



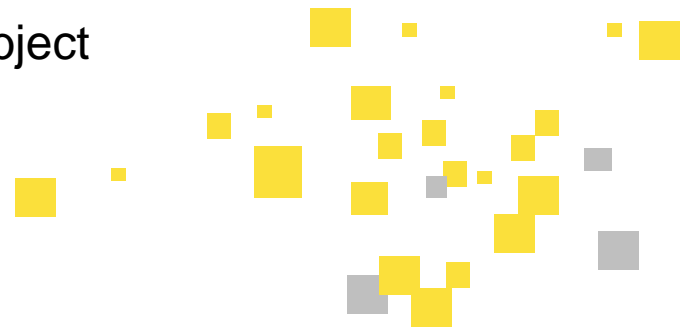
DEPARTMENT OF THE TREASURY
COMMONWEALTH OF PUERTO RICO

Commonwealth of Puerto Rico Tax Reform Project

General Observations

October 27, 2014

Data included are for discussion purposes only; subject to further revision. Document is a work in process.



Agenda



- **Project Objectives**
- **Description of Macroeconomic Model and Simulation Methodology**
- **High Level Observations**
- **High Level View of the Components of Alternative Tax Structure**
- **Detailed Options for Alternative Tax Structure**
 - Consumption Tax
 - Individual Income Tax
 - Domestic Business Tax
 - Inbound Tax (Law 154)
 - Transition Issues
- **Tax Administration**
- **Next Steps**

Project Objectives

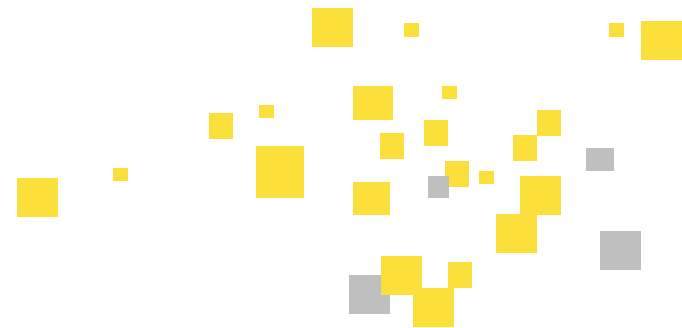


- **Essential Elements of New Tax Structure**
 - Produce adequate revenue
 - Distribute the burden of taxation fairly
 - Promote economic growth
 - Increase international competitiveness of products, workers and businesses
 - Minimize interference with private decision making
 - Streamline compliance and administration
- **Develop a Puerto Rico Centric Macroeconomic Model for Tax and Economic Policy**
- **Improve Revenue Operations**



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Macroeconomic Model





- **General explanation of the macroeconomic model**
 - What is it?
 - What does it do?
 - What does it contain?
 - What does it produce?

Macroeconomic Modeling Suite

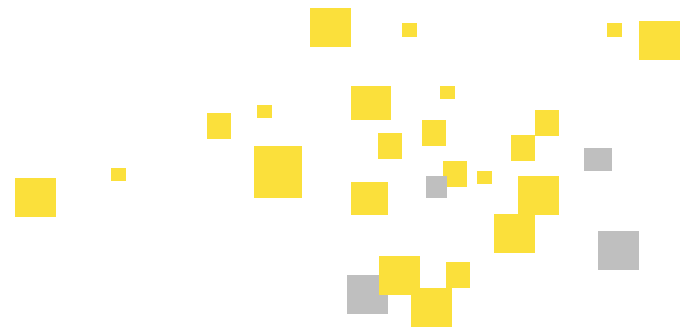


- A **Computable General Equilibrium (CGE)** model of Puerto Rico's economy
 - Accounts for around 90 production sectors, production technology, input demands, output decisions, consumers (households), investors, government, foreign demand for domestic output (exports) and domestic demand for foreign output (imports), and many other variables
 - For the current purpose: Captures the current tax system and allows for new taxes to be applied, revenue targets to be hit, etc.
 - A large array (>3 million) of interconnected economic behavioral and accounting equations, and a database containing many millions of data points
 - A state-of-the-art simulation tool, constructed over a period of 7 months by a team of PhD economists experienced in policy analysis with advanced empirical techniques,
 - **Highly valuable** input and assistance from local economists and policy experts
 - Provides highly flexible analytical capacity for a range of economic policy analysis and forecasting uses, and produces a rich variety of output to be analyzed and interpreted
- A **Structural Macroeconomic Forecasting** model
 - A combination of estimation-based and structural equations used for creating macroeconomic projections for Puerto Rico
 - Also assists in informing the macroeconomic baseline for the CGE model
- Used in concert with the insight and knowledge of experienced economists, the modeling suite provides a highly flexible simulation and forecasting capacity
- The models will be applied to economic analysis and forecasting on an ongoing basis by economists in Puerto Rico, to be trained and supported by the developers as necessary



