The Operation and Effect of the Possessions Corporation System of Taxation

First Annual Report

Department of the Treasury
June 1978

The Operation and Effect of the Possessions Corporation System of Taxation

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U.S. Department of the Treasury.
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THE SECRETARY OF THE TREASURY
WASHINGTON

JUN 29 1978

Dear Chairman Ullman:

The Report of the Committee on Ways and Means on H.R. 10612 (Public Law 94-455), The Tax Reform Act of 1976, provides that "the Treasury is to submit an annual report to the committee setting forth an analysis of the operation and effect of the possessions corporation system of taxation," and that the reports are to be submitted within 18 months following the close of the calendar year, with the first report covering calendar year 1976.

Pursuant to that provision, I hereby submit the first annual report entitled, "The Operation and Effect of the Possessions Corporation System of Taxation."

I am sending a similar letter to Senator Russell B. Long, Chairman of the Committee on Finance.

Sincerely,

W Michael Blumenthal

W. Michael Blumenthal

The Honorable
Al Ullman, Chairman
Committee on Ways and Means
House of Representatives
Washington, D.C. 20515

Enclosure

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Committee on Finance
United States Senate
Washington, D.C. 20510

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CHAPTER I. INTRODUCTION AND SUMMARY

In 1975 and 1976, Congress considered a series of proposals to change Federal taxation of income from exporting and foreign investment. Having at first contemplated repeal of section 931, which exempted from Federal taxation the income of companies incorporated in the United States* but operating primarily in Puerto Rico, American Samoa, Guam, and the Panama Canal Zone, Congress instead passed a new section 936. The new section was intended to maintain tax incentives to invest in Puerto Rico and the possessions, but to encourage U.S. companies to bring money home to the United States if it could not be profitably reinvested in the local economy. Replacing section 931 with 936 was expected to reduce the Federal tax expenditure attributable to the possessions corporation system of taxation by $10 million in calendar year 1977, roughly 4 percent of the then estimated total tax expenditure of $285 million.**

The operation and effect of the possessions corporation system of taxation were not completely understood. Thus, the staff of the Joint Committee on Taxation, adopting similar language to that used in the Reports of the House Committee on Ways and Means and the Senate Committee on Finance, stated in its General Explanation of the Tax Reform Act of 1976:

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*Although Puerto Rico and the possessions are included in some definitions of the United States, for convenience of exposition the term "United States" in this Report will mean only the fifty states and the District of Columbia. The Panama Canal Zone was never a U.S. possession, but has been treated as such under the U.S. Internal Revenue Code.

**See Special Analysis F, "Tax Expenditure," in Special Analyses of the Budget of the United States Government for Fiscal Year 1977 (January, 1976), and "Estimates of Federal Tax Expenditures," Prepared for the Committee on Ways and Means and Committee on Finance by the staff of the Joint Committee on [Internal Revenue] Taxation, (March 15, 1976).

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> "It is the understanding of Congress that the Department of the Treasury is to review the operations of section 936 corporations in order to apprise Congress of the effects of the changes made by the Act. The Treasury is to submit an annual report to the Congress setting forth an analysis of the operation and effect of the possessions corporation system of taxation. Among other things, the report is to include an analysis of the revenue effects to the provision as well as the effects on investment and employment in the possessions. These reports, which are to begin with a report for calendar year 1976, are to be submitted to the Congress within 18 months following the close of each calendar year."*

The body of this First Annual Report deals almost exclusively with Puerto Rico. Various Committee reports and other Congressional documents relating to the possessions corporation system of taxation reflect Congress' primary concern with the impact on Puerto Rico, and as indicated in Table 1, Puerto Rico accounts for over 98 percent of the tax expenditure associated with section 931 or 936 of the Internal Revenue Code. Appendix A of this Report describes the system of taxation as it affects American Samoa, Guam, and the Panama Canal Zone. The tax exemption for U.S. corporations operating principally in the Virgin Islands is delimited by section 934, which was unaffected by the Tax Reform Act of 1976. Because the Virgin Islands is also a possession, and because section 934 has many features similar to those of section 931 or 936, the taxation of U.S. companies operating in the Virgin Islands is also described in Appendix A.

In Puerto Rico, the possessions corporation system builds upon and reflects the complex interaction of the tax laws of the United States and those of the Commonwealth. This Report first reviews those tax laws and then undertakes an economic analysis of their impact. The review begins with Puerto Rico's Industrial Incentive Acts, which have provided exemptions from income, property, and other taxes

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*Pages 277-8.

Table 1
Federal Tax Expenditure Estimates and Projections,
Possessions Corporation Provisions 1/
(millions of dollars)

	Reduction in Calendar Year Tax Liabilities			Fiscal Year Receipts Foregone 2/		
		Companies Operating in:			Companies Operating in:	
Year	Total	Puerto Rico	All Other U.S. Possessions	Total	Puerto Rico	All Other U.S. Possessions
1973	255	250	5	239 3/	234 3/	5 3/
1974	368	362	6	289	284	5
1975	440	437	3	390	385	5
1976	634	630	4	498	495	3
1977	698	693	5	663	659	4
1978	673	668	5	687	682	5
1979	741	735	6	703	698	5
1980	814	808	6	774	768	6
1981	896	889	7	850	844	6
1982	985	978	7	936	929	7
1983	1,084	1,076	8	1,029	1,022	7

Office of the Secretary of the Treasury
Office of Tax Analysis

1/ The 1973 through 1975 figures are estimates based on income data taken primarily from election forms (Form 5712). The 1976 figures are estimates based on the 1975 to 1976 growth rate of income by broad industry groups for those companies for which data for both years was available. The 1977 figures are estimates based on the 1976 to 1977 increase in manufacturing employment in Puerto Rico. Figures for 1978 and all subsequent years are projections based on an assumed 10 percent growth rate. All figures are based on the assumption that in the absence of the possessions corporation provisions, the income of possessions corporations would be subject to an effective Federal corporate tax rate of 40 percent. For companies operating in Puerto Rico, the calendar year 1973 through 1977 figures are net of estimated tax payments to Puerto Rico; the figures for 1978 and subsequent years are net of an assumed 5 percent effective Puerto Rican (corporate plus tollgate) tax rate. Note that the section 936 credit, which applies in 1976 and subsequent years, is based on tax liabilities computed without regard to such tax preferences as the investment tax credit, or with regard to Puerto Rican taxes, which are taken into account in computing the tax expenditure figures. Therefore, the actual section 936 credit claimed will exceed the tax expenditure figure for the corresponding year.

2/ Calculated on the basis of normal relationships between calendar year corporate tax liabilities and fiscal year receipts. Fiscal years through 1976 end on June 30 of the corresponding calendar year; thereafter on September 30. The transition quarter in 1976 is not shown separately. The receipts estimate for that quarter is $95 million.

3/ Reflects in part reduced calendar year 1972 tax liabilities, which are estimated to have been 10 percent lower than the estimates shown for 1973.

for corporations manufacturing in Puerto Rico, passes to section 931 of the United States Internal Revenue Code, and then describes section 936.

The Report next describes Puerto Rico's tollgate tax on dividends paid to U.S. parent corporations, a tax which was changed in 1976 in anticipation of the enactment of section 936. The discussion then moves to the reform of the Industrial Incentive Act and the further modifications of the tollgate tax passed and signed into Puerto Rican law in June 1978. Finally, section 482 of the U.S. Internal Revenue Code, which guides the allocation of income and deductions between related entities is reviewed. Although section 482 has broader application than the possessions context, it is critical to the possessions corporation system of taxation.

These Federal and Commonwealth tax provisions must be assessed against the backdrop of Puerto Rico's economic development. The economic growth of the Commonwealth from the late 1940's to the early 1970's has been termed an "economic miracle." Even after adjusting for price inflation, Puerto Rican income per capita grew at an average rate of 5 percent per annum. In the 1970's, however, real income per capita began to decline as the economy remained in a long recession, and many Puerto Ricans returned from the United States. The rate of unemployment, which had declined steadily through the 1960's to just over 10 percent of the measured labor force, went up to more than 20 percent in 1976 and 1977. And, were it not for the substantial increase in net Federal transfer payments to Puerto Rican individuals and Federal grants to Puerto Rican governments, the Puerto Rican recession of 1973-77 might have been much deeper. In late 1977 and the first half of 1978, the Puerto Rican economy has begun to recover; by April 1978 the unemployment rate had been reduced to 16.5 percent, its lowest rate since May 1975.

The reasons for Puerto Rico's extended recession are many. The U.S. economy, to which Puerto Rican industry is closely linked, underwent a milder recession in 1973-74, and has not grown rapidly since. The Puerto Rican petrochemical industry suffered from the sharp increase in the price of foreign oil in 1973-74 and the consequent suspension of Federal oil import quotas. The construction industry has been hard hit by higher construction and interest costs and the sharp decline in demand for new condominiums. The traditional Puerto Rican industries, such as textiles, apparel and shoes, have had to compete with the sharp increase in U.S. imports of these goods from low-wage foreign countries.

The increasing competitiveness of foreign exports to the United States has accelerated a change in the industrial composition of U.S. companies operating in Puerto Rico. At least prior to the recent effective dates of the Orderly Marketing Agreements limiting shoe exports from South Korea and Taiwan, and the Multifiber Arrangements limiting textile and apparel exports from eighteen developing countries, companies manufacturing such products in Puerto Rico were reluctant to keep existing plants open, much less to construct new ones.

Because Congress in 1976 emphasized its desire to continue assisting Puerto Rico in obtaining employment-producing investments, the Treasury has matched income tax return information with employment and payroll information for individual possessions corporations. For all manufacturing industries, the Federal tax expenditure per Puerto Rican employee averaged $7,428 in 1975, which was slightly larger than the average compensation (wages or salary plus other benefits), $7,300, of possessions corporations' employees. Tax expenditure per employee or as a percentage of total employee compensation varies substantially from industry to industry. For pharmaceutical companies the tax expenditure represents almost $35,000 per employee, or approximately three and a half times the total compensation of the comparatively well paid pharmaceutical employees. At the low end of the spectrum were many of the traditional labor-intensive industries where the Federal tax expenditure usually averaged less than $3,000 per employee. For all manufacturers other than pharmaceuticals, the tax expenditure averaged about $4,100, which was 50-60 percent of those employees' average compensation.

In addition to the employment and payroll directly attributable to possessions corporations, Puerto Rico receives indirect benefits from this system of taxation. Manufacturing requires raw materials, intermediate goods, and services, a portion of which are supplied by the local economy. New investment in plant and equipment creates jobs in the construction and capital equipment industries. Workers in all industries spend their salaries on goods and services, which has a "multiplier" effect on the Puerto Rican economy. Including the estimated value of these "backward linkages" and multiplier effects significantly increases (and arguably overstates) the measure of the total benefit Puerto Rico receives from the possessions corporation system of taxation. Because all industries exhibit backward linkages and have a multiplier impact on the local economy, the ratio of this broader measure of Puerto Rican benefits to Federal tax expenditure varies from industry to industry, much as the narrower measures do.

The impact of changing from section 931 to 936 is difficult to separate from the effects of changes in the Puerto Rican tollgate tax, which became effective on the same date, and from other contemporary events. The rate of new investment and of dividend payments was very slow throughout 1977. In early 1978, the Puerto Rican government approved a number of new applications for tax exemption, many of which may have been either delayed during 1977 or accelerated by the anticipated announcement of the new Industrial Incentive Act. Dividend payments have also accelerated in 1978; as of early June, more than $1.4 billion in dividends have been declared, giving rise to $48 million in Puerto Rican tollgate taxes. Several changes in 1977 in the tollgate tax rules (especially the exemption for dividends paid out of non-Puerto Rican income) reduced the effective rate from the statutory 10 percent to less than 5 percent.

Because section 936 benefits are not available for income earned outside the possession where the corporation has a trade or business, but do apply to "qualified possessions source investment income," possessions corporations have had to restructure their substantial portfolios of financial assets. Eurodollar deposits have been replaced by substantial investments in Puerto Rican banks, Puerto Rican mortgages guaranteed by the Federal Government National Mortgage Association (GNMA), loans to other 936 companies, tax-exempt bonds (including Puerto Rican) and the preferred shares of U.S. corporations. To date, the special provision for "qualified possessions source investment income" does not appear to have had a material impact on long-term interest rates or credit conditions for the average Puerto Rican borrower.

The June 1978 changes in the Puerto Rican Industrial Incentive Act and the tollgate tax are complex and will not become fully effective until 1979. Preliminary analysis suggests, however, that the combined efffective rate of income and tollgate taxation may be approximately 5 percent. If so, and if the level and composition of investment by possessions corporations and other aspects of their behavior are not materially affected by this tax increase, the Federal tax expenditure will be reduced in 1978 and the near future by one eighth (because the Federal taxes foregone will represent 35 percent, rather than the currently estimated 40 percent, of pretax income).

CHAPTER II. PUERTO RICAN AND FEDERAL INCOME TAX LAW -- PAST AND PRESENT

A. Industrial Tax Exemption in Puerto Rico

The modern history of industrial tax exemption in Puerto Rico begins in 1948. Prior to that year, Puerto Rican development strategy stressed government ownership and operation of key industries, such as cement, glass, paperboard, and shoes. When the financial requirements of such a program were recognized, Puerto Rico shifted the emphasis to private enterprise. Tax exemption became the keystone of an industrial incentive program that also included providing plants at low rent, cash grants to cover start-up costs, and low interest loans. The Industrial Incentive Act of 1948 offered qualified firms an exemption from income, property, and municipal taxes, while the excise tax act exempted raw materials, machinery, and equipment used in manufacturing for export or sold to other manufacturers in Puerto Rico.

Originally, it was contemplated that the period of total exemption would end in 1959, with the exemption rate falling to 75 percent, 50 percent, and 25 percent in 1959, 1960, and 1961, respectively. All exemptions were to end in 1962. Tax exemption was restricted to items not produced on a commercial scale in Puerto Rico prior to 1948 and to certain other specified items, such as wearing apparel and processed food products. The 1948 legislation also provided for exemption from Puerto Rican taxes for a distribution of dividends to a parent outside Puerto Rico if the parent was unable to claim a foreign tax credit for the withholding tax. Finally, liquidation of an exempt company would be tax free, provided that the liquidating company was at least 80 percent owned by its parent.

Many firms established plants in Puerto Rico in the early 1950's in response to these incentives. Textiles were the fastest growing industry, but shoes and other leather goods, and assembly of mechanical, electrical and electronic devices were also important. After a few years, however, a tax exemption with a 1959-1961 phaseout became less attractive, and, in 1954 the Industrial Incentive Act was amended.

The 1954 Act provided for a ten-year exemption for new applicants. Because an established firm could lose its exemption, but a new applicant could qualify for a ten-year exemption, the 1954 Act sought to limit the ability of an old firm to obtain a new grant. If a firm received a new grant of exemption for a product produced under an old grant, the new grant would be terminated if the level of output in the predecessor operation was reduced. In addition, plant, equipment, and other property that had been used in the production of an exempted product could not be used by another enterprise to produce a similar exempt product. Both prohibitions were subsequently weakened, and the Governor had the power to waive them if he deemed it to be in the public interest.

As the 1950's drew to a close and some of the original grantees approached the end of their exemption periods, pressure for further revisions in the Industrial Incentive Act began building. An expanded Industrial Incentive Act was adopted in 1963, offering exemptions for periods of 10, 12, 15, 17, or 25 years, depending on the degree of economic development of the zone in which the plant was located. In addition, a partial exemption for up to twice the length of the original grant could be elected. A company could postpone the start of the exemption period for two years and 90 days after its first payroll, which permitted it to save the exemption for profitable years, rather than wasting it during the period of start-up losses.

In the early 1970's, Puerto Rico redefined the tax-exemption zones and lengthened some exemption periods (exemptions of 10, 15, 25, or 30 years became available). An amendment was introduced classifying passive income from certain financial investments in Puerto Rico as "industrial development income," benefitting from the same tax exemption as trade or business income. This provision sought to encourage the possessions corporations to invest a larger portion of their earnings in Puerto Rico.

B. Section 931 of the U.S. Internal Revenue Code

The essential elements of section 931 of the Internal Revenue Code of 1954 became part of U.S. law as section 262 of the Revenue Act of 1921. Proponents of this legislation had sought exemption for any U.S. corporation deriving at least 80 percent of its income from foreign sources. They stressed the competitive disadvantage of American firms in comparison to their British rivals. English law deferred taxation on foreign income until it was remitted to England, while the United States taxed the foreign income of U.S. corporations as it was earned.* The proponents settled ultimately for an exemption for firms deriving income from U.S. possessions.

The reduction in the coverage of this legislation, from the whole world to the U.S. possessions, is not as astonishing as it might seem. The demand for exemption came primarily from a group of U.S. firms then operating in the Philippines (a U.S. possession in 1921). They argued that tax exemption would encourage export trade to the Far East from the U.S. base in the Philippines, while at the same time reducing the incentive for the U.S. firms operating there to reincorporate outside the United States. Little attention was paid to the effect of this law on the Philippine economy; Puerto Rico was virtually ignored in the public debate.

Under the terms of section 931 (as subsequently amended) a U.S. corporation deriving at least 80 percent of its gross income from sources within a U.S. possession (currently Puerto Rico, American Samoa, Guam, the Panama Canal Zone, and certain other areas) and at least 50 percent of its gross income from the active conduct of a trade or business therein could exclude from its gross income for Federal tax purposes all foreign-source income except that received within the United States. The corporation had to meet the 80 percent and 50 percent tests for the current and preceding two taxable years (or less if it was just initiating operations). Corporations that satisfied these requirements came to be called "possessions corporations," "931 corporations," or sometimes simply "931's". Such corporations were usually organized as subsidiaries of U.S. parent companies in order to assure that 80 percent of gross income had its source in one or more possessions.

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*At the time, U.S. companies generally preferred not to incorporate subsidiaries under foreign laws; foreign operations were initially conducted through either a branch of the U.S. parent or a U.S.-chartered subsidiary.

A 931 corporation would often operate at a loss for the first year or two. (Even an older corporation that had been profitable could suffer a loss from time to time.) In 1971, the Tax Court ruled that a company was not "receiving the benefits" of section 931 in a year in which it lost money, so it could join its parent and other affiliated corporations in filing a consolidated return for such a year. The owner of a 931 thus avoided taxes in profitable years but was able to offset any loss against other, taxable income in unprofitable years.

A 931 corporation usually avoided earning or receiving any taxable income within the U.S. and, thus, was wholly exempt from federal taxation on its earnings. In the majority of cases the 931's were engaged in manufacturing activity that qualified them for exemption from Puerto Rican taxes as well. Thus, for the period of the Puerto Rican exemption (10 to 30 years) the 931 had a tax holiday.

In the United States, however, the parent corporation could not claim a dividends-received deduction for dividends from a 931, so the dividend would be taxable upon receipt by the parent. To avoid payment of this tax, the typical 931 accumulated its earnings, investing them (tax free) in the Eurodollar market. (Because the income was not taxable as earned, the company was not subject to the Federal accumulated earnings tax.) After a number of years (usually at the end of its period of Puerto Rican tax exemption) the 931 would be liquidated into its parent. If it was at least 80 percent owned by a U.S. corporation (as was generally the case), the liquidation was free of any federal income tax. So, although the parent had to wait for the liquidation to receive the accumulated earnings, those earnings would be free of either Puerto Rican or Federal income taxes.

C. Section 936 of the U.S. Internal Revenue Code

The Tax Reform Act of 1976 removed possessions corporations from section 931 and placed them in a newly created section 936. The primary differences between sections 931 and 936 are:

1. The method of effecting the exemption changed: instead of excluding income, section 936 provides a credit to offset any U.S. tax on income from the active conduct of a trade or business in a possession, or on "qualified possessions source investment income" (interest, dividends, and other types of passive income earned on funds invested for use in a possession in which a trade or business is actively conducted). Because the section 936 credit offsets the U.S. tax liability on this income, a 936 corporation cannot also claim a foreign tax credit for taxes actually paid with respect to such income. A foreign tax credit offsets U.S. taxes only on income ineligible for the section 936 credit.

2. The dividends-received deduction can be claimed, so the parent pays no tax on dividends received from a wholly owned 936 subsidiary. This is true not only for dividends paid out of current earnings, but also for dividends from earnings presumably accumulated while the subsidiary qualified under section 931. Because the parent is entitled to the dividends-received deduction, it cannot claim a foreign tax credit for a withholding tax on the dividend.

3. The subsidiary must elect the benefits of section 936, and that election is irrevocable for 10 years. During this period it cannot join with its parent in filing a consolidated return, although it can delay electing 936 status until profitable years begin.

Although most observers in 1976 appeared to believe that section 936 would make investing in Puerto Rico more attractive than it had been under section 931, the change had negative, as well as positive, components. On the one hand, section 936 does not allow possessions corporations to avoid Federal taxes on Eurodollar and other foreign income, as section 931 had. On the other hand, a primary obstacle to paying dividends (and, thus, an inducement to accumulate earnings) was removed by allowing the parent a dividends received deduction.*

In explaining its motives, Congress cited its desire to leave undisturbed the tax exemption of earnings from a trade or business in Puerto Rico or from investments made with those earnings for use in Puerto Rico. At the same time, Congress desired to end the exemption for passive income from funds invested in foreign capital markets and to hasten their repatriation. Congress stated that it wanted to "assist the U.S. possessions in obtaining employment-producing investments by U.S. corporations, while at the same time encouraging those corporations to bring back to the United States the earnings from these investments to the extent they cannot be reinvested productively in the possession."**

D. <u>The Puerto Rican Tollgate Tax and the New Industrial Incentive Act</u>

Prior to October 1, 1976, the Puerto Rican government imposed a 15 percent tollgate tax on dividends paid out of Puerto Rican income from hotels, manufacturing and shipping to any corporation without significant business of its own in Puerto Rico, but only if that nonresident parent corporation could claim a foreign tax credit for the tollgate tax. In the United States a foreign tax credit was available until 1976, but because dividends were rarely paid, the tollgate tax was rarely applicable, and the foreign tax credit little used. Anticipating the passage of section 936 and the other Federal provisions relating to

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*The dividends-received deduction eliminates the need to liquidate a possessions corporation to repatriate earnings free of Federal taxes; in the past liquidation was often accompanied by an actual cessation of operations and discharge of workers. The provisions of Puerto Rican law which lead to this regretable practice were ameliorated, but not wholly eliminated, in the recent (June 1978) reforms of the Industrial Incentive Act.

**Report of the Committee on Ways and Means, U.S. House of Representatives, on H.R. 10612, Report No. 94-658, November 12, 1975, pg. 255; and Report of the Committee on Finance, United States Senate, on H.R. 10612, Report No. 94-938, June 10, 1976, pg. 279.

possessions corporations, the Puerto Ricans in 1976 modified their tollgate tax in two important ways. The rate was reduced from 15 to 10 percent, and the tax became applicable to U.S. shareholders, even though they were denied a foreign tax credit. The two changes taken together had the effect of subjecting dividends paid to nonresident U.S. parent corporations to a 10 percent Puerto Rican tax.* Although the tax rate seemed low, the potential source of dividends included not only new income earned under section 936, but also earnings accumulated under section 931.

Although the 10 percent tollgate rate instituted in 1976 remains, the effective rate has been subsequently reduced by a series of amendments and rulings. In summary:

1. Dividends paid out of accumulated "931" industrial development income (i.e., income earned prior to October 1, 1976) are subject to a tollgate tax of 7 percent, rather than 10 percent, if no more than 25 percent of the balance at the beginning of the year is paid out and a matching 25 percent is invested in designated Puerto Rican assets in that year. Designated Puerto Rican assets include working capital, deposits in Puerto Rican banks, Puerto Rican government bonds, mortgages insured by the Puerto Rican Housing Bank and Finance Agency, and loans or other

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*The 10 percent tollgate tax does not apply to a resident parent corporation (e.g., a U.S. manufacturer which wholesales and retails its products in Puerto Rico). Dividend payments to such a corporation would, however, initially be subject to the regular Puerto Rican income tax, which has a maximum statutory rate of 45 percent. The 85 percent dividends-received deduction in Puerto Rico would, however, reduce the effective rate on dividends from a possessions corporation to such a resident parent corporation to no more than 6.75 percent (45 percent of 15 percent). Thus, a U.S. parent corporation resident in Puerto Rico is taxable in Puerto Rico on its dividend income from a possessions corporation, but the effective rate of taxation is less than the 10 percent tollgate tax applicable to dividends paid to nonresident U.S. parent corporations.

guaranteed mortgage bonds executed by any government pension or retirement plan. Thus, part of the accumulated earnings may be brought home subject to a reduced tollgate tax rate if a matching amount from such earnings is invested in designated assets.

