

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

October 6, 2011

The Honorable Patty Murray
Co-Chair
Joint Select Committee on Deficit Reduction
448 Russell Senate Office Building
Washington, DC 20510

The Honorable Jeb Hensarling
Co-Chair
Joint Select Committee on Deficit Reduction
129 Cannon House Office Building
Washington, DC 20515

Dear Senator Murray and Representative Hensarling:

As the Joint Select Committee on Deficit Reduction works to propose legislation to reduce the deficit by at least \$1.2 trillion from Fiscal Year 2012 to Fiscal Year 2021, I write to respectfully request that the Committee take into consideration certain issues of particular importance to Puerto Rico. Governor Luis Fortuño and I have already discussed these matters in detail with individual Members of the Committee, and I am memorializing several of them here in order to further inform your deliberations.

First, if the Committee proposes measures to create jobs or reform the federal tax code, I ask that it include the language of H.R. 3020, the *Puerto Rico Investment Promotion Act*. H.R. 3020 seeks to encourage job-creating investment in both Puerto Rico (a U.S. jurisdiction that is home to over 3.7 million American citizens) and the 50 states. Currently, most U.S. firms that conduct business in the territory are organized as controlled foreign corporations. A CFC's earnings are not subject to any federal taxation until they are received as a dividend by the CFC's U.S. parent. Firms with CFCs in Puerto Rico—like those with CFCs in other jurisdictions—have little incentive to repatriate CFC earnings because those earnings are subject to full federal taxation once received.

H.R. 3020 would authorize companies that are incorporated in Puerto Rico and that earn at least 50% of their income on the Island to operate as domestic U.S. companies. The bill would promote consistency by bringing the treatment of electing Puerto Rico companies in line with the current treatment of individuals in Puerto Rico (under IRC § 933). Specifically, an electing company would be subject to federal taxation on its worldwide income, except on the income it earns in Puerto Rico.

As a domestic firm, the Puerto Rico corporation could distribute its earnings to its U.S. parent in the form of a dividend under IRC § 243, which allows the parent to deduct 70, 80 or 100 percent

of that dividend, depending on the parent's ownership stake in the subsidiary. Therefore, profits that were previously kept outside of the United States are now more likely to be brought back into the country, where they may be subject to a reduced but still meaningful level of federal taxation under Section 243 and can help generate job-creating investments throughout the nation.

Furthermore, electing corporations that derive any income from sources outside Puerto Rico—whether in the states or foreign countries—would be subject to federal taxation on that income. This could generate additional revenue for the U.S. Treasury, since CFCs in Puerto Rico do not presently pay any federal tax on their non-Island income absent repatriation.

I have asked the Joint Committee on Taxation to prepare an official revenue estimate on H.R. 3020, which is supported by Governor Fortuño, the leaders of the two principal political parties in Puerto Rico, and key business and labor leaders on the Island. If the Committee intends to propose a broad set of measures to promote job creation or reform the tax system, I ask that it consider including H.R. 3020 as part of any package it puts forward.

Second, if the Committee proposes reductions to Medicaid or Medicare, it is critical to note that Puerto Rico is already treated unequally under these two programs in multiple respects. Therefore, I urge the Committee to avoid any action that would exacerbate the existing inequalities or that would undo the important steps that were recently taken—with bipartisan support—to reduce those disparities.

With respect to Medicaid, the federal government pays at least 50 percent of the program's cost in the wealthiest states and can pay upwards of 80 percent in the poorest states. By contrast, federal law imposes an annual cap on Medicaid funding in the territories, even though they are among the most impoverished U.S. jurisdictions. Historically, Puerto Rico's cap was so low that the federal government paid less than 20 percent of Medicaid costs on the Island each year. Inadequate federal funding has made it difficult for Puerto Rico to provide quality health care to its low-income population. It has also compelled the Puerto Rico government to fill the gap left by the shortfall in federal dollars, doing damage to the Island's fiscal health. If the policy was designed to save the federal government money, it was shortsighted. Between 2005 and 2009, over 300,000 Puerto Rico residents moved to the states. Many were individuals of limited means in search of better economic opportunities—who, upon migrating, immediately became eligible for full benefits under Medicaid (and other federally-supported entitlement programs).

