

DESCRIPTION OF TAX PROVISIONS OF S. 2237  
THE CARIBBEAN BASIN ECONOMIC RECOVERY ACT

SCHEDULED FOR A HEARING

Before the

COMMITTEE ON FINANCE

ON AUGUST 2, 1982

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By the Staff of the

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## INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on August 2, 1982, on S. 2237, the Caribbean Basin Economic Recovery Act of 1982 (introduced by Senators Dole, Percy, and Danforth). This bill embodies the Administration's Caribbean Basin Initiative, and would provide economic benefits to certain Caribbean Basin countries through direct foreign aid grants, through trade assistance (including discretionary tariff reductions), and through tax investment incentives. The bill would also extend certain tax investment incentives to effectively tax-exempt persons investing in Puerto Rico, the U. S. Virgin Islands, and the other U. S. possessions.

This document, prepared in connection with the hearing on S. 2237, contains a description of the tax provisions of the bill (Title III). This document does not describe the trade assistance provisions, including discretionary tariff reductions (in Title I), or the direct foreign aid grants (in Title II).

The first part of the document is a summary of the bill's tax provisions. The second part is a more detailed description of those provisions, including present law, issues, and effective dates. The third part presents estimates of the revenue effects of those provisions.

In the House, Mr. Michel, for himself and others, introduced an identical bill, H.R. 5900. The Subcommittee on Trade of the Committee on Ways and Means held hearings on H.R. 5900 on March 17, 23, 24, and 25, 1982. The Subcommittee has reported certain portions of the bill, but did not have jurisdiction to report Title III.



## I. SUMMARY OF THE BILL'S TAX PROVISIONS

Under present law, the investment tax credit and the Accelerated Cost Recovery System (ACRS) of writing off capital investment are generally available only for certain tangible depreciable property used predominantly in the United States. The bill would extend the benefits of the investment tax credit to investment in qualifying Caribbean Basin countries (certain countries that the President designates and that agree to exchange tax information with the United States). These benefits could pass through to U.S. shareholders of certain investing foreign corporations.

In addition, the bill would generally extend the benefits of the investment tax credit and one-half of ACRS to investment in U.S. possessions by certain U.S. corporations that are effectively exempt from U.S. tax. These benefits would pass through to certain U.S. shareholders. None of the bill's tax investment incentives could be the subject of a safe-harbor lease.

The bill also would generally allocate U.S. excise taxes on all rum imported into the United States to Puerto Rico and the U.S. Virgin Islands.

## II. DESCRIPTION OF TAX PROVISIONS OF S. 2237 (The Caribbean Basin Economic Recovery Act)

### A. Present Law

#### 1. Rum excise taxes

The Internal Revenue Code imposes an excise tax on rum. Taxes collected under the Internal Revenue Code on rum produced in Puerto Rico or the U.S. Virgin Islands and transported to the United States (less the estimated amount necessary for payment of refunds and drawbacks) are paid to Puerto Rico or the Virgin Islands, respectively. Rum produced in Puerto Rico and the U.S. Virgin Islands enters the United States duty free.

#### 2. Investment tax credit

For certain tangible depreciable property with a useful life of three years or more, taxpayers can claim, in addition to depreciation deductions, an investment tax credit that can consist of several elements. The regular investment credit can amount to as



much as ten percent of the cost of the property. An additional investment credit of up to one and one-half percent (ESOP credit) is available if certain requirements concerning the operation of an employee stock ownership plan are met. An energy investment credit is available in addition to the regular and ESOP credits for certain energy property. With specific exceptions, buildings and their structural components do not qualify for these credits.

Property used predominantly outside the United States generally is not eligible for the tax benefits of the investment tax credit or the Accelerated Cost Recovery System (ACRS). Existing Treasury Regulations define predominant use outside the United States to mean physical location outside the United States for over one-half of the taxable year.

The investment credit is available only to the person that places the property in service (or, in certain cases, to persons who contract with that person). Corporate shareholders generally cannot take an investment credit for the investments of their corporation.