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High Level Structural, Revenue and Economic Observations



High Level Observations



- **General Observation**

- Current income and consumption tax structures are inordinately complex due principally to a plethora of special provisions (that have not been subjected to a cost-benefit analysis)

- **Revenue Observations**

- Revenue from consumption and individual income taxes are below peers (Slides 8 and 9)
- Less than ten percent of filers are responsible for almost 78 percent of income tax receipts (Slide 10)
- Existing tax preferences reduce the tax base and require higher rates to achieve revenue targets

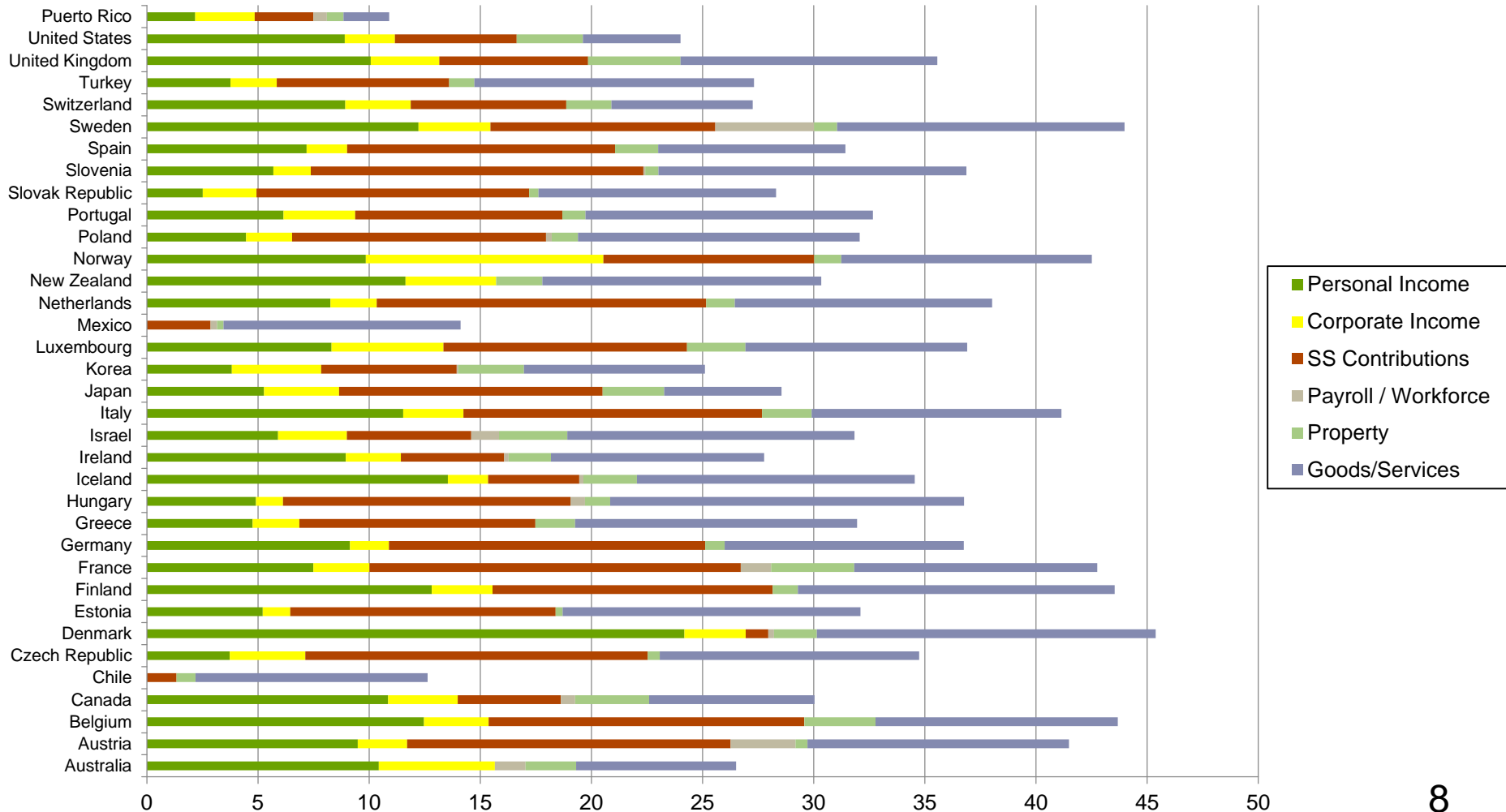
- **Economic Observations**

- Current consumption taxes are highly regressive (Slides 11 and 12)
- Capital income bears a smaller burden than labor income (Slide 13)
- Tax preferences create economic inefficiency

