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Puerto Rican Competitiveness and Pillar Two

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Key Findings

- Puerto Rico has long relied on low taxes to attract real investment and profit shifting.
- Pillar Two, the global minimum tax agreement, presents a threat to Puerto Rico's model.
- Puerto Rico may be well served by designing a new competitive tax code that works within the boundaries of Pillar Two.
- Various constraints on Puerto Rican policy and conflicting interests have made it difficult to enact a comprehensive legislative response.
- The US federal government could be more helpful in representing Puerto Rico in international tax policy matters.
- The Puerto Rican experience thus far exhibits some of Pillar Two's drawbacks. Jurisdictions pursuing a tax-competitive model are incentivized to adopt complex and opaque legal structures rather than simple, low rates.

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Introduction

Puerto Rico, a US territory with a limited ability to set its own tax policies, will be the first part of the US to be substantially affected by Pillar Two, the global tax agreement that seeks to establish a 15 percent minimum tax rate on corporate income. Pillar Two is a significant threat to Puerto Rico's development model, which has typically featured lower taxes. Puerto Rican lawmakers have begun to respond. However, no comprehensive tax reform addressing Pillar Two has thus far crossed the finish line and become law.

The US federal government has an interest in promoting Puerto Rico's fiscal health, and it has a responsibility to represent Puerto Rico in international matters.

The threat to Puerto Rico's development model is simple. Puerto Rico is a small open economy that has used low taxes to attract valuable global companies to its shores, especially in the pharmaceutical industry and in manufacturing functions. Pillar Two intends to effectively compel an increase in Puerto Rican tax rates. If Pillar Two goes into effect, and Puerto Rico retains its current tax laws, then other countries will tax income sourced in Puerto Rico. This scenario only offers downsides to Puerto Rico. Global corporate investment on the island will feel the effects of higher taxes, and the value of Puerto Rican tax incentives will be reduced or even fully canceled out, but the Puerto Rican government will not gain the revenues from those higher taxes.

Puerto Rican lawmakers are already considering changes to the tax code but were unable to pass a finished bill in the most recent session ending on June 30, 2024. This reflects the substantial difficulties of conforming to Pillar Two, pursuing a development strategy, and working within internal and external constraints, all simultaneously.

Observers from the continental United States should consider how to use federal policy to help protect Puerto Rican competitiveness. But the Puerto Rican experience may also help build perspective on Pillar Two in general: the minimum tax may not be achieving its intended goals, while at the same time generating more complexity and difficulty in compliance, especially in jurisdictions where tax legislation is constrained by other factors.

History of Puerto Rico's Tax Strategy

Puerto Rico has long been afforded some independence from the US on tax policy, especially income tax policy for its own residents. However, Puerto Ricans do pay other federal taxes, such as payroll taxes, more regularly. Puerto Rico has generally had first taxing rights on corporate activity within Puerto Rico, but large multinationals based within the US may owe a second layer of residence-based taxes to the US, such as under the global intangible low-taxed income (GILTI) regime. Puerto Rico does not generally have independent diplomacy on tax matters.

The island has often used a strategy of low corporate income taxes, which can be effective for a small open economy. Low corporate income taxes can make a location attractive for both real investment by global businesses and on-paper profit shifting of intangible investments (i.e., abstract corporate assets like intellectual property that aren't moored to a physical location).

The mainland US employs a different strategy, as it is a very large open economy with a corporate income tax rate of 21 percent. While the US could, in principle, use a very low corporate income tax rate to attract real investment or on-paper shifting of intellectual property, it also has an extraordinarily large domestic economy. Its corporate income tax policy is primarily driven by policymakers' views on that large domestic economy, while cross-border concerns remain secondary. Given the differences between Puerto Rico and the continental US, it makes sense that Puerto Rican policymakers may pursue different corporate income tax strategies if given the means to do so.

While Puerto Rico has always used a low-tax strategy, the execution of that strategy has been varied and somewhat haphazard over the decades—in part, though not entirely, because of instability in the federal treatment of Puerto Rico.

