The Operation and Effect of the Possessions Corporation System of Taxation

Second Annual Report

Department of the Treasury
June 1979

ERRATA

Page 28, 2nd paragraph, line 8:	The word "over" should be deleted.
Page 43, 2nd paragraph, line 3:	<u>Forty-four percent</u> of these retained earnings, or <u>$3.3 billion</u>, were held by pharmaceuticals, NOT forty-seven percent, or $3.5 billion.
Page 47, 2nd paragraph, line 5:	One half of total distributions, or $581 million, were attributable to the <u>chemical</u> industry, NOT the pharmaceutical industry.
Page 64, 3rd paragraph, line 4:	Dividend distributions by possessions corporations were <u>$1.15 billion</u> in 1978, NOT $1.5 billion.
Page 67, 3rd paragraph, line 3:	Collections under the tollgate tax amounted to $49.1 million in the year ending June 30, 1978, which represents an effective rate of about <u>4.1 percent</u>, NOT 4.5 percent.
Page 71, Note:	Dollar amounts are in thousands.

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U.S. Department of the Treasury

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THE SECRETARY OF THE TREASURY
WASHINGTON

JUN 28 1979

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 second (1977) 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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JUN 28 1979

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The Honorable
Russell B. Long, Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Enclosure

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CHAPTER I. INTRODUCTION AND SUMMARY

Adopting language similar to that used in the Reports of the House Committee on Ways and Means and the Senate Committee on Finance, the General Explanation of the Tax Reform Act of 1976 states:

> "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 posssessions." 1/

Congressional interest specifically in investment and employment effects stemmed from the belief that adopting section 936 to replace its predecessor, section 931, would:

> "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." 2/

This is the second annual report to the Congress on "section 936" or "possessions" corporations, which are companies incorporated in the United States but exempt under section 936 and related provisions of the U.S. Internal Revenue Code from Federal tax on income from operations in

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1/ Pages 277-278.

2/ Page 274.

Puerto Rico, American Samoa, Guam, and the Panama Canal Zone. 3/

As in the First Annual Report, the body of this 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 its impact on Puerto Rico, and as indicated below Puerto Rico accounts for over 98 percent of the Federal tax expenditure associated with the possessions corporation provisions 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 936, the taxation of U.S. controlled 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 special provisions in the U.S. tax law and the tax law and Industrial Incentives Acts of the Commonwealth. The system also forms but a part of the governmental fiscal and private economic relationships between the United States and Puerto Rico. Chapters II and III of this Report are devoted, respectively, to a description of these legal and economic frameworks. Chapter IV presents available statistical data on the actual operation and effect of the possessions corporation system.

Chapter II begins with a description of the general rules applicable to U.S. taxation of corporate income. This review covers the corporate rate structure, the definition of taxable income, treatment of intercorporate dividends and affiliated groups of corporations, and major anti-abuse provisions. Rules governing foreign operations in branch

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3/ 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.

and foreign subsidiary form are then covered. These rules include those dealing with the source of income, computation of the foreign tax credit, transactions with foreign subsidiaries, and the anti-abuse provisions that apply to foreign operations. With this general background, the Chapter then turns to the special treatment afforded business operations in Puerto Rico and the possessions in the U.S. tax system.

In many respects, Puerto Rico and the possessions are treated much like foreign countries, and their residents much like other non-U.S. persons, for purposes of the Federal income tax. However, there are major exceptions to this treatment, in particular the possessions corporation provisions. The legislative history of these provisions is sketched, and a detailed description given of section 931 and its successor, section 936.

The final section of Chapter II begins with an overview of the Puerto Rican tax system and the Puerto Rican corporate income and withholding ("tollgate") tax on corporate dividends as in effect prior to 1976. Puerto Rico's Industrial Incentive Acts, which have provided exemptions of income, excise, and property taxes as well as direct subsidies to manufacturers, are then reviewed. The Chapter concludes with a description of the rather complex changes since 1976 in the Puerto Rican tollgate tax and Industrial Incentive Act.

Chapter III begins by documenting Puerto Rico's impressive postwar economic growth through the early 1970s, the causes of the 1973-1977 recession, and steps taken by the Federal and Puerto Rican governments to mitigate its impact. The role of "real" investment -- plant, equipment, government infrastructure, etc. -- in economic development and the sources available for financing this investment in Puerto Rico are then considered. Through several direct and indirect means, including the possessions corporation provisions, the Federal government has played a major role in providing external sources of funds for investment in Puerto Rico. The particular role of the possessions corporation tax exemption system as a means of stimulating investment in Puerto Rico is then considered. It is noted that tax exemption is only attractive to firms that would otherwise be profitable in Puerto Rico -- because of lower wage rates, greater proximity to the U.S. market, tariff protection, and similar factors that make Puerto Rico a competitive location for investment by U.S. firms. The competitive position of Puerto Rico, however, has changed over the postwar period as a result of rising wage rates (due in part to application of the U.S. minimum wage), tariff reductions in the 1960s, changes in relative prices (particularly for petroleum products), and other factors. One apparent result of these changes has been a shift in the type of firm attracted to Puerto Rico by the possessions corporation system.

The final two sections of Chapter III contain an analysis of the costs, benefits and cost effectiveness of the possessions corporation system. The major cost of the system is the Federal tax expenditure, or revenue foregone, on the income of possessions corporations. The Puerto Rican government also foregoes tax revenues and incurs expenditures on behalf of possessions corporations -- some direct (such as for cash grants and interest subsidies), and others indirect (such as for special transportation facilities and additional general government services). Additional costs may be placed on Puerto Rico by firms that degrade the environment or impose other external costs.

A possessions corporation provides direct benefits to the Puerto Rican economy through the additional wages and fringe benefits it pays to Puerto Rican employees. It also provides indirect benefits through its purchases of raw materials, intermediate and capital goods, and services in Puerto Rico ("backward linkages") which in turn produce local employment and income, and through the "multiplier" effect of employee spending on food, clothing, etc. However, the total amount of income generated by these backward linkage and multiplier effects will overstate the net benefit to the Puerto Rican economy to the extent that labor and other resources had alternative economic uses or "opportunity costs." (For example, land used by possessions corporations might otherwise be used for agricultural purposes.) The total income generated, less these opportunity costs, represents the correct measure of the benefit of the possessions corporation system to Puerto Rico.

The cost effectiveness of an industrial incentive program is measured by comparing the ratio of benefits to costs for each firm, or at least each industry, against alternatives. Variations in these benefit-cost ratios would indicate that the cost effectiveness of the program could be improved by shifting spending, including tax "spending" or revenues foregone, from industries with low benefit-cost ratios to industries with high ratios of benefits to costs. There is reason to expect the possessions corporation system not to be cost effective because the main incentive it provides -- Federal tax exemption -- is in no way contingent on the value of benefits generated in Puerto Rico.

Chapter IV presents statistical data on the operation and effect of the possessions corporation system. The first section covers estimates and projections of the total Federal revenue foregone, or tax expenditure, on the possessions corporation provisions. This tax expenditure has risen from $255 million in 1973 to $662 million in 1977, the most recent year for which reasonably complete tax return data are available, and is projected to reach $1.2 billion by 1984. The second section presents data, by industry, on the Federal tax expenditure, employment, employee compensation, receipts, deductions, net income, assets, retained earnings, and other characteristics of possessions corporations. The industry data show that the Federal tax expenditure is highly concentrated by industry; in 1977 about 45 percent ($290 million) accrued to the pharmaceutical industry alone and an additional 15 percent ($104 million) to the electrical and electronic equipment industry. The Federal tax expenditure is also highly concentrated among a few parent corporations. If all the possessions corporations of each U.S. parent are consolidated, the Federal tax expenditure on the possessions corporation system was concentrated as follows in 1977:

Number of Parent Corporations	Percent of Total Federal Tax Expenditure on All Corporations
Top 5	29.7%
Top 10	47.1
Top 20	67.9
Top 30	76.2

These data also reveal that the tax expenditure per employee in 1977 for all possessions corporations was $8,222, which is slightly less than the average employee compensation paid of $8,507. This means that for every dollar of compensation paid to a Puerto Rican employee by a possessions corporation, Federal tax revenues were reduced by nearly one dollar. However, there are wide variations; for example, the pharmaceutical industry showed a tax expenditure per employee of $34,966, or nearly three times the average employee compensation for that industry, while for the apparel industry tax expenditure per employee was $1,396 or less than one-fourth of average employee compensation. The retained earnings of possessions corporations at the end of 1977 exceeded $5.7 billion, which represented about 60 percent of total liabilities and stockholders' equity of $9.8 billion. Fifty percent of total retained earnings and 35 percent of total assets were accounted for by the pharmaceutical industry.

The third section of Chapter IV provides estimates, for manufacturing industries, of the ratio of direct (employee compensation) and indirect (backward linkage and multiplier) benefits to the Federal tax expenditure. While these benefit-cost ratios are too high, because benefits are overstated and costs understated, they do reveal a wide variation by industry -- from 12.5 for textile mill products to 1.2 for pharmaceuticals. This wide interindustry variation provides a statistical indication of the cost ineffectiveness of the possessions corporation system.

Chapter IV concludes with an analysis of the impact of the adoption of section 936 and the recent changes in the Puerto Rican tollgate tax and Industrial Incentive Program.

These changes have had their primary effect on:

- <u>Dividend repatriation</u> -- Prior to 1976, most possessions corporations accumulated their earnings until the company was liquidated, usually at the end of its tax exemption grant. In 1977, possessions corporations began to repatriate dividends at an annual rate of approximately $1.2 billion. This represents nearly 70 percent of current earnings.

- <u>Composition of financial portfolios</u> -- Prior to 1976, the substantial financial portfolios of possessions corporations were invested outside of Puerto Rico, primarily in the Eurodollar market. Those portfolios continue to grow, but there has been a major shift in their composition. At year-end 1978, it is estimated that out of a financial portfolio of $6.5 billion, over $4.0 billion was invested in Puerto Rican assets, and $600 million in U.S. assets.

- <u>Puerto Rican tax revenues</u> -- Prior to 1976, Puerto Rico collected little tax on the income of possessions corporations. In the last two years, annual tax collections from their revised tollgate tax have averaged $50 million per year. Additional revenues of $15-$25 million may be generated by the recent revisions to the Puerto Rican Industrial Incentive Act, which place possessions corporations on a partially taxable basis. Total Puerto Rican income tax collections from possessions corporations are expected to represent about 5 percent of their pre-tax income.

These U.S. and Puerto Rican legislative changes have not, however, had a dramatic effect on the basic costs, benefits, or cost effectiveness of the possessions corporation system.

- Costs -- Federal tax expenditure, the major cost of the possessions corporation system, has been reduced somewhat by the relatively small increase in Puerto Rican tax collections. But as noted above, the Federal tax expenditure was nearly $662 million in 1977, and is expected to reach $1.2 billion by 1984.

- Benefits -- Benefits to Puerto Rico may also have been marginally reduced, through the disincentive effect of the tax increases, although available statistical data are not clear on this point. It does not appear that the financial investment incentives contained in the new U.S. and Puerto Rican laws has had any appreciable effect to date on the availability of credit or long run interest rates in Puerto Rico.

- Cost effectiveness -- On balance, the cost effectiveness of the possessions corporation system may not have been altered in any significant degree by the recent legislative changes. A comparison of recent growth rates of employment with computed benefit-cost ratios of the possessions corporation system for manufacturing industries suggests that the system will continue to attract the high profit, and therefore high Federal tax expenditure, operations of U.S. firms in particular industries that provide relatively few benefits to the Puerto Rican economy. The system may provide less of an incentive in the future to the traditional, labor-intensive industries.

CHAPTER II. TAXATION IN THE UNITED STATES AND PUERTO RICO, AND THE PUERTO RICAN INDUSTRIAL INCENTIVES PROGRAM

The possessions corporation provisions of the U.S. Internal Revenue Code and the Puerto Rican Industrial Incentive Acts represent substantial departures from the normal U.S. and Puerto Rican tax rules that would otherwise apply to a U.S. company operating in Puerto Rico. The intent of these departures is to reach a non-tax policy objective: increased employment in Puerto Rico. In this chapter, both the normal and these special provisions of U.S. and Puerto Rican law are covered in order to explain, and clarify, the nature of the special rules and the manner in which they operate.

A. U.S. Taxation of Domestic and Foreign Operations of U.S. Corporations

1. General Structure of the Corporate Income Tax

The United States imposes a tax upon the worldwide taxable income of corporations organized under the laws of the United States, the District of Columbia, or any of the states. The rate of tax is graduated, rising from 17 percent of the first $25,000 of taxable income, to 46 percent (48 percent prior to 1979) on corporate taxable income in excess of $100,000. Taxable income is generally defined for both corporations and individuals as the gross income from a trade or business or from investments, less the ordinary and necessary expenses incurred in earning that income.

The United States has a "classical" system of taxing corporate earnings; that is, corporate earnings are taxed at the corporate level as they are earned and a second time, at the shareholder level, upon the distribution of dividends. The "double taxation" of corporate earnings would raise a serious obstacle to multiple-tiered corporate operations if separate tax liabilities were imposed at the subsidiary level, and again upon distribution of the subsidiary's earnings to its parent corporation. To eliminate this obstacle, the Internal Revenue Code makes two special provisions. First, an 85 percent dividends received deduction is allowed for any dividend received by one U.S. corporation from another. Second, in the case of an "affiliated group" of corporations, the members of the group may report their income on a consolidated basis, or any corporation may claim a 100 percent dividends received deduction for any dividend received from another member of the group. 1/

The shareholder level tax on corporate earnings is imposed only when amounts are actually distributed as dividends to the shareholders. In addition, shareholders are subject to tax on the gain from the sale, exchange, or other disposition of the shares of the corporation. If a shareholder has held his shares for more than one year the gain will normally constitute long-term capital gain, taxable at special rates. The special rate for individual shareholders is achieved by allowing them a deduction equal to 60 percent of their net long-term capital gain; for corporations, the special rate is the lower of the ordinarily applicable rate or 28 percent.

The Internal Revenue Code taxes property gain only upon sale, exchange, disposition, or other alienation, in a legal sense, of the property; it does not tax the mere change in market value of property in a taxable period. The existence of a one-time tax on disposition, together with an exemption in the absence of disposition, has led Congress to confer "nonrecognition" treatment upon certain transactions in property. "Nonrecognition" treatment applies principally in circumstances in which a taxpayer has alienated property, in a legal sense, so that he has "realized" whatever gain or loss he has borne on the property; but in which the taxpayer retains a continuing interest either in the property, the essential interests it represented, or in similar property, after the transaction. The "nonrecognition" provisions play a significant role in giving businesses freedom to arrange and rearrange the legal form in which they are conducted. The simplest and perhaps most important cases involve the transfer of property by a shareholder to a wholly owned corporation. The transaction involves an "exchange" of the property for an interest in the corporation, which constitutes a "realization" of any gain or loss the taxpayer has on the property. But the taxpayer has a "continuing interest" in the old property, and for this reason the tax law permits (and in most cases requires) that he not "recognize" the gain or loss for tax purposes.

1/ An "affiliated group" of corporations is defined as a group of corporations including a "common parent," which owns at least 80 percent of one of the other corporations in the group, and in which all corporations other than the common parent are at least 80 percent owned by other members of the group.

2. Anti-abuse Provisions

The Internal Revenue Code includes a wide variety of measures designed to prevent persons from manipulating corporate form for tax avoidance purposes. The highest corporate tax rate (now 46 percent) is, and since the early days of the income tax has been, lower than the highest rate applicable to individuals (now 70 percent). For this reason, there would be, in the absence of anti-abuse provisions, motivation for high-bracket taxpayers to transfer income-producing property to a wholly or closely owned corporation, an "incorporated pocketbook." To prevent this, the Code since 1936 has imposed special penalty taxes upon "personal holding companies." A personal holding company is subject to a 70 percent tax on its income.

A second abuse to which corporations were subject is the accumulation of earnings in a corporation in order to avoid or to defer the shareholder's tax liability on dividends distributed by the corporation. To combat this, the Internal Revenue Code imposes an "accumulated earnings tax" at graduated rates of 27-1/2 percent and 38-1/2 percent of the company's accumulated taxable income, which are earnings in excess of the reasonable needs of the business.

A third abuse to which corporations are potentially subject is "splitting" of income among several corporations to avoid taxation at higher graduated rates. To avoid this possibility, the Internal Revenue Code provides that the aggregate amount of income of the corporations in a controlled group qualifying for the rates applicable to the lower brackets cannot exceed the amounts which would qualify for those rates in the case of a single corporation.

A fourth potential abuse involves the "shifting" of items of income or expense between two related corporations in order to reflect greater amounts of income in one of the corporations. The classic case involves "transfer pricing" between a parent corporation and its wholly owned subsidiary. A company may have tax motivations for reflecting greater profits in the subsidiary, for example, if the subsidiary has substantial losses or other deductions to offset income shown by it. Profits may be shifted to (or from) the subsidiary by having the parent charge an artifically low (or high) "transfer price" on its sales to the subsidiary, or the subsidiary may charge an artificially high (or low) transfer price on its sales to the parent. Alternatively, the parent may provide management services at little or no charge to a subsidiary, or may charge an excessive amount for them; it may make loans to, or borrow money from, a subsidiary at excessive or uncommercially low rates; and so forth.

The Internal Revenue Code provision that addresses profit shifting between related companies is section 482, which authorizes the Secretary of the Treasury to "distribute, apportion, or allocate gross income, deductions, credits, or allowances" between or among any related organizations, trades, or businesses, if the Secretary determines that "such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses."

In addition to the above, specific provisions, the Internal Revenue Code contains more general provisions aimed at combatting the avoidance or evasion of tax through manipulation of the corporate form. The most important of these is section 269, which provides that if any persons acquire control of a corporation, or acquire property of a corporation in certain kinds of transactions, and the principal purpose of the acquisition is "evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy," then the Secretary is authorized to disallow the deduction, allowance, or credit.

3. Foreign Branch Operations

The United States imposes tax on the worldwide taxable income of U.S. corporations. That is, all income is included in the tax base, regardless of the geographic place it was derived, and all allowable items of expense, deduction, and credit are taken into account, regardless of the place the income to which such items were related was derived.

Difficult questions arise when the foreign countries in which U.S. companies operate also impose taxes on the income derived by these companies. The questions concern the possibility of international "double taxation" and the means of avoiding it. By statute, the United States supplies the basic means by which double taxation of U.S. companies is avoided. This is the foreign tax credit. A U.S. company is permitted a dollar-for-dollar credit against its U.S. tax liability for income, war profits, or excess profits taxes paid or accrued to foreign governments. The amount of credit a company may claim is limited to the U.S. tax liability attributable to foreign source income. This amount is computed by multiplying the ratio of the company's foreign source taxable income to its worldwide taxable income by the company's pre-credit U.S. tax liability. The computation of foreign source taxable income is determined by explicit statutory rules governing the "sourcing" of income, and by regulations issued by the Treasury Department governing the allocation and apportionment of deductions to or among different classes of gross income, and gross income in different statutory source "groupings."