Taxes as a Percentage of GDP in Puerto Rico Compared to Selected Jurisdictions



Taxes as a Percent of GDP: Puerto Rico and OECD Countries, 2011



Comparison of Puerto Rico to OECD Countries (Percentage of GDP)



	Puerto Rico	Average	Range
Personal Income	2.18%	8.32%	2.18-24.18%
Corporate Income	2.67%	2.97%	1.21-10.70%
SS Contributions	2.65%	8.96%	0.00-16.70%
Payroll/Workforce	0.61%	0.41%	0.00-4.44%
Property	0.75%	1.76%	0.29-4.16%
Goods/Services	2.06%	10.77%	2.06-15.91%
Total	10.91%	33.17%	

2013 Income Tax Liability by Income Class (In Millions of USD)³



Income Level	Filers	Tax Liability (Excluding SS & Medicare)	Share of Tax (Excluding SS & Medicare)	Tax Liability (Including Social Security and Medicare)	Share of Tax (Including Social Security and Medicare)
Less than \$20,000	538,026	\$4	.21%	\$368	9.58%
Between \$19,999 and \$40,000	319,108	\$191	9.17%	\$791	20.59%
Between \$39,999 and \$60,000	107,107	\$270	12.98%	\$604	15.72%
Greater than \$59,999	89,459	\$1,614	77.64%(*)	\$2,079	54.11%
Total	1,053,700	\$2,079	100.00%	\$3,842	100.00%

(3) Distributional analysis based on 2012 individual tax returns provided by Department of Treasury

(*)Less than 10% of filers pay nearly 78% of the individual income tax

2013 Sales Tax Liability By Income Class⁴



Sales tax liability, as a percentage of income, falls with increases in income. This is a standard feature of a sales tax and its regressive nature indicating the sales tax burden is highest on lower incomes.

Income bracket	Total Sales Tax Liability (In Millions)	Liability Per HH	Liability As Fraction of HH Income
0 to \$21,790	\$381	\$560	5.51%
\$21,800 to \$33,000	\$194	\$833	3.07%
\$33,050 to \$69,500	\$345	\$1,042	2.22%
\$69,600 to \$84,170	\$66	\$1,464	1.93%
Greater than \$84,170	\$187	\$2,209	1.55%

(4) Figures based on expenditure shares on goods and services provided by the Department of Labor and Human Resources and allocated to income groups Footnote: Based on relative expenditure amounts Consumer Expenditure Survey

2013 Vehicle, Gasoline, Alcohol, & Tobacco Excise Tax By Income Class



Similar to sales tax liability, excise tax liability, as a percentage of income, falls with increases in income. This is a standard feature of an excise tax and its regressive nature, indicating the burden is highest on lower incomes.

Income Range	Number of Households	Average Income	Excise Tax Liability Per Household	Share of Total Liability/Pct of Households	Liability as Percent of Income
Less Than \$21,800	681,339	\$10,163	\$503.37	31.28%/49.50%	4.95%
\$21,800 to \$33,000	233,080	\$27,107	\$749.50	15.93%/16.93%	2.76%
\$33,050 to \$69,500	331,584	\$47,011	\$1,024.60	30.99%/24.09%	2.18%
\$69,600 to \$84,170	45,579	\$75,990	\$1,416.75	5.89%/3.31%	1.86%
Greater than \$84,170	84,590	\$142,953	\$2,052.02	15.90%/6.17%	1.44%

2012 Total and Capital Income Reported by Income Level (In Millions of USD)



Highest income levels receive nearly all of the favorable treatment of capital income

Income Level	Total Income	Capital Income Subject to Preferential Rates	Pct of Income Taxed At Preferential Rates
Less than \$20,000	\$5,499	\$1.3	0.02%
Between \$19,999 and \$40,000	\$9,111	\$3.9	0.04%
Between \$39,999 and \$60,000	\$5,151	\$10.6	0.21%
Greater than \$59,999	\$10,394	\$490.5	4.72%

