

**PUERTO RICO:  
INSIGHTS INTO ECONOMIC DEVELOPMENT POLICY  
Volume III  
Tax Reform and Financial Regulation**

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**ABSTRACT**

This volume presents two submissions to the Bipartisan Congressional Task on Economic Growth in Puerto Rico regarding “Tax Reforms.” First, Juan-Carlos Puig’s submission outlines a list of initiatives/actions which should be taken to improve Puerto Rico’s economy. Having served as a federal government employee for 32.5 years, 28.5 of which were served in Puerto Rico, he suggests that the task force is in a unique position to reform Puerto Rico’s tax administration and without improvement in revenue collection Puerto Rico will not be able to stand on its own two feet. Secondly, James I. Owens, an International Tax Consultant, also outlines practical recommendations to achieve economic growth in Puerto Rico. Increased revenue can be accomplished by improving tax administration and enforcement programs or by raising the current rate of the sales tax.

**Key Words:** Puerto Rico, Economic Growth, PROMESA, Tax Reforms

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## **Volume III:**

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## **A. Submission to the Bipartisan Congressional Task on Tax Reform**

**By:  
Juan-Carlos Puig**

First of all, I want to express my appreciation to the U.S. Congress and Mr. Barack Obama, President of the United States of America, for enacting a law to provide Puerto Rico the opportunity to restructure our economy, which will have a positive impact among the 3.4 million U.S. citizens residing on the island, and to you for accepting this challenge. I am positive the objective will be achieved. This will not be an easy task and will require some sacrifices, but at the end of the day we all will have a much better place to live, and everybody will be satisfied with the achieved results.

In my case, I am a U.S. citizen, born and raised in Puerto Rico, and am not planning to move another place. Therefore, I feel it is my obligation to provide the Task Force with some ideas of initiatives that should be implemented to improve our finances and quality of life.

I served as a Federal Government employee for 32.5 years, 28.5 of which were served in Puerto Rico. I worked for the U.S. Internal Revenue Service. I had the opportunity to occupy several positions, mainly in the compliance area, and for 10.5 years was assigned to the Government of Puerto Rico, mainly to the Departamento de Hacienda, where I served in different positions within the Internal Revenue Area. As a Tax Administration Advisor for four former Secretaries of the P.R. Treasury, I actively participated in the implementation of the first Collection Division, an Automated Call Site, as well as many compliance initiatives, which resulted in successful implementations. In addition, I directed a change management process for the entire Internal Revenue Area. I was also the Project Manager for the implementation of a computerized master file, which is the system Hacienda still uses to run their tax system.

I was also honored to serve as the Puerto Rico Secretary of Treasury for two years. During my tenure I implemented free electronic filing of individual income tax returns, expediting processing of income tax returns, and refunds as well. I was later on appointed by the Governor as the First Inspector General for the Government of Puerto Rico. In addition, I was the Governor's Personal Representative in the Morales Feliciano Case (a class act case at the U.S. Federal Court). During my tenure we were able to, after over 30 years, to take initial

steps to finally close the case at the satisfaction of the U.S. District Court. I also served as an Advisor to the President of the P.R. Senate for two years, conducting analysis and making recommendations for proposed legislation, mainly in the economic arena.

I am currently retired, and do some part time work for the U.S. Department of the Treasury as an International Tax Administration Advisor.

The following is a list of initiatives /actions which should be taken to improve Puerto Rico's economy and quality of life for those 3.4 millions of U.S. Citizens who live on the island.

## **I. Tax Administration System**

Taxes are the most effective mechanism through which the government receives the funds needed to provide the goods and services the citizens need. In Puerto Rico, the tax administration system has not been effective enough to collect the needed amount of taxes to meet their obligations. Among other factors, this is the reason traditionally almost all administrations have opted for amnesties, which has proven to be not only ineffective, but actually counterproductive in achieving the desired goals and have opted to indulge in deficit spending and issue general obligations bonds, which has contributed greatly to the critical situation we face, which has resulted in the necessity for PROMESA.

No matter how many laws are enacted, or funds made available to the local government, without an effective tax administration system Puerto Rico's economy will never get back on track. Therefore, to ensure the success of PROMESA, it is essential that an effective tax administration system be implemented.

The current tax administration agency lacks adequate resources to effectively carry out their mission. Human Capital is an essential component of the tax administration agency. Around four years ago, an early retirement process was established, allowing Internal Revenue Area employees to leave the agency. This event, in addition to the natural attrition process, caused irreparable harm to the administration. Several hundreds of experienced managers and technician left the agency, creating a big gap in the agency. An effective succession plan was not implemented, which resulted in considerable reduction of compliance related activities, new recruits had no opportunity to transition, no training was provided, and the new management team was for the most part unable to carry out their jobs effectively.

This has caused a big morale problem among the staff, and the taxpayers' satisfaction level is very low. No effective actions have been taken to close this gap. In an effort to increase revenue, the tax administration has implemented additional taxes, which affect only the honest full compliant taxpayers, while non-compliant taxpayers operate freely, not paying their fair share of the taxes.