Rather than enact a consistent and low corporate income tax rate, the Puerto Rican government has often elected to negotiate individually with global corporations, intending to attract investment and reported income with incentives. The results of these individual negotiations are then considered to be strong, binding contracts under Puerto Rican law.

While a low-tax strategy is valid, it is typically more efficient to consolidate corporations under a single regime. Negotiation requires resources, and a regime that negotiates taxes individually is at strong risk of offering unnecessary inframarginal incentives to some businesses while warding off other would-be investors with a high statutory rate. For example, a company that already operates well in Puerto Rico and has a strong relationship with the government may use its connections to negotiate a favorable rate on a new investment, even if it was already planning to invest on the island under less favorable treatment. Meanwhile, another company may observe that the headline top income tax rate is nearly 37.5 percent, after accounting for both the ordinary corporate income tax and a surtax, and pass on the opportunity to invest in Puerto Rico, even if it might have reconsidered if it knew it could secure a better deal.[1]

Puerto Rico has made some efforts to consolidate the individualized contracts through legislation. However, these efforts have been complicated by unstable federal policy and fiscal woes.

Between 1976 and 1996, Puerto Rico benefited from Section 936 of the federal tax code, which allowed a federal tax credit equal to the full amount of US corporate income tax liability on income sourced to US possessions. While, in principle, Section 936 could have applied to other US overseas territories, in practice, Puerto Rico, the largest territory, attracted almost all Section 936 income.[2]

1 PricewaterhouseCoopers, "Puerto Rico Taxes on Corporate Income," https://taxsummaries.pwc.com/Puerto-Rico/Corporate/Taxes-on-corporate-income.
2 Government Accountability Office, "Puerto Rico and the Section 936 Tax Credit," June 1993, https://www.gao.gov/assets/ggd-93-109.pdf.

Section 936 was ultimately repealed, primarily because federal lawmakers thought the credits cost too much revenue. It was phased out between 1996 and 2006. Puerto Rico began to have serious fiscal troubles in the mid-2010s, in part because of the global recession, and arguably from the expiration of Section 936 as well.[3] The federal government responded to those fiscal troubles with legislation known as the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), which established a financial oversight board. The board was intended to improve Puerto Rico's fiscal stability, but in doing so, it necessarily imposed some constraints on fiscal policy. Puerto Rico exited bankruptcy in 2022; however, it remains under significant fiscal constraints.[4]

While it grappled with external forces and fiscal trouble, Puerto Rico made some efforts to consolidate its corporate taxpayers under unified systems: for example, with a 4 percent levy through 2010 legislation known as Act 154. However, the 4 percent tax was an excise tax, not an income tax, and the US Treasury issued notice that it might not be creditable under the US corporate income tax over the long run. Act 154 was then largely replaced by a 10.5 percent income tax regime known as Act 52.[5] Notably, these transitions were elective to avoid breaching contracts negotiated with individual corporate taxpayers.

This history provides relevant context for Puerto Rico's present and near future. It is constrained by contracts, fiscal oversight, and the federal government, whose policies have a powerful impact on its trajectory. It therefore has a limited ability to quickly change its tax code on demand.

How Pillar Two Will Affect Puerto Rico

Pillar Two involves a series of three taxes that backstop and reinforce each other to impose a 15 percent minimum rate on large global companies. The first, a qualified domestic minimum top-up tax (QDMTT), is assessed by jurisdictions on domestic activity and would require businesses that pay below a 15 percent rate to "top up" their taxes to that 15 percent minimum. The second, an income inclusion rule (IIR), would be a similar top-up tax assessed on a country-by-country basis by the jurisdiction in which a corporation is headquartered. The parent jurisdiction would thus ensure that operations in a jurisdiction without a QDMTT would still roughly be taxed as if there were a QDMTT. Finally, and most controversially, Pillar Two includes the undertaxed profits rule (UTPR). Under the UTPR, any jurisdiction in which a multinational group operates could attempt to collect the 15 percent minimum on income taxed below 15 percent, effectively stepping in for the jurisdictions that would normally tax the income through source-based taxes like the QDMTT or through residence-based taxes like the IIR.