2013 Income and Consumption Tax By Income Level²



Income bracket	Income Tax	Consumption Taxes	Total	Share of all taxes	Weighted Distribution (Weighted by Number of HHs)
0 to \$21,790	\$10	\$724	\$734	16.94%	3.24%
\$21,800 to \$33,000	\$72	\$368	\$440	10.16%	5.68%
\$33,050 to \$69,500	\$434	\$685	\$1,116	25.75%	10.12%
\$69,600 to \$84,170	\$151	\$131	\$281	6.50%	18.59%
Greater than \$84,170	\$1,410	\$361	\$1,763	40.65%	62.37%
Total	\$2,079	\$2,271	\$4,337		

(2) Income tax distribution based on 2012 individual income tax returns provided by Department of Treasury
 Sales and Use Tax portion of consumption tax liability based on expenditure shares on goods and services provided by the Department of Labor and Human Resources and allocated to income groups based on relative expenditure amounts Consumer Expenditure Survey



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High Level View of the Components of Alternative Future Tax Structure



Primary drivers of comprehensive tax reform under discussion: lower income tax rates, broad-based GST (shift from taxing productivity to tax consumption)



- Broad-based Goods and Service Tax (“GST”)
 - Any GST would include important exemptions for small business and regressivity relief for low income persons.
 - Amount of revenue to be collected is a function of the tax rate, the capture rate (65%-85% considered), the small business exemption level (\$75,000-\$100,000 considered) and the magnitude of regressivity relief.
- Reduce Individual Income Taxes
 - Currently considering deeply lowering individual income tax rates, together with material increases in exemptions levels from taxation for singles and couples.
 - Broaden taxable base by eliminating or adjusting certain tax expenditures.
- Reduce Corporate Income Taxes
 - Considering repealing Gross Profits Tax (*Patente Nacional*) and reducing corporate tax rates, equaling them to the maximum rate paid by individuals to simplify the system. This would rationalize inefficient tax regimes by eliminating the need to create redundant or inefficient flow-through tax regimes and conduit entities as tax planning mechanisms.
 - Revenues would be made up in part by expanding the tax base through the repeal of certain business tax expenditures.
- Alternatives to Act 154 Revenues
 - Considering alternatives for the reform or substitution of Act 154 excise tax
- Optimization of Existing Property Tax Structure
 - Analyzing alternatives to property tax structure to simplify tax system, to be discussed with



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Alternative Tax Structure – Consumption Tax





Consumption tax options

- **Convert to a pure sales and use tax**
 - Puerto Rico has already experienced many of the challenges associated with a sale and use tax, not the least of which is an estimated 56%-65% compliance rate.
- **Return to the General Excise Tax**
 - The tax's narrow base, artificial values, and application to B2B transactions produced an uneven distribution of the tax and distorted production and consumption decisions.
 - The Government's view at the time was that the tax was difficult to administer and was unresponsive to its revenue needs.
- **Maintain the current system**
 - Significant reform would be required to simplify the compliance process, educate taxpayers and reduce evasion.
 - The operation of the tax would have to be simplified and the base broadened through the taxation of services and the elimination of many exemptions and B2B taxation.
 - Such reforms would effectively create a GST. The better option would be to adopt a GST based on global best practices.
- **Adopt a GST**

Reasons to adopt a GST



- More than 150 taxing regimes have implemented broad based consumption taxes, such as a GST, because of their revenue raising capacities, and neutrality in the production chain and cross border trade
 - The United States is the only OECD Member State that does not have a VAT/GST
- A broad based GST system with a single rate and few exemptions will minimize compliance and administration costs
- Staged collection through the supply chain means that the government will receive tax revenue sooner compared to retail sales tax
 - There is less risk of total loss of government revenue due to evasion in the supply chain
- Puerto Rico will be able to take advantage of the experience of over 150 countries in administering the tax

Outline of principal elements of GST



- **The key features of a GST include:**
 - It is a tax on final consumption
 - It is not a tax on business
 - **It is a multi-staged, transaction based tax that is levied at each stage of the supply chain.**
 - It is a broad based tax that applies to most goods and services.
 - Businesses claim credits for GST paid on business expenses.
- **GST leading practices include:**
 - Taxation of all goods and services, other than:
 - Exported goods and services
 - Financial services
 - Residential housing
 - Under consideration other exemptions
 - Small business exempted from registration
 - GST collected upon importation of goods
 - GST self assessment for services received from non-resident service providers (where a credit cannot be claimed in full)