Based on my experience of 10 years in Hacienda, I strongly recommend the Internal Revenue Area be completely revamped. As in the Federal system, the Treasury Department and the Internal Revenue Area should be separated. This will require legislation, and most importantly, complete restructuring of the agency, and selection of a capable management team to bring the new agency to the level of performance the island needs and the honest compliant taxpayers deserve.

In addition, strong consideration should be given to allow the private financial institutions to provide services so that the citizens have more access to receive services and to meet their tax obligations on time without having to visit a local office. This would allow for the redistribution of the human capital available to be refocused in compliance related activities, which will result in increased revenue and better services.

The following is a detailed list of areas which need attention:

#### **A. Legislation**

New legislation should be enacted to establish the “rules of the road” for the newly implemented tax administration agency. The Internal Revenue Administrations should be an independent agency under the P.R. Secretary of the Treasury. This agency must have a separate budget.

#### **B. Head Of Agency**

The Administrator should be the only official to be the “political appointee”. This incumbent should be appointed by the Secretary of Treasury, and confirmed by the Senate. The term of this position should be at least five years, renewable.

### **C. Hatch Act**

Legislation similar to the Hatch Act should be enacted. This will apply to at least all managerial positions within the agency. Employees covered under this law will be prevented from participating in any political activity. Failure to comply with this law will be just cause for separation of employment.

### **D. Politicians Intervention (Hands Off)**

Legislation should be enacted to prevent any elected official to intervene with the Internal Revenue Area employees to influence any decision (related to a taxpayer, employee or contractor) (hands off). Stiff penalties should be implemented (fines of at least \$5k for each occurrence for both the elected official and the employee). This will establish an environment free of political influence. This will be very positive for both the employees and taxpayers.

The Head of Agency will issue progress reports to the legislature on a regular basis.

### **E. Human Resources**

#### **1. Front Line Employees**

All employees will be “career employees”. A “redeployment process should be implemented. Through this process, all front line employees will be “redeployed “ to new similar positions within the new agency.

#### **2. Managers**

All managerial positions will be filled by way of a competitive process. Vacancy announcements will be published, and a competitive process will be followed. Current incumbents will be given “priority consideration” but no guarantee they will be selected for the position currently held. (Current positions will be abolished). Non selected employees will be reassigned to a front line position in accordance with their experience.

### **3. Retirement Options (Early Out)**

Those employees who are not selected through the competitive process will be given the option to retire, as long as they meet certain requirements to be established at a later date.

#### **F. Compliance Procedures**

Current operational procedures should be revised to ensure these are adequate and effective in simplifying the compliance process. Emphasis should be given to the protection of the taxpayer's bill of rights.

All efforts should be made to reduce the tax burden to compliant taxpayers. Unnecessary requirements should be abolished to expedite compliance and make the tax process less taxing.

Non-compliance taxpayers should face stiff penalties for non-compliance. Enforcement actions should be implemented in an equitable manner.

#### **G. Installment Agreement Procedures**

Installment agreement procedures should be revised to establish reasonable procedures, taking into consideration the current financial condition of the island. This should be publicized so that every taxpayer knows the rules, and everybody must be treated equally. Consequences for non-compliance should also be clearly explained upfront.

#### **H. Training**

Training to all employees will be critical. Training modules should be implemented for each position, and all personnel must be trained.

#### **I. Instructors**

Over the last five years, the Internal Revenue Area has lost a considerable amount of capable experienced employees. There is a need to bring back a number of these experienced employees to conduct a knowledge transfer process. This could

be accomplished by enacting a special legislation which authorizes retirees to come back to the agency for a predetermined period of time.

Retirees should be able to work at the agency for a predetermined amount of time (up to two years), without affecting their retirement benefits. These “retirees” will provide training and guidance to the employees on technical aspects of the job. They should be able to develop and implement a comprehensive training package to fully train new employees so they become fully capable of carrying out their duties in an effective manner.

#### **J. Special Collection Fees**

Current law provides for the assessment of an additional charge of 10% to cover enforced collection expenses. This fee should be charged to all taxpayers who have failed to comply with the established procedures after regular notification process has been exhausted.

Dollars collected as result of this “fee” should go to a “special fund”. This special fund should be used as follows:

90% of the fund should be distributed among the employees who participated in the collection process. Guidelines should be implemented to determine who will qualify for this, and the amount to be received by each participant.

10% should be used for the new agency to acquire equipment and specialized training to the staff.

#### **K. Anticipated Revenue Increase**

At this point it is not possible to determine the amount of taxes that will be collected as a result of the suggested approach. There are many factors to consider, for example, the financial condition of the taxpayers, the business activity, and the amount of resources available to run the agency. However, based on prior experience, with adequate staff, properly trained, and with upper management supporting a firm tax administration policy, revenue will increase, and at the same time the taxpaying community will regain confidence in the system. Only time will tell how much compliance will increase. However, it is assured that at the end of the day we will have a much more effective tax

administration agency, with increased revenue and much better customer and employee satisfaction at a reduced cost.

#### **L. Consolidation of Tax Related Agencies into One**

There are several local government agencies that administer different tax laws. A comprehensive study should be conducted to identify those agencies which, based in the nature of their mission (collect taxes), could be merged to effectively carry out their mission. As a result, services would improve. An example of this is the potential merge of the Labor Department Audit Division, the State Insurance Fund Tax Department, and The Centro de Ingresos de Recaudos Municipales (CRIM), among others.

