

August 4, 1955

M E M O R A N D U M\*

Subject: Federal-Commonwealth Tax Relations

This memorandum is the result of a layman's probe into the complex field of Federal-Commonwealth Tax Relations. It will have served its purpose if it stimulates legal and other experts to a fuller elaboration of the subject. The objective is to assess in a general way whether Commonwealth self-government can be increased through changes in tax relations. It is assumed that since citizens of Puerto Rico have no effective voice in the formulation of Federal tax laws nor in the appropriation of national funds, they should--as a general rule--be exempt from Federal taxes.

An effort is made at the outset to test the strength of the legal foundation for the tax relationship. More detailed consideration is then given to the only important practical problem in tax relations, which relates to the application of Federal excise taxes to Puerto Rican products and the disposition of the proceeds thereof.

Restraints in Commonwealth Taxing Power: It is apparent that there are certain restraints on the Commonwealth taxing power under the present Commonwealth status. Whatever be the legal basis, the Commonwealth unquestionably cannot tax Federal instrumentalities without Congressional consent. In this respect its position is similar to that of a state. A separate memo is being prepared on banking, but it should be noted here that the National City Bank, being a national bank,

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\*Prepared by Emil J. Sady

is exempt from certain taxes which other banks pay and to which it would be subject if Puerto Rico were a State. A general formula for selective exclusion of Puerto Rico from the intra-insular application of Federal legislation would remedy this situation.

The tax exempt status of Federal property, particularly that used for activities which serve primarily national rather than local interests, constitutes an indirect contribution to the U. S. Government. An estimate is being made of the current assessed value of land in Puerto Rico held by the armed forces. The losses in property taxes on these lands should, if not recompensed, at least be recognized by the United States as a contribution. It has long been urged and the Commission on Intergovernmental Relations has recently recommended that Federal payments should be made to State and local governments in lieu of taxes on Federal property of the type used and held by the armed forces in Puerto Rico.

The Commonwealth is prohibited by the Sailors and Soldiers Act of 1940 from taxing the income of stateside members of the armed forces stationed in Puerto Rico. The Federal Relations Act specifically prohibits export taxes and prohibits taxes which discriminate between articles imported from the United States or foreign countries and similar articles of Puerto Rican origin. The inclusion of Puerto Rico within the customs territory of the United States restricts the Commonwealth's power with respect to duties on imports of foreign products.

It is not at all clear whether the Federal restraints on the taxing power of States of the Union--such as those emerging out of court interpretations of the interstate commerce, due process, obligation of contracts, and equal protection clauses of the U. S. constitution--also limit the taxing power of the Commonwealth. Legal and constitutional consideration aside, there would seem to be some practical advantage in being able to assure potential stateside investors, for example, that they would have the protection of the Federal courts against any Commonwealth tax measure which may unjustly discriminate against them, violate tax exemption contracts, or otherwise arbitrarily infringe upon property or other rights which are protected by Federal courts in the States. On the other hand, there may be important legal or constitutional reasons for opposing the idea that the taxing power of the Commonwealth is restricted to the same extent as the taxing power of States or at least that it is restricted in the same manner (i.e. by the U. S. constitution) as States. Further study is needed to determine whether there would be any advantage in seeking to clarify the nature and scope of the legal restraints on the taxing power of the Commonwealth.

The Application of Federal Taxes and Congress' Taxing Power in Puerto Rico: There is another aspect of the tax relations which may merit special consideration--namely, the conditions under which the Congress may impose taxes in Puerto Rico and the source of such Congressional taxing power. There is further discussion below of the Federal manufacturers excise taxes and the tax on sugar, but it should be noted here that the sugar tax applies to Puerto Rico the same as to the States and the proceeds are deposited to the U. S. Treasury.

The manufacturers excise taxes apply only to taxable products shipped to the United States but only the proceeds from the taxes on liquor and tobacco are deposited to the Commonwealth Treasury. It should be noted also that the Government of Puerto Rico is required by Federal statute to pay the cost (over \$100,000 annually) of Federal supervision of industrial alcohol plants in Puerto Rico. Products shipped from the United States to Puerto Rico are exempt from Federal excise taxes and drawbacks are allowed for such taxes (other than on sugar) as are paid prior to shipment. Similarly, Commonwealth laws provide that local excise taxes do not apply to products shipped for sale in the United States.