LATAM VAT Rates

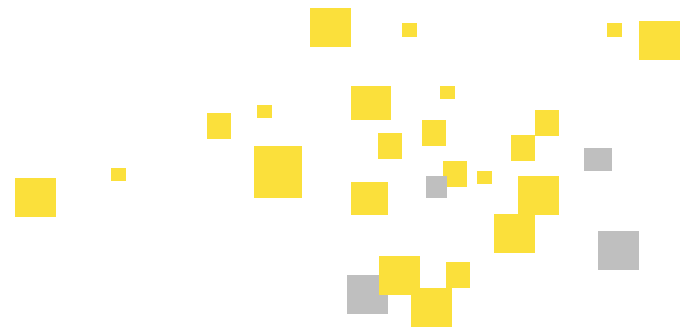


Country	Intro. Date	Current Rate	Country	Intro. Date	Current Rate
Antigua and Barbuda	2007	15%	Guyana	2007	16%
Argentina	1974	21%	Haiti	1982	10%
Bahamas	2015	7.50%	Honduras	1964	15%
Barbados	1997	17.50%	Jamaica	1991	16.50%
Belize	2006	12.50%	Mexico	1980	16%
Bolivia	1986	14.94%	Nicaragua	1984	15%
Brazil (ICMS)	1989	1.5 to 35%	Panama	1976	7%
Chile	1974	19%	Paraguay	1992	10%
Colombia	1983	16%	Peru	1991	18%
Costa Rica	1982	13%	St Lucia	2012	15%
Dominica (Commonwealth)	2006	15%	St. Kitts and Nevis	2010	17%
Ecuador	1981	12%	St. Vincent and the Grenadines	2007	15%
El Salvador	1992	13%	Trinidad and Tobago	1990	15%
Grenada	2010	15%	Uruguay	1972	22%
Guatemala	1992	12%	Venezuela	1993	12%



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Alternative Tax Structure – Individual Income Tax



Individual Income Tax General Observations



- The tax base has numerous special provisions that distort horizontal equity, promote economic inefficiency, impede compliance and enforcement and that have not been subjected to a cost-benefit analysis.
 - Wage income is taxed more heavily than capital income
- Elimination or modification of certain existing tax preferences or deductions would create a simple income tax base that would ease compliance and enforcement burdens. For example, under consideration is changing the mortgage interest deduction for a mortgage interest credit.
 - Most income in the base would be subject to either withholding or matching information reporting.
 - A significant number of taxpayers could be eliminated from the income tax base without materially affecting income tax revenue.
 - The revenue base is broadened and the rates are reduced.



Individual Tax Expenditures

- There are at least 85 provisions that are classified as individual income tax expenditures
- The aggregate static revenue loss exceeds \$1.138 billion, more than half of individual income tax receipts
 - The largest preferences relate to home mortgage interest, capital income and others
 - 53 of the preferences are claimed by less than 1,000 taxpayers
- No documentation appears to exist showing that the preferences have been subjected to a cost-benefit analysis

Example 1: Revenue and Distribution of Income Tax: Assuming \$70,000 exemption level married filing jointly and \$35,000 exemption for single or married filing jointly: full taxation of capital gains



Taxable Income	Single or Married Filing Separately		Married Filing Jointly		Total	
	Filers	Tax (Millions)	Filers	Tax (Millions)	Filers	Tax (Millions)
\$35,000 or less	569,715	\$0	152,592	\$0	722,307	\$0
\$35,001 to \$70,000	122,632	\$160	89,531	\$0	212,163	\$160
\$70,001 to \$125,000	26,345	\$188	33,765	\$73	60,110	\$261
\$125,001 to \$200,000	6,161	\$114	9,783	\$139	15,944	\$253
Greater than \$200,000	2,517	\$278	5,974	\$673	8,491	\$951
Total	727,370	\$740	291,645	\$884	1,019,015	\$1,625

Note: Approximately 835,000 (82%) filers will not owe income tax.

**Example 2: Revenue and Distribution of Income Tax:
Assuming \$60,000 exemption level married filing jointly
and \$30,000 exemption for single or married filing jointly:
full taxation of capital gains**



Taxable Income	Single or Married Filing Separately		Married Filing Jointly		Total	
	Filers	Tax (Millions)	Filers	Tax (Millions)	Filers	Tax (Millions)
\$30,000 or less	519,028	\$0	130,245	\$0	649,273	\$0
\$30,001 to \$60,000	159,538	\$194	96,159	\$0	255,697	\$194
\$60,001 to \$125,000	40,126	\$270	49,484	\$125	89,610	\$394
\$125,001 to \$200,000	6,161	\$116	9,783	\$142	15,944	\$259
Greater than \$200,000	2,517	\$279	5,974	\$673	8,491	\$952
Total	727,370	\$859	291,645	\$940	1,019,015	\$1,799

Note: Approximately 770,000 (75.8%) filers will not owe income tax.