### **II. Revamping Local Economy (Short Term)**

It is a known fact that economic activity is almost at a stop. Unfortunately, the Government is the biggest player and has accrued an unmanageable outstanding obligation. I would address this in two categories: local obligations and bonds obligations. In order to address these two areas this is what I suggest.

#### **A. Local obligations**

Local government has outstanding obligations in the amount of \$1,500 million.

These are distributed as follows:

1. income tax refunds (\$300 million)
2. Health related service providers (\$500 million)
3. Regular government suppliers (\$700 million)

Current administration has established a trend of not making payments on time, delaying these for several months. This has caused several service and goods providers to file bankruptcy and eventually go out of business. This practice has also caused the costs to the Government to increase since the vendors are forced to factor into the price of the goods the interest charges they incur for the delay on their payments. Furthermore, this causes delinquency in the payment of the local taxes, promoting noncompliance and tax evasion. Even though the payments are delayed, at

the end of the year Treasury issues information tax statements reflecting payments not yet received by the vendors, but are forced to report these amounts on their income tax returns. The way this process has been handled caused the suppliers to lose the respect for the government agencies.

## **B. Recommendation**

Funds should be advanced to the Secretary of HACIENDA to meet these obligations in a short period of time (30/60 days).

These funds should be provided as a short term loan (similar to TRANS-Treasury Anticipation Notes), so that local government meet current short term obligations with local citizens so the economy could be revamped. The Puerto Rico Government must pay back these advanced funds in the least amount of time and must agree to implement a series of changes in the current administrative procedures and to pass local legislation geared towards the support of private industry. Controls must be established to ensure compliance with the agreement. This initiative will bring money back into the economy and have it reactivated. Another benefit is that the Board will have a positive impact among the entire community.

## **III. Restructuring Of The Current Bonds Obligations**

Currently Puerto Rico's debt is at an unpayable amount. Not only the amount of the debt is excessive, but the terms and conditions of these obligations make it impossible for PR to meet these obligations.

The first task of the Control Board should be to resolve the debt situation. In my opinion there is no way that Puerto Rico government would be able to find a solution to this situation without the assistance of the U.S. Treasury Department. The recommendation is to establish a team of experts to evaluate the entire obligation, meet with the bond holders, and reach an agreement by which the agreed amount could be satisfied. Then, the U.S. Treasury will provide a long term loan to PR, which would enable them to solve this issue with a mutually agreed-upon solution so the government would be able to have access to the bond market sometime in the near future. Effective controls must be implemented to ensure that once this agreement is reached, and obligations met, no further obligations are issued unless these be

determined to be essential for the government's operation, and there is repayment ability. The Board must oversee this activity closely.

#### **IV. Federal Legislation To Be Enacted**

Special consideration should be given to provide Puerto Rico residents with similar participation in federal programs as those U.S. citizens who reside in the mainland. This, in addition to providing fair treatment to all citizens, will be a key factor in improving the living standards of Puerto Rico residents and in improving the island's economy.

The full participation of Puerto Rico in these programs will have a positive impact on the quality of life of P.R. residents, and as result, the economy will improve. The programs are as follows:

- A. Medicare Funds Parity**
- B. Earned Income Tax Credit (EITC)**
- C. Child Tax Credit (CTC)**
- D. Energy Credit (ETC)**
- E. Healthcare Plan**

The implementation of the EITC, ETC, and the CTC will provide additional monies to low income families, who are in high need of additional income to meet their basic needs. This in turn will result in expansion of the tax base and additional revenue, not only as result of the individual income, but the indirect taxes the activity will generate for the sales taxes and income taxes of the business that will increase their sales, and, as a result, the payment of taxes. Granted, an effective tax administration agency must be in place to ensure that all taxpayers meet their obligations on a voluntary basis, as it operates in the mainland.

Note: No further explanation is provided in regards to each of these topics, since this matter has been discussed extensively, and the Task Force members have broad knowledge of these topics. However, if additional information is needed, I will provide it upon request.

## **V. Infrastructure**

Adequate infrastructure is a key factor to promote economic activity and motivate investors to engage in new business activity. There are many opportunities for improvement of the current infrastructure. There is an urgent need to improve in many areas, some of which are the following:

### **A. Electric power generation**

Conversion of the biggest power generation plant from oil to gas (FERC approval has been in process for the last six years). Not only will this initiative bring the cost of energy down, but also will prevent the assessment of multimillion dollar fines being proposed by the EPA for environmental noncompliance with federal clean air laws. The initiative will also help improve the living condition of a portion of the residents since air pollution will be reduced significantly.

In addition, special emphasis should be placed on alternate power sources (solar and Eolic).

### **B. Water**

Improving of current reservoirs to ensure adequate water supplies are in optimal operating conditions so that water is not wasted.

Maintenance to the aqueduct and sewer system to reduce the amount of potable water that is wasted to provide adequate water supply to the citizens and industry to facilitate the establishment of additional industries.

### **C. Roads**

Fix main roads to facilitate the transportation of citizens, raw material and finished goods throughout the island.