Companies operating in branch form overseas accordingly account currently for items of income, loss, deduction, expense, or credit attributable to their foreign branches, and claim foreign tax credits for any taxes paid to foreign governments with respect to their operations.

4. Foreign Subsidiary Operations

Tax consequences substantially different from those flowing from foreign branch operations arise if a U.S. company conducts its foreign business operations through a corporation organized under the laws of a foreign country. The profits of a foreign corporation are generally not taxed currently by the United States; a foreign corporation is taxed by the United States only on certain U.S. source investment income, and on its income "effectively connected" with a U.S. trade or business. However, the U.S. parent corporation will be taxable on any dividends received from the foreign corporation. The insulation of the foreign corporation's profits from a corporate level U.S. tax makes the essential devices for mitigating the impact of the U.S. "double-tax" system on corporate organization -- the dividends received deduction and the opportunity to report income on a consolidated basis -- unnecessary in the context of foreign subsidiaries. Therefore, U.S. companies may not claim a dividends received deduction for dividends from a foreign corporation which did not earn income from a U.S. business, and foreign corporations may not be included in a consolidated return. However, a U.S. corporation which owns 10 percent or more of a foreign corporation may take a "deemed paid" credit for foreign income taxes paid by the foreign corporation on income represented by dividends paid to the U.S. corporation. The amount of deemed paid credit is limited in the same way as is the foreign tax credit claimable by U.S. companies operating in branch form abroad.

The insulation of foreign corporations from current U.S. tax, and the ability of U.S. companies (and other persons) to hold property or to conduct business through a foreign corporate organization, create special potentials for abuse which require special anti-abuse provisions. The "nonrecognition" provisions, for instance, create substantial abuse potentials in the foreign corporation area. When a person transfers appreciated property (such as a patent) to a U.S. corporation, there is relatively little possibility for avoiding or deferring a capital gains tax in the event of a subsequent disposition of the property by the corporation; the transferee corporation is subject to a comprehensive U.S. tax liability, just as the transferor would be. Where the transfer is made to a foreign corporation, however, a much greater abuse potential arises. In those circumstances, the foreign corporation will not be taxable upon a subsequent disposition of the property; thus the capital gains tax will be deferred indefinitely until distribution of the proceeds to the U.S. shareholder, and may by certain devices be ultimately avoided.

A related problem grows out of the practice of U.S. corporations using a branch form for startup operations in foreign countries and incorporating the branch when the operations reach a "break-even" point. Startup business operations often entail substantial "front end" losses; these losses may be used by the companies to offset other income in computing their total U.S. tax liability. But some of those losses may be the product of deductions which, though allowable by the terms of the Internal Revenue Code in the year claimed, are properly allocable to income which will be produced in subsequent years. For instance, a company may incur substantial research and development expenses, which may be deducted for U.S. tax purposes in the period during which they are incurred. But these expenses may be productive of substantial royalty or other licensing type income not realized until years subsequent to the time the expenses are incurred. By incorporating foreign operations in a timely manner, a corporation can exaggerate the deferral effect of the insulation of foreign corporate earnings from U.S. tax, for it has claimed deductions against U.S. source income currently, but in "income years" it will not incur any U.S. tax on the foreign earnings.

The Internal Revenue Code has two devices to combat these two related potential abuses. First, a 35 percent excise tax is imposed on the amount of untaxed appreciation borne by property transferred by a U.S. person as a contribution to the capital of a foreign corporation, unless the transferor satisfies the Internal Revenue Service that the transfer does not have a tax avoidance purpose. This excise tax essentially replaces the capital gains tax that is being avoided by the transfer. Second, in order to secure nonrecognition treatment on certain transfers to foreign corporations which would be nonrecognition transfers under the otherwise applicable Code provisions, a transferor must obtain a ruling from the Internal Revenue Service that the transfer does not have a tax avoidance or evasion purpose. If the Service refuses such a ruling nonrecognition treatment is not accorded the transaction -- the company is compelled to pay a "toll charge."

A third potential abuse arises from opportunities to manipulate "source" rules to reflect income in "tax haven" jurisdictions, and thereby to escape corporate level or current taxation of the income. For instance, income from the disposition of personal property is "sourced" in the jurisdiction where title passes. This "source rule" permits persons selling goods to the United States, for instance, to pass title through a foreign base company and thereby to avoid U.S. source income, which would be taxable by the United States. Similarly, income from shipping, from the performance of certain architectural, engineering, managerial or other services, or income from underwriting insurance contracts may be derived in such a manner as to characterize the income as having a source in a foreign base. In this way, the income can be sheltered from current U.S. tax through foreign incorporation; and it may receive effective exemption from current tax if the corporation is organized in a low- or no-tax "haven" jurisdiction. To combat this practice, the United States requires that U.S. shareholders of "controlled foreign corporations" currently include in their income portions of the corporation's income attributable to certain base company or passive investment income.

A fourth potential abuse is the ability of a U.S. shareholder of a foreign corporation to "transmute" what would be ordinary dividend income of a foreign corporation into lower taxed "capital gain" income by selling shares of the company or liquidating it, instead of distributing accumulated profits from a company. In addition, a U.S. company could liquidate an 80 percent owned foreign subsidiary free of tax, receiving "nonrecognition" treatment. In the absence of special provisions, it could therefore gain control of accumulated profits without the occurrence of any taxable event. To forestall "bailouts" of this type, the Internal Revenue Code requires that the gain realized on the sale of shares of any foreign corporation by a U.S. person who was more than a 10 percent shareholder of the company be treated as a dividend to the extent of the accumulated profits of the company. It also requires that in liquidating a foreign subsidiary, a U.S. person receive a ruling from the Internal Revenue Service that the liquidation does not have a tax avoidance purpose.

A final and important potential abuse of foreign corporations grows out of the ability of companies to "shift" profits from one corporate entity to another through artificial transfer pricing and other artificial pricing of intercorporate transactions. By shifting profits to a foreign subsidiary, a U.S. parent may secure deferral of (or exemption from) U.S. tax on what may in reality be genuine U.S. business activity. This problem is especially acute where profits may be shifted to a tax haven jurisdiction where they will be taxed at a rate substantially lower than that imposed by the U.S. As in the case of profit shifting between domestic corporations, this potential abuse is addressed by section 482 of the Internal Revenue Code.

B. U.S. Taxation of Business Operations in Puerto Rico and U.S. Possessions

1. Taxation of Possessions Persons

Under the Internal Revenue Code, comprehensive tax liability is imposed upon all individual residents and citizens of the United States, and upon domestic corporations. Section 932 provides that citizens of possessions (other than Guam), who are "not otherwise" U.S. citizens and who are not U.S. residents are treated as nonresident aliens under the Code. This makes them subject to tax only on their U.S. source investment income and income "effectively connected" with the conduct of a U.S. trade or business.

Only domestic corporations are subject to comprehensive U.S. tax liability under the Internal Revenue Code. Domestic corporations are defined as corporations organized under the laws of the United States or of one of the states. Foreign corporations are defined as any corporations which are not domestic. Accordingly, a corporation organized under the laws of one of the possessions, or under the laws of the Commonwealth of Puerto Rico, is deemed to be a foreign corporation for purposes of the Internal Revenue Code. Such a corporation is taxable on a withholding basis on certain U.S. source investment income, and is taxed on income effectively connected with a U.S. trade or business; but it is exempt with respect to other income, including its foreign source business income.

Section 933 of the Internal Revenue Code modifies the taxation by the United States of U.S. citizens resident in Puerto Rico, by allowing such residents to exclude from gross income amounts derived from Puerto Rican sources. Such residents may not claim deductions properly allocable to excluded income against other income taxed by the United States. They also may claim a foreign tax credit for taxes paid to Puerto Rico on their other income, including U.S. source income.

Citizens resident in the Virgin Islands and Guam satisfy their U.S. income tax liability by payment of income taxes due under the "mirrored" U.S. income tax law applicable to those jurisdictions under their respective organic acts.

2. Treatment of Possessions Source Income of Non-Possessions U.S. Persons

The Internal Revenue Code never uses the colloquial terms "domestic" and "foreign" source income; it speaks of income "from sources within" and "from sources without" the United States. Since under the Code "United States" when used in its geographic sense includes only the states thereof, and also the District of Columbia, "possessions source" income is income "from sources without" the United States within the meaning of the Code. In addition, the Code explicitly permits taxes paid the possessions to be credited against U.S. tax liability to the same extent a credit for taxes paid foreign governments is permitted. Accordingly, even in the absence of special provision for possessions source income, embodied in section 936 (and formerly section 931) of the Internal Revenue Code, companies could claim a foreign tax credit for income derived from the possessions. This, together with the provision that possessions-incorporated corporations are foreign corporations, would give the companies the same option they have with any foreign operation -- between a foreign branch and foreign subsidiary -- with virtually identical tax consequences. Possessions subsidiaries are subject to the anti-avoidance measures described above to the same extent as any other foreign corporations. 2/

But U.S. companies have a third option -- the possessions corporation qualifying for the benefits of section 936. The mechanics of this option, its evolution from its predecessor governed by section 931 of the Internal Revenue Code, and the scope of the advantages it confers, are described below.

2/ An exception to this general rule arises in the case of possessions-incorporated subsidiaries that meet the requirements set out for possessions corporations, except for the U.S. incorporation requirement.

a. Adoption of Section 931 -- The essential elements of section 931 of the Internal Revenue Code of 1954 were adopted as part of the Revenue Act of 1921. Certain U.S. companies had sought a provision in that law exempting from U.S. income tax the income of any domestic corporation which derived 80 percent or more of its gross income from foreign sources. The principal argument advanced in support of the provision was that U.S. firms were placed at a tax-induced disadvantage vis-a-vis United Kingdom competitors, because United Kingdom law did not impose income tax upon the earnings of firms until the firms remitted the earnings. The compromise reached was an exemption for U.S. firms deriving 80 percent or more of their gross income from U.S. possessions.

This compromise in fact went further toward meeting the demands of the proponents of foreign exemption than might appear from a current vantage point. Support for the exemption system came primarily from a group of firms then operating in the Philippines, a U.S. possession in 1921. Those firms argued that tax exemption would encourage U.S. trade with the Far East from the U.S. base in the Philippines, while at the same time reducing incentives for 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; other possessions, including Puerto Rico, were virtually ignored in the public debate.

b. Section 931 Prior to 1976 -- Prior to adoption of the Tax Reform Act of 1976, section 931 provided that individual citizens of the United States and domestic corporations which met certain "income tests" should be taxable in the United States only on their U.S. source income. Other income was excluded from their tax computation. There were two income tests: an "80 percent test" -- that 80 percent of the person's gross income be possessions source; and a "50 percent test" -- that 50 percent of the person's income be derived from the active conduct of business in the possessions. Both tests are made over a three-year period closing with the end of the taxable year with respect to which the tests are applied, or for a shorter period, if the person has not conducted a trade or business in a possession for the entire three year period. A possessions (or "931") corporation under this statute was required to be a domestic corporation.

The exclusion created by section 931 was different from the foreign tax credit in one crucial respect. The foreign tax credit shields a U.S. company's foreign earnings from tax only if and to the extent that the company pays tax to a foreign government. The 931 exclusion applied whether or not the company actually paid a foreign or possession income tax. The exclusion thus "preserved" the economic benefit of any tax incentive legislation adopted by a possession. The application to 931 corporations of the two basic means for mitigating the impact of the "classical" system on corporate organization, that is, permissive consolidation and the dividends received deduction, were modified. Prior to 1976, the Internal Revenue Code provided that a corporation "entitled to the benefits of section 931" could not be an "includible corporation" in an "affiliated group." Failure to qualify as an includible corporation made the company ineligible for consolidation. And parent corporations could not take a dividends received deduction for dividends paid by 931 corporations.

Corporations qualifying for section 931 therefore had difficulty distributing their accumulated earnings, because the parent corporation would be subject to tax on the full amount of any dividends the 931 paid. However, the parent company could claim a "deemed paid" credit for any taxes the 931 corporation may have paid to a possession (or foreign country) on its earnings, and for any withholding tax imposed by the possession upon the dividend. The dividend was considered foreign source income which increased the recipient's foreign tax credit limitation. In addition, the 931 company was effectively insulated from the U.S. accumulated earnings tax, since that tax is based on accumulated taxable income, and by virtue of the exclusion under section 931, the company had little if any taxable income. On the other hand, if 80 percent owned by a domestic corporation, a 931 corporation could be liquidated into its parent free of capital gains tax either to the subsidiary on any appreciated property distributed to the parent, or to the parent, on the appreciation of shares surrendered in exchange for the property distributed. This could be achieved without a ruling from the Internal Revenue Service that the transaction did not have a tax avoidance purpose of the kind which would have been required had the corporation been a regular foreign corporation or had it been organized in the possession.

As a consequence of these rules, the typical 931 corporation would accumulate earnings derived in Puerto Rico or a possession, and then would invest the earnings outside the United States, where earnings on the reinvestment continued to enjoy exemption from U.S. income taxes. Companies operating in Puerto Rico frequently placed large investments in the "Eurodollar" market in Europe, either directly or through Guamanian banks. (Since Guam is a possession, interest on a bank deposit in Guam was "possessions source", and therefore helped the 931 corporation meet its 80 percent test). After a number of years, usually at the end of Puerto Rican tax exemption, the company would be liquidated (tax-free) into its U.S. parent.

Corporations operating under section 931 were excepted from most of the anti-abuse provisions applicable to foreign corporations. Nonrecognition transfers of appreciated property (such as patents) to 931 corporations were excepted from the provisions requiring a ruling that the transfers were not for a tax avoidance purpose, and from those imposing excise taxes on transfers as contributions to capital of a foreign company. These exceptions applied even though 931 corporations, because of their tax exemption, were subject to the same abuses as foreign corporations in this regard.

Further, the sale of shares of a 931 corporation was not subject to the provisions characterizing gain on such sales as dividend income to the extent of the earnings of the company. This was true even though 931 corporations, because of their tax exemption on foreign source earnings, could be used to transmute those earnings from ordinary income to capital gain on the sale of shares. To an extent, the non-application of this provision was of little meaning, because the liquidation option permitted a company to realize the benefits of the possessions subsidiary's earnings without paying any current tax on the income. But that liquidation was itself a product of a variation of the laws which would have applied to a foreign corporation, which would have conditioned nonrecognition of gain in the absence of a tax avoidance purpose. In addition, because a possessions corporation was a domestic corporation, it could not be deemed a "controlled foreign corporation" for purposes of the anti-tax haven provisions of the Internal Revenue Code. 3/ Accordingly, either corporations chartered in the possessions or domestic corporations qualifying under section 931 could be used as tax haven base companies if they could fit base company income into the terms of the Puerto Rican tax holiday legislation.

3/ Those provisions also except corporations organized in Puerto Rico and the possessions that otherwise meet the general requirements of a possessions corporation.

One anti-abuse provision which did apply to 931 corporations was section 482, the intercompany transactions provision. The Internal Revenue Service first began substantial investigations of the transfer pricing practices of 931 corporations and their parents in the late 1950s. In August 1959, the Governor of Puerto Rico formally protested to the Secretary of the Treasury the transfer pricing standards then being applied by the Internal Revenue Service. The Governor complained that to the extent affected industries qualified for tax exemption, the standards hurt Puerto Rico's ability to attract U.S. investment; to the extent affected industries did not qualify, the standards allegedly detracted from Puerto Rico's tax collections. The Government suggested the establishment of procedures, analogous to competent authority procedures under bilateral tax conventions, to settle profit allocation disputes between Puerto Rico and the United States. The Internal Revenue Service undertook a review of its section 482 standards and suspended action on pending section 482 cases between 1961 and 1963.

In 1963, the Internal Revenue Service issued a revenue procedure governing allocations between possessions corporations and their U.S. parents. Although these standards were applicable only to transactions between 931 corporations and their parents, they became the basis for generally applicable intercompany transaction regulations issued in 1968. But the 1963 procedure did not break the backlog of profit allocation cases. The 1963 standards threatened to result in substantial reallocations of income from possessions corporation subsidiaries and pending 482 cases were again suspended in 1965. In 1968, the Treasury Department issued comprehensive intercompany transaction regulations, and at the same time issued a revenue procedure permitting 931 companies to rely on the 1963 standards if those standards produced more favorable results than the 1968 regulations.

Intercompany allocations have nevertheless remained an area of difficulty. The Internal Revenue Service has recently instituted litigation against one major pharmaceutical manufacturer which transferred a patent on a prominent prescription drug to its possessions subsidiary. The current Governor of Puerto Rico wrote the Secretary of the Treasury in 1978, protesting that the section 482 practices of the Internal Revenue Service are inhibiting Puerto Rico's ability to attract new investment through its tax exemption program, and that they threaten to erode Puerto Rico's tax base. This latter problem is being addressed by a mutual agreement procedure between the Puerto Rican Treasury and the Internal Revenue Service, completed early this year, that is designed to resolve cases of double taxation between the United States and Puerto Rico.

c. Section 936 -- In considering the Tax Reform Act of 1976, Congress perceived two substantial problems with the operation of the 931 provisions. First, the exclusion of all foreign source income, together with the tax deterrent to nonliquidating distributions by 931 corporations to their U.S. parents, were viewed as producing an unjustified revenue loss, and as creating incentives to uneconomic investments of retained earnings by 931 corporations. As noted above, most of these earnings were invested in the Eurodollar market, where they continued to enjoy tax exemption. Congress was concerned because these investments did not benefit the Puerto Rican or possessions' economies, while at the same time they involved a revenue loss to the United States. In addition, Congress believed that if the earnings could not be profitably invested in the possessions, companies should be free to choose on the basis of nontax considerations whether to invest in the United States or abroad.

The second problem grew out of the wording of the statute defining an "affiliated group." That statute provided that a corporation "entitled to the benefits of section 931" did not qualify as an "includible corporation." In years when their 931 subsidiaries ran losses, U.S. companies sought to take advantage of the losses currently, offsetting them against other income subject to taxation, on grounds that the subsidiaries were entitled to no "benefit" in the years they had no income. The Internal Revenue Service resisted this theory, but in 1971 the Tax Court accepted it. This gave 931 subsidiaries a best-of-both-worlds quality: parent companies could treat them like a branch in loss years, taking the losses currently, but like a foreign corporation in income years, excluding the income from taxation.

Congress responded by amending section 931 and adding section 936 to the Internal Revenue Code. The amendments made section 931 applicable only to individual citizens of the United States. New section 936 applies only to domestic corporations meeting the same "80-50 tests" as are applicable under section 931. But unlike 931, section 936 does not permit an exclusion from income by the 936 company. Instead, it permits the company to credit against its U.S. tax liability the portion of that liability attributable to the favored income. This credit does not depend upon tax having been paid to the possession, so that, like the 931 exclusion, it "preserves" the effect of any possessions tax holiday. But the favored income is not, as it was under section 931, all foreign source income. Instead, the favored income includes only (1) income derived from the active conduct of a trade or business in the possession; and (2) qualified possession source investment income, defined as income derived from investment of accumulated trade or business profits in the same possession as the trade or business is conducted.