Example 1: Restructured Income Tax Regime: Tax Rate and Structure for Married/Joint filers with \$70,000 exemption level



If taxable income is:

Not over \$70,000

Over \$70,000, but not over \$125,000

Over \$125,000 but not over \$200,000

Over \$200,000

The tax is:

0

15% of the excess over \$70,000

\$8,250, plus 20% of the excess over
\$125,000

\$23,250, plus 30% of the excess over
\$200,000

As an example, under this new tax structure, the effective tax rate of the following salary levels will be:

\$70,000	0%
\$100,000	4.5%
\$125,000	6.7%
\$200,000	11.6%

Example 1: Restructured Income Tax Regime: Tax Rate and Structure for Single Filers with \$35,000 exemption level



If taxable income is:

Not over \$35,000

Over \$35,000, but not over \$125,000

Over \$125,000 but not over \$200,000

Over \$200,000

The tax is:

0

15% of the excess over \$35,000

\$13,500, plus 20% of the excess over \$125,000

\$28,500, plus 30% of the excess over \$200,000

As an example, under this new tax structure, the effective tax rate of the following salary levels will be:

\$70,000	7.5%
\$100,000	9.8%
\$125,000	10.8%
\$200,000	14.3%

Example 2: Restructured Income Tax Regime: Tax Rate and Structure for Married/Joint Filers with \$60,000 exemption level



If taxable income is:

The tax is:

Not over \$60,000	0
Over \$60,000, but not over \$125,000	15% of the excess over \$60,000
Over \$125,000 but not over \$200,000	\$9,750, plus 20% of the excess over \$125,000
Over \$200,000	\$24,750, plus 30% of the excess over \$200,000

As an example, under this new tax structure, the effective tax rate of the following salary levels will be:

\$60,000	0%
\$70,000	2.1%
\$125,000	7.8%
\$200,000	12.4%

Example 2: Restructured Income Tax Regime: Tax Rate and Structure for Single Filers with \$30,000 exemption level



If taxable income is:

Not over \$30,000

Over \$30,000, but not over \$125,000

Over \$125,000 but not over \$200,000

Over \$200,000

The tax is:

0

15% of the excess over \$30,000

\$14,250, plus 20% of the excess over \$125,000

\$29,250, plus 30% of the excess over \$200,000

As an example, under this new tax structure, the effective tax rate of the following salary levels will be:

\$30,000	0%
\$70,000	8.6%
\$125,000	11.4%
\$200,000	14.6%

Examples of various scenarios with a comparison of current and proposed income tax structures for the average representative taxpayer at various income levels

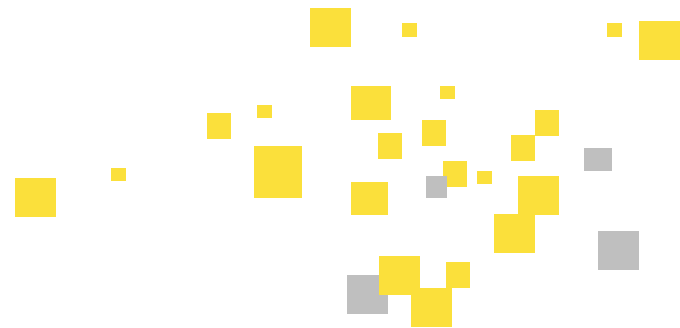


Composite Taxpayer Approximate Income	Filing Status	Wages	Exempt and Excluded	Capital Gains and Interest	Self-Proprietorship Income	Tax: Current System	Est Average Effective Rate	Tax1: Proposed System	Est Average Effective Rate
\$20,000	Single	\$12,228	\$514	\$438	\$3,970	\$133	0.67%	\$0	0.00%
\$30,000	Single	\$19,987	\$5,781	\$210	\$1,800	\$587	1.96%	\$0	0.00%
\$50,000	Single	\$37,136	\$5,259	\$190	\$4,134	\$2,629	5.26%	\$2,424	4.85%
\$75,000	Single	\$56,012	\$6,788	\$225	\$3,560	\$6,231	8.31%	\$5,801	7.73%
\$100,000	Single	\$66,806	\$8,020	\$291	\$8,601	\$11,062	11.06%	\$9,235	9.24%
\$250,000	Single	\$140,654	\$27,681	\$5,086	\$29,086	\$45,418	18.17%	\$41,830	16.73%
\$500,000	Single	\$139,016	\$78,893	\$27,765	\$134,661	\$107,211	21.44%	\$115,261	23.05%
\$20,000	Married	\$9,131	\$0	\$2,218	\$6,402	\$59	0.29%	\$0	0.00%
\$30,000	Married	\$15,437	\$9,789	\$250	\$2,263	\$267	0.89%	\$0	0.00%
\$50,000	Married	\$34,178	\$7,539	\$114	\$3,429	\$1,372	2.74%	\$0	0.00%
\$75,000	Married	\$53,339	\$9,781	\$248	\$2,793	\$3,779	5.04%	\$1,431	1.91%
\$100,000	Married	\$67,779	\$9,617	\$114	\$6,556	\$8,423	8.42%	\$4,507	4.51%
\$250,000	Married	\$119,385	\$25,479	\$1,960	\$31,674	\$43,629	17.45%	\$37,825	15.13%
\$500,000	Married	\$190,333	\$80,408	\$22,069	\$102,271	\$105,536	21.11%	\$105,792	21.16%