### **D. Communications**

Provide adequate reliable sources of communication island wide to facilitate the implementation of businesses, industries, and workplaces outside the San Juan metropolitan area.

## **VI. Local Legislation To Be Enacted/ Revised**

**A.** Streamlined process for new business to secure all needed permits to be able to be “open for business” in a short period of time. The current bureaucratic process for a new business to be established requires several unnecessary requirements, which takes an extremely long time to meet, causing startup costs to increase, and most importantly, frustrate the potential investor who in turn, decides to invest in other jurisdictions with more attractive investment opportunities.

**B.** Electronic government

Local legislation (and administrative procedures) revised to allow communication with government agencies by electronic means, expediting the compliance process with the local laws and reduce idle time to a minimum.

**C.** Labor laws should be revised.

**D.** Tax exemption to new business and investors.

**E.** Public insurances of government owned property (i.e., Government should be self-insured). This would result in several millions of dollars saved and better service provided to the citizens.

## **VII. Zero Based Budget**

Traditionally the government’s budget has been based on “last year’s budget”. Many times budgets are approved without taking into consideration the actual needs and resources available. Therefore, the procedures must be changed. Each agency must submit a budget based on their actual needs to meet their basic obligations with the citizens, taking into consideration the current financial situation. This should result in a realistic budget, in accordance with the real projected revenue for the fiscal year, and basic needs would be covered.

## **VIII. Public Employees Retirement System**

One of the biggest challenges we face is the future of the government’s retirement system. There are over 100,000 retirees whose only source of income is their annuity. A specialized work group must be established to provide alternatives to handle this issue. In the

meantime, special consideration should be given to identify additional sources of revenue to make funds available to this system. An example of additional sources of income would be special lottery initiatives, some of which have already been evaluated.

**IX. Centralized Entity To Handle Acquisition Of Goods And Services For The Entire Government**

A centralized entity should be implemented to handle all acquisition of goods and services in excess of a predetermined amount. This would provide transparency to the process and will result in reduced cost in the acquisition of the needed groups.

**X. Coordination With Federal Government Agencies**

Effective coordination with federal agencies to improve efficiency government wide and to ensure that federal grant monies are properly utilized. This would result in better services to the citizens and more transparency.

**XI. Education Department**

- A.** Complete review of the allocation of resources based on student's location and needs. Special consideration should be given to redistribution of students consistent to the current population. Buildings determined not to be needed should be dedicated to other uses. This will reduce the annual operating costs.
- B.** Due to the number of federal funds received by the Education Department, coordination should be improved between the Treasury and Education Department to ensure adequate use of funds and improved services to the students.
- C.** Another alternative would be to enter into an agreement with the municipalities so they administer the schools within their districts, and the Centralized Education Department deals only with the determination of the educational philosophy, policies, and procedures.

**XII. Government Owned Property**

There are several properties in the island which are not being properly utilized. A survey should be conducted to identify these properties, make an evaluation to determine its best

potential use, and transfer to other entities or private citizens who could turn these into productive properties.

### **XIII. Agriculture**

- A.** Identify the hundreds of acres of unproductive land which is not being used and make it available to private farmers to increase production of farm products to reduce imports and create jobs.
- B.** Review farmers aid programs to ensure adequate use of available resources in a simplified and expedited manner.

### **Conclusion**

I hope the Task Force can use my submission as a basis for action. The task force is in a unique position to reform Puerto Rico's tax administration and without improvement in revenue collection Puerto Rico will not be able to stand on its own two feet.

The infrastructure situation in Puerto Rico is appalling. Immediate investment is needed equally to jump start the economy by creating jobs and to bring island residents up to American standards. Investment in infrastructure cannot wait even for the resolution of the debt situation, meaning that the funds for the U.S. Treasury must be the source of those funds.

The Task Force should accept the responsibility of leveling the playing field. Why should a U.S citizen in Salt Lake City be treated differently from a U.S. citizen in Ponce? Legislation for leveling the playing field will take time. Including Puerto Rico in the Earned Income Tax Credit and Child Care Tax credit, an amendment to existing legislation, would provide an immediate stimulus to the economy.

The Task Force should provide the map for growth and build some of the turnpikes. The control board should take charge to supervise the implementation. I personally would welcome the opportunity to participate in the vital process.

**B. Submission to the Bipartisan Congressional Task Force on Economic Growth in Puerto Rico**

**By  
James I. Owens, document 1,**

The economic recovery of Puerto Rico requires it to have an efficient, effective tax administration with high integrity. Addressing the problems in the Internal Revenue should be a major plank in the recovery program.

The tax administration problems cannot be addressed under the political environment in Puerto Rico. The Secretary of Treasury, without regard to party affiliation, does not want to make the Internal Revenue a separate agency because they lose staffing, power, status and recognition. Furthermore, implementation in Puerto Rico Internal Revenue is a major problem. The only way it can be changed is if it is required under the umbrella of the Task Force on Economic Growth. With this change and addressing the problems outlined here, given some time, compliance and revenue would increase significantly. If not, there will be a continued high rate of noncompliance.