To receive the benefits of section 936, a corporation must make an election, and any election so made is irrevocable for a period of 10 years. The "includible corporation" definition was amended in 1976 to exclude any corporation which had made a 936 election. Thus, Congress prevented companies from an "in and out" game with the possessions provisions, electing consolidated reporting in loss years, and credit or exclusion in gain years. In order to encourage repatriation of accumulated earnings which would not be profitably invested in the possessions, Congress amended the dividends received deduction provision to permit a dividend from a section 936 corporation to qualify for a 100 percent deduction if received by another member of the corporation's "affiliated group." Finally, in order to prevent a company from claiming a credit for foreign or possessions' taxes paid on income that is not taxed by the United States, Congress amended the foreign tax credit provisions to disallow a credit to a recipient of a dividend from a section 936 corporation for foreign or possessions' taxes paid on the dividend. 4/

The 1976 changes did not alter the power of a corporation to liquidate its possessions corporation subsidiary tax-free and take out retained earnings in that manner. It did, however, eliminate the necessity for doing this in most circumstances, by permitting companies to take a 100 percent dividends received deduction on nonliquidating distributions.

The 1976 changes also left unaffected the insulation of possessions corporations from most of the anti-abuse provisions applicable to foreign corporations. Thus, companies still need not obtain a ruling from the Internal

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4/ In the Revenue Act of 1978, Congress limited this disallowance to corporate shareholders, since noncorporate shareholders generally are fully taxable on dividends received from possessions corporations.

Revenue Service to secure nonrecognition treatment on transfers of appreciated property to a possessions corporation, nor are they subject to an excise tax on such transfers. The owners of such companies, even individuals, are not subject to current tax on their share of the personal holding company or base company income of possessions corporations, even in circumstances where similarly situated shareholders would be currently subject to tax on such income if earned by a foreign corporation. Companies still need not treat gain realized on the disposition of shares in possessions corporations as dividend income, even in circumstances where they would have to do so were the corporation involved a foreign corporation. However, the intercompany transaction questions raised under the pre-1976 law continue to be raised under the new law.

C. Taxation in Puerto Rico and the Industrial Incentives Program

1. Taxation in Puerto Rico

As noted above, the Federal income tax does not apply in Puerto Rico, and this is generally true of Federal estate and gift taxes. Federal excise taxes likewise do not apply in Puerto Rico, nor do they (or State and local sales and excises taxes) apply to goods shipped to Puerto Rico from the United States. Customs duties are not imposed on shipments from Puerto Rico to the United States, or on shipments from the United States to Puerto Rico. However, the full U.S. schedule of customs duties is imposed on goods coming into Puerto Rico from foreign countries, but the proceeds are "covered over" to the Puerto Rican Treasury. The Federal social security and unemployment taxes also apply in Puerto Rico, which participates fully in the benefits as well as the contribution sides of both programs.

In addition to Federal customs duties and social security and unemployment trust fund contributions, the Puerto Rican Commonwealth and municipal governments impose a full system of taxation, consisting of individual and corporate income, excise, property, estate, gift and various license taxes. Of particular interest is the Puerto Rican corporate income tax, which in most respects is quite similar to its Federal counterpart. 5/ The Puerto Rican tax

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5/ This similarity is largely due to the fact that the Puerto Rican income tax is based on the U.S. Internal Revenue Code of 1939.

applies to the gross income, less allowable deductions, of Puerto Rican corporations and to the Puerto Rican operations of non-Puerto Rican (which includes U.S.) corporations. Gross income and allowable deductions are defined in much the same way as under the Federal tax code. However, the Puerto Rican code contains a "flexible depreciation" provision which permits taxpayers, subject to certain restrictions, to recover the cost of "qualifying property" in any taxable year or years designated by the taxpayer, without regard to the useful life of the property. Generally, property acquired to be used in agriculture, construction, manufacturing, hotels, or shipping, and certain property leased to a manufacturing, hotel, or shipping business qualifies for flexible depreciation.

The applicable Puerto Rican corporate income tax rate consists of two parts. The normal tax rate of 22 percent applies to "normal tax income" (net income less an 85 percent dividends received deduction). The second part applies to "surtax net income" (generally, normal tax income in excess of $25,000) on a graduated scale, ranging from 9 percent on surtax net incomes under $75,000 to 23 percent on surtax net incomes in excess of $275,000. Thus, the top rate of 45 percent generally applies to corporations with normal tax incomes in excess of $300,000.

In addition to its regular corporate income tax, Puerto Rico imposes a "tollgate" or withholding tax on dividends paid to nonresident shareholders of Puerto Rican corporations, or non-Puerto Rican corporations that conduct substantially all of their business in Puerto Rico (for example, possessions corporations). Prior to October 1, 1976 the rate was 15 percent on dividends paid out of manufacturing, hotel, or shipping income to any non-Puerto Rican parent corporation without business operations of its own in Puerto Rico. However, the tax only applied if the nonresident parent corporation could claim a foreign tax credit for the tax. As noted above, prior to 1976 U.S. parent corporations could claim a credit for the Puerto Rican withholding tax so the tax did apply to dividends paid by 931 corporations. Because the parent was taxable on the dividend, but not on a liquidating distribution, such dividend payments were rare.

The tollgate tax does not apply to dividends paid to a resident parent corporation (e.g., a U.S. manufacturer which wholesales and retails its products in Puerto Rico). Instead, dividend payments to such a corporation would be subject to the regular Puerto Rican income tax. The 85 percent dividends received deduction would, however, reduce the effective rate on dividends from a possessions corporation to a resident parent corporation to no more than 6.75 percent (45 percent of 15 percent).

Rather than pay a tollgate tax of 15 percent or a regular corporate tax of up to 6.75 percent on dividend payments, most U.S. parents of possessions corporations took advantage of the fact that prior to 1978 Puerto Rico did not impose any tax on liquidating distributions of the tax exempt income of possessions corporations, provided that the parent owned at least 80 percent of the stock of the possessions corporation (as was almost always the case). Normally, therefore, a possessions corporation could accumulate earnings free of U.S. or Puerto Rican tax until its industrial exemption expired, and then those accumulated earnings could be distributed to the U.S. parent through liquidation of the possessions corporation, again free of any U.S. or Puerto Rican tax.

2. The Industrial Incentives Program

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 qualifying 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. To qualify for tax exemption, a firm had to produce items not produced on a commercial scale in Puerto Rico prior to 1948, or produce certain specified items such as wearing apparel and processed food products. The 1948 Act further provided that the period of total tax 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.

Many firms established plants in Puerto Rico in the early 1950s 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 placed limitations on the ability of an existing 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 exempt 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.

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 1970s, 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 was an attempt to encourage possessions corporations to invest a larger portion of their earnings in Puerto Rico.

3. Recent Changes in the Tollgate Tax and the Industrial Incentives Program

Anticipating the passage of section 936 and the other Federal provisions relating to possessions corporations, in 1976 Puerto Rico modified its 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 by the 1976 U.S. tax changes adopted with section 936. 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. (The taxation of dividends paid to resident U.S. parents was not changed.) 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.

The 10 percent tollgate rate instituted in 1976 remains, but 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 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 designated Puerto Rican assets for a period of at least 8 years.

3. Dividends paid out of interest earned on investments in 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 guidelines concerning the tax treatment of dividends paid out of income earned outside of 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 may be paid out of the foreign sourced portion without the imposition of a Puerto Rican tollgate tax as long as an equal amount is distributed out of the Puerto Rico sourced portion. That is to say, the tollgate tax in these instances will be imposed on only 50 percent of the total distribution, thereby reducing the effective rate of tax.

On June 2, 1978, Puerto Rico enacted major revisions to the Industrial Incentive Act. The new provisions affect both the terms of new grants and the terms of old grants if the holders elect to convert them to a partially exempt status. The primary features of the legislation affecting new grants 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 year, 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.

5. Export oriented service industries (architectural, 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, provided 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 1978 legislation also contains provisions permitting currently tax-exempt corporations to elect to move to a partially exempt status. The election, which would first apply in either 1978 or 1979, 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 have elected in April 1979 (the usual filing date) to become partially taxable for either 1978 or 1979. If 1979 was elected, then the first return indicating taxes actually due would be filed in April 1980.

The election is subject to the following four 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 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 tax provided 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 tax, provided that 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. 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.

CHAPTER III. PUERTO RICAN ECONOMIC GROWTH AND DEVELOPMENT AND THE POSSESSIONS CORPORATION SYSTEM

Puerto Rico is a small, crowded Island with few natural resources. It shares a very close economic and political interdependence with the United States. Puerto Rico and the United States have a common currency and common external tariffs. There are no barriers to the free flow of goods, labor or capital between the two economies. Most Puerto Rican exports are to the United States, and most imports are from the United States. Virtually all investments in Puerto Rico by non-Puerto Rican firms have been made by U.S. companies. Federal statutes generally apply to Puerto Rico, some (such as minimum wage legislation) with potentially large economic impacts. Most Federal grant programs for state and local governments and most Federal income maintenance programs for individuals also apply in Puerto Rico, although only partially in some cases.

All of these ties between Puerto Rico and the United States have helped shape, and have in turn been shaped by, the push for economic growth and development in Puerto Rico that began in 1948. This Chapter begins with an overview of the growth in Puerto Rican gross national product since 1948, the setbacks during the 1973-1977 recession, and the recent recovery. Long range Puerto Rican development issues are then taken up, followed by an analysis of the costs, benefits, and cost effectiveness of the possessions corporation system.

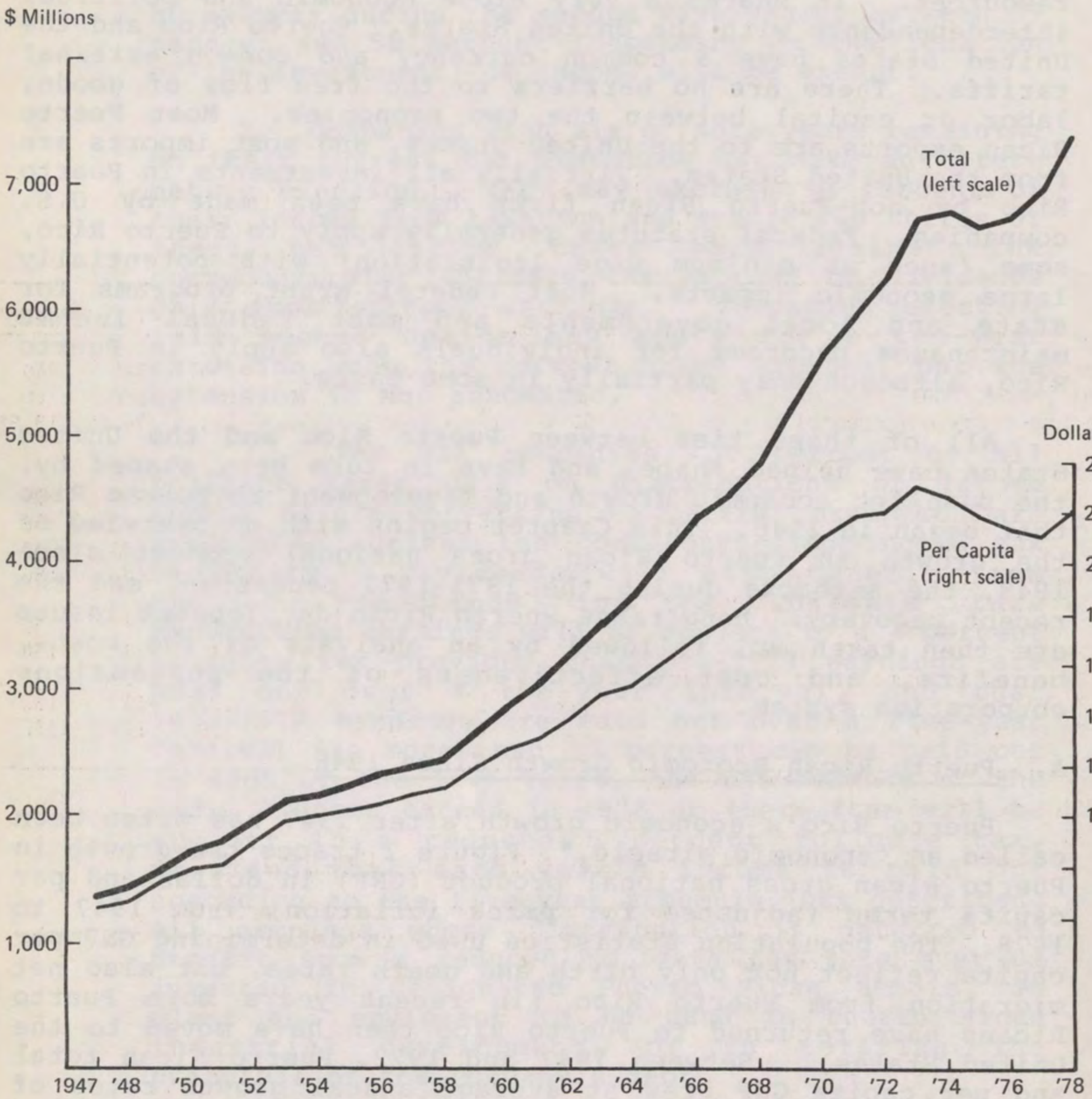
A. Puerto Rican Economic Growth Since 1948

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 (GNP) in dollar and per capita terms (adjusted for price inflation) from 1947 to 1978. The population statistics used in determining GNP 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 United States). 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. 1/

1/ 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 Capital Gross National Product of Puerto Rico, 1947-1978 (Constant 1974 Dollars)



Source: Puerto Rico Planning Board

Table 1

Puerto Rican Labor Force, Unemployment, and Employment by Major Industry, Fiscal Years 1972-1978

	Fiscal Year						
	1972	1973	1974	1975	1976	1977	1978
Labor Force (000)	837	858	884	872	890	920	960
Unemployment (000)	100	101	109	134	172	184	180
Unemployment rate (percent)	12.0%	11.8%	12.3%	15.4%	19.4%	20.0%	18.8%
Employment by industry (000)							
All industries 1/	737	757	775	738	718	739	780
Agriculture	58	49	53	49	46	41	38
Construction	79	80	79	69	53	43	44
Manufacturing	141	142	147	137	133	144	156
Transportation, communications, and utilities	49	50	54	49	46	49	50
Wholesale and retail trade	135	146	148	141	140	145	150
Finance, insurance, and real estate	16	18	18	18	18	19	21
Services	126	127	128	120	121	127	138
Government 2/	131	143	147	151	158	168	180

Office of the Secretary of the Treasury
Office of Tax Analysis

Source: Puerto Rico Planning Board, Economic Report to the Governor, 1977-78.

1/ Includes a small number of employees in industries not shown separately.
2/ Excludes employment in Puerto Rican government enterprises, which is included in the figures for other industries.

However, Puerto Rico's economic growth decelerated sharply in the 1970s. As shown in Figure I, real GNP slowed its growth in 1974, declined in 1975, remained more or less stagnant in 1976, before increasing in 1977. In part because of the influx of native Puerto Ricans returning from the United States, Puerto Rican GNP per capita declined steadily from 1973 to 1977. Table 1 illustrates the effect of the recession on employment and unemployment in Puerto Rico, providing a second, though closely related, measure to the GNP figures. The traditionally high rate of unemployment in Puerto Rico, which had been gradually reduced to just over 10 percent in the late 1960s, started edging up in the early 1970s, and reached 11.8 percent in 1973. Thereafter, it rose steadily, and reached 21.5 percent in April 1977. Part of this large increase in the unemployment rate was due to a rapidly expanding labor force, which increased from 858,000 to 920,000 workers, or 7.2 percent, between 1973 and 1977. In addition, however, total employment fell over the period -- from 757,000 to 739,000, or by 2.4 percent, despite increases between 1973-1974 and 1976-1977. Most affected was construction which lost 37,000 jobs, a fall of nearly 50 percent, between 1973 and 1977. Agriculture continued its long-term decline, while manufacturing, which lost jobs between 1974 and 1976, was slightly above its 1973 level by 1977. Other sectors tended to follow the manufacturing pattern, with the major exception of government which provided steadily increasing employment. The Puerto Rican economy began a recovery in late 1977, and in 1978 employment rose sharply while the unemployment rate fell despite a large increase in the measured labor force. By April 1979, the unemployment rate was down to 16.2 percent.

The prolonged recession in Puerto Rico would have been deeper had it not been for offsetting expenditures by the Federal and Commonwealth governments. Total Federal transfers to Puerto Rico increased very rapidly between 1968 and 1978 -- see Table 2. By 1978, net Federal transfers directly to individuals (the bonus value of food stamps, net social security and medicare payments, veterans benefits, etc.) of $1.3 billion represented 15 percent of personal income, which was three times the 5 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 1978, also three times the 8 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

Table 2

Federal Transfer Payments, Grants, and Taxes "Covered Over" to Puerto Rico, Fiscal Years 1968 and 1978 1/
(millions of dollars)

	FY 1968	FY 1978
Net Federal transfer payments to individuals, total 2/	68	1,321
Food stamps	--	682
Old age, survivors, and disability insurance	1	326
Veterans benefits	59	198
Unemployment compensation	1	33
All other	7	82
Federal grants to Puerto Rican Commonwealth and municipal governments, total	129	885
Child nutrition and special milk programs	5	62
Human development 3/	6	36
Office of Education programs	--	62
Public assistance	31	38
Community development block grants	15	56
Low rent public housing	11	56
Employment and training programs	7	246
All other	54	329
Federal taxes "covered over" to Puerto Rican treasury, total	93	271
Customs duties	27	71
Alcoholic beverage and tobacco excises	66	200
TOTAL	290	2,477

Office of the Secretary of the Treasury
Office of Tax Analysis

Sources: U.S. Department of the Treasury, Federal Aid to States: Fiscal Year 1978, and the Statistical Appendix to the Secretary's Annual Report for 1968; and Puerto Rico Planning Board, Economic Report to the Governor (various years).