2. Dividends paid out of accumulated "936" industrial development income (i.e., earned subsequent to October 1, 1976) are subject to a tollgate tax of 7 percent, rather than 10 percent, if no more than 75 percent of such income is paid out and if at least 25 percent of such income is reinvested in the designated Puerto Rican assets for a period of at least 8 years.

3. Dividends paid out of income from interest on the designated Puerto Rican assets are exempt from the tollgate tax.

4. A credit equal to 3 percent of new investment (made subsequent to the later of March 31, 1977 or the second year of tax exemption) in buildings and other structures used in manufacturing is allowed against the tollgate tax.

In December 1977, the Puerto Rican Treasury issued regulations clarifying the exemption paid out of non-Puerto Rican income earned outside Puerto Rico (e.g., Eurodollar investments). As long as a company has both undistributed earnings from Puerto Rico and earnings from foreign sources, a dividend is deemed to consist of 50 percent exempt foreign-source income. That is to say, the tollgate tax in these instances equals 5 percent of the total dividend.

In March 1978, Governor Romero Barcelo made his long awaited proposals for restructuring the Industrial Incentive Act; after debate and minor revisions, the Puerto Rican legislature enacted the Governor's program on June 2, 1978. The primary features of the new legislation are:

1. New grants will exempt from taxation only a declining fraction of income; that fraction is 90 percent in the first five years, 75 percent in the sixth through tenth years, 65 percent in the eleventh to fifteenth years, and 55 percent the sixteenth to the

twentieth years. The first $100,000 of real property will be exempt from property tax, and the remainder will be exempt in the same proportion as income is.

When the original grant expires, the company may apply for a ten year extension. If the extension is granted, 50 percent of income may be excluded for the first five years; for the second five years, between 35 percent and 50 percent may be excluded, the exact percentage depending on the location of the investment in Puerto Rico.

2. Companies earning less than $500,000 may also exclude the first $100,000 of income from taxation; companies earning more than $500,000 have no such exemption (the exemption applies to the entire controlled corporate group). Corporations ineligible for, or not claiming, the $100,000 exemption may, however, deduct an amount equal to 5 percent of production-worker payroll costs. This extra payroll deduction cannot exceed 50 percent of otherwise taxable income.

3. The regular tollgate tax will be reduced to 5 percent for funds reinvested in designated Puerto Rican assets and withdrawn according to the following schedule: 10 percent may be withdrawn annually for five years, and the remaining 50 percent may be withdrawn at the end of the five years. The list of designated assets was expanded to include investment of earnings in the company's own business or in paying off its own debt.

4. Upon liquidation, a 4 percent tollgate tax will apply to accumulated Puerto Rican income. In the past, accumulated Puerto Rican income was exempt from the tollgate tax if distributed upon liquidation of the company.

5. Export-oriented service industries (architectectural, insurance, engineering, management consulting firms, etc.), which had been fully taxable under prior law, will be able to exempt 50 percent of their export-service income, providing that 80 percent of their employees are residents of Puerto Rico and 80

percent of the cost of the services was incurred in Puerto Rico.

The new law also contains provisions permitting currently tax-exempt corporations to elect to move to a partially exempt status. The election, which may apply to either the current or the coming fiscal year, must be made when the corporation files its Puerto Rican income tax return for the fiscal year which includes December 31, 1978. Thus a possessions corporation whose fiscal year corresponds to the calendar year could elect in April 1979 (the usual filing date) to become partially taxable for either 1978 or 1979. If 1979 is elected, then the first return indicating taxes actually due would be filed in April 1980.

The election is subject to the following provisions:

1. During the years remaining until the end of the existing grant, the following percentages of income will be exempt from tax:

Years Left on Original Grant	Exemption Percentages	Maximum Effective Tax Rate (percent)
0-4 years	73.3	12.0
5-8 years	77.7	10.0
9-12 years	85.5	6.5
13-16 years	90.0	4.5
17-20 years	91.0	4.0
More than 20 years	93.3	3.0

After the period of original exemption has expired, the companies electing this option are automatically entitled to operate partially exempt from taxation for ten more years. During the first five of those ten years, 50 percent of income will be exempt; during the second five years, between 35 percent and 50 percent (depending on the location of the investment) of total income will be exempt.

2. Companies with six or more years remaining on their current tax exemption may make an alternative

election. They may exclude 90 percent of their income from taxation and credit two thirds of their net income taxes paid against the post-conversion tollgate tax imposed on dividends paid from current earnings. Companies electing this second option may apply for a ten-year extension when the current grant expires, but the extension is not automatic.

3. For all companies, 50 percent of all tollgate taxes paid on distributions of income earned before converting to partial exemption are creditable against the post-conversion income tax liability. Dividends will also benefit from special reductions in the tollgate tax. Accumulated earnings will be subject to a 4 percent tollgate providing that pre-1973 earnings are paid out over a two-year interval, and that 1973-1977 earnings are paid out over a five-year interval (no more than 10 percent can be paid out in each of the five years, and the balance at the end). Income earned in 1978 or thereafter will be subject to a reduced 5 percent tollgate, providing each year's income is paid out according to the five-year schedule just described. All earnings whose distribution is deferred to benefit from a reduced tollgate tax rate must be invested in designated Puerto Rican assets, in plant and equipment to be used in Puerto Rican industrial development, or in retiring the principal of the company's debt.

4. Finally, textile, apparel and shoe producers whose exemption grants expire within the next five years are automatically entitled to a 90 percent tax exemption for an additional five years.

The probable effects of these changes are analyzed below.

E. Allocation of Income and Deductions

Under section 482 of the Internal Revenue Code, the Internal Revenue Service may reallocate income, deductions or credits among two or more corporations under common ownership so as to prevent evasion of taxes. Nowhere has the application of section 482 been more controversial than to transactions between a U.S. parent and its possessions corporation.

Section 482 cases involving possessions corporations first surfaced in the 1950's. In determining what percentage of a subsidiary's income came from a possession rather than the United States, the Internal Revenue Service had initially ruled that exports from the subsidiary to the parent could be priced so as to attribute to the parent only the profit margin normally earned by an independent distributor. In some, but not all, cases, the Service subsequently clarified its initial ruling to indicate that it applied only to the 50 percent and 80 percent tests of eligibility for section 931 benefits. Some other income allocation rule would be used under section 482 to determine the tax liability of the parent.

In August, 1959, Governor Munoz Marin of Puerto Rico formally protested to the Secretary of the U.S. Treasury that Puerto Rico was not a tax haven, but that the Internal Revenue Service's 482 position was hurting Puerto Rico's ability to attract U.S. investment. Furthermore, because a few 931 subsidiaries of U.S. parents never had a Puerto Rican tax exemption, and because many exemptions would expire in the future, section 482 cases might diminish Puerto Rican tax collections. Although the Federal government never accepted the Governor's proposal that a Federal-Commonwealth unit (analogous to the competent authority procedures incorporated into many bilateral tax treaties) be established for resolving transfer-pricing disputes, pending section 482 cases were suspended from 1961 to 1963 while the Internal Revenue Service reviewed its transfer pricing standards.

In the early 1960's the Treasury and Internal Revenue Service were increasingly aware of transfer-pricing problems in taxing foreign income, and Puerto Rico presented an acute case of a more general problem. Although the new rules set forth by the Service in early 1963 were applicable only to transactions between possessions corporations and their U.S. parent, the 1963 rules became the foundation for the generally applicable section 482 regulations issued five years later.

The 1963 guidelines noted four situations where an improper shifting of profits might occur and a section 482 adjustment would be appropriate.

1. When the 931 subsidiary overcharged its parent for exports.

2. When the 931 subsidiary sold to an independent third party, but derived a benefit from some intangible asset belonging to the parent (e.g., a patent or trademark) without paying an appropriate fee or royalty to its parent.

3. When the parent undercharged its subsidiary for raw materials or component parts furnished by the parent.

4. When the parent incurred a direct expense on behalf of its subsidiary without charging it back to the subsidiary.

In determining appropriate transfer prices, the general standard was always to be the arm's-length price, that which would have applied to a comparable transaction between unrelated parties. In any given instance, the specific methods for applying the general standard were ranked as follows:

1. Directly Applicable Independent Prices. In some instances, the subsidiary or the parent may sell the same product to, or buy the same product from, independent parties. If so, the price used in these transactions should also be used for the inter-affiliate transactions.

2. Independent Prices for Similar Products. Even though the parent and the subsidiary deal exclusively with one another, the same or similar product may be bought and sold by others at an identifiable price. This price should be used only if the first method cannot be applied.

3. Other Methods. If the two prior methods availed nothing, then the parent should establish how much the product would have cost if purchased from an independent U.S. manufacturer. This price would include all relevant U.S. costs of production plus a reasonable profit margin.

Under this last method, if a product could be manufactured in Puerto Rico and shipped to the United States more cheaply than it could be manufactured in the United States (for example, because Puerto Rican labor is usually cheaper than mainland labor), the additional profit from manufacturing in Puerto Rico would be allocable to the subsidiary. If the opposite were the case (for example, because transport costs were higher), the Puerto Rican subsidiary would earn less than a U.S. manufacturer would.

The most difficult and contentious cases, the 1963 ruling noted, typically involve intangible property: patents, trademarks, brand names, access to established marketing and distribution channels, and goodwill with customers. For example, in the pharmaceutical industry, manufacturing and distribution costs are a small fraction of the selling price. The large profit margins reflect a return on valuable intangibles, such as a patent on the product. The value of a patent may, in turn, reflect substantial outlays for past research and development. If R&D is to be economical, the ultimate profits must cover not only the cost of the projects yielding commercial products but the "losers" as well. Regardless of whether current profits represent a low, reasonable or high return on past R&D, the tax saving of assigning those profits to a tax-exempt subsidiary can be substantial.

Because the total profit margin (i.e., that on manufacturing and distribution) often includes an implicit return on patents, trademarks, goodwill, etc., appropriate transfer prices can be established only by first determining whether the mainland parent or the 931 affiliate owns the intangibles. In some instances, an intangible asset could not possibly be owned by the affiliate (for example, goodwill with customers based on the parent's own marketing and distribution effort). In others, the intangible could have been transferred (for example, exclusive patent rights), but for one reason or another was not, so the parent, not the subsidiary, was still entitled to the return on it. Only if the intangible property truly belongs to the subsidiary could the transfer price appropriately allocate the return on the intangible to the subsidiary.

These 1963 guidelines did not fully satisfy the companies and the Puerto Rican government. The companies had not engaged in careful tax planning in the past and had not taken care to transfer ownership of relevant intangibles to the subsidiaries. The Internal Revenue Service's guidelines would have resulted, in many cases, in substantial reallocations of income to the parent. An Internal Revenue Service Manual Supplement implementing the 1963 guidelines was held in abeyance from 1965 to 1968, and section 482 cases involving possessions corporations were again suspended. Finally, in 1968, comprehensive regulations implementing section 482 were issued, as was a revenue procedure allowing companies to follow the 1963 revenue procedure instead of the 1968 regulations (with respect to Puerto Rican transactions only) if the results were more favorable. Although at least one major case dating back to the 1950's remains unresolved twenty years later, the logjam of unresolved cases was really broken in 1968.

Section 482 has, however, remained a problem. The 1963 revenue procedure did not necessarily preclude parents from allocating substantial income to their possessions corporations, but did force the companies to lay a careful legal foundation for those allocations. After 1963, the creation of the subsidiary was usually accompanied by the execution of legal documents irrevocably assigning exclusive patent and other rights to the newborn company.

Seeing that the 1963 revenue procedure and the 1968 regulations did not materially reduce profit shifting, the Internal Revenue Service has brought a case against Eli Lilly involving a possessions corporation established to manufacture Darvon. Because Eli Lilly executed the legal documents purporting to effect the transfer of intangibles, the argument that the Service has traditionally used in such cases, that the parent and not the subsidiary is entitled to the return on the intangible, will be much more difficult to make. The Service must either argue that the original transfer of the patent was a sham and can be disregarded or find a new legal basis for denying the company the tax benefits it has claimed.

Concerned by the transfer-pricing disputes, the current Governor of Puerto Rico, Carlos Romero Barcelo, has recently written the Secretary of the U.S. Treasury to protest that the Internal Revenue Service's practices are inhibiting Puerto Rico's ability to attract new investments through its tax exemption program. Furthermore, because some companies do not have a complete exemption, and because all are subject to the tollgate tax, the Governor maintains that the Internal Revenue Service's position could erode the Puerto Rican tax base. The Governor urges that the Treasury review the Service's practices and reaffirm its 1963 guidelines.

In summary, then, the allocation of income between a U.S. parent and its tax-exempt possessions corporation has been a source of contention for the last twenty years. Because the income in question has usually been exempt from Puerto Rican taxation, the threat of double taxation has until recently been remote. Successive Puerto Rican Administrations have argued, however, that the Service's proposed reallocations would seriously jeopardize the Puerto Rican industrial development program. With the recent changes in the Industrial Incentive Act and the tollgate tax, the potential for double taxation will become more immediate.

CHAPTER III. ECONOMIC IMPACT

A. Puerto Rican Economic Development

Although a full review of Puerto Rican economic development since 1947, the year of the initial Industrial Incentive Act, is beyond the scope of this study, a summary is useful in placing the possessions corporation system of taxation in perspective. Puerto Rico's economic growth after 1947 has often been called an "economic miracle." Figure I traces the growth in Puerto Rican gross national product in dollar and per capita terms (adjusted for price inflation) from 1947 to 1977.*

The population statistics used in determining national product per capita reflect not only birth and death rates, but also net migration from Puerto Rico (in recent years, more Puerto Ricans have returned to Puerto Rico than have moved to the mainland). Between 1947 and 1972, Puerto Rican total and per capita GNP grew at average annual growth rates of better than 6 percent and just under 5 percent, respectively. By any historical or international yardstick, this was a remarkable performance.**

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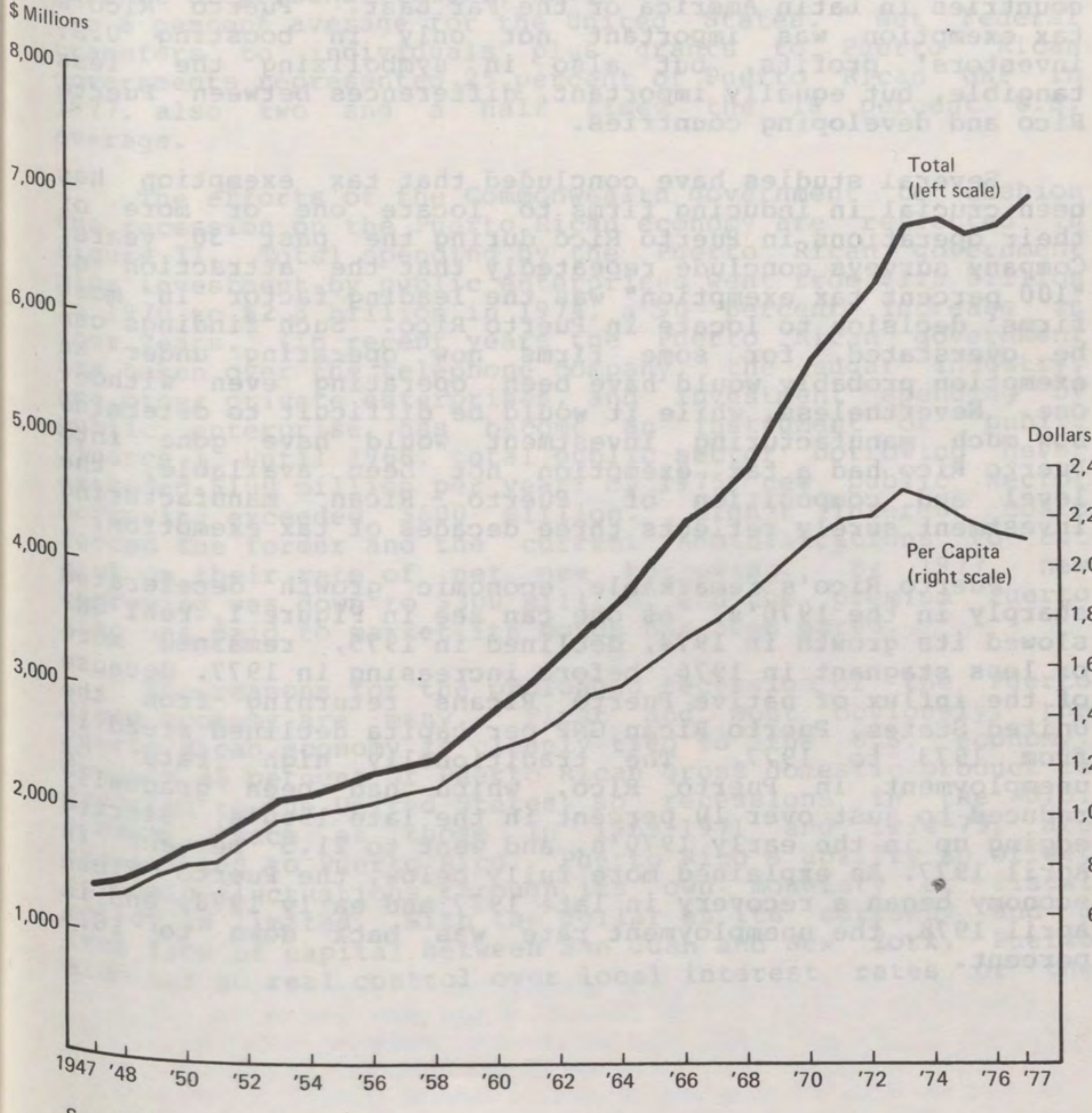
*In interpreting these and other statistics on Puerto Rico, the reader should be aware of the distinction between gross national product and gross domestic product. Gross domestic product equals gross national product plus Puerto Rican income earned by foreign residents, such as possessions corporations, less income earned by Puerto Rican residents from foreign sources (the primary example being wages paid to Puerto Rican employees of the Federal Government). Gross domestic product is a measure of the total value of all goods and services produced in Puerto Rico in a particular year, whereas gross national product is a measure of the value of the production and income earned by residents of Puerto Rico. Largely because of the growth of high-profit possessions corporations, the ratio of gross national product to gross domestic product has declined from 99 percent in 1960 to 90 percent in 1972 and to 81 percent in 1977.

**Over this same quarter century, real GNP in the United States grew at an annual rate of 3.7 percent, and GNP per capita at a rate of 2.2 percent.

FIGURE I

Total and Per Capita Gross National Product of Puerto Rico, 1947-1977 (Constant 1974 Dollars)



Source: Puerto Rico Planning Board

Explanations for this success are many. In the late 1940's and 1950's, Puerto Rican labor was very cheap by U.S. standards: per capita incomes were low, unemployment and underemployment were high, and federal minimum wage standards did not fully apply. U.S. manufacturers found Puerto Rico attractive compared to low-wage foreign countries. Puerto Rico was inside the U.S. tariff wall and offered a more stable political and economic climate than countries in Latin America or the Far East. Puerto Rico's tax exemption was important not only in boosting U.S. investors' profits, but also in symbolizing the less tangible, but equally important, differences between Puerto Rico and developing countries.

Several studies have concluded that tax exemption has been crucial in inducing firms to locate one or more of their operations in Puerto Rico during the past 30 years. Company surveys conclude repeatedly that the attraction of "100 percent tax exemption" was the leading factor in most firms' decision to locate in Puerto Rico. Such findings can be overstated, for some firms now operating under an exemption probably would have been operating even without one. Nevertheless, while it would be difficult to determine how much manufacturing investment would have gone into Puerto Rico had a tax exemption not been available, the level and composition of Puerto Rican manufacturing investment surely reflects three decades of tax exemption.

Puerto Rico's remarkable economic growth decelerated sharply in the 1970's. As one can see in Figure I, real GNP slowed its growth in 1974, declined in 1975, remained more or less stagnant in 1976, before increasing in 1977. Because of the influx of native Puerto Ricans returning from the United States, Puerto Rican GNP per capita declined steadily from 1973 to 1977. The traditionally high rate of unemployment in Puerto Rico, which had been gradually reduced to just over 10 percent in the late 1960's, started edging up in the early 1970's, and went to 21.5 percent in April 1977. As explained more fully below, the Puerto Rican economy began a recovery in late 1977 and early 1978, and in April 1978, the unemployment rate was back down to 16.5 percent.

The prolonged recession in the Puerto Rican economy would have been deeper had it not been for offsetting expenditures by the Federal and Commonwealth governments. Total Federal transfers to Puerto Rico increased almost tenfold beween 1968 and 1977 -- see Table 2. By 1977, net Federal transfers directly to individuals (the bonus value of food stamps, net social security and medicare payments, veterans benefits, etc.) of $1.2 billion represented 15 percent of personal income, which was two and a half times the 6 percent average for the United States. Net Federal transfers to individuals plus grants to Puerto Rican governments represented 25 percent of Puerto Rican GNP in 1977, also two and a half times the 10 percent U.S. average.

The efforts of the Commonwealth government to cushion the recession on the Puerto Rican economy are reflected in Figure II. Total spending by the Puerto Rican government plus investment by public enterprises went from $1.5 billion in 1970 to $2.8 billion in 1974, a 90 percent increase in four years. (In recent years the Puerto Rican government has taken over the telephone company, the sugar industry, and other private enterprises, and investment spending by public enterprise has become an instrument of public finance.) Until 1968, total public sector borrowing never exceeded $100 million per year; by 1975, new public sector borrowing exceeded $600 million. Higher interest costs forced the former and the current Administrations to cut back on their rate of net new borrowing. By 1977, new borrowing was down to $300 million, and the premium Puerto Rico has paid to market its bonds has been pared.

The reasons for the prolonged recession of the Puerto Rican economy are many. First and most obviously, the Puerto Rican economy is closely tied to the U.S. economy. Roughly 45 percent of Puerto Rican gross domestic product is exported to the United States, so recessions in the U.S. economy, such as those in 1969-1971 and 1974-75, are transmitted to Puerto Rico. Puerto Rico's ability to offset economic fluctuations through its own monetary or fiscal policy is limited. With the dollar as its currency and a free flow of capital between San Juan and New York, Puerto Rico has no real control over local interest rates or the

Table 2

Federal Transfer Payments, Grants, "Covered Over" Taxes, and Tax Expenditure on Possessions Corporations in Puerto Rico, Fiscal Years 1968 and 1977 1/
(Millions of dollars)

	FY 1968	FY 1977
Net Federal transfer payments to individuals, total 2/	68	1,235
Food stamps	--	610
Old age, survivors, and disability insurance	1	295
Veterans benefits	59	185
Unemployment compensation	1	87
All other	7	58
Federal grants to Puerto Rican Commonwealth and municipal governments, total	129	716
Child nutrition and special milk programs	5	81
Human development 3/	6	48
Office of Education programs	--	67
Public assistance	31	59
Community development block grants	15	49
Low rent public housing	11	48
Employment and training programs	7	150
All other	54	214
Federal taxes "covered over" to Puerto Rican treasury, total	93	223
Customs duties	27	60
Alcoholic beverage and tobacco excises	66	163
Federal tax expenditure on possessions corporations	99	659
TOTAL	389	2,833

Office of the Secretary of the Treasury
Office of Tax Analysis

Sources: U.S. Department of the Treasury, Federal Aid to States: Fiscal Year 1977, and the Statistical Appendix to the Secretary's Annual Report for 1968; Office of the Governor, Commonwealth of Puerto Rico, Economic Report of the Governor (various years); and U.S. Department of the Treasury estimates.