**The Problems**

1. Experience shows that when some improvements are made by one administration they have been reversed or canceled when a new administration comes into office. This is particular true when a new party comes into office. *There is no continuity of programs.*
2. Generally, the Secretary of Treasury stays only a few years. When a new Secretary is appointed that usually results in a change in the Assistant Secretary and some changes to the Bureau Heads who report to the Assistant Secretary of Internal Revenue. Generally, only persons of the “in political party” are hired as managers and advisors. *There is no long term continuity of management of the Internal Revenue.*
3. The typical Assistant Sectary of Internal Revenue has been young attorneys or accountants that are very bright, intelligent and know the tax laws. Some have told me they expected to devote their time to interpreting the law, writing regulations, etc. The

major responsibility of the Assistant Secretary of Internal Revenue is to manage. However, *they have almost no management experience and this is a very big problem.*

4. The Internal Revenue is generally identified by the public as Hacienda or Treasury. They do not generally speak of the Internal Revenue. This is because the Internal Revenue is so embedded in Hacienda it does not have its own organization identity. Contributing to this the Internal Revenue Headquarters is located in the Hacienda building. So, when taxpayers visit Internal Revenue they many times come to the Hacienda. This makes the organization less accountable since the Secretary of Treasury usually is the spoke person for Internal Revenue and not the Assistant Secretary of Internal Revenue. *So, lack of transparency and accountability is a problem.*
5. There is *insufficient attention given to the development of compliance programs* such as auditing, collection, taxpayer service and the processing of returns. Continued emphasis on these programs is a necessity if there is to be any increase in compliance and revenue.
6. *Lack of staffing and training is a problem.* The Revenue Department has been understaffed for years. And, they continue to lose the most experienced personnel through retirement. The managers need to be trained along with the technical and clerical staff. These must be addressed in order to increase compliance.
7. *Implementation has always been a major problem.* This can only be properly addressed by creating the independent agency with proper funding.

**Recommendation:** create a separate agency for the Internal Revenue headed by a Commissioner of Internal Revenue. The Commissioner would be appointed by the Governor and confirmed by the Senate following the customary practice of confirming other cabinet positions. The Commissioner could serve at the pleasure of the Governor or the appointment could be for a specific number of years. The preferred choice is to have the Commissioner appointed for a specific time. This would make the organization less political since the Governor or Secretary of Treasury would not have the authority to remove and replace the Commissioner. The agency would be responsible for developing its own budget.

## **Puerto Rico Tax Administration:**

### **Improving Transparency, Independence, Accountability, Compliance and Less Political<sup>1</sup>**

There are currently some 10-12 Assistant Secretaries in the Hacienda. The Assistant Secretary, Internal Revenue is responsible for providing taxpayer assistance, processing all tax returns, receiving and depositing payments and enforcing all Puerto Rican tax laws with the exception of criminal investigation of tax crimes. The Secretary of the Treasury is appointed by the Governor and the Secretary appoints the Assistant Secretaries. So, when a Secretary of Treasury resigns or there is a change in the administration there is a change in Assistant Secretary, Internal Revenue. And, in many cases there is a change in the Internal Revenue Bureau Heads. A modern tax administration requires a long term strategy to increase voluntary compliance. This is done by developing efficient and effective taxpayer assistance and enforcement programs with the use of technology and continuity in leadership and management. The continuity of “executive leadership” is fundamental and essential to sustaining tax administration reform momentum.

Changing the title, rank or level of a position is a very effective change management tool. The elevation of a position sends a clear message to all employees and to the public that structural changes are occurring within the organization and the future organizational performance will be different. This is especially important when modernizing a tax organization to improve the efficiency and effectiveness and thereby increase voluntary compliance and revenue.

The Internal Revenue represents the majority of the authorized staffing in the Department of the Treasury; every year it receives, collects and accounts for the vast majority of the revenue that is received by the government; the Internal Revenue has more contact and more communication with the citizens of Puerto Rico than any other department within government; and it has more offices than any single government department. Given these facts the Internal Revenue should have a higher status and be more visible and accountable for the actions and services it provides the citizens.

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<sup>1</sup> Submission to the Bipartisan Congressional Task Force on Economic Growth in Puerto Rico  
By James I. Owens, document 2,  
International Tax Consultant  
August 29, 2016

The Internal Revenue is currently such an integral part of Treasury it is not independently accountable to the administration, the public or the legislature. Currently, the Assistant Secretary Internal Revenue does not have a separate annual budget. So, it is very difficult to identify the cost of administering the tax laws and there is little or no direct accountability to the legislature regarding their expenditures, programs or collections.

**Recommendation:** create a separate agency for the Internal Revenue headed by a Commissioner of Internal Revenue. The Commissioner would be appointed by the Governor and confirmed by the Senate following the customary practice of confirming other cabinet positions. The Commissioner could serve at the pleasure of the Governor or the appointment could be for a specific number of years. The preferred choice is to have the Commissioner appointed for a specific time. This would make the organization less political since the Governor or Secretary of Treasury would not have the authority to remove and replace the Commissioner. The agency would be responsible for developing its own budget.