The Federal income tax applies to Federal employees in Puerto Rico but it also applies in the same manner to Federal employees in foreign countries. Income derived from Puerto Rico by non-residents of Puerto Rico is subject to the Federal Income Tax. Residents of Puerto Rico other than Federal employees are entitled to more generous exemptions than U. S. citizens who reside in foreign countries. The Federal income tax exemption for residents of Puerto Rico extends to both earned and unearned income derived from sources within Puerto Rico whereas only the earned income of U. S. citizens in foreign countries is exempt. The Commonwealth income tax can usually be deducted in full from the amount of Federal income taxes due. Thus, Federal employees who are residents of Puerto Rico and who have no other income, make net Federal tax payments only if their tax liability to the Federal Government is greater than that to the Commonwealth Government. The earnings in

Puerto Rico of Puerto Rican corporations are entirely exempt from Federal taxation. Under certain conditions income earned in Puerto Rico by a corporation which is incorporated in the States is entitled to more generous Federal tax exemptions than the income of such a corporation derived from foreign countries. Thus, from the standpoint of Commonwealth status, Federal taxes on the income of individuals and corporations in Puerto Rico do not pose any problems.

According to the Commonwealth Treasury Department, the Federal Estate Tax and Gift Tax apply to residents of Puerto Rico in the same manner as to the citizens of foreign countries, both being subject to these taxes only with respect to properties they own in continental United States but not with respect to properties in Puerto Rico or foreign countries.

Of the Federal occupational and regulatory taxes (e.g. on liquor wholesalers and pharmacies selling narcotics), only those relating to narcotics reportedly apply to Puerto Rico and the proceeds from the narcotics taxes are deposited to the Commonwealth Treasury. U. S. import duties apply to foreign goods imported into Puerto Rico but the proceeds therefrom, less the cost of collection, is turned over to the Commonwealth Treasury.

Finally, there are the Federal employment taxes on which the Old Age and Survivors Insurance program is based. These taxes apply in Puerto Rico the same as in States as a result of a specific request of the Commonwealth legislature.

It appears from the brief study made into the application of Federal taxes to Puerto Rico that, generally speaking, the intent of the Organic Acts of the past, the internal revenue laws of the United States, and the Federal Relations Act has been to exclude Puerto Rico from the application of Federal tax laws or to make Puerto Rico the beneficiary of such taxes (less cost of collection) as had to be applied. There are, however, minor exceptions to this rule. The pattern is not uniform. Some Federal taxes apply to Puerto Rico the same as to States, others the same as to U. S. possessions and foreign countries, and still others in a distinctive manner--in some cases to the advantage while in others to the disadvantage of Puerto Rico. Only in the case of the employment tax has the Commonwealth legislature registered specific consent to be taxed. To the extent that the Congress is now able unilaterally to increase the rates of Federal taxes applicable to Puerto Rico or to add to the items subject to Federal taxation there is violation in theory of the principle of "no taxation without representation." Moreover, the ability of Congress to levy such taxes suggests the existence of unilateral Federal taxing power in Puerto Rico which could, if misused, be harmful to the political status and conceivably also to the economic development of the Commonwealth. For example, there are caveat provisions in the U. S. Internal Revenue Code which state that, except as otherwise provided, Federal taxes apply in the possessions the same as to the States and, unless also manifestly incompatible, the word "possession" includes the Commonwealth of Puerto Rico. On the other hand, since the intent of Congress has clearly been to avoid imposing Federal

tax burdens as such on the residents of Puerto Rico, it might be preferable to continue under the present imperfect arrangement rather than risk, in the search for perfection, upsetting the tax relationship which, on the whole, is unusually advantageous to the Commonwealth.

International Tax Relations: A third legal aspect of tax relations which may deserve further study is the status of Puerto Rico under present and future tax treaties. A formula should be developed to ensure that future international agreements on tax as well as other non-political matters do not apply to Puerto Rico without its consent. Also, in order to attract investments from foreign countries, an arrangement is needed which would enable Puerto Rico, using appropriate U. S. channels, to negotiate and enter into international agreements which are designed to prevent double taxation of foreign firms established in Puerto Rico and vice versa.