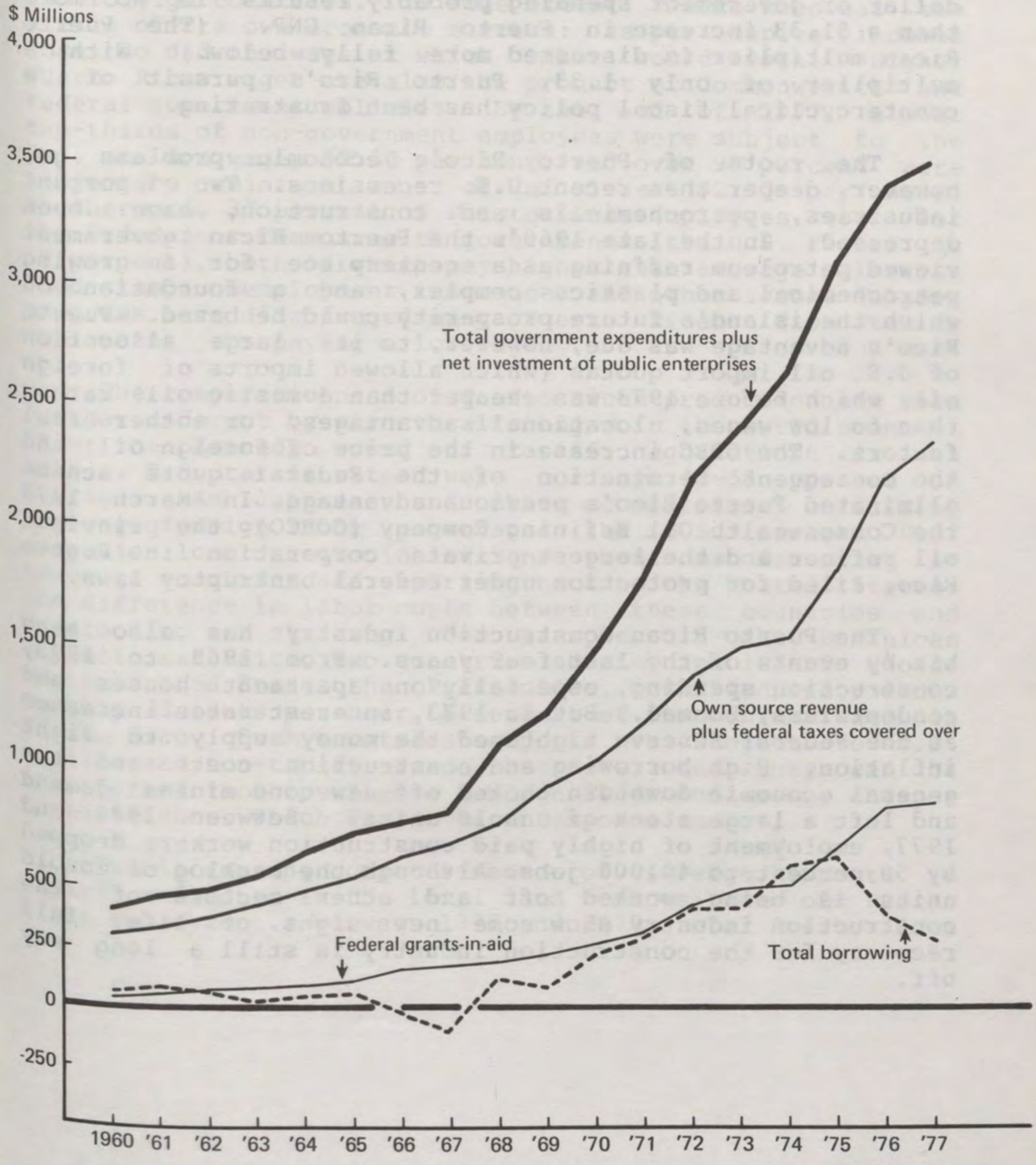
1/ In 1968 both the Federal and Puerto Rican fiscal years ended on June 30, and therefore all data for FY 1968 is based on the same time period. In 1977, however, the Federal fiscal year was changed, beginning on October 1, 1976 and ending on September 30, while the Puerto Rican fiscal year again ended on June 30. With the exception of certain Federal transfer payments, all data for 1977 is based on the Federal fiscal year.

2/ All transfer payments are net of associated payments by or on behalf of current or future recipients, such as employer, employee, and self-employment contributions for OASDI.

3/ Formerly, "child" development.

FIGURE II

Total Government Expenditures Plus Net Investment of Public Enterprises, Own Source Revenue Plus Federal Taxes Covered Over, Federal Grants-in-Aid, and Total Borrowing of Puerto Rico, 1960-1977



Source: Puerto Rico Planning Board

availability of credit. Government and public enterprise spending was increased to mitigate the recession, but the impact was dissipated by the high propensity to import. In recent years, more than 75 percent of Puerto Rican gross national product has been spent on imports, primarily from the United States. Even if all government spending is limited to Puerto Rican-produced goods and services, a dollar of government spending probably results in no more than a $1.33 increase in Puerto Rican GNP. (The Puerto Rican multiplier is discussed more fully below.) With a multiplier of only 1.33, Puerto Rico's pursuit of a countercyclical fiscal policy has been frustrating.

The roots of Puerto Rico's economic problems go, however, deeper than recent U.S. recessions. Two important industries, petrochemicals and construction, have been depressed. In the late 1960's the Puerto Rican government viewed petroleum refining as a centerpiece for a growing petrochemical and plastics complex, and a foundation on which the island's future prosperity could be based. Puerto Rico's advantage was due, however, to its large allocation of U.S. oil import quotas (which allowed imports of foreign oil, which before 1973 was cheaper than domestic oil) rather than to low wages, locational advantages, or other real factors. The OPEC increase in the price of foreign oil and the consequent termination of the Federal quota scheme eliminated Puerto Rico's previous advantage. In March 1978 the Commonwealth Oil Refining Company (CORCO), the principal oil refiner and the largest private corporation in Puerto Rico, filed for protection under Federal bankruptcy laws.

The Puerto Rican construction industry has also been hit by events of the last four years. From 1969 to 1973, construction spending, especially on apartment houses and condominiums, boomed. But in 1973, interest rates increased as the Federal Reserve tightened the money supply to fight inflation. High borrowing and construction costs and the general economic downturn choked off new condominium demand and left a large stock of unsold units. Between 1974 and 1977, employment of highly paid construction workers dropped by 50 percent to 40,000 jobs. Although the backlog of unsold units is being worked off and other sectors of the construction industry show some new signs of life, full recovery for the construction industry is still a long way off.

Puerto Rico has also been hurt by the growing competitiveness of foreign imports in U.S. markets. Its traditional advantages, cheap labor and no tariffs on exports to the U.S. market, have been undermined by a series of changes. Throughout the 1950's and 1960's (but not the 1970's) Puerto Rican wage rates rose not only in dollar terms but also relative to wages paid in the United States and foreign countries. To some extent, Puerto Rico was the victim of its own economic success: as per capita incomes rose, so did the wage at which labor would work. Higher Puerto Rican wages are also the product of Commonwealth and Federal government policies. By the end of 1977, almost two-thirds of non-government employees were subject to the U.S. minimum wage, $2.30 per hour, and over 90 percent were subject to a minimum wage of at least $2.00 per hour. Furthermore, 37 percent of Puerto Rican employees work for the Federal or Commonwealth governments (the U.S. figure is 18 percent), both of which pay higher than average salaries. Food stamp, unemployment insurance, and other income support programs have discouraged many Puerto Ricans from taking unpleasant jobs paying a low wage.

The competitiveness of Puerto Rican production has been further undercut by structural changes in the world economy. After the Kennedy round of tariff negotiations in the 1960's, U.S. tariff rates were cut by 40-50 percent on average. As Japanese and other competitors utilizing low-wage foreign labor penetrated the U.S. market, U.S. companies lost their inhibitions about manufacturing in low-wage countries and exporting back to the United States. The difference in labor costs between these countries and Puerto Rico is striking. For example, in the Dominican Republic and Haiti, two countries sharing an island closer to the United States than Puerto Rico, unskilled labor earns roughly 33 cents per hour, a seventh of the minimum wage in Puerto Rico. Such countries' exports are subject to U.S. tariffs and non-tariff trade barriers, but they can be transported in ships flying foreign flags and using cheaper foreign labor, which Puerto Rican exports cannot.

The increasing competitiveness of foreign imports is clearly reflected in the level and composition of Puerto Rican employment. Between 1973 and 1977, total Puerto Rican manufacturing employment dropped from 152,100 to 145,400, or 4.4 percent -- see Table 3.* This drop, which was much sharper in Puerto Rico than in the United States, was due to a decline in the traditional labor-intensive industries (tobacco, textiles, apparel, and leather products (including footwear)), and the petrochemical sector. By contrast, employment grew in the chemical (including pharmaceutical), non-electrical machinery, and professional and scientific industries. Because these industries taken together employ a fourth of manufacturing workers, their gain offered a partial offset to the others' loss.

An unfortunate side effect of the possessions corporation system of taxation in the past has been tax-induced plant closings. Until 1976, a U.S. parent was subject to Federal tax on dividends received from a possessions corporation, but not on the distribution upon the liquidation of that corporation. Accordingly, liquidation of the subsidiary into the parent was the final step in realizing the full tax benefit of the possession corporation system of taxation. Although Puerto Rican operations could be continued after corporate liquidation as an unincorporated branch of the U.S. parent, high Puerto Rican and Federal taxes applicable to non-exempt income discouraged companies from continuing operations as taxable establishments.

Although the available evidence is rather meager, a recent study by Fomento, the Puerto Rican agency charged with promoting new investment in Puerto Rico, provides information on this point (see Figure III for source). The Fomento study examined 149 cases in which companies were granted tax exemption between 1960 and 1962 and actually established operations. Because the grants apply to specific products, not to all the operations of the company obtaining the grant, the current status of operations in 46 of the 149 cases could not be determined. Of the 103 cases remaining, 62 operations had apparently been discontinued,

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*The statistics in Table 3 for April 1978 represent a sharp increase in manufacturing employment over the March level.

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Table 3
Total Manufacturing Employment in Puerto Rico, by Major Industry Group:
Average for Calendar Years 1973 to 1977 and April 1978

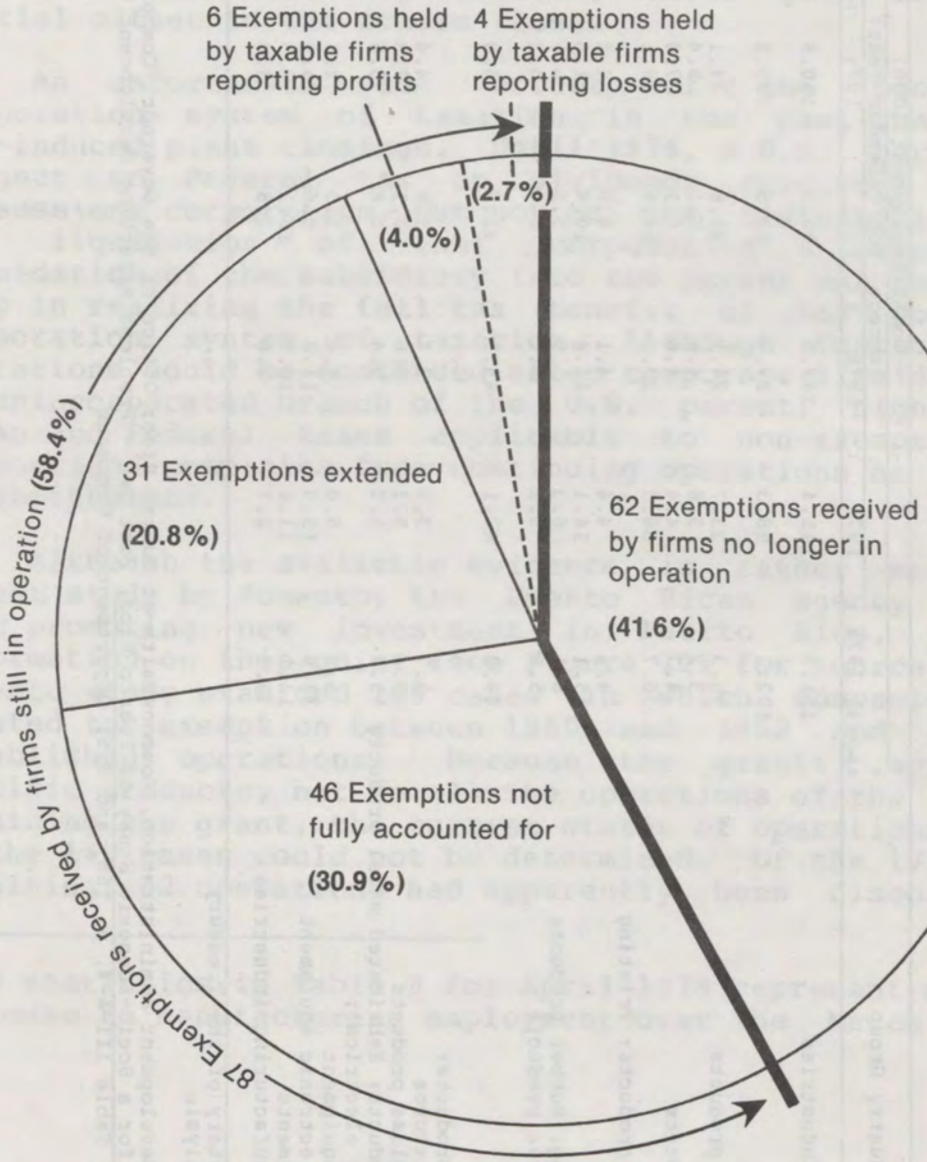
Industry Group	Total Employment (000)						Percentage Change
		Average for Calendar Year:					
	April 1978	1977	1976	1975	1974	1973	1973-1977
All Manufacturing Industries	151.5	145.4	142.5	135.2	150.9	152.1	-4.4
Nondurable goods	102.1	98.3	97.7	93.5	103.9	105.3	-6.6
Food and kindred products	26.3	23.7	24.1	23.8	24.1	24.0	-1.3
Tobacco products	3.2	3.8	4.9	5.1	5.4	5.5	-30.9
Textile mill products	4.7	4.4	4.6	5.1	7.4	7.6	-42.1
Apparel	36.7	36.3	37.5	34.6	38.1	40.3	-9.9
Paper and allied products; Printing and publishing	4.4	4.4	4.1	4.0	4.2	4.3	+2.3
Chemicals	15.1	14.1	11.4	10.4	11.6	10.6	+33.0
Petroleum refining; Rubber products	6.1	6.3	5.9	5.5	6.6	6.7	-6.0
Leather and leather products	5.6	5.2	5.2	5.0	6.2	6.4	-18.8
Durable goods	49.3	47.1	44.9	41.7	46.9	46.8	+0.6
Lumber and wood products; Furniture and fixtures	3.7	3.5	3.7	3.9	4.4	4.9	-28.6
Stone, clay and glass products	5.4	5.2	5.6	6.1	7.3	7.3	-28.8
Primary metal products; Fabricated metal products	5.7	5.2	5.4	5.8	5.6	6.8	-23.5
Machinery, except electrical; Transportation equipment	5.3	5.0	4.4	3.5	2.3	1.9	+163.2
Electrical and electronic equipment	13.9	13.9	11.8	9.6	13.9	14.0	-0.7
Scientific instruments	12.1	11.6	10.9	10.1	9.3	8.6	+34.9
Miscellaneous manufacturing industries	3.2	2.7	3.0	2.8	3.0	3.2	-15.6

Office of the Secretary of the Treasury
Office of Tax Analysis

Sources: Economic Development Administration, Commonwealth of Puerto Rico; Office of the Governor, Commonwealth of Puerto Rico, An Agenda for a Socio-Economic Study of Puerto Rico, Part Two - Problems Affecting Development of Puerto Rican Society, June 1977, Table III-A-4, p. 166; and U.S. Department of Commerce.

FIGURE III

Current Status of 149 Exemption Decrees Granted Between 1960 and 1962 and Utilized by Recipient Firms



Source: Government of Puerto Rico, Economic Development Administration, Economic Analysis of the Industrial Incentive Program of Puerto Rico, February 1978.

and 31 were still operating under an extension or a modification of the original tax exempt grant. Ten operations were continuing in a taxable status; six were paying taxes, and four were reporting losses.

As noted below, the Tax Reform Act of 1976 eliminated the Federal tax incentive to liquidate operations, and recent changes in the Puerto Rican Industrial Incentive Act ease the transition from exempt to taxable status.

B. Characteristics of Possessions Corporations

The characteristics of the possessions corporations reflect the unique features of Puerto Rican and Federal tax laws. Because most of the statistical analysis below is based on tax returns, the identities and characteristics of individual taxpayers are confidential. Companies must, however, file 10-K returns with the U.S. Securities and Exchange Commission, and these returns, which are available to the public, provide information on the importance of section 936 to individual companies. To explain why corporate income tax payments are often less than 48 percent (the maximum statutory tax rate in the United States) of book income, the S.E.C. requires corporations to indicate which provisions of the Internal Revenue Code reduced their tax liability by more than 2.4 percent of pre-tax book income. A survey of recent 10-K forms, most of which cover fiscal years ending in 1976 or the first half of 1977, provides the information shown in Table 4.

In interpreting these data, two caveats should be kept clearly in mind. First, because specific procedures for estimating the dollar value of various tax preferences have never been set forth by the S.E.C., the statistics presented in Table 4 should be regarded as only rough estimates of the importance to the companies of the possessions corporation system of taxation. Second, companies for whom the tax savings may be large in dollar terms, but less than 2.4 percent of book income before taxes, need not and generally do not report this item separately. Third, even when tax savings exceed 2.4 percent of book income, companies may combine the tax savings attributable to possessions corporations with lesser items (e.g., deferral or sometimes DISC). Companies following this practice were excluded from Table 4.

Table 4

Major U.S. Manufacturing Corporations Claiming a Reduction in Income Taxes in Excess of 2.4 Percent of Book Income Because of Section 931 or 936 of the Internal Revenue Code

Corporation	Industry	Estimated Tax Saving (millions of dollars)	Estimated Tax Saving (Percent of Book Income Before Taxes)
Esmark	Food products	$ 5.6	4.9%
H.J. Heinz	Food products	7.2	4.6
Pepsico	Beverages	7.0	2.8
Blue Bell	Textile & Apparel	3.6	3.4
Hanes Corporation	Textile & Apparel	3.1	10.6
Rohm & Haas	Chemicals	0.6	3.0
Abbott Laboratories	Pharmaceuticals	16.2	11.8
Baxter Travenol	Pharmaceuticals	12.1	14.3
Merck	Pharmaceuticals	22.9	5.5
Pfizer	Pharmaceuticals	35.6	15.1
Richardson-Merrell	Pharmaceuticals	5.8	5.3
Schering-Plough	Pharmaceuticals	37.0	15.1
G.D. Searle	Pharmaceuticals	32.5	38.5
Smith-Kline	Pharmaceuticals	24.5	22.9
American Hospital Supply	Pharmaceuticals	7.2	6.7
Johnson & Johnson	Pharmaceuticals	12.7	3.6
Eli Lilly	Pharmaceuticals	13.9	4.2
Squibb	Pharmaceuticals	21.9	14.6
Upjohn	Pharmaceuticals	10.0	8.0
Becton Dickinson	Pharmaceuticals	2.9	5.1
Chesebrough-Pond's	Toiletries	3.5	3.3
Digital Equipment	Office Equipment	11.1	6.3
Motorola	Electronics	6.2	8.2
Gould	Automotive Equipment	1.1	1.1
Perkins-Elmer	Instruments	1.7	4.5
Insilco	Miscellaneous Manufactures	2.3	10.8
Sub-total - 14 pharmaceuticals		255.2	
Total - 26 manufacturers		308.2	

Office of the Secretary of the Treasury
Office of Tax Analysis

Source: Summary of 10-K Reports filed with U.S. Securities and Exchange Commission in Tax Analysts and Advocates, Tax Notes, recent issues.

To gain as complete a picture of possessions corporations' operations as possible, information from Federal and Puerto Rican income tax returns was matched with payroll and employment data from companies' Federal unemployment insurance tax returns. This section summarizes the results based on information for 1975*, the most recent year for which relatively complete data are available. Section D below summarizes the less complete, but essentially similar information for 1976, and Appendix B sets forth comparable information for 1973 and 1974.

Table 5 indicates that 595 companies were apparently eligible for the section 931 exclusion in 1975**, the book income (net of losses) of these subsidiaries was $1.1 billion, and their estimated tax saving was $447 million. This total tax saving is estimated by multiplying book income (before deducting losses) by 40 percent and then subtracting any income taxes paid to the Puerto Rican and foreign governments.*** The tax-saving calculation ignores companies with losses because in 1975, under section 931,

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*Tables 5, 6 and 7 are based on the returns for corporations whose fiscal years ended between July 1, 1975 and June 30, 1976. Because most possessions corporations have calendar year accounting periods, the data correspond closely to calendar year 1975 operations. See Appendix B for details.

**That is to say, the companies excluded income under section 931 in 1973, 1974 or 1975 and reported a profit or a loss in 1975. Included in these 595 companies are those which may not in fact have excluded income under section 931 in 1975 because they reported a loss or failed to qualify in 1975 for the section 931 exclusion.

***The conventional practice of measuring tax savings or expenditures by calculating the tax consequences of changing the Internal Revenue Code, but assuming that corporations and individuals behave as they did before, may need explanation. The reason for the current practice is that the tax expenditure defined in this way may be estimated using available information on existing law and behavior. Estimating the behavioral change requires additional economic analysis of what would happen if tax policy were changed, and knowledgeable observers may differ in their assessment of what would indeed happen.

Table 5
Income and Estimated Tax Expenditure
by Industry, 1975 1/

Industry Group	Number of Corporations	Book Income ($000)	Estimated Tax Expenditure ($000)
All Industries	595	1,109,567	447,059
Manufacturing industries	394	1,055,462	425,369
Food and kindred products	22	71,747	28,652
Tobacco products	7	26,805	10,744
Textile mill products	8	-3,051	265
Apparel	88	43,557	17,669
Chemicals, total	69	616,191	246,470
Pharmaceuticals	47	547,060	218,210
All other chemicals	22	69,131	28,260
Rubber products	14	1,444	572
Leather and leather products	14	7,289	2,910
Stone, clay, and glass products	7	8,419	3,384
Fabricated metal products	26	24,714	10,114
Machinery, except electrical	7	1,882	759
Electrical and electronic equipment	76	195,593	79,164
Transportation equipment	5	1,074	430
Scientific instruments	27	33,688	13,627
All other manufacturing	24	26,110	10,609
Nonmanufacturing	201	54,104	21,689
Transportation, communications, and utilities	9	30,006	10,062
Wholesale trade	12	3,144	1,258
Retail trade	101	12,541	5,250
Apparel	83	2,082	1,123
Finance, insurance, real estate	26	1,284	588
Savings and loans	9	808	307
Services	16	-107	1,623
Miscellaneous and not available	37	7,236	2,908

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1/ Includes data for possessions corporations operating in American Samoa, Guam, and the Panama Canal Zone. These non-Puerto Rican operations account for less than 2 percent of total tax expenditure in any year (see Table 1).

they could join affiliated U.S. companies in filing a consolidated Federal return. The 40 percent represents the Treasury's necessarily rough estimate of what the effective rate of taxation would have been in the absence of a tax provision such as this.* (Another way of interpreting this 40 percent is that it is the effective rate which would apply if Puerto Rico were treated the same way as the fifty States and the District of Columbia.) The effective rate is less than 48 percent, the maximum statutory rate, because other provisions of the Internal Revenue Code (e.g., the investment tax credit and accelerated depreciation) would have reduced the tax burden by an estimated 8 percentage points. Puerto Rican and foreign taxes, which amounted to $6.2 million overall, would also have been creditable against the Federal income tax liability and, thus, further reduce the net saving of U.S. taxes.

Several important conclusions can be drawn from the tables in the text and Appendix B and from the underlying statistics:

-- The Federal tax expenditure in 1975 was $447 million, compared to $258 million in 1973.

-- If all the possessions corporations of each U.S. parent are consolidated, the benefits of the possessions corporation system of taxation were concentrated among all U.S. parent corporations as follows in 1975:

Number of Parent Corporations	Percent of Total Tax Benefits of All Corporations
Top 5	27.3%
Top 10	46.2
Top 20	70.0
Top 30	80.2

-- Just under 50 percent of the total tax saving from 1973-1975 was realized by pharmaceutical subsidiaries. The concentration of tax benefits for parent corporations indicated above is largely attributable to its concentration in the pharmaceutical sector.

*See Department of the Treasury, Effective Income Tax Rates Paid by United States Corporations in 1972, May 1978.