There are many advantages to creating a separate tax administration agency. Some of the most important are:

- The Commissioner, Internal Revenue would be independently responsible and accountable for administering the tax laws fairly and uniformly while preserving the rights of all taxpayers.
- The Commissioner would be required to formulate an annual budget and support and defend the request publicly before the legislature each year; public debate will make the organization more transparent and accountable.
- The public and the legislature can more easily determine the cost of the administering the tax laws. The current organizational arrangement makes it almost impossible to determine the cost of administering the tax laws.
- Each year the legislature would have an opportunity to question the viability of various compliance programs administered by the agency and independently make some judgment on the cost of the programs as compared to the benefits.

- A single agency would be easily identifiable by the public and citizens of Puerto Rico as a single organization responsible for administering the tax laws; more visibility means greater opportunities to educate taxpayers of their responsibilities and increase compliance with the tax laws.
- The Governor could appoint someone to fill the position and the person would serve at the pleasure of the Governor; or, the preferred method would to appoint someone to fill the position for a specific period of time. There is a real advantage of having a fixed term. It removes the Commissioner one step further from the political environment which is good for tax administration. Tax administration must be non-political with the highest degree of integrity.
- Creating a separate agency would also separate tax administration from tax policy; under this arrangement the Commissioner would be responsible for all tax administration and the Secretary of the Treasury would be responsible for all tax policy.
- Emphasis placed on strengthen revenue administration, management, and focusing on agency vision, mission, and objectives.

The Puerto Rico government has on many occasions enacted legislation that is overly complicated and impossible for the tax administration to implement. The Task Force should make sure that Puerto Rico does not enact policies that does not work and cannot be administer by Internal Revenue given their current level of staffing and training.

The attached Document IIA is one example of this issue. The government enacted a Value Added Tax (VAT) that was unnecessary and too complicated for the Internal Revenue to administer. Treasury insisted that the VAT would bring in a significant amount of revenue but many people insisted it would not. The revenue increase did not materialize.

All the literature and experience in other countries clearly indicate to implement a VAT requires two to three years. Where VAT has been successfully implement in various countries it has been implement over years not months. The Puerto Rico Treasury insisted the VAT be

implemented in months. The results were a failure and ultimately the legislation was changed to eliminate the VAT.

Recommendation: The Task Force should insist that any tax legislation be simple, easy to administer and provide sufficient lead time to implement and educate the public.

**Puerto Rico Value Added Tax (VAT):  
High Risk, Increased Cost to Businesses and Tax Administration, No Real Benefits**

**The Current Scenario**

The Government of Puerto Rico desperately needs revenue and is considering the Value Added Tax as the path to increasing said revenues. However, the Puerto Rican Treasury, Hacienda, does not have the capacity to administer a VAT. Even under the best of circumstances a transition to a VAT is complex, and the Puerto Rican economy presents anything but the best of circumstances. The risks implicit in a VAT are enormous and the transaction costs it places upon the business community are significant.

Puerto Rico cannot afford trying the VAT, a voodoo approach at best. Puerto Rico needs to focus its tax system on simplicity and compliance if its goal is raising revenue.

**Background**

Debate has persisted over the last decade relating to enacting and implementing a VAT. When it was decided that the previous excise tax, really an import tax, required reform, there was the debate whether to replace it with a retail sales tax or a VAT. Attached find a consultant's report from May 2003, *Replacing the Current "Puerto Rican Excise Tax": The Retail Sales Tax vs. the Value Added Tax*, which provides a thorough discussion of this topic. The authors, Mssrs. Conrad, Hexner, Lubick and Owens, were asked to assess the Puerto Rican tax system and in case of reform focus on the choice between a Retail Sales Tax and VAT as the most appropriate consumption tax for Puerto Rico.

Currently, replacing the Retail Sales Tax with a VAT is again under discussion. There is a firm belief by several who have recommended a VAT that it is a self-policing tax that will result in an increase in revenue. Government officials have indicated through the press that

implementing a VAT in Puerto Rico would double the revenue now collected under the sales tax.

The stated rationale for moving to a VAT is centered on the perception that the current indirect tax system in Puerto Rico had become too complex, resulting in tax collections below original estimates. Puerto Rico believes a VAT system monitors itself, unlike the current sales tax scheme (IVU) which relies on the consumer for oversight. According to early government estimates, a VAT would double current sales tax collections. Based on these estimates, the government is planning on including as part of the reform, an increase in the personal income tax exemption for single and married citizen, effectively removing the requirement for 82% of Puerto Rico residents to file income tax returns.

This is misleading, as the VAT and Retail Sales Tax should produce the same revenue (assuming the rate is the same). One must take into account the status of Puerto Rico, its capability to administer a VAT and its cost and risks, because VAT is not in fact a self-policing tax.

Tax Administration in Puerto Rico is underfunded, understaffed, not fully trained and with few well-developed enforcement programs. The result: compliance is not high. Implementing a VAT increases the need for more funding for the Tax Administration and results in an unnecessary increase in the cost to the business community.

### **Current Status**

Sales tax Laws 40 and 117 of 2013 and Laws 18, 19 and 80 of 2014 made significant changes in the way the sales tax is administered. Sales tax now applies at all stages of the commercial chain. It is paid by the importer, the wholesaler, the distributor and finally the retailer. Puerto Rico has implemented regulations allowing businesses that purchase items for resale to deduct the tax paid on purchases from the tax due on sales. However, the taxpayer can only offset up to seventy-five percent (75%) of the tax due each month. Unused credits are carried forward to the next month. The recent changes make the law overly complicated and put a greater burden on the businesses and the Puerto Rico Tax Administration.