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Alternative Tax Structure – Business Tax





Tax Categories of Business Activity

- Traditional corporate structure (domestic corporations)
- “Flow-through” tax entity
- Inbound investment qualifying for incentives under incentive laws

Domestic Activity: Regular Corporations



- A “classical” corporate tax system (which Puerto Rico currently has) creates both complexity and inefficiency.
- Much of that is unavoidable for publicly-traded corporations, but little if any is necessary or appropriate for small or closely-held businesses
- A simplified version of current system, with exemptions, exclusions and special rates eliminated, could be retained, but small and closely held businesses could be strongly encouraged to utilize “flow-through” entities
- Results in effective “integration” for a large segment of Puerto Rican business activity
- 38,838 of 42,740 corporate returns show net income of less than \$60,000
- To prevent use of the classical system for tax avoidance, corporate rates equal to the highest individual rate could be considered
- The Patente Nacional
 - Proposal considers its elimination, it affects a significant number of domestic companies and has added significant complexity to the tax regime.

Inbound investment: Law 73 of Incentives

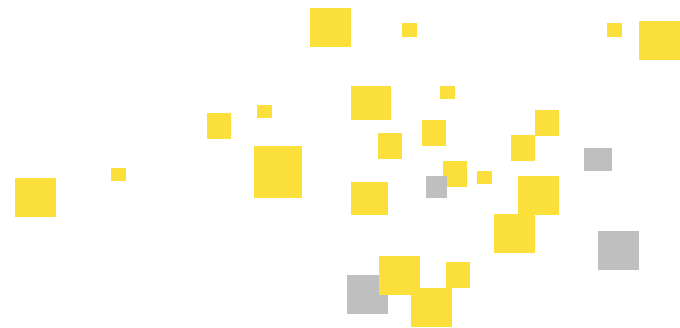


- **Law 73 or similar measures may be helpful to continue attracting inbound investment to Puerto Rico**
 - A broadly available, low-rate regime (such as that of Ireland) would not attract material amounts of inbound investment
 - Without the introduction of substantial complexity, a low-rate corporate regime would reduce the revenue collected from domestic business activities
 - Law 73 should be subjected to periodic cost-benefit analyses



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Alternative Tax Structure – Inbound Tax Structure Options



Status Report on Inbound (Law 154) Developments

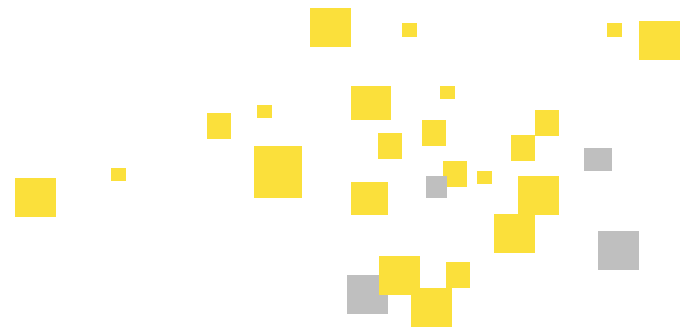


- **Ongoing conversations with U.S. Treasury**
- **Conversations with 9 “inbound” companies**
 - One additional company to converse directly with Puerto Rico Treasury