Federal Manufacturers Excise Taxes: Special problems arise from the application of Federal manufacturers excise taxes and taxes on alcohol, tobacco and sugar to Puerto Rico and the lack of uniformity in disposing of the proceeds of these taxes. Section 7652 of the U. S. Internal Revenue Code (1954) provides as follows with respect to shipments to the United States:

"(1) Rate of tax\*....articles of merchandise of Puerto Rican manufacture coming into the United States and withdrawn for consumption or sale shall be subject to a tax equal to the internal revenue tax imposed in the United States upon the like articles of merchandise of domestic manufacture.

"(2) Payment of tax. The Secretary or his delegate shall by regulations prescribe the mode and time for payment and collection of the tax described in paragraph (1).... Such regulations shall authorize the payment of such tax before shipment from Puerto Rico....

"(3) Deposit of internal revenue collections.\* All taxes collected under the internal revenue laws of the United States on articles produced in Puerto Rico and transported to the United States, or consumed in the island, shall be covered into the treasury of Puerto Rico."

All Federal manufacturing or processing taxes apply to products of Puerto Rico but, except for sugar, they apply only to taxable products which are shipped to the Mainland. Furthermore, the Federal taxes on alcoholic beverages and tobacco, totalling almost \$17,000,000 in fiscal 1955, are collected by Commonwealth officials and are deposited to the Treasury of Puerto Rico. They constitute over 10 per cent of the recurrent revenues of the Commonwealth. The Federal sugar tax applies to all sugar processed in Puerto Rico whether or not shipped to the Mainland. The fact that the local proceeds of the sugar tax, which totalled \$1,800,000 in 1954 are deposited to the Federal Treasury, can be justified--from a practical if not legal standpoint--by the fact that the U. S. Government makes payments to Commonwealth sugar growers which in 1954 totalled about \$17,000,000. There was a large net gain to the Commonwealth from Federal sugar payments even if the

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\*Subparagraphs (1) and (3) are based in part on the Foraker Act of 1900. Subparagraph (1) was codified as part of the Internal Revenue Code and did not appear in the organic act of 1917. Only subparagraph (3) appears in the Federal Relations Act.

Commonwealth is deemed to have contributed not only the sugar tax paid by refiners in Puerto Rico, but also the \$9,000,000 estimated to have been paid by refineries in the States on the Puerto Rican raw sugar processed in 1954.

However, manufacturing excise taxes were also imposed on other Commonwealth products (See table below). The proceeds from these taxes, totalling--it is believed--about \$450,000 in 1952, were deposited to the Federal Treasury and there is no Federal payment to the Government or people of Puerto Rico which can be directly related to these taxes.

ESTIMATED FEDERAL MANUFACTURERS' EXCISE TAXES COLLECTED  
ON PUERTO RICAN SHIPMENTS TO U. S. IN 1952 AND  
RETAINED BY U. S. TREASURY

Commodity	Value of Exports	Tax Rate	Amount of Tax
Electric Mowers	\$ 26,000	5%	\$ 1,300
Radio and TV Parts and Accessories	1,777,555	10%	177,755
Electric Light Bulbs and Tubes	862,601	10%	86,260
Phonograph Records	13,033	10%	1,303
Fountain Pens	657,951	10%	65,795
Sporting Goods	178,854	10%	17,885
Soldering guns, tips, switches, miscellaneous parts	490,753	10%	49,075
Spark Wheels	78,981	10%	7,898
Sporting Goods	128,596	10%	12,859
Dressed Animal Hair	326,000	10%	32,600
Total	\$4,540,324		\$452,730

Sources: Economic Development Administration  
Bureau of Economics and Statistics, Planning Board.

Furthermore, if the new refineries in Puerto Rico sell gasoline and oil in the United States in the volume planned, Federal excise taxes thereon will, according to EDA estimates, total close to \$1,900,000 annually--all of which will be retained by the Federal Treasury unless a prevailing U. S. Treasury Department ruling on the general subject is modified or other steps taken to ensure return to the Commonwealth of these anticipated tax proceeds. Although the Congress is more likely to reduce rather than to increase the products subject to manufacturers excise taxes and also the applicable tax rates, the total proceeds from Federal taxes on Puerto Rican products shipped to the States may well increase with the expansion of Puerto Rican industries.