Tables 6 and 7 are based on 280 possessions corporations for which 1975 employment and payroll data could be obtained from the Federal unemployment tax returns. While the coverage represents less than half the number of companies included in Table 5, the combined book income of the sample, $860 million, represents four fifths of the book income of all possessions corporations. For no apparent reason, information for companies in the high-profit industries was more frequently available than that for companies in the labor-intensive industries.

The first three columns of Table 6 present information comparable to that in Table 5. Columns 5 and 7 indicate the number of employees and the total employee compensation, respectively, in each industry in 1975. Finally, the last three columns indicate the tax expenditure per employee, the tax expenditure as a percent of total compensation, and average compensation.

Table 6 highlights the relationship between Federal tax expenditures and Puerto Rican employment. For the manufacturing companies covered, the tax expenditure per employee averaged $7,428, which was slightly larger than the average compensation per worker, $7,300. Table 6 also indicates that the tax expenditure per employee varied from one industry to another. In the pharmaceutical industry the Federal tax expenditure represented almost $35,000 per employee, or approximately three and a half times the total compensation of the comparatively well paid Puerto Rican pharmaceutical employee. By contrast, in the rubber industry, the tax expenditure per employee was $760, or 11 percent of the average wage. The tax expenditure per employee in all manufacturing corporations except pharmaceuticals was $4,061.

Table 7 is based on the same 280 possessions corporations shown in Table 6, but ranked according to the Federal tax expenditure per employee. At the top of the ranking was a company for which the Federal tax expenditure represented more than $500,000 per Puerto Rican employee; at the low end were the companies which incurred losses and, thus, derived no immediate tax benefit from section 931. According to Table 7, the top five possessions corporations had tax savings per employee in excess $100,000; together they accounted for 8.4 percent of the total tax savings and 0.5 percent of the total employment, of the 280 companies for which employment information was available. The top 58 possessions corporations, those for which tax savings per employee exceeded $10,000 in 1975, collectively accounted

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Table 6
Tax Expenditure, Employment and Compensation of Employees by Industry, 1975

Industry Group	Number of Corporations	Book Income ($000)	Tax Expenditure: Amount ($000)	Tax Expenditure: Percent of Total	Employees: Number	Employees: Percent of Total	Compensation of Employees 1/: Amount ($000)	Compensation of Employees 1/: Percent of Total	Tax Expenditure Per Employee ($)	Tax Expenditure as Percent of Compensation of Employees	Average Employee Compensation ($)
All industries	280	858,961	342,212	100.0	43,174	100.0	345,234	100.0	5,229 2/	67.7 2/	7,729 2/
Manufacturing industries	237	824,816	328,863	96.1	31,812	73.7	250,149	72.5	7,428 2/	101.7 2/	7,300 2/
Food and kindred products	14	37,173	13,138	3.8	5,321	12.3	38,920	11.3	2,469	33.8	7,314
Tobacco products	5	5,487	2,271	.7	861	2.0	4,600	1.3	2,638	49.4	5,342
Textile mill products	3	281	143	.1	83	.2	527	.2	1,723	27.1	6,346
Apparel	46	14,007	5,847	1.7	4,658	10.8	25,508	7.4	1,255	22.9	5,475
Chemicals, total	49	562,306	224,734	65.7	7,838	18.2	84,390	24.4	28,672	266.3	10,766
Pharmaceuticals	35	507,126	202,054	59.0	5,794	13.4	58,127	16.8	34,873	347.6	10,032
All other chemicals	14	55,108	22,680	6.6	2,044	4.7	25,075	7.3	11,096	90.4	12,300
Rubber products	8	1,173	438	.1	576	1.3	3,959	1.1	760	11.1	6,872
Leather and leather products	9	6,011	2,404	.7	1,477	3.4	8,381	2.4	1,628	28.7	5,674
Stone, clay and glass products	4	4,530	1,835	.5	414	1.0	2,775	.8	4,432	66.1	6,702
Fabricated metal products	18	21,156	8,578	2.5	1,248	2.9	10,412	3.0	6,873	82.4	8,342
Machinery, except electrical	3	963	392	.1	71	.2	457	.1	5,521	85.8	6,431
Electrical and electronic equipment	46	128,423	51,651	15.1	6,958	16.1	51,580	14.9	7,423	100.1	7,412
Transportation equipment	3	734	293	.1	109	.3	898	.3	2,688	32.6	8,239
Scientific instruments	21	26,085	10,479	3.1	1,627	3.8	11,235	3.3	6,441	93.3	6,905
All other manufacturing	8	16,487	6,660	1.9	571	1.3	7,696	2.2	11,664	86.5	13,478
Nonmanufacturing	43	34,145	13,349	3.9	11,362	26.3	95,084	27.5	768 2/	8.9 2/	8,597 2/
Transportation, communications and utilities	4	27,975	9,249	2.7	4,430	10.3	37,792	10.9	2,088	24.5	8,530
Wholesale trade	5	1,756	702	.2	340	.8	3,283	1.0	2,064	21.4	9,656
Retail trade	3	2,346	876	.3	2,400	5.6	21,944	6.4	365	4.0	9,143
Finance, insurance, real estate	12	950	390	.1	861	2.0	7,509	2.2	452	5.2	8,720
Savings and loans	8	785	298	.1	799	1.9	6,913	2.0	373	4.3	8,651
Services	8	-991	1,331	.4	2,061	4.8	15,031	4.4	646	8.9	7,292
Miscellaneous and not available	11	2,108	801	.2	1,270	2.9	9,525	2.8	631	8.4	7,500

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1/ Compensation of employees was computed by multiplying 1.189 times payroll. The additional 18.9 percent reflects the employer-paid portion of social security, unemployment insurance, and other non-payroll labor costs. The 18.9 percent is the average for all U.S. manufacturing industries in 1975; see the U.S. Department of Commerce, Survey of Current Business, July 1977, Tables 6.5 and 6.6.

2/ Compensation of employees and number of employees used to compute these amounts were weighted by industry using the ratio of tax expenditure in Table 5 and tax expenditure in this Table.

Table 7
Tax Expenditure, Employment and Compensation of Employees by Size of Tax Expenditure Per Employee, 1975

Size of Tax Expenditure per Employee	Number of Corporations	Book Income ($000)	Tax Expenditure: Amount ($000)	Tax Expenditure: Percent of Total	Employees: Number	Employees: Percent of Total	Compensation of Employees 1/: Amount ($000)	Compensation of Employees 1/: Percent of Total	Tax Expenditure Per Employee ($)	Tax Expenditure as Percent of Compensation of Employees	Average Employee Compensation ($)
All Corporations	280	858,961	342,212	100.0	43,174	100.0	345,234	100.0	5,229 2/	67.7 2/	7,729 2/
$100,000 or more	5	72,950	29,180	8.4	227	.5	2,442	.6	128,546	1,194.9	10,757
$ 50,000 under $100,000	11	266,912	106,760	30.9	1,511	3.5	16,289	4.3	70,655	655.4	10,779
$ 10,000 under $ 50,000	42	274,257	108,529	31.7	4,851	11.2	44,863	11.8	22,373	241.9	9,248
$ 5,000 under $ 10,000	39	128,198	51,266	15.0	6,810	15.8	67,322	17.7	7,528	76.2	9,885
$ 1,000 under $ 5,000	91	114,456	41,535	12.4	15,972	37.0	117,558	30.9	2,600	35.3	7,360
$ 500 under $ 1,000	28	6,695	2,636	.8	3,640	8.4	24,145	6.3	724	10.9	6,632
$ 100 under $ 500	26	5,615	2,246	.7	6,607	15.3	49,392	13.0	340	4.5	7,475
$ 1 under $ 100	6	438	59	--	896	2.1	5,574	1.5	66	1.1	6,220
Loss Corporations	32	-10,561	--	--	2,660	6.2	17,650	14.0	--	--	6,635

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1/ Compensation of employees was computed by multiplying 1.189 times payroll. The additional 18.9 percent reflects the employer-paid portion of social security, unemployment insurance, and other non-payroll labor costs. The 18.9 percent is the average for all U.S. manufacturing industries in 1975; see the U.S. Department of Commerce, Survey of Current Business, July 1977, Tables 6.5 and 6.6.

2/ Compensation of employees and number of employees used to compute these amounts were weighted by industry using the ratio of tax expenditure in Table 5 and tax expenditure in Table 6.

for 71 percent of the total tax expenditure and 15.2 percent of total employment. Because the coverage of employment and payroll statistics is not complete, possessions corporations with tax savings exceeding $10,000 per employee may in fact have realized a somewhat smaller percentage of the total tax savings and a significantly smaller percentage of the total employees of all possessions corporations than was the case for the 280 companies represented in Table 7.*

Both Tables 6 and 7 indicate a direct relationship between the company's tax saving per employee and its total compensation per employee. This reflects a tendency of the high-profit industries to employ more highly skilled workers and/or a willingness to pay those workers more than they would have been paid by other Puerto Rican employers. Finally, the industries in which tax savings per employee were the highest (pharmaceuticals, electrical and electronic equipment, scientific instruments, non-electrical machinery) tended to be the same industries in which total employment has been growing since 1973; conversely, industries in which tax savings per employee were the lowest (tobacco products, textiles, apparel, leather products) tended to be those whose employment was declining -- see Table 3 above. While taxation is not the only factor shaping the development of Puerto Rican industry -- the growth in U.S. demand for the products, international trade considerations and other factors play an important role -- the evidence does suggest that tax incentives may bring investment to Puerto Rico.

C. Linkages and the Multiplier

The preceding Section related the tax cost of the possessions corporation system of taxation to the employment and payroll of those companies. In addition to creating jobs directly, this system of taxation may bring indirect benefits to Puerto Rico. Manufacturing requires raw materials, intermediate goods, and services, a portion of which are supplied by the local economy. Investment in plant and equipment creates jobs in the construction and capital equipment industries. Workers in all industries spend their salaries on goods and services, which has a

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*These inferences are based on the assumption that tax savings per employee for companies missing from the sample equal the average tax savings per employee for companies in the same industry -- see Table 6. Because the pharmaceutical companies tend to be over represented in the sample, the biases indicated in the text may have occurred.

"multiplier" effect on the Puerto Rican economy.* In addition to these "backward linkages", the development of one industry may encourage the growth of downstream customers, a phenomenon called "forward linkage." For example, the building of a petroleum refinery facilitates the growth of the petrochemical manufacturers. This Section summarizes the evidence currently available on the importance of these indirect benefits.

1. Backward Linkages

The usual method of evaluating backward linkages begins by examining industries' expenditures on various inputs. In order to compare linkages in one industry to those in another, each industry's expenditures on labor, capital, locally purchased materials and on imports are expressed as a percentage of the total value of its production. The sum of the shares of all expenditures measured in this way, plus the rate of return on invested capital, is 100 percent.

The costs of materials, labor and other inputs as a percentage of the total value of production by Puerto Rican manufacturing industries in 1972 are depicted in Table 8. The primary statistical source on which Table 8 is based does not differentiate between possessions corporations and locally owned companies or between imported and locally produced materials. Because the operations of a possessions corporation are often integrated with those of its U.S. parent, the linkage of possessions corporations with the local economy may be somewhat weaker than the linkage for all Puerto Rican manufacturers, as measured in Table 8.

To estimate how much possessions corporations purchase from the local economy, one must first determine how total purchases are apportioned between Puerto Rican and imported inputs. Unfortunately, neither the 1972 Census of Manufactures nor any other recent study provides up to date information on this point. Rather than assuming that every industry's propensity to import was the same as that of the Puerto Rican economy as a whole, each industry's 1972 expenditure was apportioned using data from a recently

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*As a general practice, the Treasury does not estimate the linkage and multiplier impacts of specific tax provisions. This is because tax changes are usually taken in the context of an overall Federal budget. The purpose of undertaking the analysis here is to assess the impact of section 931/936, both in total and by industry, on Puerto Rico alone, not on the U.S. and Puerto Rico taken together.

Table 8
Expenditures on Materials, Labor, Plant, and Equipment
as a Percent of the Value of Production by Manufacturing Establishments in Puerto Rico, 1972

	All Manufacturing Industries	Food and Kindred Products	Tobacco Products	Textile Mill Products	Apparel	Lumber and Wood Products
Cost of Materials from All Sources 1/	54.3	64.7	59.3	60.8	46.1	56.3
Cost of Materials from Puerto Rico 2/	26.8	49.8	19.0	16.4	14.8	18.0
Value Added 1/	45.7	35.3	40.7	39.2	53.9	43.7
Labor Costs 3/	17.0	14.5	16.3	18.9	30.8	30.0
Return on Capital and Overhead Costs 4/	28.4	20.6	24.1	20.0	22.7	12.8
Expenditures on New Plant 1/	2.1	1.1	.1	.1	.1	.2
Expenditures on New Equipment 1/	2.2	3.2	2.2	.9	.8	1.0
Expenditures on Used Equipment 1/	*	.3	.5	*	.4	*
Total Expenditures on Materials, Labor, Plant, and Equipment in Puerto Rico 5/	45.9	66.2	36.3	35.6	46.3	48.4
Ratio of Labor Costs to Total Expenditures in Puerto Rico	.370	.219	.449	.531	.665	.620

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*Less than 0.05 percent.

Table 8-continued

	Furniture and Fixtures	Paper and Allied Products	Printing and Publishing	Chemicals: Total	Chemicals: Pharmaceuticals	Petroleum Refining
Cost of Materials from All Sources 1/	46.3	57.8	34.2	42.3	16.4	75.4
Cost of Materials from Puerto Rico 2/	24.5	24.9	20.9	19.0	7.4	31.7
Value Added 1/	53.7	42.2	65.8	57.7	83.6	24.6
Labor Costs 3/	27.5	22.4	30.3	8.7	6.9	6.4
Return on Capital and Overhead Costs 4/	25.7	19.5	35.1	48.9	76.6	18.1
Expenditures on New Plant 1/	3.7	3.3	3.0	4.3	4.0	5.5
Expenditures on New Equipment 1/	1.2	8.1	3.9	3.0	3.5	.2
Expenditures on Used Equipment 1/	.2	.2	--	*	*	*
Total Expenditures on Materials, Labor, Plant, and Equipment from Puerto Rico 5/	55.4	51.7	54.4	31.8	18.1	42.5
Ratio of Labor Costs to Total Expenditures in Puerto Rico	.496	.433	.557	.274	.381	.151

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*Less than 0.05 percent.

Table 8-continued

	Rubber Products	Leather and Leather Products	Stone, Clay and Glass Products	Primary Metals	Fabricated Metal Products	Machinery Except Electrical
Cost of Materials from All Sources 1/	53.5	51.2	45.3	58.4	50.1	34.1
Cost of Materials from Puerto Rico 2/	17.1	9.7	38.5	31.5	16.0	10.9
Value Added 1/	46.5	48.8	54.7	41.6	49.9	65.9
Labor Costs 3/	27.5	29.3	25.3	17.8	21.9	26.1
Return on Capital and Overhead Costs 4/	18.6	19.0	29.0	23.5	27.7	39.4
Expenditures on New Plant 1/	.2	*	1.6	1.1	1.4	.2
Expenditures on New Equipment 1/	.2	.5	4.2	5.4	2.4	1.6
Expenditures on Used Equipment 1/	2.2	*	.2	--	.1	*
Total Expenditures on Materials, Labor, Plant, and Equipment from Puerto Rico 5/	45.3	39.1	66.2	51.2	39.2	37.5
Ratio of Labor Costs to Total Expenditures in Puerto Rico	.607	.749	.382	.348	.558	.696

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*Less than 0.05 percent.

Table 8-continued

	Electrical and Electronic Equipment	Transportation Equipment	Scientific Instruments	Miscellaneous Manufacturing Industries
Cost of Materials from All Sources 1/	42.5	46.6	36.2	54.6
Cost of Materials from Puerto Rico 2/	13.6	14.9	11.6	17.5
Value Added 1/	57.5	53.4	63.8	45.4
Labor Costs 3/	19.8	28.9	25.5	21.0
Return on Capital and Overhead Costs 4/	37.4	24.1	37.9	24.1
Expenditures on New Plant 1/	2.7	*	.5	1.2
Expenditures on New Equipment 1/	1.3	.9	1.8	.6
Expenditures on Used Equipment 1/	.2	.1	.1	.1
Total Expenditures on Materials, Labor, Plant, and Equipment from Puerto Rico 5/	36.1	44.3	38.0	39.8
Ratio of Labor Costs to Total Expenditures in Puerto Rico	.548	.655	.671	.530

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*Less than 0.05 percent.

*Less than 0.05 percent.

Table 8-continued

Notes:

1/ Based on U.S. Department of Commerce, 1972 Economic Census of Outlying Areas, Manufacturing, Puerto Rico, October 1974, Chapter 2, Table 2. All statistics are expressed as a percentage of value added plus cost of materials.

2/ Percentage of cost of materials from Puerto Rico is estimated by multiplying the cost of materials from all sources by the share of intermediate imports in total intermediate inputs. This latter share was estimated by Richard Weisskoff and Edward Wolff, "Development and Trade Dependence: The Case of Puerto Rico, 1948-1963," Review of Economics and Statistics, November 1975, Table 2, p. 474. These import shares are based on 1963 data; more recent information is unavailable. Whether the degree of dependence on imported inputs for individual industries decreased between 1963 and 1972 is impossible to determine, but the ratio of Puerto Rican imports of capital goods, raw materials and other intermediate goods to the value of shipments for all industries decreased only slightly over this interval.

3/ Labor costs are estimated by multiplying total payroll, as reported by the U.S. Department of Commerce, op. cit., by 1.16. The additional 16 percent reflects the employer-paid portion of social security, unemployment insurance and other non-payroll labor costs. The 16 percent is the average for all U.S. manufacturing industries in 1972; see the U.S. Department of Commerce, The National Income and Product Accounts of the United States 1929-74: Statistical Tables, 1976, Tables 6.5 and 6.6.

4/ Value shown equals the differential between value added and labor costs. The return on capital includes not only profits, but also interest expenses, depreciation, expenditures on accounting and legal services, and any other overhead costs.

5/ Value shown equals the sum of the cost of materials from Puerto Rico, labor costs, 80 percent of expenditures on new plant, 21 percent of expenditures on new equipment and total expenditures on used equipment. The 80 percent of expenditures on new plant corresponds to the estimated ratio of expenditures on Puerto Rican inputs to total expenditures by the construction industry, as reported in Weisskoff and Wolff, op. cit. The 21 percent of expenditures on new equipment corresponds to the ratio of the value of shipments of machinery except electrical with a Puerto Rican destination to total expenditures for new equipment by all manufacturers.

published study based on 1963 data (see footnote 2 to Table 8). Because Puerto Rico's total imports of capital equipment, raw materials and intermediate products as a percentage of either aggregate manufacturing shipments or gross domestic output decreased only slightly between 1963 and 1972, applying the 1963 apportionment ratios to the 1972 data may produce reasonable results. Between 1972 and 1977, however, the ratio of imported capital equipment, raw materials and intermediate products increased substantially, so the statistics in Table 8 may overstate possessions corporations dependence on the local economy.*

With these caveats in mind, Table 8 indicates that for all manufacturers the cost of materials represented 54.3 percent of the value of production. Just under half of these materials (26.8 percent of the value of production) were estimated to have been obtained in Puerto Rico, and the rest were imported, primarily from the United States. Labor costs, which include the employer-paid Social Security contribution and the cost of other non-wage benefits, constituted 17.0 percent of the value of production. The return on capital plus overhead costs (interest, depreciation of existing capital, accounting and legal costs, etc.) accounted for the remaining 28.4 percent of the value of production. Although the source on which Table 8 is based does not estimate the cost of existing capital used in production, it does report new investment in plant and equipment, be it for replacement or expansion. New investment represented 4.3 percent of the value of manufacturing production, roughly a seventh of the current return on capital plus overhead costs.

The last two rows in Table 8 show estimated expenditures on all Puerto Rican inputs (labor plus locally purchased materials, plant and equipment) as a percent of the value of production, and labor costs as a percentage of estimated expenditures on all Puerto Rican inputs, respectively. The former statistic is useful in comparing one

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*A group of 12 pharmaceutical companies indicated in an April 19, 1978 submission to the Treasury that their own recent annual purchases in Puerto Rico of materials and services totaled $89.9 million, which was 11 percent larger than their own total payroll in Puerto Rico. By comparison, Table 8 estimates the cost of materials from Puerto Rico for all pharmaceutical manufacterers was 7 percent larger than the cost of labor in 1972. In this one industry, at least, the use of 1963 data has produced a result close to that based on more recent and presumably more accurate data.

industry's use of Puerto Rican inputs to another's, while the latter will be used below to translate the Federal tax expenditure as a percent of compensation of employees into tax expenditure as a percent of Puerto Rican income associated directly or indirectly with possessions corporations.

The second to last row in Table 8 indicates that some Puerto Rican manufacturers depend much more than others on locally produced inputs. For example, food, furniture, paper, printing, stone, clay and glass, and primary metal manufacturers' expenditures on Puerto Rican inputs represent more than half of the total value of their own production. At the opposite extreme, the pharmaceutical manufacturers spent less than a fifth of the value of production on Puerto Rican inputs. The low pharmaceutical percentage reflects a high return on capital plus overhead costs, not a heavier than average dependence on imported versus locally purchased materials. (The pharmaceutical companies are estimated to import approximately 55 percent of their total inputs, which is slightly higher than the 51 percent average for all manufacturers.) Finally, Table 8 also indicates that the pharmaceutical companies reinvested 7.6 percent of the value of their current production in additions to plant and equipment, more than the 4.3 percent for all manufacturers. As Table 3 above indicated, the chemical sector, which includes pharmaceuticals, has expanded rapidly since 1972.

2. The Multiplier

In addition to the income generated by payroll and purchases of locally produced materials, expenditures by possessions corporations have a multiplier impact on the local economy. The original increase in spending generates income, part of which is used to purchase locally produced goods and services, thereby inducing a secondary increase in spending and income. Lacking any econometric model of the Puerto Rican economy, one must resort to less exact methods to estimate the size of the Puerto Rican multiplier. According to standard textbook macroeconomic analysis, the size of the multiplier for an increase in spending (assuming, as seems reasonable in the case of Puerto Rico, that the government cannot change the rate of interest or credit conditions) is:

$$\frac{1}{s+m}$$

The symbols s and m represent the fraction of an increase in GNP which is saved or is spent on imports, respectively.

Saving and importing represent "leakages" -- the opposite of "linkages" -- from the spending-income cycle; the greater these leakages are, the more quickly the impact of increased spending is dissipated, and the smaller the multipler is.

In Puerto Rico, the propensity to save appears to be small, and the propensity to import high. In 1976, imports equaled 72 percent of gross national product; between 1974 and 1976 the increase in the dollar value of imports equaled 79 percent of the increase in the dollar value of gross national product. If the marginal propensity to save, s, is assumed to be zero and the marginal propensity to import, m, to be .75, then the formula given above indicates a multiplier of 1.33. That is to say, if spending increases by $1.00, an additional $.33 in local spending will be subsequently generated, so the total increase in income is $1.33.*

3. Direct, Indirect and Total Effects

Information on total employee compensation of possessions corporations was presented in Section B above. A broader measure of Puerto Rican benefits can be obtained by adding to employee compensation estimates of the companies' purchases of Puerto Rican materials, new plant and equipment, and then incrementing that total spending on Puerto Rican inputs by the multiplier. The final result would be a measure of the total Puerto Rican income associated directly and indirectly with possessions corporations.

An assumption implicit in this new, broader measure is that all Puerto Rican resources used by the possessions corporation in their production have no alternative economic use -- they would be unemployed but for the possessions corporations. Although this may be a resonable assumption for the Puerto Rican labor used, other Puerto Rican factors may be scarce. Capital must be diverted from other productive uses. Water and land are scarce in Puerto Rico; their use by possessions corporations precludes their use in other sectors, such as agriculture. Some purchased inputs, such as gas, oil, sugar, wood, or alcohol, are standard commodities which must be bought or could be sold overseas.

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*This estimate ignores government taxation and spending. If part of an additional dollar of income is paid in taxes and the Puerto Rican government does not increase its spending by a matching amount, the "leakage" will be greater, and the multiplier will be smaller, than this simple analysis indicates.

Sewage treatment, solid-waste collection and disposal and other government services may also have economic costs. If employee compensation by possessions corporations is too narrow a measure of the benefits they bring Puerto Rico, the total income associated directly or indirectly with those corporations is probably too broad a measure.