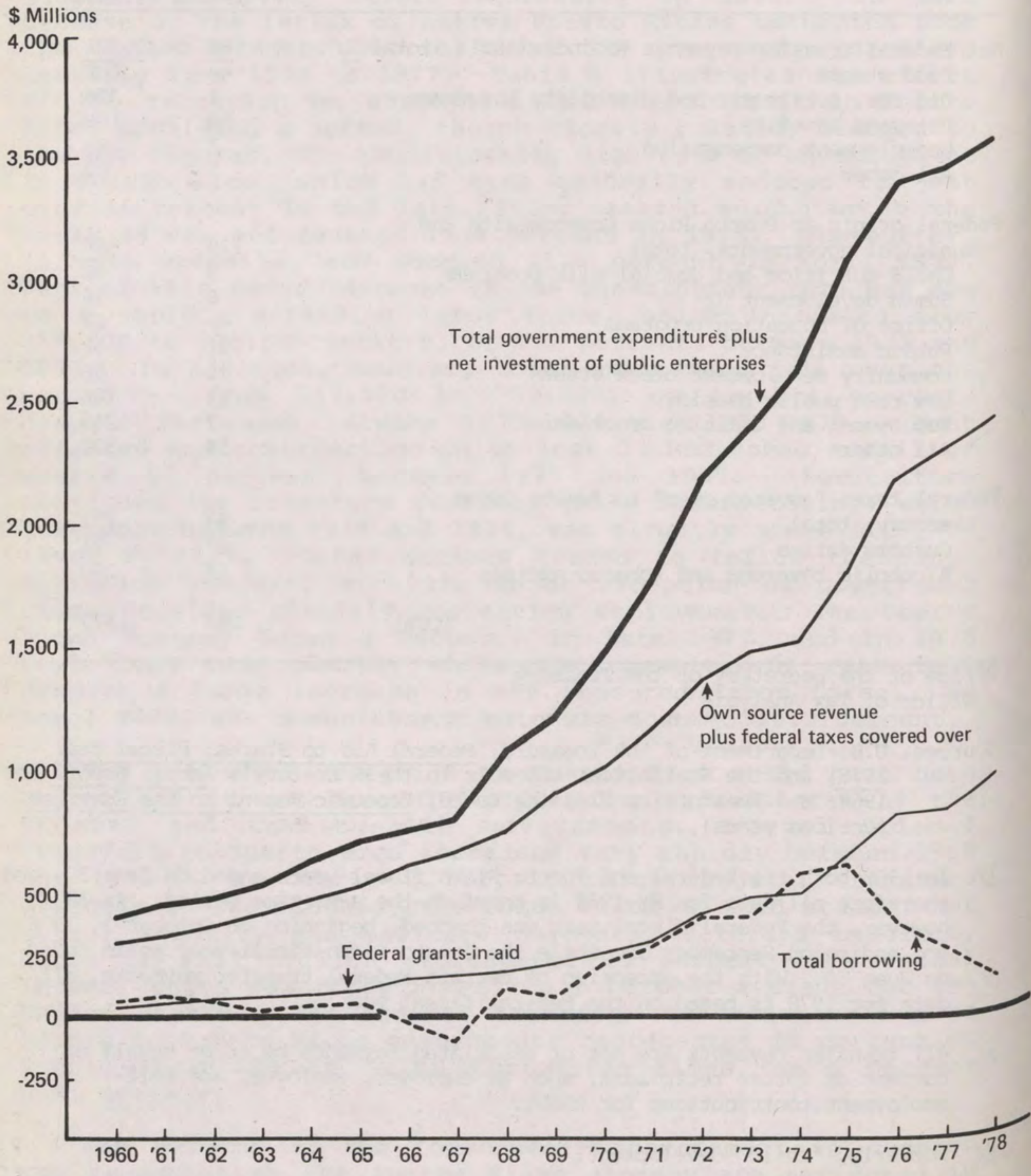
1/ In 1968 both the Federal and Puerto Rican fiscal years ended on June 30, and therefore all data for FY 1968 is based on the same time period. In 1977, however, the Federal fiscal year was changed, beginning on October 1, 1976 and ending on September 30, while the Puerto Rican fiscal year again ended on June 30. With the exception of certain Federal transfer payments, all data for 1978 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, 1960-1978



Source: Puerto Rico Planning Board

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.) However, 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 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, roughly 75 percent of Puerto Rican GNP 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 can only meet with limited success.

Further, to the extent Puerto Rican government spending is financed from external borrowing (in the United States or elsewhere), repayment requires a transfer of real goods and services from Puerto Rico at some point in the future. Such external borrowing, if carried too far, can also raise the interest rate lenders demand on government bonds. (This was particularly true in 1975, when the near default by New York City affected the entire state and local government bond market.) Until 1968, total public sector borrowing in Puerto Rico had 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 had paid to market its bonds had 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 1974-1975, are transmitted to Puerto Rico. High interest rates that have accompanied U.S. anti-inflation policy have also affected the Puerto Rican economy. 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 greatly reduced the demand for new condominiums and left a large stock of unsold units. The result was a large decline in employment of highly paid construction workers, as noted above.

An additional cause of the recession, but one with much longer-run implications, was the large increase in oil prices in 1973. In the 1960s 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 the U.S. oil import quota (which allowed imports of foreign oil, which before 1973 was cheaper than domestic oil) rather than to low wages or other locational advantages. 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.

Finally, it has been suggested that changes in the U.S. tax law and the Puerto Rican tollgate tax in 1976, changes in the administration of the Industrial Incentives Program, and the anticipation of changes to the structure of the Industrial Incentives Program created sufficient uncertainty among potential new or expanding investors to adversely affect investment in Puerto Rico during 1976 and 1977. This question is addressed in Section D of Chapter IV.

Whatever the immediate causes of the 1973-1977 Puerto Rican recession, it appears that both its length and breadth can only be adequately explained by looking beyond these causes to more fundamental, long range problems.

B. Long Range Development of the Puerto Rican Economy

The basic goal of any economic development program is to increase real income per capita. As indicated in the preceding Section, Puerto Rico's development program has been very successful in achieving this goal, at least through the early 1970s. A major contributor to economic growth is investment in the plant, equipment, and inventories of private firms as well as in publicly provided infrastructure -- streets and highways, water supplies, etc. and in public buildings and equipment used by government in carrying out its general functions. Investment also includes new housing, which produces housing services (shelter) over its lifetime, and thereby contributes to real economic income over many years. These components of investment in Puerto Rico are illustrated in Figure III for the years 1965-1978. 2/ It is clear from Figure III that while both total and business investment in Puerto Rico grew quite rapidly in the late 1960s, the rate showed in the 1970s. In fact, if the business investment figures were adjusted for high inventory accumulations during the 1973-77 recession, both the business and total investment figures would be essentially level throughout the 1970-1978 period.

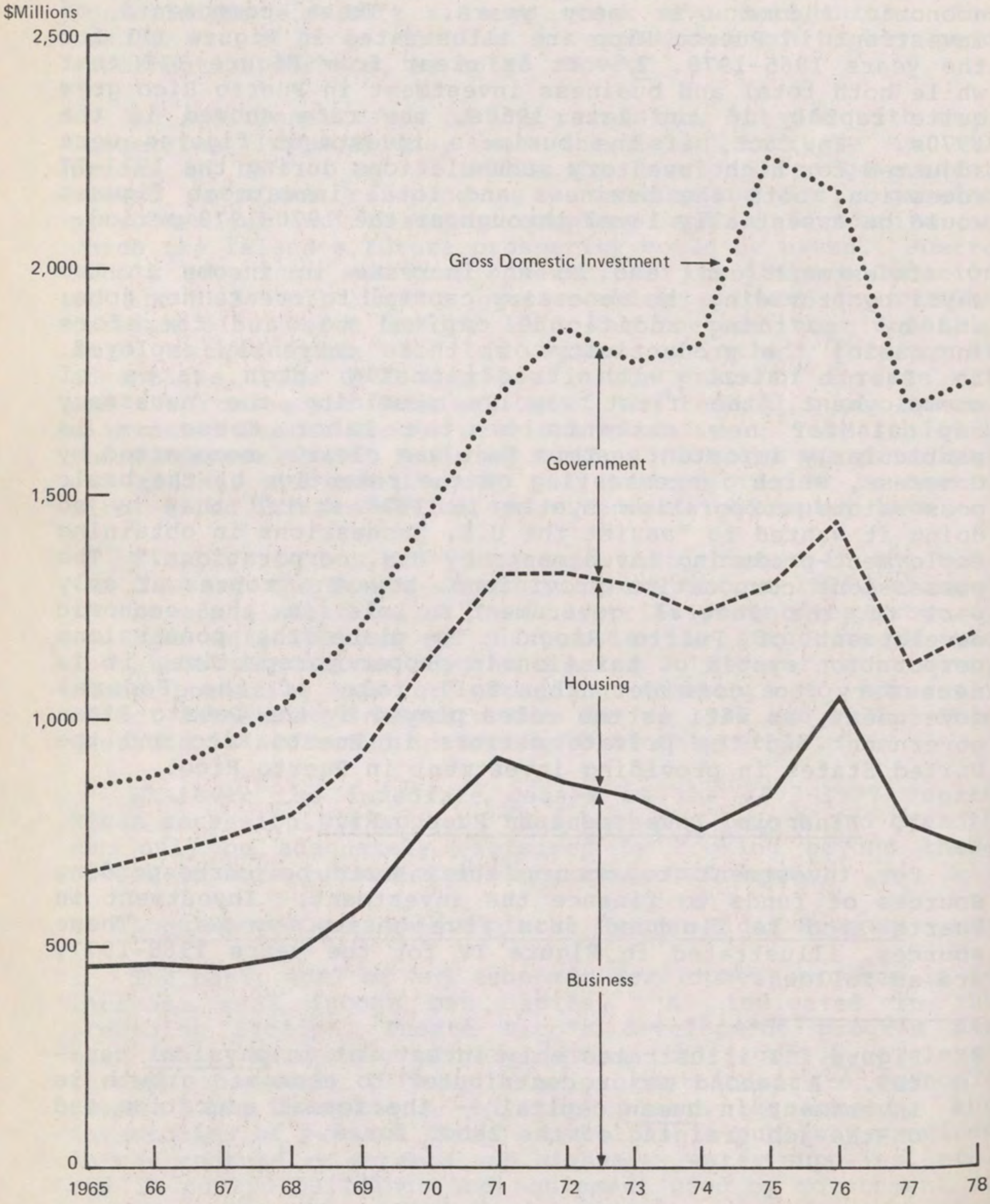
Investment can lead to an increase in income in two ways: by providing the necessary capital to create new jobs; and by providing additional capital to, and therefore increasing the productivity of, those currently employed. In Puerto Rico, with traditionally high rates of unemployment, the first way -- providing the necessary capital for new entrants to the labor force -- is particularly important. This fact was clearly recognized by Congress, which in commenting on the retention of the basic possessions corporation system in 1976 stated that by so doing it wanted to "assist the U.S. possessions in obtaining employment-producing investments by U.S. corporations." The possessions corporation provisions, however, represent only part of the Federal government's role in the economic development of Puerto Rico. To place the possessions corporation system of taxation in proper perspective, it is necessary to consider the full role of the Federal government, as well as the roles played by the Puerto Rican government and the private sectors in Puerto Rico and the United States in providing investment in Puerto Rico.

1. Financing Investment in Puerto Rico

For investment to occur, there must be corresponding sources of funds to finance the investment. Investment in Puerto Rico is financed from five basic sources. These sources, illustrated in Figure IV for the years 1965-1977, are as follows:

2/ Figure III illustrates only investment in physical capital. A second major contributor to economic growth is investment in human capital -- the formal education and on-the-job training of the labor force.

FIGURE III
Components of Investment in Puerto Rico, 1965-1978



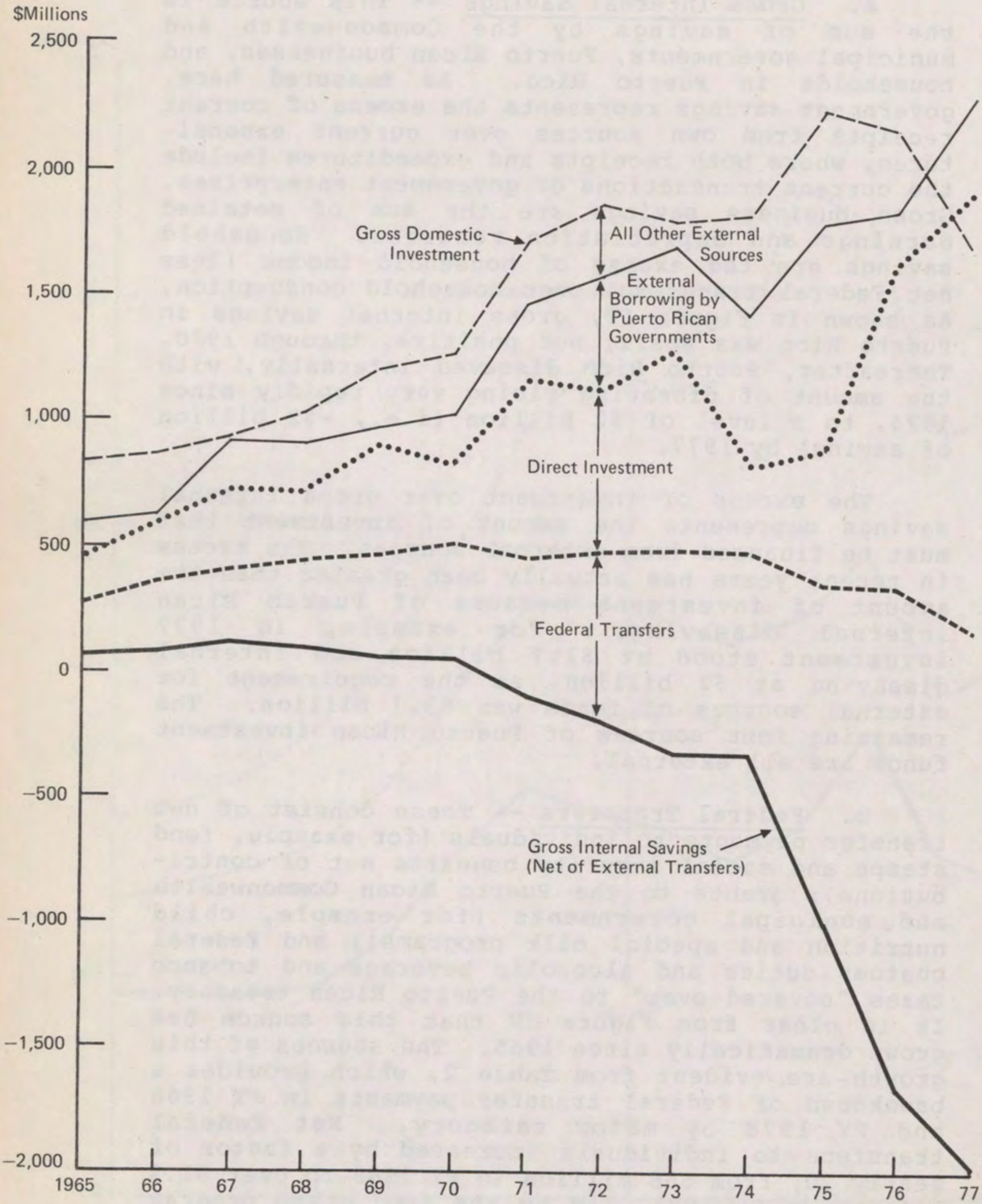
Source: Puerto Rico Planning Board

a. Gross Internal Savings -- This source is the sum of savings by the Commonwealth and municipal governments, Puerto Rican businesses, and households in Puerto Rico. As measured here, government savings represents the excess of current receipts from own sources over current expenditures, where both receipts and expenditures include the current transactions of government enterprises. Gross business savings are the sum of retained earnings and depreciation reserves. Household savings are the excess of household income (less net Federal transfers) over household consumption. As shown in Figure IV, gross internal savings in Puerto Rico was small, but positive, through 1970. Thereafter, Puerto Rico dissaved internally, with the amount of dissaving rising very rapidly since 1974, to a level of $2 billion (i.e., -$2 billion of saving) by 1977.

The excess of investment over gross internal savings represents the amount of investment that must be financed from external sources. The excess in recent years has actually been greater than the amount of investment because of Puerto Rican internal dissaving. For example, in 1977 investment stood at $1.7 billion and internal dissaving at $2 billion, so the requirement for external sources of funds was $3.7 billion. The remaining four sources of Puerto Rican investment funds are all external.

b. Federal Transfers -- These consist of net transfer payments to individuals (for example, food stamps and social security benefits net of contributions); grants to the Puerto Rican Commonwealth and municipal governments (for example, child nutrition and special milk programs); and Federal customs duties and alcoholic beverage and tobacco taxes "covered over" to the Puerto Rican treasury. It is clear from Figure IV that this source has grown dramatically since 1965. The sources of this growth are evident from Table 2, which provides a breakdown of Federal transfer payments in FY 1968 and FY 1978 by major category. Net Federal transfers to individuals increased by a factor of nearly 20, from $68 million in FY 1968 to over $1.3 billion in FY 1978, led by the food stamp program which was not introduced in Puerto Rico until FY 1975, but had reached $682 million by FY 1978.

FIGURE IV
Financing Investment in Puerto Rico, 1965-1977



Source: Puerto Rico Planning Board

Grants to Puerto Rican governments increased in all major program areas, from a total of $129 million in FY 1968 to $885 million in FY 1978, or by nearly 600 percent. And Federal taxes covered over increased from $93 million to $271 million between FY 1968 and FY 1978.

c. Direct Investment -- This represents the increase in net worth of U.S. (and other non-Puerto Rican) corporations operating in Puerto Rico. The great majority of these funds represent the unrepatriated earnings of possessions corporations; they also represent the retained earnings of Puerto Rico-incorporated subsidiaries of U.S. and other non-Puerto Rican companies, and other U.S.- and non-Puerto Rican-controlled corporate activity in Puerto Rico. Direct investment by U.S. companies has been a major source of funds for Puerto Rico throughout the postwar period, but has grown particularly fast in the 1970s.

It is important to note that direct investment is merely a source of funds and does not give any indication of the amount of actual plant, equipment, and inventory investment of U.S. firms in Puerto Rico. In fact, many of these funds may ultimately not be invested in Puerto Rico at all. Under section 931, a very substantial amount of possessions corporations' retained earnings was invested through Guamanian banks or directly in the Eurodollar market. Under section 936, interest on Eurodollar deposits is taxable and therefore much less attractive, but alternative non-Puerto Rican investments such as U.S. state and local bonds and preferred stock of U.S. corporations have become major investment outlets for possessions corporations. 3/ These outflows show up as reductions to "all other" external sources of funds.

Further, it should be noted that an increase in direct investment funds (or funds from any other source) may merely represent a displacement of funds from other sources rather than a net addition to sources for financing investment. For example, the purchase of Puerto Rican government bonds by

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3/ The impact of section 936 on the financial investments of possessions corporations is treated more fully in Section D of Chapter IV.

possessions corporations may merely reduce the external borrowing of Puerto Rican governments, without affecting the total availability of funds or interest rates in Puerto Rico.

d. External Borrowing by Puerto Rican Governments -- Bonds issued by the Commonwealth and municipal governments may be purchased by nonresident individuals, corporations, and other non-Puerto Rican entities, in which case sale of the bonds provides an external source of finance.

e. All Other External Sources -- This residual category includes Puerto Rican business and household external borrowing, non-Federal unilateral transfers, certain inter-bank transfers, and various other sources, all net of financial outflows from Puerto Rico. As shown in Figure IV, "all other external sources" was actually negative in 1977, primarily because of large repayments of head office loans by Puerto Rican branches of U.S. banks.