## VAT and Revenue Risks

There is no doubt Puerto Rico needs additional revenue to fund the government's increasing needs. However, implementing a VAT would not guarantee more revenue. To the contrary, there is a very high risk that revenue will decrease and false refund credits will be claimed.

In *Replacing the Current "Puerto Rican Excise Tax": The Retail Sales Tax vs. the Value Added Tax*, Conrad, et al. discuss in detail the plentiful complications of implementing a VAT:

Refunds and fraudulent credit and refund claims are also a difficulty with a VAT. VAT is refundable or creditable on all exports, since consumption will take place outside Puerto Rico. This places a burden on companies located in Puerto Rico for processing imported goods for re-export. For a large percentage of the Puerto Rican economy, imported goods are re-exported, meaning that taxes would be imposed upon import, and refunds granted upon export, which amounts to wheel-spinning. To avoid an overwhelming administrative burden on processing clearly inevitable refunds and claims, much of the manufacturing sector should be exempted from the VAT. That would mean a complicated system for many fewer intermediaries before the retail level, making the VAT closer to application primarily as a retail sales tax in impact but without the simplicity of administration.<sup>2</sup>

Will Hacienda make refunds without first auditing the return? If so, they will issue erroneous refunds. If they audit all the returns before making the refund it will delay refunds. Thus, the tax administration auditors will devote a significant amount of time auditing VAT refund claims rather than auditing income tax and business returns.

The sales tax rules limit the offset to 75% of the tax due each month. Unused credits are carried forward to the next month. If a similar rule is followed with the implementation of a VAT it continues to increase the cost of business by requiring them to finance more of the government. A VAT will not be acceptable to the business community if refunds are not made to the taxpayers in a timely manner.

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<sup>2</sup> Conrad, *Replacing the Current "Puerto Rican Excise Tax": The Retail Sales Tax vs. The Value Added Tax*, 5.

Experience has shown that it takes about eighteen (18) months to implement a VAT. The various steps and time table are outlined in the chapter “Chronological Schedule of Work to Be Done to Introduce a VAT in About Eighteen Months” in Alan A. Tait’s seminal book *Value Added Tax: International Practice and Problems*.<sup>3</sup>

There is an easy and simple way to raise more revenue without the complications of implementing a VAT. Increase the sales tax rate. This will minimize the burden on the business community and tax administration and can be effectively implemented in a very short time: in fact, weeks.

### **VAT Compliance and Cost**

Compliance with the tax laws has been a continuing problem in Puerto Rico which results in a loss of revenue. Those who recommend VAT must understand tax administration in Puerto Rico continues to decline because of insufficient human and capital resources and a continued strong enforcement and taxpayer education program. This is unlikely to change because of the budget constraints.

The recent change in the Sales Tax Law requires significant changes in the administration of the law. New procedures, the increased number of taxpayers, procedures to track the use of credits claimed, etc. This requires additional training for administrative and technical staff. Enacting a VAT would exacerbate the current situation and increase cost to the government and businesses

A VAT requires a well-trained technical staff and a fully developed and implemented audit and collection strategy. Where VAT has been implemented without this there has been and continues to be major problems with taxpayers claiming refunds and fraudulent credits. Since Puerto Rico does not have sufficient resources this would be a major problem if a VAT is implemented.

Tait goes further: To estimate VAT compliance costs needs an evaluation of the size and costs of the resources committed to VAT work within the business. This includes the wages and

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<sup>3</sup> Alan A. Tait, *Value Added Tax: International Practice and Problems* (New York: IMF, 1988), Appendix II, 409.

salaries and fringe benefits of full- and part-time workers involved with the tax, including accounting, clerical, and sales staff. The overhead costs ... of the employees should also be costed, as should computer hardware, software, time, other equipment and supplies, and any outside advice contracted. Of course, the real cost of all this is what these people and productive capacity could have earned the company had they not been dealing with VAT.<sup>4</sup>

In *Replacing the Current “Puerto Rican Excise Tax”: The Retail Sales Tax vs. the Value Added Tax* Conrad, et al consider Tait’s assertions further,

Tait’s seminal work discusses the complications of the VAT in compliance and administration. In this report it is not necessary to list them in elaborate detail. Suffice it to say that VAT requires novel and not currently maintained record keeping that is substantial. Tait concludes at p. 39: “The principal costs of administering a single rate VAT are the same whatever the rate chosen; given the widely perceived high costs of administration and compliance (see Chapters 12 and 16) it might be considered a poor allocation of resources to levy a VAT at a low rate. *For most countries, a VAT is probably not worth introducing at less than 10 percent.* [Emphasis added]”<sup>5</sup>

VAT rates vary throughout the world with most countries having a rate in the 13-16 per cent range. The cost to administer a VAT is basically the same regardless of the rate. However, if there is not an effective and efficient administration it may have adverse effects on the business community. For example, if valid refunds are not paid timely, the higher the rate, the more it reduces the cash flow for a business. A new business that purchases an inventory would pay the tax but have few sales to offset the tax and would be due a refund. A delay in refunds adds a hidden cost to businesses.