There are both legal and policy questions involved in the disposition of Federal excise taxes. The legal questions relating to the disposition of taxes collected on products such as listed in the above table, are fully discussed in the previously mentioned opinion of the U. S. Treasury Department dated July 19, 1951 and in a well-reasoned opposing view presented in a letter from the Commonwealth Secretary of Justice to the Governor dated May 10, 1954. The Treasury opinion held that the only Federal excise taxes which could be turned over to the Treasury of Puerto Rico were "those taxes such as tobacco and liquor taxes where the tax is imposed on the manufacturers or importers at the time the article is withdrawn from a factory or bonded warehouse" for sale in the United States. It indicated that the other excise taxes were on the sale and not on the manufacture of the products and that the tax liability on the sale of products manufactured in Puerto Rico would

not attach until the goods have entered into commerce in the United States. It then noted the difficulty of collecting the tax on products which are not withdrawn from government controlled warehouses. The opinion concludes that the Congressional intent was to limit the tax liability in Puerto Rico to situations where there is government control of the flow of taxable commodities to the States.

The Commonwealth Justice Department's letter convincingly refutes this view but recommended that the matter be left in abeyance until it could be considered in conjunction with other questions involving Federal-Commonwealth relations. The Justice opinion contends that the word "withdrawn" in the Foraker Act refers to customs withdrawals and not to bonded warehouses and to the "taxable event" and not to the mechanical event. The opinion notes that rum and tobacco were at the time the only taxable products being shipped to the U. S., which accounts for the stipulation regarding "withdrawn for consumption and sale." However, the Justice opinion reasons that the law contemplated the addition of future products to the list. It states that the excise tax provision in the Foraker Act was designed to avoid giving Puerto Rican producers an unfair advantage in the U. S. market. Since the Act also provided for the duty-free entry of Puerto Rican products into the United States, the Federal excise taxes were levied on Puerto Rican products shipped to the U. S. and provision was made for turning over the proceeds thereof to the Puerto Rican treasury.

The Justice Department's position also reflected the views at the time of the Commonwealth Treasury Department, EDA, Dr. Fernós, and Walton Hamilton. It was not thus for any lack of legal argument that steps were not taken then to press for the deposit of these tax proceeds to the Commonwealth Treasury. It should be noted also that Commonwealth officials were aware that their argument would justify, if not even require, the deposit also of the sugar processing taxes to the Commonwealth Treasury.

Assuming that free trade between Puerto Rico and the U. S. is essential and that Puerto Rican products entering the U. S. market should be taxed at the same rate as the Federal rate applicable to products of the Mainland, there are basically three alternative approaches to the inconsistencies involved in the application of these excise taxes to Puerto Rican products and the disposition of the proceeds therefrom.

Alternative I: Maintain the status quo legally and attempt administratively to obtain a reversal of the U. S. Treasury opinion or at least arrange, to the extent practicable, for taxable products to be "withdrawn" from facilities under U. S. control prior to shipment to the end that the largest amount possible of the proceeds from Federal manufacturer's excise taxes on products shipped to the U. S. will be deposited to the Commonwealth Treasury.

Advantages:

- a. Ensures Commonwealth retention of the proceeds from taxes on rum and tobacco shipped to the States.
- b. Opens possibility for the proceeds of other Federal manufacturer's excise taxes to be deposited to Commonwealth Treasury.

Disadvantages:

- a. Continues the present illogical basis for differences in the disposition of the proceeds from various excise taxes.
- b. Continues or increases an indirect Federal subsidy to the Commonwealth since the manufacturer's excise taxes on Puerto Rican products, except locally consumed sugar, are actually paid by U. S. consumers.
- c. Requires clumsy arrangements to be instituted in order to obtain the proceeds of other excise taxes if the U. S. Treasury refuses to modify its position.
- d. Could raise questions regarding sugar payments to Puerto Rican farmers if the proceeds of the sugar tax are deposited to the Commonwealth Treasury.
- e. Continues the applicability of the sugar tax to locally consumed sugar, which violates in theory the principle of "no taxation without representation."