A prominent feature of the external sources of investment funds for Puerto Rico is the important role played by the Federal government, either directly or indirectly, in making those funds available. The Federal government directly provides transfers to individuals and governments in Puerto Rico. These transfers are quite distinct from all other external sources in that they carry no obligation for future repayment. Puerto Rican government bonds are subsidized, through exemption from Federal, state, and local income taxes under Federal statute. And the encouragement of U.S. firms to locate in Puerto Rico, and to reinvest there in employment producing assets, is the stated Congressional purpose for maintaining the possessions corporation system of taxation.

2. Profitability and Location in Puerto Rico

The possessions corporation system has provided, under section 931 and subsequently section 936, that profits earned by U.S. corporations from operations in Puerto Rico be exempt from Federal tax. The combined possessions corporation system and Puerto Rican tax exemption do not create profitable investment opportunities in Puerto Rico; they can only make otherwise profitable investments more profitable by exempting the profits from such investments from tax. A U.S. firm will not locate in Puerto Rico unless the firm can expect to earn a before tax rate of return on an investment in Puerto Rico equal to its after tax rate of return on an investment in the United States. Thus, Puerto Rico must be a competitive location aside from tax exemption for a U.S. firm considering investment (or reinvestment) before tax exemption will provide any attraction to the firm.

Before turning to a consideration of the factors that determine the competitiveness of Puerto Rico as a location for investment by U.S. firms, one important aspect of a profit tax exemption system should be noted. Since the amount of tax saving depends directly on the amount of profits attributed to the possessions corporation, the exemption system creates very strong incentives to shift profits from fully-taxed operations in the United States to the tax exempt operations in Puerto Rico. There are a number of ways such profit shifting can occur. For example, a possessions corporation may overcharge its parent for exports; the parent may undercharge the possessions corporation for raw materials or component parts, or fail to charge it for expenses undertaken in its behalf; or the possessions corporation may benefit from intangibles developed by the parent (e.g., a patent or trademark) without proper accounting for the costs incurred in developing the intangible or the manner in which it is used. As indicated in Chapter II, there are several anti-abuse provisions in the Federal tax law which are aimed at such profit shifting activities. However, the complexity of both the legal issues and the specific transactions involved, as well as the desire not to interfere in the legitimate tax benefits intended for possessions corporations by the Congress, have left this area of the Federal tax exemption somewhat unsettled over many years. The essential point here is that in instances where profits are shifted, it is not clear whether the possessions corporation located in Puerto Rico because of the underlying locational competitiveness of Puerto Rico, or merely because of the potential for profit shifting.

When the tax exemption program was introducted in 1947, a combination of factors made Puerto Rico a highly competitive location for U.S. firms. These factors included political stability, a common currency, protection under the U.S. tariff schedule, the general application of Federal statutes, and proximity to the United States. As noted above, a disproportionate allocation of the Federal oil import quota prior to 1973 provided the main basis for development of the petrochemical industry in Puerto Rico.

Perhaps the single most important factor, however, was low unit labor costs resulting from both low wages and the high productivity of Puerto Rican workers. These factors provided the necessary profit making opportunities for the tax exemption program to work. Taken together, Puerto Rico's locational advantages and the tax exemption program contributed substantially to the rapid growth of the Puerto Rican economy throughout the 1950s and 1960s, noted above. However, since 1947 the competitive position of Puerto Rico has been significantly altered by changes in these underlying locational factors.

U.S. firms have exhibited an increasing willingness to invest abroad in jurisdictions that provide low cost labor and acceptable political risks. For firms that have already invested in Puerto Rico, this may grow out of a desire to diversify their operations over a broader geographical area. The Kennedy round of tariff reductions in the 1960s exposed Puerto Rican (and U.S.) manufacturers to more vigorous competition from imports. Unlike trade with foreign countries, trade between Puerto Rico and the United States must be carried on higher-cost U.S. flag ships. The 1973 oil embargo and subsequent large increases in world oil prices removed Puerto Rico's relative advantage in petrochemicals, as previously noted. Finally, a number of changes have occurred in the Puerto Rican labor market. Wages have risen, in part due to successful economic development, but also due to other forces which have put upward pressures on wages in spite of a continually high rate of unemployment. Chief among these forces is U.S. minimum wage legislation, which has been gradually applied in Puerto Rico, with virtually full application to be achieved by 1981. In addition, the Puerto Rican government has mandated observance of more holidays than are generally observed in the United States, as well as a fairly generous system of employee fringe benefits. The disproportionate level of relatively well paid government employees in Puerto Rico (Federal, Commonwealth and municipal) may add upward pressure on private sector wages. And the introduction of the food stamp program in 1975 and the expansion of other Federal income maintenance programs may affect the Puerto Rican labor market by reducing work incentives and encouraging higher labor turnover rates.

While the preceding represent basically adverse changes in Puerto Rico's competitive position, some changes have had a favorable effect. Through formal education and on-the-job training, the skills and therefore productivity of the Puerto Rican labor force have risen steadily. General devaluation of the dollar since 1973 has made goods produced in Puerto Rico more competitive in both the U.S. and foreign markets. In addition, the recent Orderly Marketing Agreements limiting shoe exports to the United States from South Korea and Taiwan and the Multifiber Arrangements limiting textile and apparel exports from eighteen developing countries should benefit these industries, which have traditionally invested heavily in Puerto Rico.

At the same time that changes were taking place in the underlying competitiveness of Puerto Rico as a location, changes were affecting both the U.S. and Puerto Rican tax exemptions for possessions corporations. Direct changes to the tax exemptions, including the series of Industrial Incentive Acts in Puerto Rico, the 1976 Federal revisions, and the 1976 and subsequent Puerto Rican tollgate tax changes are covered in detail in Chapter II. In addition to these, a series of changes to the U.S. Internal Revenue Code had an indirect effect on the relative profitability of locating in Puerto Rico. The top Federal corporate tax rate, which stood at 38 percent in 1947, rose to 52 percent by 1952 and remained at that level until 1963. Thereafter, with the exception of the surtax years of 1968-70, the top rate has been reduced in several steps to its current level of 46 percent. The investment tax credit was introduced in 1962 and has generally been in effect since then. Its terms have been liberalized on several occasions, and the rate increased from an initial 7 percent to the current level of 10 percent. In 1971 the asset depreciation range (ADR), a major liberalization of the period over which assets could be depreciated for Federal tax purposes, was introduced.

These three changes since 1962 -- the investment tax credit, lower statutory rates, and ADR -- combined to significantly lower the overall effective Federal tax rate on income earned in the United States. As U.S. effective tax rates fell, the relative attraction of tax exemption offered by the possessions corporation system was steadily diminished. Some Federal tax changes, however, may have increased the relative attractiveness of Puerto Rico. In particular, this may be true of the anti-tax haven provisions adopted in 1962, which do not apply to Puerto Rico or to possessions corporations, as noted in Chapter II.

In summary, many fundamental changes have taken place in the Puerto Rican, U.S., and world economies which have a direct and substantial bearing on the competiveness of Puerto Rico as a location for U.S. investment. As suggested above, one result of these changes appears to have been a much longer and deeper recession in Puerto Rico, beginning in 1973, than affected the United States. A second result, which emerges from the statistical data presented in Chapter IV, is that the focus of the possessions corporation system has become highly concentrated in a few industries.

C. The Costs and Benefits of the Possessions Corporation System

The combination of the possessions corporation provisions in the U.S. Internal Revenue Code and the Puerto Rican Industrial Incentives Program impose direct as well as indirect costs on the Federal government and Puerto Rico, and produce direct as well as indirect benefits to the Puerto Rican economy. All costs and benefits, direct and indirect, ideally should be identified and taken into account in assessing the possessions corporation system. However, while the major costs and benefits of the system are fairly readily identified and are measurable with reasonable accuracy, it would be very difficult (if not impossible) to identify and measure all associated costs or benefits. This limitation should be borne in mind in the following discussion in which the major costs and benefits are identified and their measurement discussed, and in Chapter IV in which actual measures of some of these costs and benefits are presented.

1. Costs

The most obvious cost of the possessions corporation system is the Federal tax expenditure (i.e., Federal tax revenue foregone) arising from the exemption afforded possessions corporations. The size of the Federal tax expenditure depends, in the first instance, on the amount of exempt income earned by possessions corporations. In addition, however, some estimates or assumptions must be made about the amount of income possessions (or other, possibly unrelated) corporations would earn in the absence of Federal tax exemption, and the rate of tax that would have applied to those earnings. It is important to note that, because of the interaction between the Federal and Puerto Rican tax codes (in particular, through the foreign tax credit provisions), the estimates and assumptions made regarding the Federal tax expenditure will affect the measured Puerto Rican tax expenditure arising from the income tax exemption Puerto Rico provides possessions corporations through its Industrial Incentive Program.

In addition to the possible loss of income tax revenues, Puerto Rican revenues are reduced by the exemption granted for property, municipal, and excise taxes. On the expenditure side of the Puerto Rican budget both the direct costs

-- such as for cash grants and interest and rent subsidies -- and indirect costs -- such as for special transportation facilities, utility connections, and additional police, fire, and other government services -- should be included. Further, in cases where the possessions corporation system attracts industries that degrade the Puerto Rican environment or impose other external costs, these costs should be added to the budgetary costs of the system.

2. Direct Benefits

When a possessions corporation locates in Puerto Rico, it generates both direct and indirect benefits to the Puerto Rican economy. The major direct benefit is additional wages and fringe benefits paid to Puerto Rican workers. In the case of workers that would otherwise be unemployed, the entire amount of wages and fringe benefits is "additional," and should be included fully in measured benefits. In the case of workers that would otherwise be employed (presumably at a lower total compensation) only the additional compensation of the workers should be included in measured benefits. A direct benefit may also arise if the financial investments of possession corporations increase the availability of funds, and lower interest rates in Puerto Rico. However, any such benefit would presumably entail an offsetting cost in credit markets in the United States.

3. Indirect Benefits

In addition to creating these direct benefits, the possessions corporation will generate indirect benefits through the impact of its purchases, and the additional remuneration it provides its employees, on the Puerto Rican economy. 4/

a. Backward Linkages -- When a possessions corporation purchases raw materials, intermediate goods, insurance and other services, or plant and equipment, some of the purchases may be made

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4/ 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 the possessions corporation system on Puerto Rico alone, not on the United States and Puerto Rico taken together.

directly from U.S. or other non-Puerto Rican sources, and therefore represent a "leakage" from the Puerto Rican economy. Other purchases, however, are made directly from Puerto Rican suppliers that in turn provide employment and increase Puerto Rican incomes through wage and salary payments and possibly interest, profits, and other returns to Puerto Rican owners of capital. These suppliers must also make purchases of raw materials, intermediate goods, etc., some of which will be from non-Puerto Rican suppliers and some from other Puerto Rican suppliers -- who in turn will provide additional income payments to Puerto Ricans. However, the sum of all the income generated in Puerto Rico by the purchases of possessions corporations through these "backward linkages" undoubtedly overstates the net indirect benefits they provide to Puerto Rico. This is because the Puerto Rican resources purchased by possessions corporations and their suppliers have alternative uses -- they would not be unemployed in the absence of possessions corporations.

Capital must be diverted from other productive uses. Water and land are scarce in Puerto Rico; their use by possessions corporations (and their suppliers) 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. A proper assessment of the benefits generated by backward linkages should therefore reduce total measured benefits by these "opportunity costs" in order to reflect only the additional benefits to the Puerto Rican economy.

b. 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 will be dissipated, and the smaller the multiplier will be.

In Puerto Rico, the propensity to save appears to be small, and the propensity to import high. In 1978, imports equaled about 75 percent of GNP. 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 will be $1.33. 5/

c. Forward Linkages -- In addition to backward linkages and any multiplier effect, some possessions corporations may generate additional benefits to the Puerto Rican economy by inducing other firms, that will purchase from the possessions corporation, to also locate in Puerto Rico and therefore generate additional income and employment. Although such "forward linkages" seem plausible, and undoubtedly occur in some cases, generally suppliers locate near their customers rather than customers locating near suppliers. It would therefore be inappropriate in most cases to impute any benefit to a forward linkage that in fact was not caused by the possessions corporation. Further, if the customer firm is itself a possessions corporation the benefit of the

5/ 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 matched amount, the "leakage" will be greater, and the multiplier will be smaller, than this simple analysis indicates.

additional income it generates in Puerto Rico will already be counted in the direct, indirect, and multiplier measures, and should therefore not be counted again to any extent.

D. Cost Effectiveness of the Possessions Corporation System

The final step in assessing the possessions corporation system is to compare costs and benefits. Ideally perhaps, this comparison should be made for each possessions corporation. Realistically, however, the comparison can only be made on an industry-by-industry basis. Quite obviously, if for any industry the costs of the system exceeded the benefits to the Puerto Rican economy, the system would not be cost effective in that industry; a net benefit could be derived by not extending the system to that industry at all. Less obvious but of equal importance is the fact that even though benefits exceed costs for all industries, the system is still not cost effective if the ratio of benefits to cost in some industries are lower than the comparable ratio in other industries. In this case, a net benefit could be derived by providing more incentive to industries with high ratios of benefits to costs, and less incentive to industries with low ratios.

Even in the absence of any measures of actual costs and benefits, there is reason to expect that the possessions corporation system may not be cost effective between industries. This expectation of cost ineffectiveness stems from the fact that the system relies primarily on Federal profit tax exemption to attract firms to Puerto Rico. A basic feature of a profit tax exemption system is that, even in the absence of profit shifting, it provides an incentive to locate investment in Puerto Rico irrespective of the amount of employment or other benefits that the investment might provide, directly or indirectly, to the Puerto Rican economy. Thus, location of a highly capital-intensive (e.g., petrochemical) plant in Puerto Rico may be as expensive to the Federal treasury in revenue foregone as the location of several labor-intensive (e.g., apparel), plants but would provide many fewer employment opportunities for unemployed or under employed Puerto Ricans. Alternatively, the lack of cost effectiveness may be viewed as follows. A job in the petrochemical industry costs the Federal government more foregone revenue than does a job in the apparel industry. Therefore, more jobs will be created in Puerto Rico if Federal revenue "spending" is diverted from the petrochemical industry to the apparel industry.

CHAPTER IV. STATISTICAL DATA ON THE OPERATION AND EFFECT OF THE POSSESSIONS CORPORATION SYSTEM

The preceding Chapter presented an overview of economic growth in Puerto Rico since 1947, the role of the possessions corporation system in that growth, and a description of the costs, benefits, and cost effectiveness of the system. This Chapter focuses on the actual operation of the system in 1977, the latest year for which data on the income, employment, and other characteristics of possessions corporations are available. Data for years 1973-1976 are presented in summary form only; more detailed data for these years are contained in Appendix B. 1/

The Chapter is divided into four sections. The first presents estimates and projections of the total Federal tax expenditure on possessions corporations; the second presents basic statistical data, on an industry basis, for possessions corporations; and the third extends industry measures of Puerto Rican benefits to include backward linkage and multiplier effects. The Chapter concludes with an assessment of the impact of the recent changes in U.S. and Puerto Rican law.

A. Federal Tax Expenditure on Possessions Corporations

Table 3 presents estimates and projections for calendar and fiscal years 1973 through 1984 of the Federal tax expenditure on possessions corporations. Puerto Rico accounts for over 98 percent of these tax expenditures in all years, which have risen from $255 million in calendar 1973 to $662 million in calendar 1977, the latest year based on reasonably complete data from actual tax returns. Taking into account the recent increases in Puerto Rican taxes due to changes in their tollgate tax and Industrial Incentive

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1/ As explained more fully in Appendix B, most of the data on possessions corporations are taken from Federal tax returns, which are classified by year according to the accounting period of the corporation. For example, data for 1977 are taken from tax returns filed for possessions corporations' fiscal years ending between July 1, 1977 and June 30, 1978.

Table 3

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

Year	Reduction in Calendar Year Tax Liabilities: Total	Companies Operating in: Puerto Rico	Companies Operating in: All Other U.S. Possessions	Fiscal Year Receipts Foregone 2/: Total	Companies Operating in: Puerto Rico	Companies Operating in: 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	605	602	3	490	487	3
1977	662	658	4	631	627	4
1978	733	729	4	694	690	4
1979	747	742	4	739	735	4
1980	822	818	4	781	777	4
1981	904	900	4	859	855	4
1982	994	989	5	945	940	5
1983	1,094	1,089	5	1,039	1,034	5
1984	1,203	1,198	5	1,143	1,138	5

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1/ The 1973 through 1975 figures are estimates based on book income data taken primarily from election forms (Form 5712). The 1976 estimates are based on net income data taken primarily from Federal income tax forms (Form 1120). The 1977 figures are estimates based on the 1976 to 1977 growth rate of income for those companies for which data from Form 1120 for both years was available. 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 1973 to 1978, and 38 percent for 1979 and all subsequent years (the statutory Federal corporate tax rate is reduced 2 percentage points -- from 48 percent to 46 percent -- beginning in 1979). For companies operating in Puerto Rico, the calendar year 1973 through 1978 figures are net of estimated tax payments to Puerto Rico; the figures for 1979 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 $91 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.

Act and the reduction in the Federal corporate tax rate, 2/ and assuming a 10 percent growth rate, the Federal tax expenditure is projected to reach $1.2 billion by 1984. In interpreting these data on Federal tax expenditures, it should be noted that the figures essentially represent spending out of after-tax income; a comparable direct spending program, which would result in pre-tax income to recipients, would therefore need to be considerably larger in dollar amount.

In making these estimates and projections, it has been assumed that in the absence of the possessions corporation provisions, the effective rate of U.S. tax that would have applied to the income of possessions corporations (before any credit for Puerto Rican or foreign taxes) would have been 40 percent in 1973-1978, and 38 percent thereafter. 3/ The effective rate would have been less than 48 percent (46 percent after 1979), 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 would have been creditable against the Federal income tax liability and, thus, have further reduced the net saving of U.S. taxes.

The Federal tax expenditure estimates and projections are also based on the assumption of "no behavioral change." The assumption of no behavioral change should not be taken literally; undoubtedly possessions corporations (and other persons) would behave differently in the absence of the possessions corporation provisions. The reason for following the assumption here is that it allows tax expenditures to be estimated using available information on existing law and behavior. Estimating the effect on tax expenditures of behavioral changes would require additional analysis of, and assumptions about, what would happen if the possessions corporation provisions were repealed, and knowledgeable observers may differ in their assessment of what would happen.

2/ The top statutory Federal corporate income tax rate was reduced 2 percentage points -- from 48 percent to 46 percent -- beginning in 1979.