Table 9 below shows for various manufacturing industries Federal tax expenditures as a percentage of direct labor costs, of total direct expenditures on Puerto Rican inputs, and of Puerto Rican income directly or indirectly associated with those expenditures. The first percentage is identical to that in Table 6 above, the second is obtained by multiplying the first by the percentage in the last row of Table 8, and the third by dividing the second by the multiplier. Finally, the fourth column is simply the inverse of the third column -- Puerto Rican expenditures directly or indirectly generated by possessions corporations per dollar of Federal tax expenditure.

Table 9 indicates that Federal tax expenditure in some industries is associated directly or indirectly with more Puerto Rican expenditures or income than in other industries. The average for all manufacturing is 3.5. In some industries (e.g., food products, rubber products), the ratio is between 15 and 20, reflecting a low level of tax-exempt income and/or substantial purchases of goods and services from the Puerto Rican economy. In other industries, the ratio is quite low, usually because the tax-exempt income is high and local purchases are only average.

In summary, taking account of the backward linkages and the multiplier effect significantly expands -- and probably overstates -- the total benefit to Puerto Rico associated with the possessions corporation system of taxation. And while the measured cost-benefit ratios are reduced, they continue to vary widely from one industry to another.*

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*Note that a benefit-cost ratio of 1.0 does <u>not</u> mark the boundary between a "good" program and a "bad" one. For the reasons indicated above, the total income associated directly or indirectly with possessions corporations may overstate the benefits to Puerto Rico. More importantly, the benefit-cost ratio of one program should be compared not to some fixed benchmark, but rather to the ratio for alternative programs. For example (and only for example), a public-works program funded by the Federal government would, because of the multiplier effect, have a benefit-cost ratio of 1.3. The alternative program could, of course, be a restructured tax incentive.

Table 9
Tax Expenditures as a Percent of Compensation of Employees, of Direct Expenditure in Puerto Rico, and of Direct and Indirect Expenditure in Puerto Rico, for Manufacturing Industries

	Tax Expenditure as a Percent of Compensation of Employees 1/	Tax Expenditure as Percent of Direct Expenditures in Puerto Rico 2/	Tax Expenditure as Percent of Total Direct and Indirect Expenditures in Puerto Rico 3/	Total Direct and Indirect Expenditures in Puerto Rico Divided by Tax Expenditure 4/
Manufacturing industries	101.7	37.6	28.2	3.5
Food and kindred products	33.8	7.4	5.6	17.9
Tobacco products	49.4	22.2	16.7	6.0
Textile mill products	27.1	14.4	10.8	9.3
Apparel	22.9	15.2	11.4	8.8
Chemicals, total	266.3	73.0	54.8	1.8
Pharmaceuticals	347.6	132.4	99.3	1.0
Rubber products	11.1	6.7	5.0	20.0
Leather and leather products	28.7	21.5	16.1	6.2
Stone, clay, and glass products	66.1	25.3	19.0	5.3
Fabricated metal products	82.4	46.0	34.5	2.9
Machinery, except electrical	85.8	59.7	44.8	2.2
Electrical and electronic equipment	100.1	54.9	41.2	2.4
Transportation equipment	32.6	21.4	16.1	6.2
Scientific instruments	93.3	62.6	47.0	2.1

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1/ From Table 6, column (10).
2/ Column (1) times Table 8, line (10).
3/ Column (2) divided by 1.33.
4/ Inverse of column (3).

4. Forward Linkages

Forward linkages are usually evaluated by examining the percentage of total sales to various types of customers. Table 10 shows the percentages of manufacturing industries' shipments in 1972 to Puerto Rico, to the United States and to foreign countries, respectively. For manufacturing as a whole, 41.2 percent went to individual and industrial consumers in Puerto Rico, 54.2 percent to buyers (including parent companies) in the United States, and 4.5 percent to foreign purchasers. If indirect exports (i.e., goods sold to other Puerto Rican manufacturers who, in turn, were exporting to the United States or foreign countries) could be estimated separately, Puerto Rico's dependence on export markets would appear larger than what Table 10 indicates.

Table 10 indicates that some industries' forward linkages with other sectors of the Puerto Rican economy are stronger than others'. The lumber and wood industry sells its limited output to Puerto Rican users, and its primary customers -- the furniture and paper industries -- also sell almost exclusively to the local market. By contrast, the pharmaceutical industry derived 1 percent of its total sales from the Puerto Rican market. Sales to United States buyers, many of whom may be parent corporations, accounted for 76 percent of total sales. The remaining 23 percent of pharmaceuticals' sales were to foreign purchasers (many of whom may have been affiliated foreign subsidiaries), a larger percentage than the corresponding figure for any other industry. The machinery industry, which exported 15 percent of its total shipments to foreign buyers, was second in terms of non-U.S. exports. Because possessions corporations sell mostly outside Puerto Rico, their operations were not depressed by the 1973-77 recession in the local economy.

D. Impact of Changing from Section 931 to Section 936 and of Restructuring the Tollgate Tax

This Section reviews the available evidence on the impact of the Federal Tax Reform Act of 1976 and of the Commonwealth's restructuring of its tollgate tax on dividends paid by possessions corporations. Because the tollgate tax changes became effective on the same date (October 1, 1976) as section 936, and because the entire Puerto Rican Industrial Incentive Act has been under close scrutiny and its reform anticipated, the impact of shifting from section 931 to section 936 cannot be completely disentangled from the impact of the tollgate tax or the uncertainty about the future of the tax exemption program.

Table 10
Destination of Shipments by Puerto Rican
Manufacturing Industries, 1972
(Percentage of Total)

Industry Group	Puerto Rico	United States 1/	Foreign Countries
All manufacturing industries	41.2	54.2	4.5
Food and kindred products	59.2	37.2	3.7
Tobacco products	15.5	84.5	*
Textile mill products	28.7	71.3	*
Apparel	21.8	78.0	*
Lumber and wood products	100.0	-	-
Furniture and fixtures	97.9	2.1	*
Paper and allied products	87.5	5.0	7.5
Printing and publishing	78.2	18.2	3.6
Chemicals	18.9	66.5	14.6
Pharmaceuticals	1.0	76.0	23.0
Petroleum refining	64.2	32.7	3.3
Rubber products	47.8	52.2	*
Leather and leather products	15.6	83.1	*
Stone, clay and glass products	91.7	8.3	*
Primary metal products	87.1	9.7	3.2
Fabricated metal products	77.1	22.2	1.4
Machinery except electrical	35.2	50.0	14.8
Electrical and electronic equipment	10.7	87.9	.2
Transportation equipment	72.7	9.1	9.1
Scientific instruments	3.9	94.6	2.3
Miscellaneous manufacturing industries	12.3	87.7	*

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Source: U.S. Department of Commerce, 1972 Economic Censuses of Outlying Areas, Manufactures, Puerto Rico, October 1974, Chapter 2, Table 3.

1/ Includes shipments to the Virgin Islands.

* Less than 0.05 percent.

1. New Investment in Puerto Rico

The Puerto Rican economy remained sluggish throughout 1977, but has been picking up speed in 1978. To a large extent these recent gains represent a welcome, if long overdue, recovery from the recession which began in 1973-74. In addition, Puerto Rico is a primary beneficiary of recent changes in the international economy. The recent depreciation of the dollar against many foreign currencies has helped Puerto Rican goods and services compete with foreign producers for U.S. markets. The Orderly Marketing Agreements limiting Korean and Taiwanese exports of shoes to the U.S., and the Multifiber Arrangements limiting eighteen developing countries' exports of textiles and apparel to the U.S., have lessened the competitive pressure on Puerto Rican manufacturers in these industries. The winter of 1977-78 was apparently the best ever for Puerto Rico's tourist industry. As the dollar depreciated and foreign vacations became more expensive, Puerto Rico seemed more attractive. In addition, the Tax Reform Act of 1976 imposed record-keeping and other requirements on Americans attending foreign conventions, but exempted those attending conventions in Puerto Rico and the possessions from those limitations.

The combined Federal and Commonwealth tax changes enacted in 1976 apparently made investing in Puerto Rico somewhat less attractive for most U.S. companies. The Federal tax change added new incentives and disincentives to investing in Puerto Rico. Those companies anxious to bring money home from Puerto Rico as soon as possible benefitted from the dividends-received deduction made available in 1976; those who felt no pressing need for domestic use of accumulated Puerto Rican income might have preferred to keep section 931 because of the exemption for Eurodollar interest income. But when the Puerto Rican tollgate tax rules and rates were also changed to make the dividends taxable, the gains U.S. investors expected from the Tax Reform Act of 1976 were diminished and, perhaps, reversed.

Table 11 below is based on 394 corporations claiming section 936 benefits for fiscal years ending before July 1, 1977 (most of which were for the calendar year 1976). The 394 corporations included in Table 11 accounted for approximately 80 percent of the income excludable under section 931 in 1975 (as shown in Table 5 above). For corporations included in both the 1975 statistics of Table 5 and the 1976 statistics of Table 11, total book income and total Federal tax savings increased by 43 percent and 44 percent, respectively. Accordingly, the estimated tax expenditure for sections 931 and 936 in calendar year 1976 is $634 million, a 44 percent increase over the $440 million for 1975.

Table 11
Income and Estimated Tax Expenditure by Industry, 1976 1/

Industry Group	Number of Corporations	Book Income ($000)	Estimated Tax Expenditure ($000)
All industries	394	1,325,963	532,996
Manufacturing industries	301	1,217,482	489,579
Food and kindred products	18	79,205	31,882
Tobacco products	6	15,989	6,396
Textile mill products	6	-272	192
Apparel	67	47,462	19,072
Chemicals, total	52	758,401	303,360
Pharmaceuticals	36	654,540	261,816
All other chemicals	16	103,861	41,544
Rubber products	7	1,560	626
Leather and leather products	6	5,818	2,327
Stone, clay and glass products	3	9,242	3,697
Fabricated metal products	15	15,475	6,199
Machinery, except electrical	7	2,012	808
Electrical and electronic equipment	67	224,057	89,772
Transportation equipment			
Scientific instruments	21	44,174	17,670
All other manufacturing	26	14,359	7,578
Nonmanufacturing	93	108,482	43,417
Transportation, communications and utilities	9	97,948	39,179
Wholesale trade	11	1,881	753
Retail trade	39	2,056	840
Finance, insurance, real estate	9	1,065	434
Services	10	743	297
Miscellaneous and not available	15	4,787	1,915

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1/ Preliminary statistics. See text. Includes data for possessions corporations operating in American Samoa, Guam, and the Panama Canal Zone. These non-Puerto Rican operations account for less than 2 percent of total tax expenditure in any year (see Table 1).

Tables 12 and 13 present information for the 209 possessions corporations included in Table 11 for which 1976 employment and payroll data are available. Comparing Table 12 to Table 6 above suggests that between 1975 and 1976 the Federal tax expenditure increased not only in dollar terms, but also relative to Puerto Rican employment and payroll. This increase appears to be attributable as much to higher tax expenditure per employee or per dollar of employee compensation in the high-profit industries as to an increase in the relative importance of these industries. For the 143 manufacturing corporations included in both Table 6 and Table 12, tax expenditure as a percentage of total employee compensation increased from 138 percent in 1975 to 149 percent in 1976. (As noted above, employment and payroll data were, for no apparent reason, more often available for high-profit companies.)

Because Tables 11, 12, and 13 are based largely on operations for calendar year 1976, they do not capture the effect of the Puerto Rican tollgate tax, which was passed and signed into law in the second half of 1976, much less the uncertainty of 1977 about the future investment climate in Puerto Rico. A better indicator of the impact of those developments may be the number of new tax exemptions applied for or granted over the last few years. Throughout 1977, each was low by historical standards, but this may have been due more to broader political and economic factors than to the technical changes in Federal and Commonwealth tax laws.

As the outlines of the Puerto Rican Administration's proposals for reforming the Industrial Incentive Act became apparent, investors realized that the days of total tax exemption were about to end. The large number of exemptions granted just before the new program was announced presumably included both a backlog of those that might have applied earlier and a rush of those that would have applied later.

As of May 1978, 711 corporations had filed a section 936 election form -- see Table 14. Taken together, these 711 companies accounted for 99.5 percent of the income excludable under section 931 in 1975. Of these, 635 were included in one or more of the tables for 1973 to 1976 in this Report. The remaining 76 corporations are "new" 936 corporations; that is to say, they excluded no income under section 931 between 1973 and 1975, nor did they claim a section 936 credit for a fiscal year ending before July 1, 1977. Thirty-five of these 76 new companies were incorporated in 1977 or 1978, while the remaining 41 were incorporated prior to 1977. This last group includes

Table 12
Tax Expenditure, Employment and Compensation of Employees by Industry, 1976 1/

Industry Group	Number of Corporations	Book Income ($000)	Tax Expenditure: Amount ($000)	Tax Expenditure: Percent of Total	Employees: Number	Employees: Percent of Total	Compensation of Employees 2/: Amount ($000)	Compensation of Employees 2/: Percent of Total	Tax Expenditure Per Employee ($)	Tax Expenditure as Percent of Compensation of Employees	Average Employee Compensation ($)
All industries	209	815,305	328,627	100.0	32,912	100.0	266,223	100.0	5,127 3/	71.1 3/	7,208 3/
Manufacturing industries	192	811,909	327,271	99.6	31,697	96.3	255,590	96.0	7,522 3/	119.7 3/	6,287 3/
Food and kindred products	10	38,557	15,621	4.8	4,239	12.9	30,199	11.3	3,685	51.7	7,124
Tobacco products	5	12,158	4,863	1.5	1,882	5.7	13,276	5.0	2,584	36.6	7,054
Textile mill products	4	-454	119	—	212	.6	1,449	.5	562	8.2	6,834
Apparel	42	30,099	12,066	3.7	7,938	24.1	46,390	17.4	1,520	26.0	5,844
Chemicals, total	35	549,315	219,722	66.9	6,220	18.9	76,707	28.8	35,325	286.4	12,332
Pharmaceuticals	25	478,329	191,329	58.2	4,428	13.5	48,691	18.3	43,209	392.9	10,996
All other chemicals	10	70,986	28,393	8.6	1,792	5.4	28,016	10.5	15,844	101.3	15,634
Rubber products	5	1,069	430	.1	180	.5	1,407	.5	2,386	30.6	7,816
Leather and leather products	5	5,550	2,219	.7	995	3.0	6,362	2.4	2,230	34.9	6,393
Fabricated metal products	12	11,141	4,465	1.4	522	1.6	4,232	1.6	8,553	105.5	8,107
Electrical and electronic equipment	38	110,042	44,160	13.4	6,147	18.7	47,934	18.0	7,184	92.1	7,797
Scientific instruments	18	38,466	15,386	4.7	1,792	5.4	13,721	5.2	8,586	112.1	7,656
All other manufacturing 4/	18	15,966	8,220	2.5	1,570	4.8	13,913	5.2	5,236	59.1	8,862
Nonmanufacturing	17	3,396	1,357	.4	1,215	3.7	10,633	4.0	1,118	12.8	8,751

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1/ Preliminary statistics. See text.
2/ Compensation of employees was computed by multiplying 1.195 times payroll. The additional 19.5 percent reflects the employer-paid portion of social security, unemployment insurance, and other non-payroll labor costs. The 19.5 percent is the average for all U.S. manufacturing industries in 1976; see the U.S. Department of Commerce, Survey of Current Business, July 1977, Tables 6.5 and 6.6
3/ Compensation of employees and number of employees used to compute these amounts were weighted by industry using the ratio of tax expenditure in Table 11 and tax expenditure in this Table.
4/ Includes manufacturing industries where data were available for less than 3 corporations.

Table 13

Tax Expenditure, Employment and Compensation of Employees by Size of Tax Expenditure Per Employee, 1976 1/

Size of Tax Expenditure per Employee	Number of Corporations	Book Income ($000)	Tax Expenditure		Employees		Compensation of Employees 2/		Tax Expenditure Per Employee ($)	Tax Expenditure as Percent of Compensation of Employees	Average Employee Compensation ($)
			Amount ($000)	Percent of Total	Number	Percent of Total	Amount ($000)	Percent of Total			
All Corporations	209	815,305	328,627	100.0	32,912	100.0	266,223	100.0	5,127 3/	71.1 3/	7,208 3/
$ 50,000 under $100,000	9	339,728	135,889	41.4	1,721	5.2	20,121	7.6	78,959	675.4	11,691
$ 10,000 under $ 50,000	50	314,304	125,719	38.3	6,291	19.1	72,339	27.2	19,984	173.8	11,498
$ 5,000 under $ 10,000	28	64,402	25,761	7.8	3,780	11.5	29,038	10.9	6,815	88.7	7,682
$ 1,000 under $ 5,000	64	95,374	38,136	11.6	14,567	44.3	100,039	37.6	2,618	38.1	6,867
$ 500 under $ 1,000	29	6,314	2,522	.8	3,588	10.9	22,364	8.4	703	11.3	6,232
$ 100 under $ 500	16	1,460	584	.2	1,780	5.4	11,691	4.4	328	5.0	6,568
$ 1 under $ 100	3	33	13	--	224	.7	1,242	.5	58	1.0	5,545
Loss Corporations	10	-6,309	--	--	961	2.9	9,389	3.5	--	--	9,770

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1/ Preliminary statistics. See text.

2/ Compensation of employees was computed by multiplying 1.195 times payroll. The additional 19.5 percent reflects the employer-paid portion of social security, unemployment insurance, and other non-payroll labor costs. The 19.5 percent is the average for all U.S. manufacturing industries in 1976; see the U.S. Department of Commerce, Survey of Current Business, July 1977, Tables 6.5 and 6.6.

3/ Compensation of employees and number of employees used to compute these amounts were weighted by industry using the ratio of tax expenditure in Table 11 and tax expenditure in Table 12.

Table 14
Elections under Section 936 by Industry

Industry	Total as of May 1978	Included in Report	New Elections: Total	New Elections: Date of Incorporation: 1977 or 1978	New Elections: Date of Incorporation: Before 1977
All industries	711	635	76	35	41
Manufacturing industries	546	491	55	27	28
Food and kindred products	32	28	4	1	3
Apparel	126	114	12	6	6
Chemicals, total	95	87	8	4	4
Pharmaceuticals	65	61	4	2	2
All other chemicals	30	26	4	2	2
Fabricated metal products	35	31	4	2	2
Electrical and electronic equipment	106	97	9	5	4
Scientific instruments	36	32	4	1	3
All other manufacturing	116	102	14	8	6
Nonmanufacturing	165	144	21	8	13
Wholesale and retail trade	70	65	5	2	3
Finance, insurance, real estate	29	23	6	1	5
All other nonmanufacturing	66	56	10	5	5

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several companies incorporated in the last five years, but which presumably had start-up losses making an earlier section 936 election disadvantageous. Table 14 does not include companies who recently obtained a tax exemption from Puerto Rico, but have delayed their 936 election until they are past their start-up losses. Table 14 indicates that the new 936 corporations have very much the same industrial composition as the old ones do.

2. Repatriation of Dividends

In denying a tax exemption for income earned outside the possession in which the corporation had a trade or business, and in making a dividends-received deduction available to the parent, Congress hoped to speed the repatriation of dividends. Because of the Puerto Rican tollgate tax, however, dividend payments were slow throughout 1977. With the entire 936 community seeking repeal or substantial modification of the tax, most companies waited to see what would happen. Because the tollgate tax does not apply to a liquidating distribution, the incentive to wait until the income tax exemption expired and then liquidate the subsidiary into the parent remained, albeit with diminished force and for Commonwealth, rather than for Federal, tax reasons. Finally, some companies initially wondered whether they could pay any tollgate tax without being required by their accountants to establish a reserve to provide for future tollgate taxes on all accumulated earnings. Creating such a reserve could depress income in financial statements in the quarter in which the reserve was established. Accounting firms have, however, taken the position that a reserve for taxes on accumulated earnings need not be established, providing the company commits itself to repatriating only current earnings.

In the first six months of 1978, the rate of dividend payments increased appreciably. As of early June, companies have committed themselves to paying in excess of $1.4 billion in dividends and $48 million in tollgate taxes. The effective rate of taxation of 3-4 percent reflects the Puerto Rican Treasury Department's ruling in December 1977 (clarifying the exemption for dividends from income earned outside Puerto Rico from the 10 percent tollgate tax and allowing a company to designate up to 50 percent of a dividend as coming from undistributed foreign income). The increased flow of dividends reflects not only the lowering of the effective rate of the tollgate tax from 10 percent to less than 5 percent, but also the investors' recognition that further reductions in the tollgate tax are unlikely.

3. Financial Portfolios

As of mid-1977, accumulated retained earnings of possessions corporations were estimated to be between $5 billion and $6 billion and growing at a rate of $1.6 billion annually. (The increase in dividend payments in 1978 has cut the growth of accumulated retained earnings.) Under section 931, a portion of the accumulated funds found their way to the Eurodollar market through banks in Guam. Interest on Guam deposits was not only exempt from Guam and Puerto Rican taxes, but under section 931 was possessions source income, and, therefore, helped the recipient to remain qualified for the section 931 exclusion. Subsidiaries whose Eurodollar and other passive income was about to exceed 50 percent of their total income and, thus, stood to lose their 931 exemption on this account often invested in tax-exempt municipal bonds, Puerto Rican and U.S., because the interest was not counted as income in determining the eligibility for section 931 benefits.

The tax exemption for interest on Eurodollar investments generally and Guam certificates of deposit in particular was terminated by section 936, which provided a tax credit only for income earned in the possession where the 936 company had a trade or business. The estimated composition of financial investments by 936 corporations as of mid-1977 is shown in Table 15. The nearly $3 billion invested in Puerto Rican assets represents a substantial increase over earlier years and reflects the section 936 tax credit for "qualified possessions source investment income."

Despite the apparent infusion of 936 funds, long-term interest rates in Puerto Rico have not been appreciably reduced for the average borrower. As indicated in Table 15, established 936 companies are willing to make construction loans to new 936 subsidiaries of established U.S. companies, but not to less credit-worthy Puerto Rican borrowers. Under temporary federal tax regulations, Puerto Rican banks (including the Puerto Rican branches of mainland banks) can "warehouse" 936 deposits in New York for up to six months, so much of the 936 bank deposits shown in Table 15 has led to increased investment outside of Puerto Rico.

The substantial increase since 1976 in purchases of Puerto Rican government bonds and the contemporaneous reduction in interest rates on these bonds is sometimes attributed to the 936 credit for qualified possessions source investment income -- see Table 16. In fact, this is not the case -- such interest is tax-exempt under the Puerto

Table 15

Estimated Composition of Financial Investments by 936 Corporations in Mid-1977

$ billions	Asset
1.6	Deposits in Puerto Rican Banks
.6	Puerto Rican source GNMA mortgages
.4	931-936 loans
.3	Puerto Rican Government bonds
2.9	Total invested in Puerto Rico
.6	U.S. municipals
.3	U.S. project notes
.4	Preferred stock
1.3	Total invested in the U.S.
.6	Canada and Europe
.5+	Unaccounted for
5.3+	Total 936 funds

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Table 16
Sales of Bonds by the Government Development Bank for Puerto Rico
October 1976 - May 1978

Issuing Agency	Date (1)	Amount ($ millions) (2)	Average Life (Years) (3)	Net Interest Cost (percent) (4)	Bond Buyer's Index of 20 Bonds 1/ (5)	Point Spread (4-5) (6)
Water Resources Authority	10-13-76	60.0	18.13	8.23	6.25	1.98
Government Development Bank 2/	12-06-76	85.0	8.65	7.75	5.96	1.79
Aqueduct & Sewer Authority	12-10-76	35.0	15.40	7.88	5.96	1.92
Highway Authority	2-18-77	62.5	13.66	7.61	5.83	1.78
Commonwealth Series 1977	4-14-77	300.0	24.24	7.89	5.70	2.19
Government Development Bank 2/	7-13-77	50.0	6.21	6.15	5.64	.51
Highway Authority	8-10-77	75.0	22.38	6.99	5.63	1.36
Ports Authority	11-17-77	29.5	20.06	7.33	5.45	1.88
Public Buildings Authority	2-14-78	110.0	14.71	7.72	5.61	2.11
Puerto Rico Industrial Development	3-31-78	40.0	16.80	7.98	5.69	2.29
Government Development Bank 2/	5-05-78	50.0	7.64	7.04	5.89	1.15

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1/ Bond Buyer Index, The Weekly Bond Buyer.