If a taxpayer makes an early disposition of property for which he took an investment credit, part of the credit is recaptured. Recapture also occurs if the taxpayer uses the property for which he took a credit predominantly outside the United States in any taxable year prior to the end of the recapture period.

### 3. Unapproved treaty credits

As explained above, the investment tax credit is generally not allowed for property used abroad.

In the 1960's, income tax treaties were signed with three countries, Brazil, Israel, and Thailand, that included limited extensions of the U.S. investment tax credit to certain investments in those countries. The Senate did not approve any of these extensions of the credit. The Senate reserved on the Brazilian credit after the Foreign Relations Committee urged postponement of consideration of a credit for foreign investment "until such time as the United States is able to put its political and economic houses in order. And the Committee wishes to make it clear that until that time arrives, it does not expect to give sympathetic consideration to any proposal designed to allow a tax credit for overseas investments by United States citizens."

Under the proposed treaty provisions, the investment tax credit would have been targeted so as to be available only for property used in certain businesses. The Brazilian treaty, for example, would have allowed the credit only for investments in "a qualified trade or business" in Brazil, which meant an activity using at least 80 percent of its assets in and deriving at least 80 percent of its gross income from a list of specific trades and business.





The rejected Brazilian treaty explicitly conditioned the credit on exclusive use of the property in Brazil. Moreover, the credit under each of the proposed treaties could not exceed the amount of U.S. property that the company acquired during the current year and the preceding year.

4. Possessions system of taxation

Certain U.S. corporations that do business primarily in Puerto Rico, the U.S. Virgin Islands, and the other U.S. possessions are effectively exempt from U.S. taxation on certain income (secs. 934 and 936). The Senate-passed version of H.R. 4961, the Tax Equity and Fiscal Responsibility Act of 1982, would restrict this effective exemption as it applies to passive investment income and to income from intangibles. Individual residents of the possessions are also generally exempt from U.S. taxation (secs. 931, 932, 933 and 934).

Property used predominantly in Puerto Rico, the U.S. Virgin Islands, or the other U.S. possessions is eligible for the investment tax credit and ACRS if the taxpayer does not qualify for the special tax rules for the possessions described above (secs. 931, 932, 933 and 936).

5. Safe-harbor leasing

Under the Economic Recovery Tax Act of 1981, a person who has acquired and will use certain tangible personal property can, in effect, sell some of the tax benefits associated with the property to another person, while the seller retains all the other benefits and burdens of ownership. These tax benefits include the investment tax credit and ACRS deductions.

6. Deferral

In general, income earned by a foreign corporation owned wholly or partially by U.S. shareholders is not subject to U.S. taxation until the U.S. shareholders receive that income in the form of dividends. This treatment is generally known as "deferral" of tax on foreign income. The shareholders of these corporations do not get the benefits of rapid cost recovery, an investment tax credit, or other tax benefits.

B. Issues

1. Should Congress use the revenue laws to encourage overseas investment by U.S. companies?
2. Is it appropriate to give tax credits for foreign investment that will yield income that may benefit from tax deferral or even (because of foreign tax credits) effective tax exemption?



3. Should Congress grant a credit when foreign multinational corporations use U.S. subsidiaries to invest in the Caribbean Basin instead of investing directly?
4. Should Congress give a credit for all investment in a designated country or should it target a credit at certain industries to avoid runaway plants or to encourage only certain activities?
5. Should foreign investment benefit from the ESOP credit and the energy credit?
6. Should the investment credit and ACRS provisions be extended to investment in Puerto Rico and other possessions by corporations effectively exempt from tax?
7. Should revenues attributable to excise taxes on rum from all countries be paid to Puerto Rico and the Virgin Islands?