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

B. Basic Statistical Data on Possessions Corporations

1. Summary Data for 1973-1977

Table 4 presents data on the number, net income, estimated tax expenditure, tax expenditure per employee, and tax expenditure as a percent of compensation of employees of all possessions corporations and possessions corporations in selected industries for 1973-1977. In interpreting these data, it is important to note that the data for 1977 is preliminary, and still incomplete. Therefore, accurate comparisons cannot be made between the number of possessions corporations, their income, or Federal tax expenditure in 1977 and in earlier years. Several important conclusions, however, can be drawn from Table 4:

- o The number of possessions corporations has apparently fallen somewhat between 1973 and 1976, while the ratio of manufacturing to total has risen slightly.

- o Net income and estimated tax expenditure have more than doubled between 1973 and 1976. Nearly all (over 90 percent) net income and estimated tax expenditure is attributable to manufacturing industries.

- o Over 45 percent of total net income and estimated tax expenditure in each year (except 1973) are attributable to the pharmaceutical industry alone, and an additional 15-20 percent to the electrical and electronic equipment industry.

- o The expenditure per employee in all industries rose from $2,118 in 1973 to $8,222 in 1977, an increase of nearly 300 percent.

- o In the pharmaceutical industry, tax expenditure per employee was $27,293 in 1973 and $34,966 in 1977.

- o Tax expenditure as a percent of compensation of employees rose from 35.3 percent to 96.6 percent for all industries between 1973 and 1977, while for manufacturing industries, the comparable figures rose from 38.9 percent in 1973 to 120.8 percent in 1977.

Table 4

Summary Data on Possessions Corporations, 1973-1977 1/

	1973	1974	1975	1976	1977 2/
Number of corporations, all industries	568	596	595	528	479
Manufacturing industries	385	399	394	395	348
Pharmaceuticals	39	44	47	52	48
Electrical and electronic equipment	64	76	76	81	79
All other manufacturing	282	279	271	262	221
Nonmanufacturing industries	183	197	201	133	131
Net income, all industries	650,515	852,058	1,108,881	1,627,213	1,591,671
Manufacturing industries	591,724	813,057	1,055,060	1,551,677	1,464,386
Pharmaceuticals	251,897	405,355	547,060	779,954	722,170
Electrical and electronic equipment	116,277	167,389	195,593	323,249	262,136
All other manufacturing	223,550	240,313	312,407	448,474	480,080
Nonmanufacturing industries	58,792	39,002	54,059	75,536	127,285
Estimated tax expenditures, all industries 3/	258,278	372,507	446,863	651,348	638,735
Manufacturing industries	242,116	352,908	425,213	621,190	587,609
Pharmaceuticals	103,533	161,341	218,210	311,948	290,050
Electrical and electronic equipment	46,749	66,872	79,164	129,400	104,870
All other manufacturing	91,834	124,695	127,839	179,842	192,689
Nonmanufacturing industries	16,162	19,599	21,612	30,158	51,126
Tax expenditure per employee, 4/ all industries	2,118	4,567	6,164	8,762	8,222
Manufacturing industries	2,287	5,609	7,566	10,181	9,971
Pharmaceuticals	27,239	33,892	34,694	41,925	34,966
Electrical and electronic equipment	2,995	5,544	8,434	9,614	10,058
All other manufacturing	1,317	3,092	3,544	4,711	3,939
Nonmanufacturing industries	1,007	1,051	1,326	2,263	2,724
Tax expenditure as a percent of compensation of employees, 4/ all industries	35.3	64.8	81.3	105.7	96.6
Manufacturing industries	38.9	81.5	103.2	127.4	120.8
Pharmaceuticals	377.1	378.2	345.9	380.5	291.1
Electrical and electronic equipment	47.7	83.1	112.0	114.8	112.5
All other manufacturing	23.8	46.8	49.6	64.3	55.3
Nonmanufacturing industries	14.7	13.8	15.7	23.4	29.3

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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 3).

2/ Preliminary statistics; see text.

3/ Note that the figures shown here differ from the corresponding years shown in Table 3 because Table 3 is based on calendar and (Federal) fiscal years, whereas the data in this and subsequent tables is based on the taxable years of possessions corporations, as explained more fully in Appendix B.

4/ These figures are based only on those returns for which employment and compensation of employees was available. (See Tables 7 and 8, and B-5 through B-12 for details.)

- For the pharmaceutical industry, tax expenditure was over 300 percent of compensation of employees in every year from 1973 to 1976, and just under that amount in 1977. This means that for every $1.00 of wages and fringe benefits paid to Puerto Rican workers by the pharmaceutical industry, the Federal government lost over $3 of tax revenue.

2. Detailed Data for 1977

Because most of the statistical data presented in this Section is based on tax returns, the identities and characteristics of individual possessions corporations or their parent corporations cannot be made public. Many parent companies must, however, file 10-K Reports with the U.S. Securities and Exchange Commission and these Reports, which are available to the public, provide information on the importance of section 936 to individual parent companies. To explain why Federal income tax payments are less than 48 percent (the statutory Federal tax rate prior to 1979) of pre-tax book income, the SEC 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 10-K Reports, for calendar year 1977 provides the information shown in Table 5.

In interpreting these data, three points should be kept in mind. First, because specific procedures for estimating the dollar value of various tax preferences have never been set forth by the SEC, the statistics presented in Table 5 should be regarded as only rough estimates of the importance to the companies of section 936. 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 corporation subsidiaries with other items (e.g., deferral or DISC). Companies following this practice were excluded from Table 5.

Tables 6, 7 and 8 are based on preliminary data from the actual Federal tax returns of individual possessions corporations filed for the taxable year 1977, which includes fiscal years ending between July 1, 1977 and June 30, 1978 (most returns are for calendar year 1977). Although some possessions corporations' returns for 1977 were not processed in time to be included in these tables, a compar-

Table 5

Major U.S. Manufacturing Corporations Indicating a Tax Saving Under Section 936 on Their SEC 10-K Reports for 1977

Corporation	Industry	Tax Savings: Amount ($ millions)	Tax Savings: Percent of Book Income (Before Taxes)
Blue Bell	Textile and Apparel	$ 4.5	3.5%
CPC	Food Products	3.4	1.4
Chesebrough-Pond's	Toiletries	3.2	2.9
Conagra	Food Products	2.0	8.2
Digital Equipment	Office Equipment	14.4	7.9
Esmark	Food Products	7.4	7.5
Gould	Automotive Equipment	1.2	0.8
Hanes Corporation	Textile and Apparel	3.1	9.6
H. J. Heinz	Food Products	9.7	5.9
Morton-Norwich	Chemicals	2.3	4.3
Motorola	Electronics	9.1	5.0
Sub-total - 11 Non-pharmaceuticals		$63.3	4.5%
Abbott Laboratories	Pharmaceuticals	21.8	12.2
American Hospital Supply	Pharmaceuticals	10.3	8.2
Baxter Travenol	Pharmaceuticals	17.9	17.1
Becton Dickinson	Pharmaceuticals	3.4	4.3
Bristol Myers	Pharmaceuticals	18.6	6.0
Johnson & Johnson	Pharmaceuticals	21.1	5.0
Eli Lilly	Pharmaceuticals	19.3	5.2
Merck	Pharmaceuticals	22.6	5.1
Pfizer	Pharmaceuticals	46.4	18.2
Richardson-Merrell	Pharmaceuticals	5.6	5.3
Schering Plough	Pharmaceuticals	47.4	19.9
G.D. Searle	Pharmaceuticals	16.6	19.1
Smith-Kline	Pharmaceuticals	19.6	14.9
Squibb	Pharmaceuticals	29.1	18.5
Upjohn	Pharmaceuticals	20.6	14.1
Warner Lambert	Pharmaceuticals	24.0	7.3
Sub-total - 16 Pharmaceuticals		$344.3	9.9%
Total - 27 Manufacturers		$407.6	8.3%

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Source: Taxation with Representation, Tax Notes (recent issues).

ison with the completed file for 1976 returns indicates that over 76 percent of the possessions corporations filing in 1976, accounting for 80 percent of the total 1976 net income, are also included in the 1977 statistics.

Table 6 presents industry detail on several items summarized in Table 4 (number of corporations, net income, and estimated tax expenditure), and on selected balance sheet and income statement items. The total assets of possessions corporations stood at $9.8 billion at year-end 1977, with over 75 percent of the assets held by manufacturing companies. Within manufacturing, the pharmaceutical industry accounted for $3.5 billion, or 47 percent of the total, and the electrical and electronic equipment industry for $1.1 billion, or 15 percent of the total.

The relatively small amount of "real" assets (net value of plant and equipment) shown in Table 6 clearly reflects the unique operating characteristics of possessions corporations. For manufacturing possessions corporations, these real assets represented only 18.4 percent of total assets, whereas for U.S. manufacturers as a whole, the comparable figure (in 1975) was 27.3 percent. 4/ The counterpart to relatively little investment in real assets by possessions corporations is relatively large investments in financial assets.

Some of this difference could be attributed to differences in the industry mix of possessions corporations and all U.S. corporations engaged in manufacturing. To correct for differing industrial mix, the total assets of possessions corporations in each industry were distributed between these real and all other assets in the same manner as were assets of all U.S. corporations in the same industry. These "U.S.-weighted" amounts were then summed over industries to get U.S.-weighted amounts for total manufacturing. Taking the ratio of actual to U.S.-weighted figures for total manufacturing gives 24.9 percent for these real assets. Thus, the differing industry mix between possessions corporations and all U.S. corporations explains only about one-fourth (27.3-24.9)/(27.3-18.4) of the difference between the types of assets held.

The continuing incentive to retain earnings in possessions corporations is also clearly reflected in the

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4/ Data for all U.S. corporations is from U.S. Department of the Treasury, Source Book, Statistics of Income 1975: Corporation Income Tax Returns.

Table 6

Number of Possessions Corporations, Selected Income Statement and Balance Sheet Items, and Estimated Tax Expenditures by Industry, 1977 1/
(Dollar amounts in thousands)

	All Industries	Manufacturing Industries								
		Total	Food and Kindred Products	Tobacco Products	Textile Mill Products	Apparel	Chemicals			Rubber Products
							Total	Pharmaceuticals	All Other	
Number of corporations	479	348	18	4	6	75	61	48	13	8
Balance Sheet Items:										
Total assets	9,811,454	7,384,647	616,493	141,173	9,136	610,830	3,964,097	3,452,649	511,448	33,090
Depreciable assets	2,189,328	1,357,249	106,344	29,433	2,639	27,974	843,433	412,284	431,149	15,520
Less: accumulated depreciation	637,265	468,524	39,054	8,452	603	12,134	277,957	84,527	193,430	4,815
Net depreciable assets	1,552,063	888,725	67,290	20,981	2,036	15,840	565,476	327,757	237,719	10,705
Retained earnings, total	5,735,368	5,535,769	473,173	84,539	6,414	205,788	3,152,524	2,862,869	289,655	22,749
Unappropriated	5,619,545	5,449,908	473,173	84,539	6,414	201,076	3,150,058	2,860,403	289,655	22,749
Appropriated	115,823	85,861	—	—	—	4,712	2,466	2,466	—	—
Income statement items:										
Total receipts	5,785,545	4,581,786	613,737	190,416	13,485	291,656	1,905,610	1,433,351	472,259	35,061
Business receipts	5,419,321	4,347,720	593,949	187,174	6,986	277,538	1,785,356	1,314,800	470,556	34,451
Nongovernment interest	245,952	165,871	17,915	2,814	81	2,212	98,702	97,644	1,058	256
Other receipts	120,272	68,195	1,873	428	6,418	11,906	21,552	20,907	645	354
Total deductions	4,193,874	3,117,400	482,575	167,875	11,170	238,938	1,081,129	711,181	369,948	29,564
Cost of sales and operations	3,248,977	2,459,359	395,589	85,075	5,285	215,246	747,245	428,966	318,279	18,840
All other deductions	944,897	658,041	86,986	82,800	5,885	23,692	333,884	282,215	51,669	10,724
Net income per return	1,591,671	1,464,386	131,162	22,541	2,315	52,718	824,481	722,170	102,311	5,497
Net income per books	1,546,950	1,454,254	122,918	22,209	1,909	57,045	824,605	726,501	98,104	5,067
Estimated tax expenditures	638,735	587,609	52,662	9,013	931	21,179	330,966	290,050	40,916	2,194

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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 3).

Table 6 - continued

	Manufacturing Industries - continued							
	Leather and Leather Products	Stone, Clay, and Glass Products	Fabricated Metal Products	Machinery, Except Electrical	Electrical and Electronic Equipment	Transportation Equipment	Scientific Instruments	All Other Manufacturing
Number of corporations	11	4	23	5	79	3	24	28
Balance Sheet Items:								
Total assets	51,216	296,545	110,263	9,448	1,071,156	8,861	176,137	413,202
Depreciable assets	5,616	15,181	31,167	737	158,859	1,370	20,713	98,263
Less: accumulated depreciation	2,813	6,163	10,032	94	60,973	737	5,215	42,295
Net depreciable assets	2,803	9,018	21,135	643	97,886	633	15,498	56,000
Retained earnings, total	41,327	46,535	98,627	6,413	1,036,028	4,426	149,723	207,503
Unappropriated	34,386	46,535	97,731	6,413	974,050	4,426	140,855	207,503
Appropriated	6,941	—	896	—	61,978	—	8,868	—
Income statement items:								
Total receipts	48,045	46,484	101,288	14,337	726,295	10,930	101,421	483,021
Business receipts	46,580	38,930	99,103	13,710	691,134	10,808	97,239	464,762
Nongovernment interest	790	1,094	1,749	79	33,195	—	3,230	3,754
Other receipts	675	6,460	436	548	1,966	122	952	14,505
Total deductions	40,401	33,473	79,144	8,744	464,159	9,882	59,752	410,594
Cost of sales and operations	36,424	27,740	71,900	7,011	404,835	8,291	46,436	389,442
All other deductions	3,977	5,733	7,244	1,733	59,324	1,591	13,316	21,152
Net income per return	7,644	13,011	22,144	5,593	262,136	1,048	41,669	72,427
Net income per books	7,739	12,777	22,523	5,119	262,104	1,061	37,893	181,285
Estimated tax expenditures	3,071	5,202	8,880	2,235	104,870	417	17,021	28,965

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Table 6 - continued

	Nonmanufacturing Industries						
	Total	Transportation, Communications and Utilities	Wholesale Trade	Retail Trade	Finance, Insurance, Real Estate	Services	Miscellaneous and Not Available
Number of corporations	131	10	15	50	24	12	20
Balance Sheet Items:							
Total assets	2,426,807	624,598	148,130	111,186	1,408,214	88,137	46,524
Depreciable assets	832,079	703,706	9,190	50,060	24,512	32,584	12,027
Less: accumulated depreciation	168,741	131,293	2,420	21,550	4,024	5,797	3,657
Net depreciable assets	663,338	572,413	6,770	28,510	20,488	26,787	8,370
Retained earnings, total	169,637	3,358	25,789	27,090	56,144	63,529	23,689
Unappropriated	169,637	2,683	25,667	26,725	27,855	63,529	23,178
Appropriated	—	675	122	365	28,289	—	511
Income statement items:							
Total receipts	1,203,759	173,081	466,510	320,935	114,144	61,251	67,838
Business receipts	1,071,601	165,046	462,377	310,965	14,486	53,417	65,310
Nongovernment interest	80,081	117	62	186	78,043	1,416	257
Other receipts	52,077	7,918	4,071	9,784	21,615	6,418	2,271
Total deductions	1,076,474	129,629	438,171	311,743	89,187	49,166	58,578
Cost of sales and operations	789,618	65,555	405,366	231,295	2,648	34,308	50,446
All other deductions	286,856	64,074	32,805	80,448	86,539	14,858	8,132
Net income per return	127,285	43,452	28,339	9,192	24,957	12,085	9,260
Net income per books	92,696	43,094	13,409	6,085	11,776	11,685	6,647
Estimated tax expenditures	51,126	17,383	11,484	3,750	9,969	4,835	3,705

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$5.7 billion of retained earnings they held at year-end 1977. $2.9 billion, or 50 percent of these retained earnings were being held by pharmaceuticals, for which retained earnings represented over 80 percent of total liabilities and stockholders' equity. The latter ratio for all manufacturing possessions corporations was 75.0 percent, compared to 29.6 percent for all U.S. manufacturing corporations. 5/

Table 6 shows that gross receipts of possessions corporations were $5.8 billion in 1977, with $5.4 billion (93.7 percent) attributable to business receipts and $366 million (6.3 percent) attributable to all other receipts, primarily interest on nongovernment securities. (Note that interest on government securities is excluded from gross income for Federal tax purposes, and therefore does not appear in the figures shown in Table 6.) Total deductions of $4.2 billion consisted primarily of "Cost of sales and operations" of $3.2 billion. Net income per return (= gross receipts - total deductions) amounted to $1.6 billion.

The final line in Table 6 shows estimated tax expenditure which, as explained above, is obtained by applying an assumed 40 percent effective U.S. tax rate to net income per return. (Puerto Rican tax payments are not available on an industry basis and have therefore not been taken into account in Table 6, but are reflected in the estimates shown in Table 3.)

Tables 7 and 8 are based on 317 possessions corporations for which 1977 employment and payroll data could be obtained from their Federal unemployment tax returns. While the coverage represents only 66 percent of the number of companies included in Table 6, the combined net income of the sample, $1,169 million, represents nearly 75 percent of the net income of all possessions corporations.

The first three columns of Table 7 present information comparable to that in Table 6. Columns 5 and 7 indicate the number of employees and the total employee compensation, respectively, in each industry in 1977. Finally, the last three columns indicate the tax expenditure per employee, the tax expenditure as a percent of total compensation, and average compensation.

5/ Using the same weighting scheme described above, the industry mix corrected ratio is 31.7 percent.