Recently, Congress authorized additional Medicaid funding for Puerto Rico. The increased funding—while historic—does not provide parity with even the wealthiest states. Moreover, Island residents continue to face a number of disparities under Medicare. Accordingly, I urge the Committee to avoid any proposal that would serve to aggravate the existing inequalities under Medicaid and Medicare or to reverse the recent progress made to mitigate the Medicaid inequalities.

Third, I urge the Committee to follow the lead of President Obama’s bipartisan National Commission on Fiscal Responsibility and to refrain from proposing any cuts to the Supplemental Nutrition Assistance Program (SNAP) or the Nutritional Assistance Program (NAP), a block grant program that has applied in Puerto Rico in lieu of SNAP since the early 1980s. The *Food, Conservation, and Energy Act of 2008* directed the U.S. Department of Agriculture’s Food and Nutrition Service to prepare a report evaluating the feasibility and effect of including Puerto Rico in SNAP. FNS’s report concluded that Puerto Rico’s inclusion in SNAP would mean that over 100,000 additional families on the Island would be able to receive critical anti-hunger assistance. Accordingly, since Puerto Rico is already treated unequally under this food assistance program, I urge the Committee not to take any action that would exacerbate this inequity or otherwise reduce the NAP block grant.

Fourth, if the Committee intends to address “extenders” in its proposal—that is, to recommend the extension of a package of expiring tax provisions for one or more years—I urge the Committee to extend the provision relating to the rum “cover-over” program, and to make the common-sense, revenue-protecting reforms to that program proposed in the bipartisan bills, H.R. 1883 and S. 986.

Under IRC § 7652, most of the revenue generated from the federal excise tax on rum produced in either Puerto Rico or the U.S. Virgin Islands and sold in the United States is granted—“covered-over”—to the treasury of the producing territory. Specifically, of the \$13.50 tax collected on each proof-gallon of rum produced in the territory, \$13.25 is granted to that territory. Of that amount, \$10.50 is authorized by “permanent” law and the remaining \$2.75 requires periodic reauthorization by Congress. In the 111th Congress, the \$2.75 was extended through tax year 2010 pursuant to H.R. 4213.

The cover-over program is of critical importance to Puerto Rico, helping the Island compensate for the less-than-equal treatment it receives under many federal safety-net programs. For decades, Puerto Rico has used cover-over funds to support education, health, public safety, infrastructure development and environmental protection.

However, the cover-over program is on an unsustainable path. In 2008, Diageo—the world’s largest producer of spirits—announced it would move its operation from Puerto Rico to the USVI in 2012. Under the contract Diageo negotiated with the USVI government, the USVI will provide Diageo with subsidies that amount to 47.5% of the cover-over revenue the USVI will receive as a result of Diageo’s relocation. These subsidies will be paid for with federal cover-over revenue intended to help the people of the territories.

The deal has sparked a race to the bottom. In its wake, the USVI reached a similar deal with another rum producer. And Puerto Rico, in order to preserve its rum industry, is in the process of substantially increasing its assistance to its remaining rum producers.

H.R. 1883 and S. 986 would impose reasonable limits on subsidies to rum producers. For Fiscal Year 2011, the U.S. Department of the Treasury is projected to grant \$546 million to Puerto Rico and the USVI in cover-over funds. Fueled in large part by these new subsidies, rum companies in the territories are expected to increase production. According to estimates, this will result in the federal government having to grant over \$800 million by 2020 and almost \$1 billion by 2030. Because the reforms embodied in H.R. 1883 and S. 986 would protect the U.S. Treasury and American taxpayers, as well as preserve the integrity of the cover-over program, I hope the Committee will consider including these reforms in its legislative proposal.

Thank you for your attention to these requests.

Sincerely,

A handwritten signature in cursive script, appearing to read "Pierluisi".

Pedro R. Pierluisi
Member of Congress