create a global minimum level of taxation.

Although the overarching purpose of the various base erosion proposals that have been put forward for discussion is to equalize the tax treatment provided in all jurisdictions, such a provision could create an unintended problem in the case of Puerto Rico absent modification. Puerto Rico's highest corporate income tax rate is 39 percent, which is well above the minimum

rate that would be established under any of the proposals to prevent base erosion. However, to attract investment, the Puerto Rico government has entered into multi-year agreements with many CFCs affiliated with companies based in the states. These agreements provide for the CFC in question to pay a reduced income tax rate that is substantially below the minimum rate called for under the base erosion proposals. The Puerto Rico government may not be able to unilaterally modify or set aside the income tax agreements in the event that base erosion provisions are enacted. In that event, Puerto Rico's corporate tax rates would be below the minimum rate proposed in the staff drafts and, as a result, Puerto Rico would not be able to derive any fiscal benefit from the additional revenue raised as a result of the application of tax reform to CFCs doing business on the island.

Consistent with the principle that tax reform should help and not hurt Puerto Rico, I therefore propose the following modification to the base erosion provisions:

- Until the expiration of the multi-year tax reduction agreements that are in place at the time of the enactment of federal tax reform legislation, any revenue raised as a result of the application of base erosion provisions to business activities in Puerto Rico would be granted by the U.S. government to the territory government.
- Congress should place reasonable conditions on the granted revenue, requiring that such revenue be used by the Puerto Rico government for specified *public* purposes, such as initiatives to reduce the cost of electricity and water, improving the public education system, enhancing public safety, and reducing public debt.

Thank you in advance for your attention to this matter, and I look forward to working with you and your colleagues on the Committee to ensure that whatever tax reform legislation is enacted by Congress promotes job-creating investment in Puerto Rico and the other U.S. territories.

Sincerely,



Pedro R. Pierluisi
Member of Congress

cc: The Honorable Dave Camp, Chairman, House Committee on Ways and Means
The Honorable Sander M. Levin, Ranking Member, House Committee on Ways and Means
The Honorable Ron Wyden, U.S. Senator