The public and the businesses understand sales tax. VAT is a new concept that the business community and the public do not necessarily understand. A VAT would impose additional cost and burdens on the business community and the Hacienda administration, including a

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<sup>4</sup> Tait, *Value Added Tax: International Practice and Problems*, 351.

<sup>5</sup> Conrad, *Replacing the Current “Puerto Rican Excise Tax”: The Retail Sales Tax vs. the Value Added Tax*, 4.

major public education program that would take several months and require funding and staffing that is not available.

### **United Parcel Service, Inc. et al., v. Honorable Juan Antonio Flores-Galarza: Yet another Complication**

The government has taken several administrative steps to collect tax due on goods arriving via air cargo such as Federal Express (FedEx), United Parcel Service (UPS), United States Postal Service (USPS), etc. None of these steps have been successful. UPS looked to the courts to prevent Hacienda from enforcing the administrative rules requiring, among other things, that UPS pay the tax before delivery or collect the tax from the recipient before delivering the goods. In May 2002 the court granted summary judgment in favor of UPS thereby preventing Hacienda from requiring UPS to pay or collect the tax. This means the Hacienda must rely on the recipient to pay the sales or VAT tax. However, Hacienda does not know the name of the recipient or the value of the goods. So, based on the UPS case, payment of the tax on goods arriving via air cargo is strictly voluntary. The results are very little, if any tax will be paid on goods arriving in Puerto Rico via air. Of course, the higher the rate the more incentive there is to bring goods in by air.

### **Capacity of Hacienda**

The Hacienda has endured a significant reduction in human resources and capital expenditures during the budget crises in Puerto Rico. The result is:

- Insufficient staffing to audit returns
- Insufficient staffing to collect delinquent accounts
- Lack of skilled auditors and collectors
- Lack of enforcement programs and follow up
- Lack of staff for taxpayer service programs
- Delayed or eliminated technical training
- No integrated data base for all types of tax and taxpayers (i.e., Information Technology)
- No capacity for the Hacienda to assume new responsibilities

It generally takes about two years to train a new auditor or collector so they understand the law, report writing, procedures and audit and interview techniques. So approval of additional technical staffing would not solve any of the above issues for at least one to two years.

Each of these points is a major issue. Those that recommend a VAT need to understand simplicity is needed in the tax law. A VAT adds significant complexity for the businesses and tax administration. Without substantial improvements in the tax administration it is very unlikely there will be any increase in revenue. More likely revenue will decline, assuming the same tax rate.

## **Conclusion**

Administering a Retail Sales Tax is much simpler and requires fewer resources for the tax administration than administering a VAT. The Puerto Rico sales tax is a specific rate payable at each level of transaction where purchasers are allowed to deduct the tax paid on purchases from the tax due on sales. A VAT is very different.

First, a VAT allows the taxpayer to take credit for the VAT paid on imports and the amount of the credit is different for each taxpayer and transaction. So, it is more difficult for the tax administration to determine if the credits claimed are correct and more records have to be maintained by the businesses.

Second, a VAT will involve refunds and fraudulent credits. Fraudulent credits are always a problem to be reckoned with. However, at the same time valid refund claims must be paid in a timely manner by the government.

Third, there will have to be exemptions. This adds complexity, but if there are no exemptions there will be wheel spinning by many manufacturers, particularly the pharmaceutical companies who might well consider the VAT a cost not worth bearing and leave Puerto Rico.

Fourth, the Hacienda simply does not currently have, and will not have in the near future, the capacity to follow-up, administer and enforce a VAT.

Fifth, VAT experts estimate that the transaction and administrative cost of a VAT are such that it is only worthwhile at a 10% rate. This is the minimum rate. It is likely to be higher for Puerto Rico due to the need for revenue, lack of border controls, lack of enforcement, goods shipped by air cargo and insignificant staff to administer the VAT.

Finally, it is argued that there are basically two administrative benefits to a VAT. They both relate to the multi-stage collection of the tax. The benefits are: 1) the government gets its revenue earlier than the final retail sale; 2) if there is noncompliance at any stage in the chain the government gets some of the revenue, if we assume the business who did not pay does not claim a credit for the tax.

However, the Puerto Rico Sales Tax is now a multi-stage tax and sales tax is due and payable at each stage of the commercial chain the same as a VAT. So there is no administrative benefit to be gained by implementing a VAT. Implementing a VAT only adds complexity and cost to the administration and businesses.

## **Recommendation**

There is cost, complexity and added difficulty in administering a VAT and no real benefit. The manufacturers, businesses and government need to thoroughly understand this before moving forward to implement a VAT. Puerto Ricans understand Sales Tax. VAT is a totally new concept.

Given the current level of tax administration in Puerto Rico and the added complexity and cost to businesses Puerto Rico should continue with the Sales Tax and not implement a VAT.

Increased revenue can be accomplished by improving tax administration and enforcement programs or by raising the current rate of the sales tax. Increasing the rate could indeed have some adverse economic effects. However, raising the sales tax rate would be quick and simple and could be implemented almost immediately.