Puerto Rico will first feel the impact of Pillar Two through the income inclusion rule. The territory has attracted some manufacturing investment from global companies headquartered in Europe, and the European Union has adopted the income inclusion rule in EU Member States for fiscal years beginning on or after December 31, 2023. This is a problem for the island all by itself: the effective tax rate on investments in Puerto Rico is being raised, but Puerto Rico—which could use the revenue—does not receive the tax

3 Gavin Ekins and Scott Greenberg, "Tax Policy Helped Create Puerto Rico's Fiscal Crisis," Tax Foundation, Jun. 30, 2015, https://taxfoundation.org/blog/tax-policy-helped-create-puerto-rico-fiscal-crisis/.

4 D. Andrew Austin, "Puerto Rico's Public Debts: Accumulation and Restructuring," Congressional Research Service, May 2, 2022, https://crsreports.congress.gov/product/pdf/R/R46788.

5 PricewaterhouseCoopers, "Notice 2022-42 addresses creditability of Puerto Rico income tax for taxpayers who transition out of the 4% excise tax," October 2022, https://www.pwc.com/us/en/services/tax/library/notice-addresses-creditability-of-pr-income-tax-for-taxpayers.html.

money. Of course, European countries are entitled to assess residence-based taxes if they so desire, but the economic results may be suboptimal from a Puerto Rican perspective.

Later down the line, the problem will escalate substantially if countries attempt to assess UTPR on Puerto Rico, because it will spread to US-based companies. In addition to presenting an economic problem, this arguably presents a significant legal one: if Pillar Two countries assess UTPR on US companies' operations in Puerto Rico, then they will be taxing according to neither source-based principles nor residence-based principles.

The strongest escalation of the UTPR would be to assess it on the continental US-source income of US companies, for example, because they had a sub-15 percent rate under the Pillar Two calculation after taking R&D credits into account. Though the US currently has safe harbor from the UTPR, according to OECD guidance, US companies could in principle owe UTPR after that safe harbor expires in 2026.[6]

Pillar Two does allow some means for jurisdictions to offer tax incentives, despite its nominal goal of raising rates to 15 percent. Certain tax credits, if structured correctly as qualified refundable tax credits (QRTCs), count as an increase in income, rather than a reduction in tax, for the purposes of a Pillar Two calculation. This makes them count for far less, in a tax rate calculation, than they would if they were accounted for as a reduction in tax instead.

Jurisdictions intending to pursue a low-tax strategy therefore have an incentive, if they are able, to officially adopt a higher headline corporate income tax rate while returning some money to corporations with QRTCs to emulate the effects of a lower rate.

Puerto Rican Legislative Solutions

A jurisdiction like Puerto Rico might attempt to resolve Pillar Two-induced problems by finding a way to impose effectively low taxes, but not count them as low taxes for Pillar Two purposes. This strategy—as pursued by, for example, Bermuda—would combine a QDMTT with QRTCs to roughly restore the status quo ante while maintaining a 15 percent rate under the Pillar Two calculation.[7]

This strategy still involves downsides: a higher headline rate is less competitive, and a tax code with a high rate plus refundable credits is likely to be less efficient than a simple, low rate for all. Refundable credits are opaque, and corporations may find more assurance in a simple, low rate than in a complex scheme with a higher rate and the promise of reductions later.

When jurisdictions pursue this QDMTT-QRTC combination, it is not because that tax policy is optimal. Rather, it is because that is what Pillar Two demands of low-tax jurisdictions that prefer to remain low-tax jurisdictions.

6 Organisation for Economic Co-operation and Development, "Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two), July 2023," https://www.oecd.org/content/dam/oecd/en/topics/policy-sub-issues/global-minimum-tax/administrative-guidance-global-anti-base-erosion-rules-pillar-two-july-2023.pdf.