C. Explanation of Tax Provisions

1. Rum excise taxes

All excise taxes collected at the current tax rates on rum imported into the United States from any country (less the estimated amount necessary for payment of refunds and drawbacks) would be paid over to the treasuries of Puerto Rico and the U.S. Virgin Islands. The amount per proof gallon paid over could not exceed the amount per proof gallon which would have been paid over if the rum had been produced in Puerto Rico or the U.S. Virgin Islands. The Secretary of the Treasury would prescribe by regulations a formula for the division of these tax collections between Puerto Rico and the U.S. Virgin Islands.

2. Extension of the investment tax credit to qualifying Caribbean Basin countries

In general

The bill would extend the investment tax credit to certain investments in property used predominantly in qualifying Caribbean Basin countries. The credit would generally be available for investments in property eligible (except for its location) under present law for the credit. The credit would be available only for property placed in service during the five-year period beginning after the date of enactment.

If during a taxable year the Caribbean Basin property for which a taxpayer took the investment credit were used predominantly outside one or more qualifying Caribbean Basin countries or the United States, the credit would be subject to the general investment credit recapture rules. However, recapture would not occur solely because the country in which the property is used ceases to be a qualifying country



(because the President terminates the designation or because of termination of an exchange of information agreement).

For the purpose of depreciation deductions, the bill would treat Caribbean Basin property as property used outside the United States. Therefore, use of Caribbean Basin property would not entitle the taxpayer to the benefits of the Accelerated Cost Recovery System.

#### Qualifying Caribbean Basin country

The bill would apply only to property used predominantly in a qualifying Caribbean Basin country. Qualifying countries are those among certain enumerated countries and territories 2/ located in the

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2/ The countries and territories are: Anguilla, Antigua and Barbuda, the Bahamas, Barbados, Belize, Costa Rica, Cuba, Dominica, the Dominican Republic, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Nicaragua, Panama, Saint Lucia, Saint Vincent and the Grenadines, Surinam, Trinidad and Tobago, the Cayman Islands, Montserrat, the Netherlands Antilles, Saint Christopher-Nevis, Turks and Caicos Islands, and the British Virgin Islands. The bill defines country to include overseas dependent territories and possessions. Successor political entities of the enumerated countries and territories would be eligible for the benefits of the bill.

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Caribbean and Central America that (1) the President designates as beneficiaries of the bill, and (2) that become parties to bilateral executive agreements with the United States providing for the exchange of tax information between the United States and the other country.

In determining whether to designate any country a beneficiary country under this Act, the President is to take into account a variety of factors, including an expression by the country of its desire to be so designated, the economic conditions in the country, the living standards of its inhabitants and any other economic factors that he deems appropriate, and the degree to which the country follows certain accepted rules of international trade. No one of these factors alone, however, is sufficient to require or to prevent designation. Before the President designates any country as a beneficiary country for purposes of the bill, he must notify the House of Representatives and the Senate of his intention to make the designation, together with the considerations entering into his decision.



Notwithstanding these factors, the bill provides four kinds of countries that the President generally cannot designate as beneficiary countries: Communist countries, countries that seize property of U.S. persons, countries that refuse to honor certain international arbitral awards, and countries that favor products of other developed countries over U.S. products.

The President may terminate designation of a country as a beneficiary country, but only if at least sixty days before such termination, he has notified the House of Representatives and the Senate and has notified such country of his intention to terminate such designation, together with the considerations entering into such decision. The President must terminate an existing designation (after complying with the notification requirements above) if he determines that, because of changed circumstances, a country is no longer eligible for beneficiary country status.

#### Exchange of information agreement

In order to qualify for the tax benefits provided by the bill, the bill requires not only presidential designation of the country but also an agreement providing for the exchange of tax information with the United States.