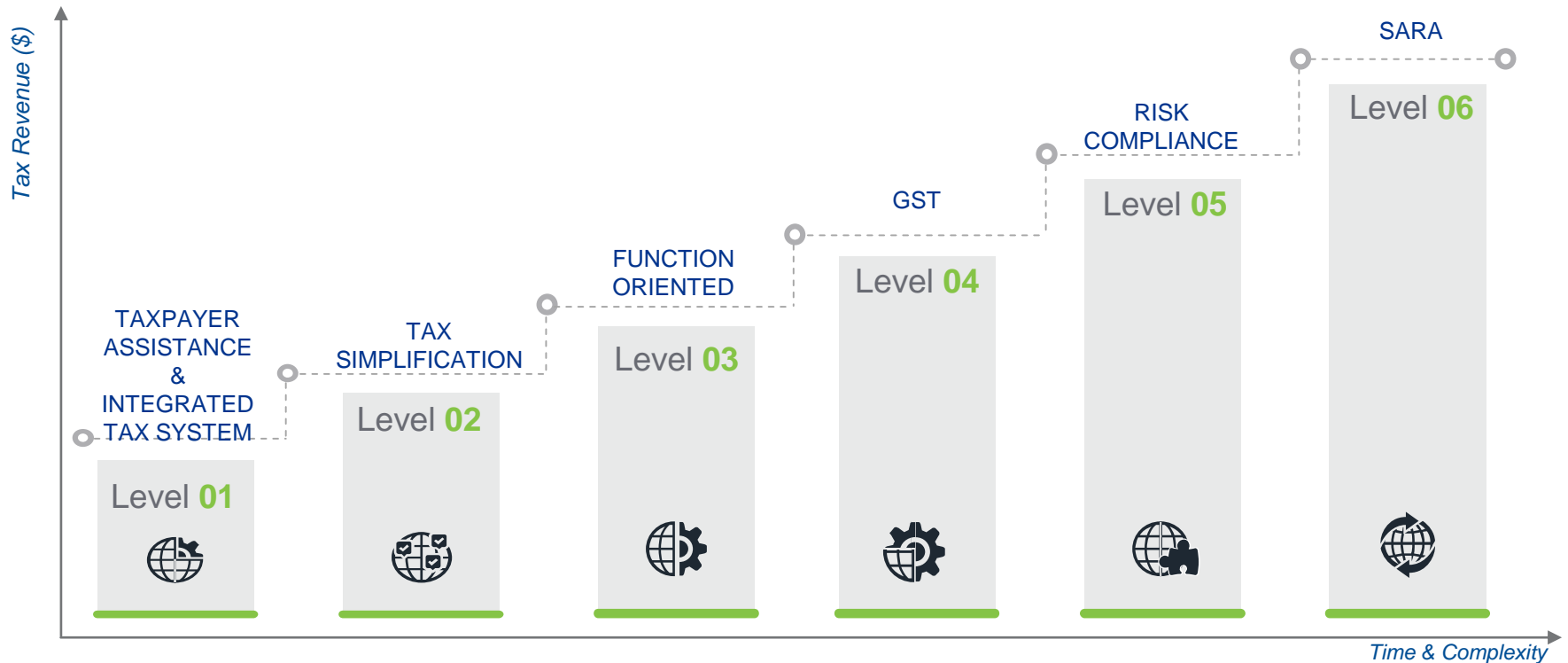


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Tax Administration



Capabilities Evolution



BUILD FOUNDATION

A foundation has to be implemented to improve its taxpayer service and strengthen the administrative processes using an integrated IT platform

SIMPLIFIED ADMINISTRATION

Eliminating tax expenditures and reducing the tax payer base will require a simplified tax administration, which will lower the costs of compliance and administration

TAXPAYER CENTRIC

Creating a fully function oriented organization will enable the Tax Administration to serve the tax payer across its life events and influence compliance behavior.

GOODS & SERVICES TAX

Goods and Services Tax will enable higher compliance rates and consumption tax revenues due to a collection throughout the value chain

RISK BASED ENFORCEMENT

Leveraging data & analytics and understanding risk profile of tax payers will help the Tax Administration focus its enforcement and audit resources effectively.

INDEPENDENT & PERFORMANCE DRIVEN

A non-political and independent Tax Administration will allow for a performance driven culture, more transparency and access to talent.



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Observations



Observations



- As part of the Reform Project, more than 40 meetings have taken place with various interest groups, among them Asociación de Industriales, Cámara de Comercio, Asociación de Bancos, Centro Unido de Detallistas, and others.
- In regards to Act 154, meetings and discussions have taken place with pharmaceutical, biotech companies and other companies subject to Act 154.
- KPMG has modeled several options using the Macroeconomic model developed, considering different tax systems and using the experience in other countries.
- Right now, certain fine tuning of the proposal is taking place. Results are being presented to the Advisory Committee appointed by the Governor, to the Governor and members of the Legislature.
- Decisions in regards to the new tax structure will be discussed with interest groups.
- Drafting of legislation commenced, will run in various parallel groups in charge of the drafting of legislation related to consumption tax, individual income tax, corporate tax (domestic and inbound taxes) and property taxes.
- Transition issues are being considered and included.
- Tax administration and reorganization of Treasury to achieve the goals of the new system, also part of the study.