2/ Issued directly to 936 corporations.

Source: Government Development Bank for Puerto Rico.

Rican Relations Act.* Like interest on U.S. state and municipal bonds, interest on Puerto Rican government obligations was not counted in determining eligibility of section 931 and is similarly treated under section 936. By contrast, "qualified possessions source investment income" helps a possession corporation establish that 80 percent of its gross income is possessions-source. Thus, the increased demand by the 936's for Puerto Rican government bonds is attributable to several other factors:

(1) the recent progress the former and the current Puerto Rican Administrations have made in reducing their borrowing requirements (see Figure II above) and thereby increasing the appeal of their bonds;

(2) the tollgate tax reductions obtainable by investing in government bonds;

(3) the increased demand for tax exempt bonds generally (because income earned outside a possession where the corporation has a trade or business is no longer tax exempt);

(4) the "jawboning" of the Puerto Rican government to induce the 936's to reinvest more of their earnings in Puerto Rico; and

(5) banks buying government bonds and reselling them to the 936's with a guarantee that the bank will repurchase the bonds as specified at the time of the original sale, should the 936's wish to sell them back.

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* In 1970, the Internal Revenue Service ruled (Rev. Rul. 70-219) that Puerto Rican Government Bonds were exempt under the Act of March 2, 1917, as amended by the Puerto Rican Relations Act, rather than under section 103 of the Internal Revenue Code (which exempts interest on bonds on States, Territories, Possessions and political subdivisions thereof) The effect of this ruling was to exempt Puerto Rico from the additional restrictions in section 103 of the Internal Revenue Code on industrial development bonds, arbitrage bonds, and so forth.

To date, the section 936 credit for "qualified possessions source investment income" has allowed the 936's an additional source of tax-exempt income and permitted certain borrowers (other 936 companies, GNMA mortgage holders, the banks) to obtain funds at reduced interest rates, but apparently has not had a measurable impact on total new investment in Puerto Rico.

Investments in tax-exempt U.S. municipals and in U.S. preferred stocks (which are entitled to an 85 percent dividends-received deduction for Federal tax purposes) by possessions corporations have also increased sharply. One company went so far as to obtain a letter ruling from the U.S. Internal Revenue Service that a 936's purchase of its own parent's common stock would not be treated as a constructive dividend for Federal tax purposes. But when the Puerto Rican Treasury declined to issue a comparable ruling for tollgate tax purposes, the planned purchase was abandoned.

E. Possible Impact of the New Industrial Incentive Act

The newly enacted reforms in the Puerto Rican Industrial Incentive Act are exceptionally complex, and the companies themselves will need some time to weigh the options before determining their own course of behavior. Because April 1979 is the soonest a company must decide whether to convert to partial income taxation for its current fiscal year, several years may pass before the impact of the recent changes can be assessed with any precision. Nonetheless, some basic features of the recent changes can be considered now:

-- For some companies, especially those with only a few years remaining on their exemption grants, the best option may still be to keep their total exemption from income taxes, repatriate no dividends, and when the tax exemption expires, liquidate tax-free into the parent.

-- For those who do convert, the effective rates of taxation will be quite low, perhaps averaging 5 percent of pretax income, in the near future. The low effective rates would reflect the provision allowing 50 percent of tollgate taxes paid on income earned prior to conversion to be credited against the post-conversion income tax, the "progressive" structure of the Puerto Rican corporate income tax rates, and the provisions allowing two-thirds of income taxes paid by some companies to be credited against post-conversion tollgate taxes.

-- To alleviate unemployment, three declining industries -- textiles, apparel and shoes -- will be able to extend their tax exemption grants on terms more favorable than other industries can. In addition, export-oriented service industries, which heretofore have been fully taxable, but might bring high paying jobs to Puerto Rico, will qualify for grants of partial tax exemption.

-- The tax incentive to liquidate companies and close plants will be lessened. New grants will exempt a large, but declining, fraction of income from taxation, thereby easing companies into paying taxes. A primary incentive existing companies have to convert to partial tax exemption is an automatic extension of the partial exemption grant.

How much of an economic impact will the new changes have? The measured Federal income tax expenditure will be reduced by any income and tollgate taxes paid in Puerto Rico, but an effective Puerto Rican rate of 5 percent is one eighth of the 40 percent rate which this Report has assumed would be applicable in the absence of section 936. If the new effective tax rates are low enough not to have a measurable impact on the volume or industrial composition of investment, or on inter-affiliate transfer prices or other features of possessions corporations' behavior, the measured Federal tax expenditure (in dollar terms or relative to employment, employee compensation, total Puerto Rican income generated, and so forth) will be reduced by one eighth (because the Federal taxes foregone will represent 35 percent, rather than 40 percent of pretax income). Accordingly, the Federal tax expenditures for 1978 and thereafter, as shown in Table 1, above, have been reduced by one eighth of the value they otherwise would have taken.

Appendix A -- Operation of the Possessions Corporation System of Taxation in American Samoa, Guam, the Panama Canal Zone and the Virgin Islands

American Samoa, Guam and the Panama Canal Zone

1. Federal and Possessions Taxation

The income tax laws in effect in Guam are a mirror of those in force in the United States, i.e., the word "Guam" is substituted for the words "United States" wherever they appear in the United States Internal Revenue Code. This mirror system is provided for under section 31 of the Organic Act of Guam (48 U.S.C. section 1421). In contrast to Guam and the Virgin Islands, whose income tax laws were the result of Federal enactment, the U.S. Internal Revenue Code was enacted by American Samoa as the American Samoa Income Tax Act. The Act, effective January 1, 1963, established the "mirror system" for American Samoa.

Under this "mirror" system, the U.S. and the possessions are separate tax jurisdictions and a taxpayer's status, whether resident or nonresident, alien or citizen for individuals, or whether domestic or foreign for corporations, is determined by reference to the jursisdiction involved. The mirror system also means that any amendments to the U.S. Code automatically change the tax law in effect in the possession. In contrast, the tax laws operative in Puerto Rico are based on the 1939 U.S. Internal Revenue Code and are not automatically amended with changes in the U.S. Code.

U.S.-chartered corporations operating in American Samoa and Guam are considered foreign corporations for purposes of the income tax laws of these possessions. Similarly, a corporation chartered in American Samoa or Guam is considered a foreign corporation for purposes of the Federal income tax. However, Code sections 881 and 1442 provide an exception to this foreign corporation treatment for purposes of imposing the 30 percent withholding tax on fixed determinable, annual or periodical U.S. source income earned by a Guamanian corporation. Under these sections and applying the mirror concept, Guam and the U.S. are not considered foreign and no withholding tax is imposed.

U.S. corporations operating in American Samoa, Guam, and the Panama Canal Zone may qualify for special tax treatment under section 936 in the same manner as U.S. corporations in Puerto Rico, if they satisfy the 80 and 50 percent source rules. (The Virgin Islands are not treated as a possession for purposes of section 936). Corporations qualifying under section 936 are allowed a credit to offset any U.S. tax on income from the active conduct of a trade or business in the possession as well as for "qualified possessions source investment income". Also, the U.S. parent corporation of a 936 subsidiary operating in American Samoa, Guam, or the Panama Canal Zone is entitled to a dividends-received deduction. Finally, the 936 election is irrevocable for 10 years and during that period the subsidiary cannot join the parent in filing a consolidated return.

Under the industrial incentive program of Guam, corporations that meet minimum investment and certain other requirements (such as increasing employment, replacing imports, or creating vitally needed facilities) can qualify for rebates of corporate income taxes and income taxes on dividends, and exemption from taxes on income derived from the lease of land, buildings, machinery and equipment, property taxes and gross receipts taxes on petroleum and alcoholic beverages manufactured in Guam. The rebate for corporate income taxes is allowed for up to 20 years, up to 5 years for taxes on dividends and up to 10 years for all other tax exemptions. The company has the option of doubling the allowable time period for the rebates or exemptions by electing to enjoy half the rebate or exemption.

The government of American Samoa grants temporary exemptions from the payment of all or some taxes, duties, and business license fees for the establishment or expansion of qualifying industrial or business enterprise. In order to qualify, the business must be owned by a resident of American Samoa. In addition, 75 percent of the work force of the exempt firm must be residents of American Samoa. The tax exemption can be for a period up to 10 years, although it may be made to terminate earlier if the cumulative amount of taxes forgiven equal 200 percent of the net current investment.

The Panama Canal Zone, although treated as a possession under section 936, differs from the other possessions in several respects. It is operated by a federal agency (the Canal Zone Company) and government officials are appointed by the President rather than elected locally. It has few private businesses except for oil, shipping and insurance companies which assist in operating the Canal. Most of the expenditures of the Canal Zone government and Company are financed through toll collections. Although the President has the authority to impose taxes, it has never been used. Finally, as a result of the new Panama Canal Treaties, the Canal Zone will no longer be considered a possession for U.S. tax purposes.

2. Statistical Data

Table A-1 shows for 1975 the number of corporations in each possession which qualified for the benefits of section 931, their book income, and estimated tax saving (i.e., Federal tax expenditure). The data show that 13 companies with book incomes of $7 million accounted for a tax saving of almost $3 million under section 936. These figures compare with 1975 book incomes of $1.1 billion and tax savings of $447 million for 595 companies oerating in Puerto Rico. Payroll and employment data were unavailable for the companies operating in American Samoa, Guam and the Panama Canal Zone.

Virgin Islands

1. Virgin Islands and Federal Taxation

Under the Naval Appropriations Act of 1921, the income tax laws of the Virgin Islands are those currently in force in the United States; i.e., the U.S. Internal Revenue Code is transformed into a Virgin Islands Internal Revenue Code by substituting the words "Virgin Islands" wherever "United States" appears in the Code. In addition, under section 28(a) of the Revised Organic Act of 1954, "inhabitants" of the Virgin Islands are taxed on their worldwide income by the Virgin Islands and are exempt from any income tax liability to the United States Treasury, even on their United States source income. The question of whether a corporation is an "inhabitant" of the Virgin Islands is an

Table A-1

Income and Estimated Tax Expenditure
by Possession, 1975

Possessions	Number of Corporations	Book Income ($000)	Estimated Tax Expenditure ($000)
American Samoa	4	4,102	1,641
Guam	3	1,086	434
Panama Canal	6	2,034	814
Total	13	7,222	2,889

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unsettled one. Corporations organized in the Virgin Islands are considered "inhabitants" of the Virgin Islands. Corporations organized outside the Virgin Islands may also be considered "inhabitants" of the Virgin Islands, although the precise conditions under which they will be so considered are not clearly defined.

Foreign (including U.S.) corporations which do not qualify as inhabitants of the Virgin Islands are subject to taxation as foreign corporations under the "mirrored" Virgin Islands Code. Thus, they are taxed on a net basis on all income which is effectively connected with the conduct of a trade or business in the Virgin Islands. Although fixed or determinable annual or periodical income (such as interest, rents, dividends, wages) which is not effectively connected with the conduct of a trade or business is generally subject to taxation at a flat 30 percent rate, recent court decisions have raised questions as to whether and in what circumstances this income is subject to withholding by the Virgin Islands. The Virgin Islands tax administrators have in recent years assumed that such income is subject to withholding, and have imposed the withholding taxes. However, a 1977 decision of the United States Court of Appeals in the Third Circuit has cast serious doubt on whether the withholding taxes may be imposed upon payments to United States persons under the "mirrored" Virgin Islands Code. If withholding taxes are imposed, the taxes are creditable (subject to limits) against United States tax liability.

During the post World War II period, many developing countries (including the Virgin Islands) enacted legislation providing tax incentives to encourage business investment. The Virgin Islands' first Tax Incentive Act was passed in 1948 (the same year the Puerto Rican Industrial Incentive Act was enacted), and was amended several times thereafter. In 1975, a new industrial incentive program was enacted by the Virgin Islands Legislature. The program established significant new incentives (tax exemptions and subsidies) for businesses to establish operations in the Virgin Islands. However, in order to receive the tax benefits under the industrial incentive program, the corporation must qualify not only under the industrial incentive program, but must also qualify under section 934 of the Internal Revenue Code.

Enacted by the Congress in 1960, section 934 aims to prevent the Virgin Islands from granting tax rebates or subsidies for taxes attributable to income derived from sources within the United States. The Virgin Islands are permitted to make rebates and subsidies to a U.S. or Virgin Islands corporation on tax liability based on income from sources without the United States, but only if the corporation meets the so-called "80-50 tests." These are:

(1) that 80 percent or more of the corporations income for the 3-year period preceding the close of the taxable year must be from sources within the Virgin Islands; and,

(2) that 50 percent of the corporation's income for the period must have been derived from the active conduct of a trade or business in the Virgin Islands.

Under the current Virgin Islands Industrial Incentive Program, U.S. corporations which meet the requirements of section 934 and certain other requirements (including minimum investment, employment, and ecological standards) are eligible for the two types of benefits:

(1) total exemption from property taxes attributable to the exempt business, gross receipts taxes, and excise taxes on materials, appliances, and supplies used in the construction, alteration, reconstruction, or extension of the facilities of the exempt business;

(2) tax refunds for (a) 90 percent of the customs duties on raw materials or component parts imported into the Virgin Islands used to produce, create or assemble articles, goods or commodities; (b) 90 percent of the income tax paid to the Virgin Islands on income derived from V.I. sources.

These exemptions and subsidies are permitted for 10 years, but the beneficiary has the option of electing partial benefits for up to 20 years provided that the percentage of the benefits taken multiplied by total number of years equals 10. The percentage subsidy available for each term chosen by the taxpayer is given in the following table:

Term	Percent of Subsidy or Exemption
10 years	100.0%
11 years	90.9
12 years	83.3
13 years	76.9
14 years	71.4
15 years	66.7
16 years	62.5
17 years	58.8
18 years	55.5
19 years	52.6
20 years	50.0

Although tax exemptions and subsidies do not have to follow the same time schedule, the dates of election must be within the first five years of the operation of the business. Moreover, an additional five years of benefits (or up to 10 years of no less than 50 percent of the benefits) may be obtained by locating in certain economically depressed areas.

A U.S. corporation which qualifies as an "inhabitant" of the Virgin Islands, meets the 80-50 tests, and elects a 10 year subsidy pays a maximum effective corporate income tax rate in the Virgin Islands of 4.8 percent, assuming the corporation is taxed at a 48 percent and 90 percent of the tax is refunded. The actual effective V.I. tax rate is probably less if the impact of other tax provisions, such as the investment tax credit and accelerated depreciation, is taken into account. For example, the effective tax rate on domestic income of U.S. manufacturing corporations is about 40 percent after taking into account other provisions in the law which reduce taxes. 1/ Therefore, U.S. corporations which do business in the V.I. may pay effective rates in the V.I. as low as 4 percent, if they take advantage of these provisions.

A United States corporation which qualifies as an inhabitant of the V.I. is treated as a domestic corporation

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1/ Department of the Treasury, Effective Income Tax Rates Paid by United States Corporations in 1972, May 1978.

for U.S. tax purposes. Like 936's in Puerto Rico, dividends paid by a U.S. subsidiary in the V.I. to its U.S. parent qualify for a dividends-received deduction. If the subsidiary is 80 percent or more owned by the parent, the U.S. subsidiary in the V.I. may be liquidated, and its assets distributed to its parent, without recognition of gain or loss upon the liquidating distributions. In addition, other corporate organizations and reorganizations involving the subsidiary do not require a section 367 ruling or toll charge, because no foreign corporation is involved. Unlike section 936 companies, the U.S. subsidiary may be a member of an affiliated group for purposes of filing a consolidated return. Finally, under section 28 of the Revised Organic Act, the U.S. subsidiary which qualifies as an inhabitant of the V.I. satisfies its U.S. tax liability by reporting and paying taxes to the Virgin Islands. Not only does it escape U.S. tax jurisdiction, but it may also qualify for a reduced V.I. tax liability if it meets the 80 and 50 percent source of income rules under section 934 of the Code.

Although dividends paid by the U.S. subsidiary operating in the V.I. qualify for the dividends-received deduction for purposes of computing the parent's United States tax liability, the Virgin Islands may seek to impose a 30 percent withholding tax on these dividends (as discussed above). If withholding taxes are imposed, the United States would allow the parent corporation to credit these taxes (subject to limits) against its U.S. tax liablity. Puerto Rican possession corporations are also allowed a dividends-received deduction, but are not allowed a foreign tax credit for withholding taxes.

If the parent wishes to "repatriate" the earnings without paying the V.I. withholding tax, it may permit the subsidiary to accumulate its earnings and then liquidate the subsidiary. The United States would not recognize a gain or loss on the transaction (although the earnings might be subject to the accumulated profits tax). The Virgin Islands would treat the liquidation as a capital transaction not subject to the withholding tax.

2. Statistical Data

At the end of the 1975 fiscal year, 92 firms held certificates of tax exemption and subsidy in the Virgin Islands. The average wage and payroll distribution for the tax exempt industries is presented on Table A-2. These firms employed about 4,800 persons and had a payroll of approximately $34 million. Employees of firms in the chemical (including pharmaceuticals) and hotel industries alone accounted for almost 66 percent of total employment in tax exempt industries and 20 percent of total private employment in the Virgin Islands.

Table A-3 shows the subsidy payments received by tax exempt businesses during fiscal year 1975. According to the figures on Table A-3, subsidy payments of almost $137 million have been made during fiscal year 1975. This amount is large when it is compared to total operating revenues of only $294 million for the Virgin Islands. Subsidy claims increased to $146 million for fiscal year 1976, probably reflecting the enactment of the new industrial incentive program in October 1975. Moreover, it should be noted that most of these businesses also enjoyed exemption from license fees, excise taxes or building materials and real property taxes.

Published data are inadequate for estimating the tax loss from the tax exemptions and subsidies permitted by section 934. The income tax subsidies presented on Table A-3 do not accurately reflect the U.S. tax loss because the data include both U.S. and V.I. corporations and represent actual payments rather than claims. 1/

1/ The published data for 1975 show both pending certified claims and actual payments of $18,651,249 and $4,432,365, respectively.

Table A-2
Average Payroll and Employment for Tax Exempt Industries in the Virgin Islands, FY 1975

Industry	Average Number of Employees	Percent of Total Employees	Annual Average Payroll	Percent of Total Payroll
Hotels, Guest Houses and Motels	1,117	23.1	$5,249,000	15.5
Watches and Related Products	589	12.2	3,055,000	9.0
Costume Jewelry and Related Products	18	0.4	95,000	0.3
Knitting, Weaving, Spinning, Laminating and Shower-Proofing Woolens	186	3.8	1,170,000	3.4
Chemicals and Related Products	2,071	42.7	19,362,000	57.0
Housing Projects	31	0.6	248,000	0.7
All Others	832	17.2	4,778,000	14.1
Total	4,844	100.0	$33,957,000	100.0

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Source: 1975 and 1976 Annual Reports of the Governor of the Virgin Islands to the Secretary of the Interior for the fiscal years ended June 30.

Table A-3

Virgin Islands Tax Incentive Program Subsidy Claims, Fiscal Years 1975 and 1976

	FY 1976	FY 1975
Customs Duties	$122,495,822	$132,408,111
Excise Tax	87,731	86,062
Income Tax (Business)	23,245,850	4,352,717
Total	145,829,557	136,848,890

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Source: 1975 and 1976 Annual Reports of the Governor of the Virgin Islands to the Secretary of the Interior for the Fiscal Years ended June 30.

Appendix B -- Sources and Limitations of the Data and Statistical Data for 1973 and 1974

Introduction

This Appendix includes tables covering data for 1973 and 1974, similar to text Tables 5, 6, and 7 covering data for 1975 and Tables 11, 12, and 13 covering 1976, and a discussion of the sources and limitations of the data. All of the data in these text and Appendix tables are based on 910 corporations that either excluded income under section 931 in one or more of the years 1973, 1974, and 1975, or made an election under section 936 for 1976. Tables for each year are based on corporations' accounting periods ending between July 1 of the year and June 30 of the following year. For example, tables for 1973 contain data for corporations with accounting periods ending on or after July 1, 1973 and on or before June 30, 1974.

Sources and limitations of the data

The primary source of income data was Form 5712, "Election to be Treated as a Possessions Corporation Under Section 936". (Appendix C contains copies of all tax forms from which data included in this Report was obtained.) If the corporation filing Form 5712 or any other member of its controlled group excluded income under section 931 for any taxable year beginning in 1973, 1974, or 1975, the net income per books of that corporation for each year 1973-1975 was reported on the Form. One problem with this data is that the income for all three years, 1973-1975, was reported even though the corporation may not have excluded income under section 931 all three of those years. In particular, some of these companies incurred losses in one or more years between 1973 and 1975 and therefore presumably filed on a consolidated basis with their parent. Inclusion of such companies in the tables for these years may therefore cause an understatement of the amount of income excluded under section 931 for 1973-1975. However, this understatement appears to have been relatively small in all three years, and does not affect the tax expenditure estimates which are based on the income of profitable firms only.

In addition to Form 5712, some income data and all of the Puerto Rican tax data were obtained from income tax returns (Forms 480.20) filed with the Puerto Rican Government. Most of the 1976 income data were derived from Form 5735, "Computation of Possessions Corporation Tax Credit Allowed Under Section 936".

The employment and payroll data was taken from Form 940, "Employer's Annual Federal Unemployment Tax Return". These returns are filed on a calendar year basis; for companies with a non-calendar year accounting period the Form 940 data was associated with income data for the accounting period most nearly corresponding to the calendar year. For example, the calendar year 1973 Form 940 data was associated with annual accounting periods ending between July 1, 1973 and June 30, 1974.

The number of employees was computed by dividing total taxable wages (line 15, Form 940) by $4,200, the maximum amount per employee subject to unemployment tax. This procedure gives an estimate of the number of full-time equivalent employees during the year rather than the actual number of persons employed at any particular time during the year. If the corporation paid its workers less than $4,200 (the minimum wage in several industries was sufficiently low that this could occur), the number of employees could be understated. On the other hand, because the $4,200 ceiling is tied to individual employees, the procedure could overestimate employment for a company with relatively high wages and part-time employees or a high labor turnover rate. However, secondary data, from Forms 940 and other sources, suggests that the method used here provides reasonably accurate estimates of full-time equivalent employment.

Total compensation was computed by multiplying total remuneration (line 11, Form 940) by a factor representing the ratio of total compensation to total remuneration. The value of this factor is noted in the tables for each year. Total compensation exceeds total remuneration because it includes certain fringe benefits and other items, such as the employer share of social security contributions, that are excluded from total remuneration.

Some corporations did not report an amount for total remuneration or reported the same amount as for taxable wages. In the latter case, the firm's reporting was assumed to be correct. For the corporations that did not report total remuneration, the reported amount of taxable wages was used. Total compensation may therefore be slightly understated.

The number of corporations included in the tables for any particular year is less than the number (910) included in at least one year for several reasons. Some corporations were organized after 1973, in some cases as late as 1976, and therefore do not appear in tables for the years prior to their establishment. Similarly, some firms were liquidated (or became inactive) before 1976, in some cases as early as 1974, and therefore do not appear in tables for the years following their liquidation (or cessation of active business). Finally, for some corporations that have not made an election under section 936 and are not related to an electing corporation, data from Puerto Rico Forms 480.20 was not available for all years 1973-1975.

The number of corporations included in text Tables 11, 12, and 13 covering 1976, is considerably less than the number included in Tables 5, 6, and 7, covering 1975, for several reasons. The 1976 returns of some corporations were not received in time for inclusion in the tabulations. In addition, some of the corporations included in the tables for 1975 (as well as earlier years) are included solely on the basis of being related to an electing 936 corporation and having benefited from section 931 in at least one of the years 1973-1975. These corporations, for various reasons, have not themselves made an election under section 936 and in most instances will therefore not appear even in complete 1976 data. For example, there were 115 corporations included in the 1975 tables that did not elect under section 936, compared with only 10 in 1976. (These 10 had accounting periods beginning before January 1, 1976, and therefore could still claim the benefits of section 931. They may elect under section 936 for subsequent years.) A large portion of the section 931 corporations classified as non-manufacturing did not make an election under section 936. As a result, relatively few non-manufacturing corporations are present in the 1976 data.

Statistical Data for 1973 and 1974

Tables B-1 and B-2 correspond to Tables 5 and 11 in the text and provide data for 1974 and 1973, respectively. Similarly, Tables B-3 and B-4 correspond to Tables 6 and 12 in the text, and Tables B-5 and B-6 to Tables 7 and 13.