The bill authorizes the Secretary or his delegate to negotiate and conclude an agreement for the exchange of information with any beneficiary country. An exchange of information agreement is to provide for the exchange of such information, not limited to information concerning nationals or residents of the United States or the beneficiary country, as may be necessary and appropriate to carry out and enforce the tax laws of the United States and the beneficiary country, including information which may otherwise be subject to non-disclosure provisions of the local law of the beneficiary country such as provisions respecting bank secrecy and bearer shares. The exchange of information agreement is to be terminable by either country on reasonable notice and is to provide that information received by either country will be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or determination of appeals in respect of taxes of the United States or the beneficiary country. An exchange of information agreement will generally become effective on signature. The text of the agreement must be transmitted to Congress not later than sixty days after signature under the Case Act (1 U.S.C. section 112(b)).

#### Pass-through to U.S. shareholders

The investment credit would be available for property used by a branch of a U.S. corporation. The bill would not, however, directly permit the credit for property used by a foreign corporation. To





create an investment incentive for investors who use a foreign corporation, however, the bill would deem a pro rata share of the otherwise available investment credit to be attributable to U.S. shareholders who own 5 percent or more of a foreign corporation that invests in qualifying Caribbean Basin property.

This "pass-through" of the credit to U.S. shareholders would be limited, however. The credit passed through to a U.S. shareholder could not exceed the shareholder's post-enactment net additional equity investment in the foreign corporation. Reinvested retained earnings of the foreign corporation thus would not qualify as additional investment. This rule would prevent allowance of the investment credit for the reinvestment of earnings that are free of U.S. tax until such earnings are repatriated in the form of dividends (and then subject to U.S. tax).

The bill would require the Secretary to prescribe regulations relating to the pass-through of the credit. Such regulations are to include at-risk rules and recapture rules similar to those now in effect for subchapter S corporations (such as the rule requiring recapture when a shareholder who took a credit disposes of subchapter S stock).

### 3. Investment Incentive Provisions Relating to U.S. Possessions

The bill would generally extend the investment tax credit and the Accelerated Cost Recovery System to property used by section 936 companies and other effectively tax-exempt persons in Puerto Rico and the other possessions. Because U.S. corporations (including section 936 companies) operating in Puerto Rico, the U.S. Virgin Islands, and the other possessions that are effectively free of U.S. tax would be unable to use these tax benefits, the bill would provide for a pass-through of the investment tax credit and fifty percent of the cost recovery deductions attributable to property owned by such corporations to certain corporations that together own 80 percent or more of the stock of such effectively tax-exempt corporations. Thus, a U.S. corporation that is a member of an affiliated group that includes the effectively tax-exempt corporation (but for special rules excluding the effectively tax-exempt corporation from an affiliated group) would be allowed the investment tax credit and fifty percent of the ACRS deductions attributable to the investment of the effectively tax-exempt corporation.



4. Safe-harbor Leasing

The bill would prevent the safe harbor leasing (under section 168(f)(8)) of tax benefits from extension of the investment tax credit to Caribbean Basin property or from extension of the investment tax credit and ACRS to the possessions.

D. Effective date

The extension of the investment tax credit to qualifying Caribbean Basin property would apply to property placed in service after the date of enactment. Property placed in service 5 years after the date of enactment (or thereafter) would not be eligible for the credit.



III. ESTIMATE OF REVENUE EFFECT

Proposal	Fiscal Year (In millions of dollars)					
	<u>1982</u> <sup>2/</sup>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
1. Payment of excise taxes collected on rum to Puerto Rico and U.S. Virgin Islands	-0	-20	-20	-24	-27	-33
2. Extension of ITC to Caribbean <sup>1/</sup> Basin property	-0	-25	-52	-56	-61	-55 <sup>3/</sup>
3. Extension of ITC and ACRS to persons engaged in trade or business in Puerto Rico or possessions.	<u>-8</u>	<u>-30</u>	<u>-56</u>	<u>-83</u>	<u>-113</u>	<u>-147</u>
Total revenue effect	-8	-75	-128	-163	-206	-235

Estimate based on Treasury Department estimate for 1980. The forecast assumes 8 percent annual growth.

<sup>2/</sup> Assumes effective as of October 1, 1982.

<sup>3/</sup> Assumes expiration date of October 1, 1987.