Alternative II: Amend the Federal Relations Act to provide that the Commonwealth Government shall impose local manufacturers excise taxes on Puerto Rican products shipped to the states which are no lower than the Federal rates.

Advantages:

- a. Protects against unfair competition from Puerto Rican producers in the U. S. market while substituting Commonwealth for Federal authority at all stages of the tax process.
- b. Ensures return of all present and future proceeds of these excise taxes to the Commonwealth.
- c. Enables Puerto Rico to attain more rapidly the position where it could, if desired, contribute to the U. S. Treasury.
- d. Eliminates the "Federal" tax on locally consumed sugar.

Disadvantages:

- a. Raises the question of Puerto Rican residents benefiting from taxes paid by mainlanders while exempt from Federal taxation and benefitting from Federal grants, services, sugar payments, etc.
- b. Forces the Commonwealth to adopt U. S. excise tax schedules as minimums under local law and also perhaps, in view of traditional U. S. attitudes toward "export taxes", to apply such taxes to products consumed locally as well as to those shipped to the States.

Alternative III: Work toward eventual retention by the U. S. of all excise taxes imposed on the products of Puerto Rico which are shipped to the U. S. and modify collection procedures to avoid the implication that Federal taxes are imposed on Puerto Ricans.

Advantages:

- a. Removes inconsistencies in present arrangement.
- b. Eliminates an important Federal subsidy to Commonwealth Government financing and therefore strengthens the autonomy of the Commonwealth.

Disadvantages:

- a. Attracts less credit to Puerto Rico than would a separate Commonwealth contribution in like amount to the U. S. Treasury.
- b. Retards development of Commonwealth public services to the extent that present and potential tax proceeds are given up.

The first alternative--seeking to obtain the deposit to the Commonwealth Treasury of the maximum tax proceeds allowable under existing Federal law--seems to be the soundest course to follow at the moment. It does not close the door on either of the other alternatives and provides a basis for immediate action to gain the tax proceeds on fuel shipments to the States, which may be lost for all time if a procedure

is established for depositing these proceeds in the U. S. Treasury. If the U. S. Treasury starts to benefit from the excise tax on fuel as well as certain other shipments, it will be more difficult to obtain Congressional as well as Treasury Department approval of the second alternative.

The second alternative--applying the Federal rates as Commonwealth taxes--would be better but would jeopardize existing proceeds from the tax on rum and tobacco shipments to the States, particularly if sought through separate legislation. It would, however, be a neat substitute for Section 9 of the Federal Relations Act and should be considered in that connection if and when the Act is substantially revised.

The third alternative entails costs without commensurate benefits. There may be other alternatives and, if so, they should be explored.

If the first-mentioned course or one resembling it is adopted, an immediate decision must be made. The refineries are in a position to begin selling their products to the United States. As mentioned above, the stage should be set for the Commonwealth to be credited with the first Federal taxes collected on these products. This could best be done by seeking a reversal of the 1951 U. S. Treasury opinion. However, there may<sup>not</sup> be time to wait for such a reversal. Pending such reversal, the possibility should be explored of making the refinery storage facilities into "bonded warehouses", or otherwise arranging so that the refinery products will be "withdrawn for consumption and sale" within the narrow U. S. Treasury interpretation of the law, without loss to the Commonwealth of the proceeds of tariff on crude oil.

Summary: Federal-Commonwealth tax relations, though imperfect in minor detail, are unusually advantageous to the Commonwealth. Consideration should be given to the desirability and practicability of (1) clarifying the nature and scope of Federal restraints on the Commonwealth's taxing power; (2) clarifying the source and scope of Congressional taxing power in Puerto Rico; and (3) developing the use of international tax agreements to Puerto Rico's advantage.

The only major practical problem in tax relations relates to the application and disposition of the proceeds of Federal excise taxes on various manufactured products of Puerto Rico. Several alternative solutions merit consideration. The most advantageous course at present would be for the Commonwealth to try to arrange administratively--i.e. without changing existing laws--for the deposit to its Treasury of all the proceeds from Federal taxes on its products. Since the refineries will soon be shipping taxable petroleum products to the States, an early decision on the course to be followed would be desirable.