Table B-1 indicates that 594 corporations had income of $852 million and tax savings of $372 million in 1974. Table B-2 presents data for 563 corporations with income of $651 million and tax savings of $258 million in 1973.

Tables B-3 through B-6 are limited to those corporations for which both income and employment data were available. Although these tables present data for less than half the number of corporations included in Tables B-1 and B-2, their coverage in terms of income and tax expenditure exceed 60 percent for 1974. The coverage for 1973, however, is much more limited because employment data were less readily available.

Table B-3 presents data for 243 corporations with 42,000 employees and income of $541 million in 1974. The tax expenditure per employee ranges from $55 for textile mill products to $36,050 for pharmaceuticals.

The 1973 data presented in Table B-4 is considerably weaker than the data for other years, as noted above. Although the number of corporations (187) is only slightly lower than for 1974, the book income ($143 million) is only one-fourth and the number of employees (16,000) about 40 percent of the corresponding 1974 figure.

Tables B-5 and B-6 present tax expenditure, income and payroll data classified by size of tax expenditure per employee. None of the 243 corporations included in Table B-5, covering 1974, had tax savings greater than $100,000 per employee. The 7 corporations with tax expenditure per employee in excess of $50,000 in 1974 had average tax savings per employee of $67,370, compared to $78,216 for the 18 corporations in the same group in 1975. Data for 1973 is shown in Table B-6.

Table B-1
Income and Estimated Tax Expenditure by Industry, 1974 1/

Industry Group	Number of Corporations	Book Income ($000)	Estimated Tax Expenditure ($000)
All industries	594	852,092	372,362
Manufacturing industries	398	813,056	352,759
Food and kindred products	25	65,123	26,517
Tobacco products	6	12,472	4,938
Textile mill products	8	-66,071	624
Apparel	94	42,052	17,515
Chemicals, total	65	478,329	190,683
Pharmaceuticals	44	405,355	161,341
All other chemicals	21	62,974	29,342
Rubber products	14	2,150	922
Leather and leather products	14	7,080	2,689
Stone, clay and glass products	6	8,684	3,418
Fabricated metal products	27	28,017	11,221
Machinery, except electrical	7	2,281	908
Electrical and electronic equipment	76	167,389	66,750
Transportation equipment	5	1,100	440
Scientific instruments	25	27,452	11,044
All other manufacturing	26	36,998	15,090
Nonmanufacturing	196	39,035	19,602
Transportation, communications and utilities	7	16,701	6,750
Wholesale trade	10	1,709	704
Retail trade	105	12,154	5,057
Finance, insurance, real estate	19	2,035	893
Services	14	-457	580
Miscellaneous and not available	41	6,893	5,620

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1/ Includes data for possessions corporations operating in America Samoa, Guam, and the Panama Canal Zone. These non-Puerto Rican operations account for less than 2 percent of total tax expenditure in any year (see Table 1).

Table B-2
Income and Estimated Tax Expenditure by Industry, 1973 1/

Industry Group	Number of Corporations	Book Income ($000)	Estimated Tax Expenditure ($000)
All industries	563	650,759	258,316
Manufacturing industries	382	591,721	242,064
Food and kindred products	22	60,937	21,960
Tobacco products	8	15,265	6,089
Textile mill products	16	-4,539	1,190
Apparel	93	36,991	15,240
Chemicals, total	57	268,868	110,380
Pharmaceuticals	39	251,897	103,533
All other chemicals	18	16,971	6,847
Rubber products	14	1,606	1,149
Leather and leather products	19	4,283	1,853
Stone, clay and glass products	8	6,272	2,505
Fabricated metal products	24	15,465	6,828
Machinery, except electrical	4	1,830	732
Electrical and electronic equipment	64	116,277	46,734
Transportation equipment	3	601	240
Scientific instruments	23	22,176	8,794
All other manufacturing	27	45,689	18,370
Nonmanufacturing	181	59,038	16,252
Transportation, communications and utilities	6	6,952	2,843
Wholesale trade	10	29,834	541
Retail trade	98	10,901	4,506
Finance, insurance, real estate	16	2,601	1,081
Services	17	-6,923	423
Miscellaneous and not available	34	15,671	6,858

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1/ Includes data for possessions corporations operating in America Samoa, Guam, and the Panama Canal Zone. These non-Puerto Rican operations account for less than 2 percent of total tax expenditures in any year (see Table 1).

Table B-3
Tax Expenditure, Employment and Compensation of Employees by Industry, 1974

Industry Group	Number of Corporations	Book Income ($000)	Tax Expenditure: Amount ($000)	Tax Expenditure: Percent of Total	Employees: Number	Employees: Percent of Total	Compensation of Employees 1/: Amount ($000)	Compensation of Employees 1/: Percent of Total	Tax Expenditure Per Employee ($)	Tax Expenditure as Percent of Compensation of Employees	Average Employee Compensation ($)
All industries	243	540,975	245,197	100.0	42,394	100.0	308,337	100.0	4,033 2/	56.1 2/	7,184 2/
Manufacturing industries	207	525,413	235,652	96.1	32,118	75.8	225,741	73.2	5,424 2/	77.8 2/	6,973 2/
Food and kindred products	15	30,062	12,124	4.9	4,764	11.2	32,298	10.5	2,545	37.5	6,780
Tobacco products	6	12,472	4,938	2.0	1,435	3.4	9,215	3.0	3,441	53.6	6,422
Textile mill products	3	-67,294	135	.1	2,472	5.8	19,132	6.2	55	.7	7,739
Apparel	44	19,717	8,580	3.5	5,993	14.1	32,202	10.4	1,432	26.6	5,373
Chemicals, total	28	372,565	146,741	59.8	5,066	11.9	50,554	16.4	28,966	290.3	9,979
Pharmaceuticals	21	323,048	126,931	51.8	3,521	8.3	31,675	10.3	36,050	400.7	8,996
All other chemicals	7	49,417	19,810	8.1	1,545	3.6	18,879	6.1	12,822	104.9	12,219
Rubber products	9	1,987	752	.3	531	1.3	3,268	1.1	1,416	23.0	6,154
Leather and leather products	10	3,813	1,568	.6	1,025	2.4	5,494	1.8	1,530	28.5	5,360
Stone, clay and glass products	3	6,603	2,586	1.1	466	1.1	2,997	1.0	5,549	86.3	6,431
Fabricated metal products	17	17,453	6,981	2.8	1,120	2.6	7,827	2.5	6,233	89.2	6,988
Electrical and electronic equipment	37	76,250	30,317	12.4	6,302	14.9	42,453	13.8	4,811	71.4	6,736
Transportation equipment	3	474	189	.1	113	.3	855	.3	1,673	22.1	7,566
Scientific instruments	18	20,169	8,058	3.3	2,063	4.9	12,040	3.9	3,906	66.9	5,836
All other manufacturing 3/	14	31,142	12,683	5.2	768	1.8	7,406	2.4	16,514	171.3	9,643
Nonmanufacturing	36	15,562	9,546	3.9	10,276	24.2	82,595	26.8	718 2/	9.3 2/	7,688
Transportation, communications and utilities	3	14,744	5,967	2.4	4,138	9.8	36,906	12.0	1,442	16.2	8,919
Wholesale trade	3	716	286	.1	179	.4	1,642	.5	1,598	17.4	9,173
Finance, insurance, real estate	6	835	367	.1	238	.6	2,087	.7	1,542	17.6	8,769
Services	7	-475	431	.2	981	2.3	6,991	2.3	439	6.2	7,126
Miscellaneous and not available 4/	17	-258	2,495	1.0	4,740	11.2	34,969	11.3	526	7.1	7,377

Office of the Secretary of the Treasury
Office of Tax Analysis

1/ Compensation of employees was computed by multiplying 1.178 times payroll. The additional 17.8 percent reflects the employer-paid portion of social security, unemployment insurance, and other non-payroll labor costs. The 17.8 percent is the average for all U.S. manufacturing industries in 1974; see the U.S. Department of Commerce, Survey of Current Business, July 1977, Tables 6.5 and 6.6.

2/ Compensation of employees and number of employees used to compute these amounts were weighted by industry using the ratio of tax expenditure in Table B-1 and tax expenditure in this Table.

3/ Includes manufacturing industries where data were available for less than 3 corporations.

4/ Includes nonmanufacturing industries where data were available for less than 3 corporations.

Table B-4
Tax Expenditure, Employment and Compensation of Employees by Industry, 1973

Industry Group	Number of Corporations	Book Income ($000)	Tax Expenditure Amount ($000)	Tax Expenditure Percent of Total	Employees Number	Employees Percent of Total	Compensation of Employees 1/ Amount ($000)	Compensation of Employees 1/ Percent of Total	Tax Expenditure Per Employee ($)	Tax Expenditure as Percent of Compensation of Employees	Average Employee Compensation ($)
All industries	187	143,448	51,846	100.0	16,339	100.0	97,226	100.0	1,740 2/	19.3 2/	9,013 2/
Manufacturing industries	157	110,587	49,842	96.1	14,578	89.2	84,162	86.6	1,810 2/	19.6 2/	9,236 2/
Food and kindred products	6	3,700	1,416	2.7	673	4.1	4,611	4.7	2,104	30.7	6,851
Tobacco products	4	2,338	918	1.8	444	2.7	2,285	2.4	2,068	40.2	5,146
Textile mill products	10	-7,084	128	.2	2,919	17.9	14,588	15.0	44	.9	4,998
Apparel	44	6,943	3,206	6.2	4,265	26.1	22,668	23.3	752	14.1	5,315
Chemicals, total	18	83,031	35,731	68.9	1,265	7.7	9,113	9.4	28,246	392.1	7,204
Pharmaceuticals	12	79,686	34,393	66.3	1,057	6.5	7,680	7.9	32,538	447.8	7,266
All other chemicals	6	3,345	1,338	2.6	208	1.3	1,433	1.5	6,433	93.4	6,889
Rubber products	9	1,949	740	1.4	533	3.3	3,026	3.1	1,388	24.5	5,677
Leather and leather products	9	2,255	896	1.7	749	4.6	3,876	4.0	1,196	23.1	5,175
Fabricated metal products	12	1,841	727	1.4	350	2.1	2,070	2.1	2,077	35.1	5,914
Electrical and electronic equipment	20	9,197	3,488	6.7	2,347	14.4	15,401	15.8	1,486	22.6	6,562
Scientific instruments	11	4,911	1,887	3.6	405	2.5	2,510	2.6	4,659	75.2	6,198
All other manufacturing 3/	14	1,506	705	1.4	628	3.8	11,046	11.4	1,123	6.4	17,589
Nonmanufacturing	30	32,861	2,003	3.9	1,761	10.8	13,063	13.4	1,104 2/	15.8	6,988 2/
Wholesale trade	5	29,345	343	.7	338	2.1	2,655	2.7	1,015	33.8	7,855
Finance, insurance, real estate	5	1,427	571	1.1	198	1.2	1,585	1.6	2,884	36.0	8,005
Services	9	534	378	.7	566	3.5	4,279	4.4	668	8.8	7,560
Miscellaneous and not available 4/	11	1,555	711	1.4	659	4.0	4,545	4.7	1,079	15.6	6,897

Office of the Secretary of the Treasury
Office of Tax Analysis

1/ Compensation of employees was computed by multiplying 1.172 times payroll. The additional 17.2 percent reflects the employer-paid portion of social security, unemployment insurance, and other non-payroll labor costs. The 17.2 percent is the average for all U.S. manufacturing industries in 1973; see the U.S. Department of Commerce, Survey of Current Business, July 1977, Tables 6.5 and 6.6.

2/ Compensation of employees and number of employees used to compute these amounts were weighted by industry using the ratio of tax expenditure in Table B-2 and tax expenditure in this Table.

3/ Includes manufacturing industries where data were available for less than 3 corporations.

4/ Includes nonmanufacturing industries where data were available for less than 3 corporations.

Table B-5

Tax Expenditure, Employment and Compensation of Employees by Size of Tax Expenditure Per Employee, 1974

Size of Tax Expenditure per Employee	Number of Corporations	Book Income ($000)	Tax Expenditure: Amount ($000)	Tax Expenditure: Percent of Total	Employees: Number	Employees: Percent of Total	Compensation of Employees 1/: Amount ($000)	Compensation of Employees 1/: Percent of Total	Tax Expenditure Per Employee ($)	Tax Expenditure as Percent of Compensation of Employees	Average Employee Compensation ($)
All Corporations	243	540,975	245,197	100.0	42,394	100.0	308,337	100.0	4,033 2/	56.1 2/	7,184 2/
$ 50,000 under $100,000	7	149,057	59,623	24.3	885	2.1	8,127	2.6	67,370	733.6	9,183
$ 10,000 under $ 50,000	35	291,488	115,661	47.2	5,261	12.4	52,376	17.0	21,984	220.8	9,956
$ 5,000 under $ 10,000	29	49,775	19,884	8.1	2,725	6.4	20,836	6.8	7,296	95.4	7,646
$ 1,000 under $ 5,000	91	116,875	46,405	18.9	19,099	45.1	127,471	41.3	2,429	36.4	6,674
$ 500 under $ 1,000	14	3,650	1,460	.6	1,811	4.3	10,364	3.4	806	14.1	5,723
$ 100 under $ 500	26	5,822	2,107	.9	6,577	15.5	46,599	15.1	320	4.5	7,085
$ 1 under $ 100	8	3,700	58	---	1,150	2.7	7,070	2.3	50	.8	6,148
Loss Corporations	33	-79,392	---	---	4,886	11.5	35,492	11.5	---	---	7,264

Office of the Secretary of the Treasury
Office of Tax Analysis

1/ Compensation of employees was computed by multiplying 1.178 times payroll. The additional 17.8 percent reflects the employer-paid portion of social security, unemployment insurance, and other non-payroll labor costs. The 17.8 percent is the average for all U.S. manufacturing industries in 1974; see the U.S. Department of Commerce, Survey of Current Business, July 1977, Tables 6.5 and 6.6.

2/ Compensation of employees and number of employees used to compute these amounts were weighted by industry using the ratio of tax expenditure in Table B-1 and tax expenditure in Table B-3.

Table B-6

Tax Expenditure, Employment and Compensation of Employees by Size of Tax Expenditure Per Employee, 1973

Size of Tax Expenditure per Employee	Number of Corporations	Book Income ($000)	Tax Expenditure Amount ($000)	Tax Expenditure Percent of Total	Employees Number	Employees Percent of Total	Compensation of Employees 1/ Amount ($000)	Compensation of Employees 1/ Percent of Total	Tax Expenditure Per Employee ($)	Tax Expenditure as Percent of Compensation of Employees	Average Employee Compensation ($)
All Corporations	187	143,448	51,846	100.0	16,339	100.0	97,226	100.0	1,740 2/	19.3 2/	9,013 2/
$ 50,000 under $100,000	5	68,559	27,423	52.9	410	2.5	3,372	3.5	66,885	813.3	8,224
$ 10,000 under $ 50,000	14	20,479	8,106	15.6	413	2.5	2,833	2.9	19,627	286.1	6,860
$ 5,000 under $ 10,000	12	13,566	5,395	10.4	707	4.3	4,441	4.6	7,631	121.5	6,281
$ 1,000 under $ 5,000	60	21,647	8,474	16.3	3,944	24.1	23,684	24.4	2,149	35.8	6,005
$ 500 under $ 1,000	22	4,272	1,701	3.3	2,288	14.0	13,474	13.9	743	12.6	5,889
$ 100 under $ 500	25	1,979	708	1.4	2,525	15.5	14,645	15.1	280	4.8	5,800
$ 1 under $ 100	12	28,820	38	.1	935	5.7	5,226	5.4	41	.7	5,589
Loss Corporations	37	-15,873	--	--	5,117	31.3	29,550	30.4	--	--	5,775

Office of the Secretary of the Treasury
Office of Tax Analysis

1/ Compensation of employees was computed by multiplying 1.172 times payroll. The additional 17.2 percent reflects the employer-paid portion of social security, unemployment insurance, and other non-payroll labor costs. The 17.2 percent is the average for all U.S. manufacturing industries in 1973; see the U.S. Department of Commerce, Survey of Current Business, July 1977, Tables 6.5 and 6.6.

2/ Compensation of employees and number of employees used to compute these amounts were weighted by industry using the ratio of tax expenditure in Table B-2 and tax expenditure in Table B-4.

Appendix C -- Tax Forms from which Data Included in this Report was Obtained

Form **5712**
(Rev. March 1978)
Department of the Treasury
Internal Revenue Service

Election to be Treated as a Possessions Corporation Under Section 936

The corporation named below hereby elects under section 936(e) of the Internal Revenue Code to be treated as a possessions corporation for income tax purposes.

Name of corporation		Employer identification number
Number and street		Date of incorporation
City or town, State and ZIP code		Place of incorporation
Business code number	Principal business activity	Principal product or service

Description of each class of stock	Number of shares of each class issued and outstanding

The following information must be submitted for each shareholder owning 10% or more of the issued and outstanding stock of any class:

Name of shareholder	Identifying number	Address	Class of stock	Number of shares owned

Election is made for the taxable year beginning (month, day, year)	Date corporation commenced business in a U.S. possession	Annual return will be filed for the taxable year ending (enter the month or "unknown")

For any taxable year beginning in 1973, 1974, or 1975 did you, or any other corporation which is (or was in that year) a member of your controlled group (as defined in section 993(a)(3)), exclude income under section 931? . . ☐ Yes ☐ No

If "Yes," for each such corporation (attach additional schedules if required):

(1) Enter the corporation's name and employer identification number ▶ ....

(2) Complete the following schedule—

Taxable year (use a separate line for each full or short taxable year beginning in 1973, 1974, or 1975)		Principal place of business (enter name of U.S. possession or country)	Net income per books
Beginning (month/day/year)	Ending (month/day/year)		

U.S. income tax returns filed:

If corporation filed separately:		If corporation joined in filing a consolidated return:	
Taxable income or (loss) shown on return	Amount of gross income excluded under section 931	Name and employer identification number of corporation filing return	Internal Revenue Service Center in which return was filed

Under penalties of perjury, I declare that I have been duly authorized by the above named corporation to make this election and that the statements made are to the best of my knowledge and belief, true, correct, and complete.

Signature and title of officer	Date

Instructions

Who Can Elect

Only domestic corporations can elect to be treated as possessions corporations.

When to File

Form 5712 must be filed within 90 days after the beginning of the first taxable year for which such election is made.

Where to File

File this form with the Internal Revenue Service Center, Philadelphia, PA 19255. File separately from your regular income tax return.

U.S. Possessions

For purposes of section 936, U.S. possessions include Puerto Rico but not the Virgin Islands.

Period of Election

The election applies to the first taxable year for which such election has been made and for which the domestic corporation qualifies under section 936(a).

This election may be revoked for any taxable year beginning before the expiration of the 9th taxable year following the taxable year for which such election first applies only with the consent of the Secretary. For any taxable year beginning after the expiration of such 9th taxable year, this election may be revoked without the consent of the Secretary.

Form 5735

For every year for which an election under section 936(e) is in effect, you must complete Form 5735, Computation of Possessions Corporation Tax Credit Under Section 936, and attach it to your income tax return.

Consolidated Returns

A corporation may not join in filing a consolidated return for any year for which an election under section 936(e) is in effect.

Business Classification

Refer to the Codes for Principal Business Activity and Principal Product or Service in the Instructions for Form 1120 and enter the (1) business code number, (2) principal business activity, and (3) principal product or service.

Identifying Number

The identifying number for individuals is their social security number. For all others it is their employer identification number.

Signature

This form must be signed by the president, vice president, treasurer, assistant treasurer, chief accounting officer, or other corporate officer (such as tax officer) who is authorized to sign.

Form 480.20
Dec. 3, 1974

Auditor	Reviewer
Field Audited by:	
Date	

Commonwealth of Puerto Rico
DEPARTMENT OF THE TREASURY
INTERNAL REVENUE ADMINISTRATION
BUREAU OF INCOME TAX

197 CORPORATION INCOME TAX RETURN 197

FOR CALENDAR YEAR 197
OR OTHER TAXABLE YEAR BEGINNING
______197 ____ AND ENDING________, 197____

Serial Number
RECEIPT

Corporation's Name	Employer's Account Number	C.D.
Postal Address	"Zip Code"	
Location of Principal Industry or Business—Street, Number and City	Mun. Code	
Kind of Principal Industry or Business	Ind. Code	

Does this Corporation have exempt activities other than under the Industrial Incentive Act? Yes ☐ No ☐
Under what Act or Acts?________

SCHEDULE 1 NET INCOME	1. Total Gross Income (From Schedule 4)	10 (01)	$	
	2. Less: Total Deductions (From Schedule 5)	(02)		
	3. Net operating income (or loss) for the year	(03)	$	
	4. Less: Net operating loss deduction for the preceding year (submit statement)	(04)		
	5. NET INCOME (or Loss)	(05)	$	
SCHEDULE 2 CREDITS	6. Dividends or profits received from corporations or partnerships (See booklet of instructions)	12 (06)	$	
	7. Net income subject to normal tax	(07)		
	8. Less: Surtax net income credit (See booklet of instructions)	(08)		
	9. Net income subject to surtax	(09)	$	
SCHEDULE 3 COMPUTATION OF TAX	10. Normal tax (22% of net income subject to normal tax, line 7)	14 (10)	$	
	11. Surtax (See booklet of instructions)	(11)		
	12. Total Tax (normal tax and surtax)	(12)	$	
	13. Alternative tax (line 28 of Annex "B")	(13)		
	14. TAX DETERMINED (Item 12 or 13, whichever is lower)	(14)	$	
	15. Credits: Tax Paid: (a) At Source	(15)		$
	(b) Allowable proportion of the tax paid to U.S. or its possessions or foreign countries (See booklet of instructions and submit details)	(16)	$	$
	16. THIS IS YOUR TAX LIABILITY (Subtract item 15 from item 14. Enter difference here)	(17)	$	
	17. Less: Estimated tax paid: Current year $........ Excess of previous years $	16 (18)		
	18. Balance of tax payable (Enter here the difference, if item 16 is larger than item 17)	(19)		
	19. Less: Amount paid with tentative return $........ With this return $	(20)		
	20. Balance of tax due	(21)	$	
	21. Amount of tax overpaid to be credited to estimated tax for 197	(22)	$	
	22. Amount of tax overpaid to be refunded	(23)	$	

OATH

WE, the undersigned, president (or vicepresident, or other principal officer) and treasurer (or assistant treasurer), or agent of the corporation for which this return is made, being severally duly sworn, each for himself deposes and says that this return (including any accompanying schedules and statements) has been examined by him and is, to the best of his knowledge and belief, a true, correct, and complete return, made in good faith, for the taxable year stated, pursuant to the Income Tax Act of 1954 and the Regulations issued thereunder.

NOTARIAL SEAL

.... Treasurer or Assistant Treasurer (State title)

.... President or other Principal Officer (State title)

.... Agent

Affidavit No..............................