7 Alan Cole, "The Fatal Flaw of Pillar Two," Tax Foundation, Feb. 27, 2024, https://taxfoundation.org/blog/pillar-two-flaw/.

For Puerto Rico, pursuing this strategy is simple in theory but difficult in practice. Constraints are numerous. Contracts signed with Puerto Rican taxpayers demand that changes to the tax regime be elective, or risk unconstitutionality. Fiscal constraints make it more difficult to enact tax provisions that might increase deficits. And furthermore, Pillar Two guidance suggests that tax credits too closely tied to income may not qualify as QRTCs.

The Puerto Rico House of Representatives passed one bill, known as HB 1908, that attempted to satisfy all the constraints. However, the Senate did not take up the bill, and the US Treasury reportedly raised some doubts as to whether it would satisfy Pillar Two requirements shortly before the Puerto Rico legislative session was set to close. The Treasury then reportedly recommended that Puerto Rico seek guidance from the OECD on compliance.[8]

This approach did not yield results in time for legislation to pass by the end of the 2024 legislative session on June 30. It is unclear whether the OECD can provide guidance on tight legislative timelines—or perhaps at all—regarding how jurisdictions can navigate internal legal constraints and conform with Pillar Two.

How the Federal Government Might Help

Puerto Rico is making a fair effort to abide by all of the constraints. Rather than taking a passive role, the US federal government should actively help alleviate the difficulties.

At a minimum, the federal government should argue that good-faith efforts by the Puerto Rican legislature to build a Pillar Two-compliant regime should not be disqualified on technicalities. Not every government in the world will be able to immediately re-orient domestic laws around a new Pillar Two-optimized structure. If Puerto Rico makes a good effort to replicate QDMTT-QRTC regimes that have been approved elsewhere, the US should argue that the Puerto Rican regime be approved as well. In any event, given insufficient OECD guidance and a tight timeline, Puerto Rico may need to ask for forgiveness rather than for permission.

The federal government should also consider, in its next reform of the global intangible low-taxed income (GILTI) regime, offering more generous foreign tax credits to Puerto Rico than to other jurisdictions, reflecting the fact that the federal government places more value on Puerto Rican tax collections than on genuinely foreign tax collections.

An ambitious federal negotiating position might ask that Puerto Rico be counted as part of the US for the purposes of Pillar Two's country-by-country calculations. This would effectively create room for Puerto Rican tax policy because most Puerto Rico-source income is attributable to corporations with a large amount of US-source income, which is taxed at a statutory rate of 21 percent under current law. The US might make the case that on average, US regimes are more than Pillar Two compliant, and the OECD need not concern itself with details internal to the US and its territories.

8 Angélica Serrano-Román, "Stuck Between US and OECD, Puerto Rico Seeks Path on Minimum Tax," Bloomberg Tax, Jul. 1, 2024, https://news.bloomberglaw.com/daily-tax-report-international/stuck-between-us-and-oecd-puerto-rico-seeks-path-on-minimum-tax.

Furthermore, the arrangement could have an upside for the US regarding profit-shifting. A small, low-tax regime paired with a very large, moderate-tax regime could make for a potent combination in a Pillar Two world. Puerto Rico's low-tax regime would act as a magnet for mobile, intangible-derived income, and it would do so extremely effectively because companies could blend low-tax income with a massive amount of moderate-tax continental US-source income.

A variety of tax provisions—from the US foreign-derived intangible income (FDII) tax treatment to "patent boxes" in European countries—seek to offer lower tax rates on more elastic income to keep a hold on it. These low tax rates contrast with ordinary, higher taxes on less elastic income. Such an approach has trade-offs—it certainly is more complex and less principled—but it is one way of handling the real challenges that mobile income presents to tax systems. These low-tax provisions for elastic income often use some means to distinguish types of mobile income; for example, FDII, coming from intangible assets and sales to foreign markets, would be easier to shift than more concrete and domestic income. Puerto Rico's corporate income tax base serves some of these same purposes. Income sourced to Puerto Rico is likely to be more mobile than typical income, and it is taxed by a US territorial government at a lower rate than ordinary income.