Table 7

Tax Expenditure, Employment and Compensation of Employees by Industry, 1977 1/

Industry Group	Number of Corporations	Net 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 a Percent of Compensation of Employees	Average Employee Compensation ($)
All industries	317	1,169,375	468,914	100.0	51,251	100.0	437,504	100.0	8,222 3/	96.6 3/	8,507 3/
Manufacturing industries	257	1,080,124	433,138	92.4	40,357	78.7	337,828	77.2	9,971 3/	120.8 3/	8,252 3/
Food and kindred products	12	61,834	24,857	5.3	4,970	9.7	38,537	8.8	5,001	64.5	7,754
Textile mill products	4	2,177	868	.2	597	1.2	4,339	1.0	1,461	20.0	7,268
Apparel	64	36,961	14,875	3.2	10,653	20.8	63,672	14.5	1,396	23.3	5,977
Chemicals, total	39	629,522	252,272	53.8	7,258	14.2	87,038	19.9	34,757	289.8	11,992
Pharmaceuticals	34	624,366	250,214	53.3	7,156	14.0	85,967	19.6	34,966	291.1	12,013
All other chemicals	5	5,156	2,058	.4	102	.2	1,071	.2	20,176	192.2	10,500
Rubber products	7	3,161	1,260	.3	303	.6	2,368	.5	4,158	51.0	8,145
Leather and leather products	9	7,210	2,898	.6	1,802	3.5	10,920	2.5	1,608	26.5	6,060
Fabricated metal products	15	17,628	7,078	1.5	994	1.9	9,522	2.2	7,121	74.3	9,579
Electrical and electronic equipment	60	214,142	85,684	18.3	8,519	16.6	76,137	17.4	10,058	112.5	8,937
Scientific instruments	21	32,447	13,334	2.8	2,143	4.2	18,018	4.1	6,222	74.0	8,408
All other manufacturing 4/	26	75,042	30,012	6.4	3,118	6.0	27,277	6.2	9,625	110.0	8,748
Nonmanufacturing industries	60	89,251	35,776	7.6	10,893	21.3	99,676	22.8	2,724 3/	29.3 3/	9,309 3/
Transportation, communications, utilities	5	40,057	16,028	3.4	7,680	15.0	63,197	14.4	2,087	25.4	8,229
Wholesale trade	9	28,002	11,251	2.4	382	.7	4,819	1.1	29,453	233.5	12,615
Retail trade	13	6,519	2,639	.6	269	.5	2,785	.6	9,810	94.8	10,353
Finance, insurance, real estate	13	3,564	1,417	.3	752	1.5	7,087	1.6	1,884	50.2	9,424
Services	10	8,222	3,291	.7	842	1.6	13,088	3.0	3,909	25.1	15,544
Miscellaneous and not available	10	2,887	1,150	.2	968	1.9	8,698	2.0	1,188	33.2	8,986

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1/ Preliminary statistics; see text.
2/ Compensation of employees was computed by multiplying 1.212 times payroll. The additional 21.2 percent reflects the employer-paid portion of social security, unemployment insurance, and other non-payroll labor costs. The 21.2 percent is the average for all U.S. manufacturing industries in 1977; see the U.S. Department of Commerce, Survey of Current Business, July 1978, 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 6 and tax expenditure in this Table.
4/ Includes manufacturing industries where data were available for less than 3 corporations.

Table 7 highlights the relationship between Federal tax expenditures and Puerto Rican employment. For the manufacturing companies covered, the tax expenditure per employee averaged \$9,971 which was about 20 percent greater than the average compensation per worker, \$8,252. Table 7 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 times the total compensation of the comparatively well paid Puerto Rican pharmaceutical employee. By contrast, in the apparel industry, the tax expenditure per employee was \$1,396, or 23.3 percent of the average wage. The tax expenditure per employee in all manufacturing corporations except pharmaceuticals was \$5,494.

Table 8 is based on the same 317 possessions corporations shown in Table 7, but ranked according to the Federal tax expenditure per employee. According to Table 8, the top 6 possessions corporations had tax expenditures per employee in excess \$100,000; together they accounted for 14.9 percent of the total tax expenditure but only 1.0 percent of the total employment of the 317 companies for which employment information was available. The top 17 possessions corporations, those for which tax savings per employee exceeded \$50,000 in 1977, collectively accounted for 39.6 percent of the total tax expenditure and 4.2 percent of total employment. Because the coverage of employment and payroll statistics is not complete, possessions corporations with tax savings exceeding \$50,000 per employee may in fact have realized a somewhat smaller percentage of the total tax expenditure and accounted for a smaller percentage of the total employees of all possessions corporations than was the case for the 317 companies represented in Table 7. 6/

Finally, both Tables 7 and 8 indicate a direct relationship between a 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.

6/ These inferences are based on the assumption that tax expenditure per employee for companies missing from the sample equal the average tax expenditure per employee for companies in the same industry -- see Table 7. Because the pharmaceutical companies tend to be over represented in the sample, the biases indicated in the text may have occurred.

Table 8

Tax Expenditure, Employment and Compensation of Employees by Size of Tax Expenditure Per Employee, 1977 1/

Size of Tax Expenditure per Employee	Number of Corporations	Net 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 a Percent of Compensation of Employees	Average Employee Compensation ($)
All corporations	317	1,169,375	468,914	100.0	51,251	100.0	437,504	100.0	8,222 3/	96.6 3/	8,507 3/
$100,000 or more	6	175,228	70,087	14.9	533	1.0	9,060	2.1	131,495	773.6	16,998
$ 50,000 under $100,000	11	290,121	116,042	24.7	1,618	3.2	20,468	4.7	71,719	566.9	12,650
$ 10,000 under $ 50,000	71	411,483	164,549	35.1	8,411	16.4	91,866	21.0	19,564	179.1	10,922
$ 5,000 under $ 10,000	43	149,626	59,825	12.8	8,718	17.0	73,071	16.7	6,862	81.9	8,382
$ 1,000 under $ 5,000	113	138,028	55,143	11.8	24,075	47.0	183,820	42.0	2,290	30.0	7,635
$ 500 under $ 1,000	22	6,031	2,400	.5	2,992	5.8	23,224	5.3	802	10.3	7,762
$ 100 under $ 500	23	2,180	858	.2	3,350	6.5	23,307	5.3	256	3.7	6,957
$ 1 under $ 100	6	31	10	*	422	.8	3,452	.8	24	.2	8,180
Loss corporations	22	-3,353	-	-	1,131	2.2	9,234	2.1	-	-	8,164

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1/ Preliminary statistics; see text.
2/ Compensation of employees was computed by multiplying 1.212 times payroll. The additional 21.2 percent reflects the employer-paid portion of social security, unemployment insurance, and other non-payroll labor costs. The 21.2 percent is the average for all U.S. manufacturing industries in 1977; see the U.S. Department of Commerce, Survey of Current Business, July 1978, 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 6 and tax expenditure in Table 7.

* Less than 0.05 percent

C. Estimates of Backward Linkage and Multiplier Effects

In the preceding Section, the Federal tax expenditure on possessions corporations was compared to the employment and payroll of those companies. As indicated in Chapter III, however, in addition to these direct benefits a possessions corporation may generate indirect benefits through the impact of its purchases and the additional compensation it provides its employees on the Puerto Rican economy. The first step in estimating these "backward linkage" and "multiplier" effects is to compute the ratio of compensation of employees to total direct expenditures in Puerto Rico. This ratio, by industry, provides a means of estimating the backward linkage effects of possessions corporations based on data for employee compensation, such as those presented in Table 7. No new data have become available since publication of the First Annual Report which would allow updated estimates to be made of these ratios. Therefore, the same ratios used in the First Annual Report are used here. The very rough estimate of the Puerto Rican multiplier presented in Chapter II, 1.33, will be used to estimate multiplier effects.

In interpreting results obtained from using these ratios and multiplier estimates, it must be kept in mind that they provide estimates of indirect benefits that are undoubtedly overstated because they do not take into account the "opportunity costs," or other alternative uses, to which some Puerto Rican resources could be put in the absence of possessions corporations. It should also be noted that, as indicated in Chapter III, the Federal tax expenditure is the most obvious, but not the only, cost of the possessions corporation system. Puerto Rico also foregoes tax revenues, and it incurs direct expenses for cash grants, interest subsidies and other items under its Industrial Incentive Program, as well as indirect costs for special transportation facilities, utility connections, and additional general government services provided to possessions corporations. Thus, if the ratio of Federal tax expenditure to employee compensation of possessions corporations overstates their costs relative to benefits generated, the ratio of Federal tax expenditure to total (direct and indirect) income generated by possessions corporations probably understates their costs relative to benefits.

Table 9 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

Table 9

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

Industry	Tax Expenditure as a Percent of Compensation of Employees 1/	Ratio of Compensation of Employees to Total Direct Expenditures in Puerto Rico 2/	Tax Expenditure as Percent of Total Direct Expenditures in Puerto Rico 3/	Tax Expenditure as Percent of Total Direct and Indirect Expenditures in Puerto Rico 4/	Total Direct and Indirect Expenditures in Puerto Rico Divided by Tax Expenditure 5/
Manufacturing industries	120.8	.370	44.7	33.6	3.0
Food and kindred products	64.5	.219	14.1	10.6	9.4
Textile mill products	20.0	.531	10.6	8.0	12.5
Apparel	23.3	.665	15.5	11.6	8.6
Chemicals, total	289.8	.274	79.4	59.7	1.7
Pharmaceuticals	291.1	.381	110.9	83.4	1.2
Rubber products	51.0	.607	31.0	23.3	4.3
Leather and leather products	26.5	.749	19.8	14.9	6.7
Fabricated metal products	74.3	.558	41.4	31.2	3.2
Electrical and electronic equipment	112.5	.548	61.6	46.3	2.2
Scientific instruments	74.0	.671	49.6	37.3	2.7

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1/ From Table 7, column (10).
2/ From First Annual Report, Table 8, line (10).
3/ Column (1) times column (2).
4/ Column (3) divided by 1.33.
5/ Inverse of column (4).

to that in Table 7, the second (in column three) is obtained by multiplying the first by the ratio of compensation of employees to total direct expenditures in Puerto Rico (from Table 8 in the First Annual Report), and the third (in column four) by dividing the second by the multiplier. Finally, the fifth column is simply the inverse of the fourth 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 3.0. In some industries (e.g., food and kindred products, textile mill products, and apparel), the ratio is over eight, reflecting a low level of tax-exempt income and/or substantial purchases of goods and services from the Puerto Rican economy. In other industries, (e.g., chemicals including pharmaceuticals, electrical and electronic equipment, and scientific instruments) the ratio is less than three, 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. And while the measured cost-benefit ratios are reduced, they continue to vary widely from one industry to another. 7/ This wide interindustry variation in benefit-cost ratios indicates that the possessions corporation system is not cost effective as an incentive program; there is no close

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7/ Note that a benefit-cost ratio of 1.0 does not 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, and the Federal tax expenditure is not the only cost of the system. 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.

close relationship between the costs of the program in each industry and the benefits to the Puerto Rican economy generated by the industry.

D. Impact of the Adoption of Section 936 and Recent Changes in the Puerto Rican Tollgate Tax and Industrial Incentives Program

The preceding Sections of this Chapter have presented statistical data on the total costs, benefits, and cost effectiveness of the possessions corporation system. This Section is concerned with changes in the costs, benefits, and cost effectiveness of the system due to the adoption, in the Tax Reform Act of 1976, of section 936 in place of section 931 of the U.S. Internal Revenue Code; to the coincident changes in the Puerto Rican tollgate tax, and its subsequent modifications; and to the June 2, 1978, restructuring of the Puerto Rican Industrial Incentive Act.

The effects of these three sets of legislative changes are difficult, if not impossible, to separate one from the other, or to separate as a group from the other short- and longer-range changes, discussed in Chapter III, taking place in the Puerto Rican economy. This difficulty stems both from the close interrelationships that existed prior to 1976 between the possessions corporation provisions of the U.S. Internal Revenue Code, the tollgate tax, and the industrial Incentive Acts, and from the fact that all three were changed within a relatively short period. In spite of these difficulties, however, an increasing amount of statistical evidence and analysis permits some tentative observations to be made.

1. Change in Costs

The change from section 931 to section 936, by making exempt only income from certain investments in the same possession as the trade or business is conducted, made former investments outside Puerto Rico -- in particular in Eurodollar market either directly or through Guamanian banks -- taxable. The change also removed the U.S. tax cost (due to the disallowance of a dividends received deduction for parent corporations) to repatriation. 8/ To the extent possessions corporations retained non-Puerto Rican investments in their financial portfolios, Federal tax expenditures have been reduced. In 1976, income earned prior to October from non-U.S. financial investments was still exempt, and since then the majority of investments outside Puerto Rico have been withdrawn (see below).

If the combination of the dividends received deduction and the taxability of non-Puerto Rican investment income leads, on balance, to more investment in Puerto Rico than would otherwise have occurred, the Federal tax expenditure will increase; if on balance to less investment in Puerto Rico, the Federal tax expenditure will decrease. While there is some reason to think the balance may tip toward more investment in Puerto Rico, the effect cannot be separated from the coincidence (and later) changes in the Puerto Rican tollgate tax and Industrial Incentive Act.

The changes to these Puerto Rican laws, by increasing Puerto Rican tax collections, will also reduce the Federal tax expenditure because it is computed net of Puerto Rican (and any foreign) income or tollgate taxes paid, which would be creditable against U.S. tax in the absence of the possessions corporation system. The initial changes in the tollgate tax became effective at the same time as section 936 (October, 1976) but few dividends were paid over the next few months because: (a) firms hoped to persuade the Puerto Rican Government to lower the rate or repeal the tax (as noted in Chapter II, the rate was subsequently altered in several ways, generally lowering the effective rate); (b) liquidations were still free of any tollgate (this is still true for firms on old grants, but not for firms with new or converted grants); and (c) some companies were concerned that paying even $1 of dividends would force them to "book" a tollgate tax liability on all accumulated earnings, thus depressing earnings in the quarter the dividend was paid. Accounting firms eventually ruled that if dividends did not exceed current earnings, no provision for a tollgate tax on accumulated earnings needed to be made.

8/ This had only a negligible effect on increasing the Federal tax expenditure, since firms could always escape the tax cost through liquidating distributions, and parent corporations that did receive dividends could take a foreign tax credit for any Puerto Rican or foreign taxes paid, or use the dividend to absorb excess credits on foreign source income.

Because of the subsequent developments in tollgate tax and accounting practice dividends picked up, reaching an estimated $1.0 billion in the year ending June 30, 1978, on which tollgate tax of $46 million, representing an effective rate of about 4.5 percent, were paid. In the year ending June 30, 1979, Puerto Rico anticipates tollgate tax collections of $55 million, which will again represent about 4.5 percent of the $1.2 billion of expected dividends paid by possessions corporations.

In addition to tollgate tax collections, Puerto Rico has begun to receive modest amounts of tax revenues from companies operating under the new Industrial Incentive Act, which provides for only a partial exemption from income tax for new, or converting old, firms. 9/ Since the first firms were not taxable until this year, no data is available on Puerto Rican income tax collections under the new Act. However, the current estimates of the Puerto Rican Treasury are for collections of $12-$15 million in the current year, $20-$24 million in 1980, and $45 million by 1985. 10/

Combining the above estimates on Puerto Rican tax collections from the tollgate tax and new Industrial Incentive Act, it appears that together they will reduce the Federal tax expenditure by about 5 percentage points, or from 38 percent to 33 percent of pre-tax income for 1979 and subsequent years. The combination would reduce the Federal tax expenditure further to the extent these taxes discourage U.S. firms, that would have located in Puerto Rico under the old tollgate tax and Industrial Incentive Act, from making an investment in Puerto Rico. This point is taken up below.

2. Change in Benefits

The changes in U.S. and Puerto Rican law may increase benefits to Puerto Rico from the possessions corporation system in two ways: (a) by making the system more attractive for U.S. firms, and therefore encouraging more to locate in Puerto Rico than would have under prior law, thus increasing employment and wages paid as well as backward linkage and multiplier benefits; and (b) by making a net addition to funds available to finance investment by others in Puerto Rico, and thereby encouraging such investment through lower interest rates.

9/ See, Section C of Chapter II for a full discussion of changes in the Industrial Incentive Act.

10/ Chemical Week, April 11, 1979.

As suggested in the preceding, it is not clear from an examination of the changes in the U.S. and Puerto Rican laws whether the possessions corporation system provides more or less of an attraction to U.S. firms than it did before the changes. The U.S. change from section 931 to section 936 may have discouraged location in Puerto Rico by restricting U.S. tax exemption on investment income to "qualified possession source investment income," and by requiring firms to make binding 10 year elections which carry a prohibition from inclusion in a consolidated return, so that in loss years possessions corporations can no longer bring the loss home to offset income of its parent corporation. But it may have encouraged investment in Puerto Rico by allowing U.S. parent corporations a 100 percent dividends received deduction for dividends from a possessions corporation.

Table 10 presents data on the number of companies that have made an election under section 936. As of June 1979, 736 corporations had filed a section 936 election form. Taken together, these 736 companies accounted for over 99 percent of the income excludable under section 931 in 1975. Of these, 600 were included in one or more of the tables for 1973 to 1977 in this Report. The remaining 136 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, 1978. Forty-one of these 136 new companies were incorporated in 1977 or 1978, while the remaining 95 were incorporated prior to 1977. This last group includes several companies incorporated in the last five years, but which presumably had start-up losses making an earlier section 936 election disadvantageous. Table 10 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 10 indicates that the new 936 corporations have very much the same industrial composition as the old ones do.

In interpreting the data in Table 10, two points must be kept in mind. First, electors are reacting to all other forces, including changes in Puerto Rican law, as well as underlying locational advantages (discussed at length in Chapter III) in Puerto Rico. It is not clear, therefore, whether the number electing is higher or lower than it would have been without changes. Second, as already noted above, virtually all of the income earned in 1976 and 1977 by electing 936 corporations was earned by companies that were already operating in Puerto Rico, under section 931, in 1975.

Table 10

Elections under Section 936 by Industry

Industry	Total as of June 1979	Included in Report: Total	Included in Report: Date of Incorporation: 1976 or 1977	Included in Report: Date of Incorporation: Before 1976	New Elections: Total	New Elections: Date of Incorporation: 1977 or 1978	New Elections: Date of Incorporation: Before 1977
All industries	736	600	54	546	136	41	95
Manufacturing industries	564	469	44	425	95	35	60
Food and kindred products							
Apparel	123	104	10	94	19	6	13
Chemicals, total	100	86	4	82	14	5	9
Fabricated metal products	37	30	3	27	7	3	4
Electrical and electronic equipment	109	91	12	79	18	8	10
All other manufacturing	195	158	15	143	37	13	24
Nonmanufacturing industries	172	131	10	121	41	6	35

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The basic result of the changes in the Puerto Rican law, both the tollgate tax and the new Industrial Incentive Act, was to impose new or additional taxes on possessions corporations. Because the effective rate of tax, at least initially, is very low for most firms, and because some firms undoubtedly would invest in Puerto Rico even with full taxation, these new taxes may provide little disincentive to investment in Puerto Rico. And for some firms the new Industrial Incentive Act provides incentives not available under prior law. In particular, export oriented service industries, which had been fully taxable under prior law, can qualify for partial tax exemption under the new Act. Also, firms with existing grants could convert to a new, partially taxable status and receive a guarantee of an automatic 10 year extension of the grant whereas under prior law extensions (or the availability of a new grant) were not guaranteed.