Sworn and suscribed to before me by____________, of legal age, occupation ____________ and resident of ____________; and by ____________ of legal age, occupation ____________ and resident of ____________, personally known to me at ____________, Puerto Rico, this ________ day of ____________, 19____

.... Official Title

.... Signature of officer administering oath

A RETURN NOT PROPERLY FILLED OUT WILL NOT BE CONSIDERED
AS MEETING THE STATUTORY REQUIREMENTS

COMPARATIVE BALANCE SHEETS

ASSETS		Beginning of Taxable Year Amount	Beginning of Taxable Year Total		(30) End of Taxable Year Amount	End of Taxable Year Total
1. Cash on hand and in banks (28)	(01)		$	(01)		$
2. Accounts receivable	(02)	$		(02)	$	
LESS: Reserve for bad debts	(03)			(03)		
3. Notes receivable	(04)			(04)		
4. Inventories	(05)			(05)		
5. Investments	(06)			(06)		
6. Depreciable assets	(07)	$		(07)	$	
LESS: Reserve for depreciation (28)	(08)			(08)		
7. Land	(09)			(09)		
8. Other assets	(10)			(10)		
TOTAL ASSETS	(11)		$	(11)		$
LIABILITIES AND NET WORTH						
Liabilities						
10. Accounts payable (28)	(12)	$		(12)	$	
11. Bonds, notes and mortgages payable	(13)			(13)		
12. Accrued expenses	(14)		$	(14)		$
13. Other liabilities	(15)			(15)		
Net Worth						
14. Capital stock:						
(a) Preferred stock (28)	(16)	$		(16)	$	
(b) Common stock	(17)			(17)		
15. Capital surplus	(18)			(18)		
16. Earned surplus	(19)			(19)		
17. Surplus reserves	(20)			(20)		
18. Total Liabilities and Net Worth	(21)		$	(21)		$

RECONCILIATION OF INCOME PER BOOKS WITH INCOME PER RETURN

1. Net income per books (32)	(01)	$	7. Income recorded on books this year not included in this return (itemized, use rider if necessary) (a) Tax-exempt interest $ (34)	(01)	$
2. Income tax	(02)		8. Deductions in this tax retun not charged against book income this year (itemize, use rider if necessary) (a) Depreciation $ (b) Depletion $	(02)	
3. Excess of capital losses over capital gains	(03)		9. Total of lines 7 and 8	(03)	$
4. Taxable income not recorded on books this year (itemized)	(04)		10. Income (Line 5 page 1)—Line 6 less Line 9	(04)	$
5. Expenses recorded on books this year not deducted in this return (itemize, use rider if necessary) (a) $ (b) $	(05)				
6. Total (Lines 1 through 5)	(06)	$			

ANALYSIS OF UNAPPROPRIATED RETAINED EARNINGS PER BOOKS

1. Balance at beginning of year (36)	(01)	$	5. Distributions: (a) Cash (38)	(01)	$
2. Net income per books	(02)		(b) Stock	(02)	
3. Other increases (itemize, use rider if necessary)			(c) Property	(03)	
	(03)		6. Other decreases (itemize, use rider if necessary)	(04)	
	(04)				
	(05)		7. Total of lines 5 and 6	(05)	$
4. Total (Lines 1, 2, and 3)	(06)	$	8. Balance at end of year (Line 4 less Line 7)	(06)	$

QUESTIONAIRE

1. Incorporation date: ____
2. Place of incorporation: ____
3. Registry Number in the Department of State ____
4. Indicate the accounting method used by the corporation.
   - ☐ Cash method.
   - ☐ Other: ____
5. Income (or deficit) as per return for proceding year $ ____
6. Number of controlled corporations ____ (See instructions).

7. Is this corporation engaged in Trade or Business within Puerto Rico? Yes ☐ No ☐
8. Did the corporation file the following documents?
   (a) Annual informative Return (Forms 480.5 and 480.6) Yes ☐ No ☐
   (b) Withholding Statements (Forms 499 R-2). Yes ☐ No ☐
9. The corporation's books are in care of:
   Name ____
   Address ____

J. 5-0735—40,000—29—PRGPD.

Form **5735**
(Rev. January 1978)
Department of the Treasury
Internal Revenue Service

Computation of Possessions Corporation Tax Credit Allowed Under Section 936

▶ Attach to your tax return.

For calendar year 19........ or other taxable year beginning ...., 19........, and ending ...., 19........

Name | Employer identification number

Part I Gross Income in Applicable Period

Taxable year (Use a separate line for each taxable year ending with or within your applicable period, starting with the earliest such taxable year. See instruction B.) Beginning (a)	Ending (b)	Name of U.S. possession in which trade or business was actively conducted (c)	Periods in which trade or business was actively conducted in a U.S. possession (Dates are inclusive) From— (d)	To— (e)

Gross income during periods shown in columns (d) and (e)

	Gross income from the active conduct of a trade or business in a U.S. possession			Gross qualified posssession source investment income	All other gross income		
	From sources within U.S. possessions (f)	From all other sources without the U.S. (g)	From sources within the U.S. (h)	(i)	From sources within U.S. possessions (j)	From all other sources without the U.S. (k)	From sources within the U.S. (l)
Totals							

1 Total gross income in applicable period (add totals of columns (f) through (l)) . . . .

2 Gross income in applicable period from sources within U.S. possessions (add totals of columns (f), (i), and (j)) .

3 Line 2 divided by line 1 (if less than 80%, do not complete Part II) . . . .

4 Gross income in applicable period from the active conduct of a trade or business within a U.S. possession (add totals of columns (f), (g), and (h)) . . . .

5 Line 4 divided by line 1 (if less than 50%, do not complete Part II) . . . .

Part II Computation of Section 936 Credit

6 Qualified gross income in current year:

(a) From sources without the U.S. from the active conduct of a trade or business within a U.S. possession . . . .

(b) Gross qualified possession source investment income . . . .

(c) Less: Amounts received in the U.S. . . . .

(d) Total (add lines 6(a) and 6(b) and subtract line 6(c)) . . . .

7 Applicable deductions (attach schedule):

(a) Definitely allocable deductions . . . .

(b) Ratable part of deductions not definitely allocable . . . .

(c) Total (add lines 7(a) and 7(b)) . . . .

8 Qualified taxable income before loss adjustments (line 6(d) less line 7(c)). If loss, do not complete lines 9 through 14 . . . .

9 Loss adjustments (attach schedule):

(a) Current year losses from non-qualified sources . . . .

(b) Recapture of prior year overall foreign losses . . . .

(c) Total (add lines 9(a) and 9(b)) . . . .

10 Qualified taxable income (line 8 less line 9(c)) . . . .

11 Total taxable income from all sources (enter taxable income from your tax return) . . . .

12 Line 10 divided by line 11 . . . .

13 Total U.S. income tax against which section 936 credit is allowed (see Instruction E) . . . .

14 Section 936 credit (line 12 multiplied by line 13). Enter here and on your tax return . . . . . . ▶

Instructions

(References are to the Internal Revenue Code)

A. Corporations Required to File Form 5735

Form 5735 must be completed and attached to the income tax return of any domestic corporation for which an election to be treated as a possessions corporation under section 936(e) is in effect.

B. Qualifications for Section 936 Credit (Section 936(a))

To qualify for the section 936 credit, a corporation must:

(1) make a valid election under section 936(e) on Form 5712, Election to be Treated as a Possessions Corporation Under Section 936;

(2) have derived 80 percent or more of its gross income from sources within a U.S. possession during the applicable period immediately preceding the close of the taxable year; and

(3) have derived 50 percent or more of its gross income from the active conduct of a trade or business within a U.S. possession during the applicable period immediately preceding the close of the taxable year.

Generally, the "applicable period" is the lesser of 36 months or the period during which the corporation was engaged in the active conduct of a trade or business within a U.S. possession.

C. Ineligible Corporations

A corporation is ineligible for the section 936 credit in any taxable year in which it is a DISC or former DISC, or in which it owns at any time stock in a DISC or former DISC. (Section 936(f).)

D. U.S. Possessions

For purposes of section 936, U.S. possessions include Puerto Rico but not the Virgin Islands. (Section 936(d)(1).)

E. Taxes Against Which Credit is Allowed

The section 936 credit is allowed against income tax imposed by Chapter 1 but not against any:

(1) minimum tax for tax preferences imposed by section 56;

(2) tax on accumulated earnings imposed by section 531;

(3) personal holding company tax imposed by section 541;

(4) additional tax imposed for the taxable year under section 1351 (relating to recoveries of foreign expropriation losses);

(5) increase in tax under section 47 (relating to dispositions of investment credit property);

(6) increase in tax under section 50A(c) (relating to early termination by an employer in a WIN program); and

(7) tax on certain capital gains of electing small business corporations imposed by section 1378.

F. Qualified Possession Source Investment Income

Qualified possession source investment income is gross income (less applicable deductions) from sources within a U.S. possession in which a trade or business is actively conducted which you establish to the satisfaction of the Secretary is attributable to investment in such possession (for use therein) of funds derived from the active conduct of a trade or business in such possession, or from such investment. (Section 936(d)(2).) However, income derived from any source outside the U.S. from investment of such funds is "qualified possession source investment income" if you establish to the satisfaction of the Secretary that the income was earned before October 1, 1976.

See temporary income tax regulation 7.936–1 concerning certain deposits in Puerto Rican banks and other financial intermediaries which may earn qualified income.

G. Computation of Qualified Taxable Income

(1) General Source Rules.—The determination of gross income, applicable deductions, and taxable income within and without the U.S., and within a U.S. possession must be made in accordance with sections 638 and 861 through 864.

(2) Amounts Received in the U.S.—Gross income received in the U.S., regardless of source, may not be taken into account as income from sources without the U.S. (Section 936(b).)

(3) Certain Foreign Taxes.—No deduction (or foreign tax credit) is allowed for any tax paid or accrued to a foreign country or U.S. possession with respect to qualified taxable income. (Section 936(c).)

(4) Current Year Losses.—If you sustain a loss for the current year in the U.S. or on any type of income for which a separate foreign tax credit limitation applies, allocate the loss to qualified taxable income in proportion to the ratio of qualified taxable income to total taxable income (excluding the loss).

(5) Recapture of Prior Year Overall Foreign Losses.—If in any taxable year beginning after December 31, 1975 you sustain an overall foreign loss, the loss is recaptured in succeeding taxable years by treating some portion of your taxable income from sources without the U.S. as income from sources within the U.S. (Section 904(f).)

H. Coordination with Foreign Tax Credit

Qualified taxable income is not taken into account in computing the foreign tax credit limitation. (Section 904(b).)

I. Where to File

Attach Form 5735 to your tax return and file it with the Internal Revenue Service Center, Philadelphia, PA 19255.

Form **940**
Department of the Treasury
Internal Revenue Service

Employer's Annual Federal Unemployment Tax Return

1976

Name of State 1	State reporting number as shown on employer's State contribution returns 2	Taxable payroll (As defined in State act) 3	Experience rate period 4 From—	To—	Experience rate 5	Contributions had rate been 2.7% (col. 3 × 2.7%) 6	Contributions payable at experience rate (col. 3 × col. 5) 7	Additional credit (col. 6 minus col. 7) 8	Contributions actually paid to State 9
	Totals ▶								

10 Total tentative credit (Column 8 plus column 9) . . . .

11 Total remuneration (including exempt remuneration) PAID during the calendar year for services of employees

Exempt Remuneration	Approximate number of employees involved	Amount paid
12 Exempt remuneration. (Explain each exemption shown, attaching additional sheet if necessary):		
13 Remuneration in excess of $4,200. (Enter only the excess over the first $4,200 paid to individual employees exclusive of exempt amounts entered on line 12) . .		

14 Total exempt remuneration (line 12 plus line 13) . . . .

15 Total taxable wages (line 11 less line 14) . . . .

16 Gross Federal tax (3.2% of line 15) . . . .

17 Enter 2.7% of the amount of wages shown on line 15 . . . .

18 Line 10 or line 17 whichever is smaller . . . .

19 Amount, if any, of wages on line 15 attributable to the following States:

(a) Vermont $.................... × .003 . . .

(b) Washington $.................... × .003 . . .

(c) Total (add lines 19(a) and (b)) . . . .

20 Credit allowable (line 18 less line 19(c)) . . . .

21 Net Federal tax (line 16 less line 20) . . . .

Record of Federal Tax Deposits for Unemployment Tax (Form 508)

Quarter	Liability by period	Date of deposit	Amount of deposit
First			
Second			
Third			
Fourth			

22 Total Federal tax deposited . . . .

23 Balance due (line 21 less line 22—this should not exceed $100). Pay to "Internal Revenue Service" . . ▶

24 If no longer in business at end of year, write **"FINAL"** here ▶

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete, and that no part of any payment made to a State unemployment fund, which is claimed as a credit on line 20 above, was or is to be deducted from the remuneration of employees.

Date ▶ Signature ▶ Title (Owner, etc.) ▶

T
FF
FD
FP
I
T

(If incorrect make any necessary change.) ▶

Name (as distinguished from trade name)

Trade name, if any

Address and ZIP code

Calendar Year
1976

Employer Identification No.

General Instructions

Additional instructions for withholding, depositing, paying, and reporting Federal income tax, social security taxes, and Federal unemployment tax, are contained in Circular E, Employer's Tax Guide, available free from any Internal Revenue Service office.

Refer to Circular E to find which employers must file Form 940, the types of payments defined by law as wages, and the kind of services covered by the Federal Unemployment Tax Act.

Purpose of Form 940.—This form is for the annual reporting of tax under the Federal Unemployment Tax Act. Federal unemployment tax is paid by the employer. It is not deductible from wages paid employees. The tax rate is 3.2 percent on the first $4,200 of wages paid to each employee during 1976 and 3.4 percent during 1977.

Who Must File.—Every employer who during the current or preceding calendar year paid wages of $1,500 or more in any calendar quarter, or at any time had ONE or more employees in any 20 calendar weeks must file Form 940. Count all regular, temporary, and part-time employees. A partnership should not count its partners. If there is a change of ownership or other transfer of the business during the year, each employer who during the current or preceding calendar year paid wages of $1,500 or more in a calendar quarter, or had ONE or more employees at any time in each of 20 calendar weeks, must file Form 940, but neither should report wages paid by the other.

If you receive a preaddressed form and are not liable for Federal unemployment tax for 1976, write "Not Liable" across the front of the form and return it to the Internal Revenue Service. If you are no longer in business at the end of a year, write "Final" in line 24.

If you sold or transferred the business during the year, attach a statement showing the name, address, and employer identification number (if known) of the new owner.

Once you have filed a Form 940, the Service will send you a preaddressed form near the close of each calendar year. If you do not receive a form, request one from any Internal Revenue Service office in time to file when due.

Due Date of Return.—Form 940 for calendar year 1976 is due on or before January 31, 1977. However, if you made timely deposits in full payment of the tax due for the year, you may file the return on or before February 10, 1977.

Where to File.

If your principal business, office, or agency is located in	Use this address
New Jersey, New York City and counties of Nassau, Rockland, Suffolk, and Westchester	Internal Revenue Service Center 1040 Waverly Avenue Holtsville, New York 11799
New York (all other counties), Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, Vermont	Internal Revenue Service Center 310 Lowell Street Andover, Massachusetts 01812
District of Columbia, Delaware, Maryland, Pennsylvania	Internal Revenue Service Center 11601 Roosevelt Boulevard Philadelphia, Pennsylvania 19155
Alabama, Florida, Georgia, Mississippi, South Carolina	Internal Revenue Service Center 4800 Buford Highway Chamblee, Georgia 30006
Michigan, Ohio	Internal Revenue Service Center Cincinnati, Ohio 45298
Arkansas, Kansas, Louisiana, New Mexico, Oklahoma, Texas	Internal Revenue Service Center 3651 S. Interregional Hwy. Austin, Texas 78740
Alaska, Arizona, Colorado, Idaho, Minnesota, Montana, Nebraska, Nevada, North Dakota, Oregon, South Dakota, Utah, Washington, Wyoming	Internal Revenue Service Center 1160 West 1200 South St. Ogden, Utah 84201
Illinois, Iowa, Missouri, Wisconsin	Internal Revenue Service Center 2306 E. Bannister Road Kansas City, Missouri 64170
California, Hawaii	Internal Revenue Service Center 5045 East Butler Avenue Fresno, California 93888
Indiana, Kentucky, North Carolina, Tennessee, Virginia, West Virginia	Internal Revenue Service Center 3131 Democrat Road Memphis, Tennessee 38110

If you have no legal residence or principal place of business in any Internal Revenue Service district, or if your principal place of business is in Puerto Rico, file Form 940 with the Internal Revenue Service Center, 11601 Roosevelt Boulevard, Philadelphia, Pennsylvania 19155.

Deposit Requirements.—You must deposit Federal unemployment tax in an authorized commercial bank or a Federal Reserve bank. Deposits must be made in accordance with instructions on the reverse of Federal Tax Deposit Form 508 which must accompany each deposit.

You must compute Federal unemployment tax on a quarterly basis. Deposit any amount due on or before the last day of the first month, following the close of the quarter. (If you do not qualify as an employer until the second or third quarter, your deposit requirements do not begin until the end of the second or third quarter, respectively.)

To determine whether you must make a deposit for any of the first three quarters in **1977**, compute the total tax by multiplying by .007 that part of the first $4,200 of each of your employee's annual wages you paid during the quarter.

If the amount subject to deposit (plus the amount subject to deposit for any prior quarter but not deposited) is more than $100, deposit it during the first month following the quarter. If the amount is $100 or less, you do not have to deposit it, but you must add it to the amount subject to deposit for the next quarter.

If the tax reportable on Form 940 less amounts deposited for the year is more than $100, you must deposit the entire amount. If your tax for the year (less any deposits) is $100 or less, you may either deposit the tax or send payment with Form 940.

If you deposited the proper amounts in accordance with these rules, the balance due on line 23 will not exceed $100.

How to Make Deposits.—Fill in a preinscribed Federal Tax Deposit Form 508 in accordance with its instructions.

Send the Federal tax deposit form and your tax deposit to a commercial bank qualified as a depository for Federal taxes, or to a Federal Reserve bank, in accordance with instructions appearing on the reverse of the Federal tax deposit form. Make your check or money order payable to that bank.

The timeliness of deposits is determined by the date the commercial bank depository or Federal Reserve bank receives them. A deposit received after the due date will be considered timely if you establish that you mailed it two or more days before the due date.

Employer's Name, Address, and Identification Number.—Use the preaddressed Form 940 mailed to you. If you must use a nonpreaddressed form, type or print your name, trade name, address, and employer identification number on it.

Penalties and Interest.—Avoid penalties and interest by filing a correct return and paying the proper amount of tax when due. The law provides a penalty for late filing unless you show reasonable cause for the delay. If you file late, attach an explanation.

There are also penalties for willful failure to pay tax, keep records and make returns, and for filing false or fraudulent returns. Taxpayers who willfully claim credit on the record of Federal tax deposits or on line 22 for deposits not made are subject to fine and/or other criminal penalties.

Credit for Contributions Paid into State Funds.—You are entitled to a credit against your Federal unemployment tax for contributions you pay into a certified State unemployment compensation fund on or before the due date of Form 940.

The term "contributions" means payments required by a State law to be made into an unemployment fund by any person on account of having individuals in his or her employ, to the extent that such payments are made without being deducted or deductible from the remuneration of individuals employed.

You may credit contributions against the tax whether or not you paid them with respect to "employment." You may not take credit for voluntary contributions or for penalties or interest you pay to a State.

Credit for contributions you make after the due date (or extended due date) for filing Form 940 may not exceed 90 percent of the amount that would have been allowable if you had paid the contributions on or before the due date.

Employers who have been granted an experience rate lower than 2.7 percent by a State for the whole or part of the year are entitled to an "additional credit." This is equal to the difference between actual contributions and the amount they would have been required to contribute at (1) the highest rate applied by the State, or (2) 2.7 percent, whichever is lower.

Section 3302(e) of the Code provides a special credit if an employer during any calendar year acquires substantially all of the property used in the trade or business (or in a separate unit of a trade or business) of another person who is not an "employer" and immediately after the acquisition the successor employs in the trade or business one or more individuals who immediately prior to the acquisition were employed in the trade or business of the predecessor. This special credit is not allowable to any successor employer whose predecessor also is an "employer," nor is it allowable to a corporation acquiring the trade or business of another corporation in a statutory merger or consolidation. The amount of the special credit is based on the amount of remuneration, subject to the unemployment compensation law of a State, paid by the predecessor to those employees who were employed by the predecessor immediately before the transfer of the trade or business (or separate unit thereof) and who also were employed by the successor immediately after the transfer.

The total credit allowable under Section 3302 may not exceed 2.7 percent of taxable wages.

Computation of Credit Against Federal Unemployment Tax

Experience Rate.—If a State has granted you an experience rate lower than 2.7 percent for all or part of the taxable year, use columns 1 through 9. If you have not been granted an experience rate use columns 1, 2, 3, and 9 only. If you have been granted an experience rate of 2.7 percent or higher, use columns 1, 2, 3, 4, 5, and 9 only.

If a State has granted you an experience rate on part of your payroll, enter separately in columns 1, 2, 3, and 9, that part to which the experience rate does not apply.

If you were granted an experience rate for only part of the year or your experience rate was changed during the year, show in the appropriate columns the period to which each separate rate applied, your payroll, rate of contributions, and required contributions for each period.

Column 1.—Enter the name of the State or States (including Puerto Rico) to which you were required to pay contributions.

Column 2.—Enter your State reporting number as shown on your State contribution return. If you had a place of employment in more than one State, enter the reporting number assigned to you by each State.

Column 3.—Enter the taxable payroll on which you must pay contributions to the unemployment fund of the State shown in column 1. If you have been granted an experience rate of zero, enter the amount on which you would have had to make contributions if that rate had not been granted.

Column 4.—Enter the period(s) of the year to which the experience rate(s) applies.

Column 5.—Enter the experience rate(s) the State(s) granted you for the period(s) shown in column 4.

Column 6.—Multiply the payroll in column 3 by 2.7 percent and enter the result in column 6.

Column 7.—Multiply the payroll in column 3 by the "experience rate" in column 5, and enter the result in column 7.

Column 8.—Subtract the amount in column 7 from the amount in column 6 and enter the result in column 8. If zero or less, enter zero (0).

Column 9.—Enter in column 9 the amount of contributions actually paid into the State fund.

Line 10.—Enter the sum of columns 8 and 9. Also include any special credit as explained below.

Line 19.—Enter in the appropriate line the amount (if any) of wages, as defined in the Federal Unemployment Tax Act, paid in 1976 which are subject to the unemployment compensation law of Vermont or Washington or are otherwise attributable to those States. (If in doubt, ask your local Internal Revenue Service office.) Such amounts, multiplied by .003, are a credit reduction required by Internal Revenue Code section 3302(c)(3). If there were no wages paid attributable to these States, enter "none" or "0" in the appropriate spaces on line 19.

Special Credit.—If you are claiming special credit as a successor employer, attach a statement showing (a) the name, address, and employer identification number of your predecessor, (b) how you acquired your predecessor's trade or business (or a separate unit of it), (c) the date you acquired it, (d) each item in columns 1 through 9 that applies to your predecessor, (e) the number of individuals your predecessor employed immediately before the acquisition, whom you also employed immediately after the acquisition, (f) the total remuneration subject to State unemployment compensation your predecessor paid to the employees in (e) above during the calendar year.

The amount of the special credit is determined by (1) adding the "Additional Credit" and "Contributions actually paid to the State" determined for your predecessor in step (d) above, and (2) multiplying this total by a fraction of which the numerator is the amount determined in step (f) above, and the denominator is the "Taxable Payroll (as defined in State Act)" paid to all individuals in the employ of your predecessor prior to your acquisition during the calendar year.

Computation of Taxable Wages

Line 11.—Total remuneration (including exempt remuneration) PAID during the calendar year for services of employees.—Enter on line 11 the total remuneration for services you paid employees during the calendar year, regardless of whether that remuneration is taxable. It should include salaries, wages, commissions, fees, bonuses, vacation allowances, salaries and wages paid to temporary or part-time employees, the value of goods, lodging, food and clothing, and all amounts deducted from employees' wages as employee tax or as deductions for other reasons.

The basis on which you pay the remuneration is immaterial in determining whether it constitutes wages. Thus, you may pay it on the basis of piecework or a percentage of profits, and you may pay it hourly, daily, weekly, monthly, or annually.

You may pay the remuneration in cash or in some other medium, such as goods, lodging, food or clothing. Compute remuneration paid in items other than cash on the basis of the fair value of the items at time of payment.

Exempt Remuneration.—The terms "wages" and "employment" as defined for Federal unemployment tax purposes do not include every payment of remuneration to an employee and every kind of service which an employee may perform. In general, any remuneration which is excluded from "wages" and any remuneration for services which are excepted from "employment," are not included in the total wages subject to the tax. These remuneration payments may be deducted from the total remuneration paid only if they are identified on line 12.

Line 12.—Enter on line 12 such items as (1) agricultural labor, (2) benefit payments for sickness or injury, under a workmen's compensation law, insurance plan and certain employer plans, (3) domestic service, (4) family employment, (5) certain fishing activities, and (6) any other exempt payments or services. For more detailed information with respect to these exemptions, see Circular E, Employer's Tax Guide.

Line 13.—Enter on line 13 the approximate number of employees to whom you paid more than $4,200 during the year and the aggregate amount of the excess above $4,200 paid to all of those employees. For example, assume that you had 10 employees and that you paid each of them $5,000 during the year. $50,000 should be included on line 11 and $8,000 on line 13.

(For General Instructions, see back of your copy.)

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