The most dramatic way the federal government might help—but could also hurt—would be to engage in a prolonged fight over the application of the UTPR, potentially retaliating in tax, trade, or other arenas. The US already considered such measures in proposed legislation.[9] If such an initiative were focused and successful in derailing attempts to apply the UTPR to the United States, it would be beneficial. But there is a significant chance—especially if the politics of trade are unfocused, adversarial, and scattershot—of US retaliatory measures simply provoking further trade offenses by others and ultimately worsening the environment for US-based global businesses.

Lessons to Draw

Puerto Rico does not have easy solutions to Pillar Two. Almost every provision or idea mentioned above contains some kind of drawback. At a minimum, asking for concessions on Pillar Two may cost the US some negotiating leverage that might also be needed in other policy areas.

International corporate income tax policy will always be muddled. It is difficult to draw clean lines between jurisdictions to apportion income, especially as the global economy becomes more dominated by the flow of information and data and less by the flow of physical goods or services. However, international corporate income tax policy is especially muddled in Puerto Rico.

Some of the problems in Puerto Rican policy may be self-inflicted; a simple, long-standing policy of low income tax rates would have been superior to ad hoc negotiations and a variety of alternate regimes. But some problems are externally imposed as well, and Pillar Two is creating new problems for Puerto Rico.

9 Daniel Bunn, "New Ways & Means Proposal Shows Continued Commitment to Combat Extraterritorial Taxes," Tax Foundation, May 26, 2023, https://taxfoundation.org/blog/extraterritorial-taxes-global-tax/.

Indeed, it is likely that Pillar Two will spur a return to a nominally high headline rate, coupled with opaque tax credits returning some of that money to taxpayers—effectively, a step backwards. A simple, low rate is better than a complex system, as it would help spawn a more dynamic economy where local businesses, not just large multinationals, can thrive.

In the best case, this new tax code will be greenlit by Pillar Two as a reasonably compliant QDMTT-QRTC regime. But we should ask ourselves whether QDMTT-QRTC regimes are good tax policy or merely the kind of low-tax regime that happens to be accepted by the Pillar Two agreement. If former low-tax regimes simply reconstitute themselves—with added complexity—and begin to compete over incentives rather than headline rates, Pillar Two will have arguably failed to achieve its goals.

The Puerto Rican experience of attempting to comply with Pillar Two but failing to produce final legislation in the most recent session also might indicate that Pillar Two is too hard to comply with in general, especially for jurisdictions that decided long ago to impose some limitations on their ability to rapidly change tax policies. Other jurisdictions with different idiosyncratic limitations may also find their Pillar Two bills delayed or stalled.

The approach taken by the US Treasury in June—to direct Puerto Rican officials in the direction of the OECD—is a feasible solution only if the OECD is ready and able to help every jurisdiction navigate some path to compliance with Pillar Two. This seems unlikely. Understanding one country's corporate income tax laws is difficult enough, much less understanding two hundred. The OECD almost certainly does not have the resources to help every country make a good-faith implementation.

The US should take a more proactive approach in arguing on Puerto Rico's behalf—and on behalf of the continental states. Much like Puerto Rican policy, federal policy cannot turn on a dime. The slow-moving nature of Congress, the sheer size of the US economy, and a variety of constitutional and procedural constraints may make it difficult, for example, to suddenly abolish the current US research and development regime and replace it entirely with something more Pillar Two-compliant for largely arbitrary reasons.

The Puerto Rican problems are interesting in their own right and leave no easy solutions. But they are also important as a warning to the continental US that Pillar Two compliance will not come easily, and may ultimately require a substantial application of resources—resources that could be better used in more productive parts of the economy—merely to rebuild the tax code to conform to arbitrary standards.