One indication, however, of an overall disincentive effect of the new Industrial Incentive Act is the fact that just prior to its adoption in June 1978 there was a very large number of petitions filed for full tax exemption under the old Act. Some of these petitions were undoubtedly filed by firms merely wishing to keep their options open and will never result in an actual operation. Others appear to have been filed by companies that will make investments in Puerto Rico, but avoid the terms of the new Act. Consistent with this observation is the fact that there were relatively few petitions (90) filed under the new Act as of early May, 1979. And of these 90, more than half were filed by firms that expect to earn profits of under $100,000 per year and therefore be fully tax exempt under an exception in the new Act, as they would have been under the old Act. None of the petitions were for firms engaged in export oriented service industries, in spite of the more favorable treatment afforded them under the new Act. Only about one third of the petitions were filed by non-Puerto Rican firms, and of these about half were filed by firms that already have operations in Puerto Rico.

A much larger number, 213, of conversion petitions were filed by April, 1979 (the originally scheduled deadline for most firms). This represents about 15 percent of grants outstanding under prior Industrial Incentive Acts. Conversions, of course, do not represent new firms investing in Puerto Rico or even new investment by existing firms. But they may represent, because of the guaranteed extension feature of conversion, some commitment to continued operations in Puerto Rico. As with filings under the old Acts, the fact that most petitions were filed just ahead of the deadline suggests many firms were merely maintaining options. The issue is further clouded by the fact that the previously untried conversion procedure is still being established within the Puerto Rican government. Regulations have not been issued, but are expected by mid-summer. Further, a new filing deadline of December 31, 1979, may be approved. These changes may encourage some additional conversion petitions to be filed and also encourage some firms that have already filed to carry through with their conversion plans.

The second way in which the changes in U.S. and Puerto Rican law might increase benefits from the possessions corporation system is by lowering interest rates in Puerto Rico, thereby encouraging additional real investment. The specific change in U.S. tax law aimed at this goal was the investment provisions of section 936, which limits the U.S. tax exemption for income from financial investments to certain investments in the same possession in which the trade or business giving rise to the investable funds is conducted. At the same time, however, by allowing parent companies a 100 percent dividends received deduction Congress wanted to encourage possessions corporations to repatriate their earnings to the United States. Taken together, the net effect of these two changes on incentives to increase financial investments in Puerto Rico is uncertain. For reasons given below it is even less certain, in any event, whether a change in financial investments by possessions corporations would have any real impact on the availability of credit or interest rates in Puerto Rico.

Prior to 1976, the Puerto Rican tollgate tax did not apply to dividends paid to a parent corporation if the parent could not receive a foreign tax credit for the tollgate tax in its country of residence. Since the combination of a dividends received deduction and the 936 credit exempted most, if not all, income of possessions corporations from U.S. tax, Congress disallowed any credit to U.S. shareholders for possessions or foreign withholding taxes, including the Puerto Rican tollgate tax, imposed on dividends paid by possessions corporations. Therefore, the Puerto Rican tollgate tax had to be revised in 1976 in order for it to apply to dividends paid by possesssions corporations. By imposing a tax cost on such dividends, the tollgate encourages possessions corporations to postpone repatriation of earnings, thereby increasing their potential for making financial investments in Puerto Rico.

The estimated composition of possessions corporations financial portfolios at the end of 1978 is shown in Table 11. The total portfolio of $6.5 billion is growing at an annual rate of approximately $500 million, the difference between annual earnings of $1.8 billion, and dividend payments plus other uses of funds (real investment, debt repayment, etc.) of $1.3 billion. Some $4 billion, or about two thirds of these portfolios, is invested in Puerto Rico. This represents a very sizeable increase in such investments since early 1976, when only a few hundred million dollars (out of a total portfolio of approximately $4 billion) was invested in Puerto Rico. Over half of the increase (from under $100 million to $2 billion) was due to new deposits by possessions corporations in Puerto Rican banks, including the Puerto Rican branches of large U.S. banks which hold over half of these deposits. The remaining increase in possessions corporations' portfolio investments in Puerto Rico has gone primarily into GNMA mortgages and bonds issued by the Puerto Rican Commonwealth and municipal governments, which absorbed roughly $800 million each of possessions corporations' portfolio investments. Additional investments of an estimated $100 million have been in the form of loans to other possessions corporations and $200+ million in miscellaneous Puerto Rican assets.

Of the $2.4+ billion invested outside Puerto Rico by possessions corporations, approximately $200 million has gone into tax exempt U.S. state and local bonds, and $400+ million into preferred stock of U.S. corporations. 11/ The balance of $1.8+ billion is invested in the Eurodollar market, Canada, and other non-Puerto Rican, non-U.S. assets, or cannot be fully accounted for.

While possessions corporations have greatly increased their portfolio investments in Puerto Rico since 1976, there is little evidence that the increase has had any significant effect on the total availability of credit, or long term interest rates, in Puerto Rico. While precise interest rate comparisons are difficult because of differences in the maturity, risk, and other factors attached to financial instruments, a reasonable comparison is possible for government bonds. Table 12 shows that the interest rate spread (column 6) between interest rates paid on bonds sold by the

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11/ A possessions corporation can take an 85 percent dividends received deduction for the preferred dividends, making the maximum U.S. tax on $100 of such dividends 46% x $15 = $6.90.

Table 11

Estimated Composition of the Financial Investments of Possessions Corporations at Yearend 1978

Investment	$ billions
Total investments	6.5
Investments in Puerto Rico, total	4.0+
Deposits in Puerto Rican banks	2.0
Puerto Rican source GNMA mortgages	.8
Loans to other possessions corporations .	.1
Puerto Rican government bonds	.8
Other investments in Puerto Rico	.2+
Investments in the United States, total	.6+
U.S. municipals and project notes	.2
Preferred stock of U.S. corporations	.4+
Other investments, total	1.8+

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Table 12

Sales of Bonds by the Government Development Bank for Puerto Rico
October 1976 - April 1979

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	7.98	5.61	2.37
Industrial Development Company	3-31-78	40.0	16.80	7.98	5.69	2.29
Government Development Bank 2/	5-05-78	50.0	7.64	7.08	5.89	1.19
Telephone Authority	6-24-78	100.0	22.20	7.99	6.31	1.68
Water Resources Authority	9-26-78	125.0	22.10	7.71	6.12	1.59
Telephone Authority	11-01-78	25.0	15.20	7.67	6.22	1.45
Commonwealth Series 1978	11-10-78	100.0	16.24	7.98	6.10	1.88
Development Fund (GDB)	12-07-78	25.0	10.00	8.00	6.29	1.71
Public Buildings Authority	4-05-79	125.0	N/A	7.90	6.25	1.65

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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

Government Development Bank for Puerto Rico and the Bond Buyer's index for 20 (U.S. municipal) bonds has changed little, if at all, since October 1976 (the effective date of section 936).

There are several explanations for the general lack of impact of possessions corporations' financial portfolios on credit conditions in Puerto Rico. Bank deposits may simply finance loans to Puerto Rican subsidiaries of large U.S. companies (or to other possessions corporations) which would otherwise have borrowed from their parent corporations; they may, at least temporarily, be "warehoused" in U.S. investments, such as U.S. Treasury securities; and, in the case of Puerto Rican branches of U.S. (and other non-Puerto Rican) banks, they may simply reduce the branches' loans from its home office. Similarly, possessions corporations' purchases of Puerto Rican GNMAs, government bonds, and other assets may only substitute for other non-Puerto Rican purchasers, and therefore not affect total funds available in Puerto Rico to finance investment. Further, most of the bank deposits of possessions corporations are in the form of short term certificates of deposits, and many of the Puerto Rican GNMAs and government bonds are held under repurchase agreements with brokers or banks, thus effectively converting them into short-term investments. Banks (and brokers) cannot risk making additional long term loans, the type of loan needed to finance real investment in Puerto Rican plant and equipment, if the funds at their disposal from possessions corporations are only committed for short periods of time.

It is reasonably clear why possessions corporations are unwilling to over commit their financial portfolios in Puerto Rico. They, like any other investors, have alternative uses for funds, including investments in the United States and other non-Puerto Rican assets, as well as the option to repatriate funds to their U.S. parents. Unless the after-tax return on an investment in a Puerto Rican asset is at least as high as from a non-Puerto Rican asset of equal risk, a possessions corporation (or any other investor) has no incentive to purchase the Puerto Rican asset. 12/ The fact that the Puerto Rican capital market is highly integrated with the U.S. capital market means that

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12/ Note that because of tax exemption a possessions corporation bears all risk on investments, whereas a taxable corporation shares some risk with the government. Therefore, a possessions corporation will be relatively less willing to finance risky investments.

all investors, including possessions corporations, can readily compare after-tax rates of return in Puerto Rico and the United States, and will quickly adjust their financial portfolios in response to changes in these returns. A "good" investment in Puerto Rico will be financed with or without the financial portfolios of possessions corporations; a "bad" investment will not.

3. Change in Cost Effectiveness

From the preceding, it appears that the cost effectiveness of the possessions corporation system was not greatly altered by the 1976-1978 changes in the U.S. and Puerto Rican laws. Costs have been reduced somewhat through the relatively small increases in U.S. and Puerto Rican tax collections, while benefits may have fallen slightly because of new disincentives to invest which have probably not been offset by improved credit conditions in Puerto Rico.

Some additional indication of recent changes in the cost effectiveness of the system can be obtained by comparing the growth rate of employment in manufacturing industries with their benefit-cost ratios. Table 13 shows manufacturing employment by industry for 1973-1978, and the rate of growth of that employment over the entire period and for the 1976-1978 period. A comparison of these growth rate figures with the benefit-cost ratios shown in column 5 of Table 9 indicates the following. The three industries with the lowest benefit-cost ratios -- chemicals (including pharmaceuticals), electrical and electronic equipment, and scientific instruments -- have been three of the fastest growing industries over both the entire 1973-1978 period, and the more recent 1976-1978 period. The reverse is true of the three industries with the highest benefit-cost ratios -- food and kindred products, textile mill products, and apparel. These three industries have grown very slowly, or actually lost employment, between 1976 and 1978 and over the entire 1973-1978 period. These comparisons suggest that that the possessions corporation system as revised will continue to make Puerto Rico most attractive to relatively high profit operations of U.S. firms in selected industries that produce relatively fewer benefits to Puerto Rico than the traditional, labor-intensive industries.

Table 13

Total Manufacturing Employment in Puerto Rico by Industry,
Calendar Years 1973-1978
(thousands)

Industry Group	1978	1977	1976	1975	1974	1973	Percentage Change 1973-1978	Percentage Change 1976-1978
	Year							
All Manufacturing Industries	152.4	146.2	142.5	135.2	150.9	152.1	.2%	6.9%
Nondurable goods	101.1	99.0	97.7	93.5	103.9	105.3	-4.0	3.5
Food and kindred products	24.6	23.9	24.1	23.8	24.1	24.0	2.5	2.1
Tobacco products	3.0	3.7	4.9	5.1	5.4	5.5	-45.5	-38.8
Textile mill products	4.8	4.7	4.6	5.1	7.4	7.6	-36.8	4.3
Apparel	36.4	36.5	37.5	34.6	38.1	40.3	-9.7	-2.9
Paper and allied products; Printing and publishing	4.4	4.4	4.1	4.0	4.2	4.3	2.3	7.3
Chemicals	15.7	14.2	11.4	10.4	11.6	10.6	48.1	37.7
Petroleum refining; Rubber products; Plastics	6.4	6.3	5.9	5.5	6.6	6.7	-4.5	8.5
Leather and leather products	5.7	5.3	5.2	5.0	6.2	6.4	-10.9	9.6
Durable goods	51.3	47.2	44.9	41.7	46.9	46.8	9.6	14.3
Lumber and wood products; Furniture and fixtures	3.7	3.4	3.7	3.9	4.4	4.9	-24.5	0
Stone, clay and glass products	5.3	5.2	5.6	6.1	7.3	7.3	-27.4	-5.4
Primary metal products; Fabricated metal products	5.9	5.3	5.4	5.8	5.6	6.8	-13.2	9.3
Machinery, except electrical; Transporation equipment	5.7	5.2	4.4	3.5	2.3	1.9	200.0	29.5
Electrical and electronic equipment	15.2	10.0	11.8	9.6	13.9	14.0	8.6	28.8
Scientific instruments	12.1	11.2	10.9	10.1	9.3	8.6	40.7	11.0
Miscellaneous manufacturing industries	3.4	2.8	3.0	2.8	3.0	3.2	6.3	13.3

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Sources: Economic Development Administration, Commonwealth of Puerto Rico; and 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.

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

The term "possession" as used in section 936 of the Internal Revenue Code includes not only Puerto Rico, but also American Samoa, Guam, the Panama Canal Zone, and other smaller U.S. territories. 1/ It does not include the Virgin Islands. U.S. corporations operating in American Samoa, Guam, and the Canal Zone qualify for special tax treatment under section 936 in the same manner as U.S. corporations operating in Puerto Rico. As in the case of 936 companies in Puerto Rico, the Federal tax expenditure associated with section 936 and related provisions depends upon the amount of income tax paid by each 936 company to the host possession. The loss of revenue to the Federal Treasury is the amount of U.S. tax liability on each company's qualified income in the absence of either a foreign tax credit or section 936, less the tax payments to the host possession.

The first section of this Appendix describes the income tax law and tax-incentive programs of American Samoa, Guam, and the Panama Canal Zone. It shows that the overall effective rate of tax paid by 936 corporations was 11.5 percent on income derived from Guam and zero percent on income derived from the Canal Zone. The combined Federal tax expenditure for all three possessions was $2.2 million in 1977.

The second section of the Appendix compares the tax treatment accorded to 936 companies with that accorded to U.S.-controlled corporations operating in the Virgin Islands. Certain corporations operating in the Virgin Islands are exempt from U.S. tax under section 28(a) of the Revised Organic Act of the Virgin Islands. The confusion regarding the proper interpretation of section 28(a) is described, as well as the tax law and tax-incentive program of the Virgin Islands. Depending upon the interpretation of section 28(a), the overall effective tax rate on V.I.-source income could vary from zero to 46 percent. The Federal tax expenditure associated with section 28(a) was approximately $13.5 million in 1977. The average Federal tax expenditure per employee of tax-exempt corporations was $4,300.

1/ Other territories to which section 936 benefits apply are the Northern Mariana Islands and Wake and Midway Islands. As of 1977, no 936 corporations were operating in these territories.

I. American Samoa, Guam and the Panama Canal Zone

A. Federal and Possessions Taxation

American Samoa and Guam, like Puerto Rico, constitute tax jurisdictions separate and distinct from that of the United States. Corporations organized in the United States and operating in American Samoa and Guam are generally considered foreign corporations for purposes of the possessions income tax laws. Thus, a 936 corporation files a tax return with the host possession as well as with the United States.

The income tax laws in effect in American Samoa and Guam are a "mirror image" of those in force in the United States. This means that the U.S. Internal Revenue Code is applied as a local territorial tax code, with the words "American Samoa" or "Guam" substituted for the words "United States" wherever they appear in the U.S. Code. In American Samoa, the "mirror system" was enacted by the local legislature in the American Samoa Income Tax Act, effective January 1, 1963. In Guam, the "mirror system" was provided for under section 31 of the Federal Organic Act of Guam (48 U.S.C. 1421(i)), effective January 1, 1951. Under this section,

> "The income tax laws in force in the United States of America and those which may hereafter be enacted shall be held to be likewise in force in Guam."

Although both American Samoa and Guam use the U.S. Internal Revenue Code as a local territorial tax, special provisions in the Code exempt from tax dividends, interest, and other passive investment income paid by companies operating in Guam to U.S. persons. Under the "mirrored" versions of sections 881(b) and 1442(c), a U.S. parent corporation is not subject to tax, or to withholding of tax at source, on payments derived from Guam. Under section 935(c), a U.S. individual is similarly exempt from tax on payments derived from Guam.

No Federal provision explicitly limits the authority of American Samoa or Guam to provide income tax relief with respect to possessions source income. Under the tax-incentive program of American Samoa, the government of American Samoa grants to qualifying corporations temporary exemptions from the payment of some or all income taxes. In order to qualify, the corporation must be owned by a resident of American Samoa and employ a work force at least

75 percent of which consists of American Samoan residents. The period of tax exemption is for up to 10 years, although it may be made to terminate earlier if the cumulative amount of income taxes forgiven equals 100 percent of the net current investment in American Samoa.

The Guam Economic Development Authority grants rebates of up to 100 percent of Guam income taxes to corporations that meet minimum investment and certain other requirements (such as increasing employment, replacing imports, or creating vitally needed facilities). The rebate is allowed for up to 20 years.

As of 1978, all 936 corporations operating in Guam received a rebate of 75 percent of Guam income taxes. Given the 936 forgiveness of their U.S. tax liability, these corporations paid a maximum effective tax rate of 11.5 percent on income from the active conduct of a trade or business in Guam and on passive income derived from the reinvestment of income from the trade or business. Many of these corporations enjoyed, in addition, a 10-year exemption from the Guam real property tax. In the case of a few tax-exempt corporations, the individual shareholders were granted rebates of 75 percent of the income tax on any dividends received.

The Panama Canal Zone imposes no local territorial income tax. A Federal agency (the Panama Canal Company), administers the Canal Zone 2/ and finances its expenditures through toll collections. Possessions corporations operating in the Canal Zone thus do not file a territorial tax return in addition to the U.S. return. Since section 936 relieves them from Federal tax on qualified Canal Zone income, they are effectively exempt from any tax on income derived from the active conduct of a trade or business in the Canal Zone and on passive income derived from the reinvestment of profits from that trade or business. Thus, the Federal tax loss resulting from section 936 forgiveness of U.S. tax liability is the dollar amount of the qualified Canal Zone taxable income, multiplied by the effective Federal corporate tax rate. After taking into account all

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2/ As a result of the Panama Canal Treaties of 1977, the United States will cease to have jurisdiction over the Canal Zone on October 1, 1979; on that date, the Canal Zone will cease to be a possession for purposes of section 936.

provisions of the Internal Revenue Code, the effective U.S. tax rate on domestic income of U.S. manufacturing corporations is 38 percent. 3/

B. Characteristics of Possessions Corporations

Table A-1 shows that in 1977, there were four 936 corporations operating in American Samoa and Guam. These corporations had a net income of $2.7 million (and a book income of $2.0 million). Under section 936, they obtained tax savings of $1.1 million. These figures compare with 1975 book incomes of $5.2 million and tax savings of $2.1 million for seven 936 corporations in American Samoa and Guam.

There were five 936 corporations operating in the Panama Canal Zone in 1977. They had a net income (and a book income) of $2.8 million and accounted for a Federal revenue loss of $1.1 million under section 936. These figures compare with 1975 book incomes of $2.0 million and tax savings of $0.8 million for six 936 corporations.

II. Virgin Islands

A. Federal and Virgin Islands Taxation

The Virgin Islands are not treated as a possession for purposes of section 936. However, corporations operating in the Virgin Islands receive benefits similar to those provided to 936 corporations. Under section 28(a) of the Revised Organic Act of the Virgin Islands, "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 Federal Treasury, even on their U.S.-source income. All corporations chartered in the Virgin Islands are considered to be "inhabitants of the Virgin Islands." It has not been established by the Internal Revenue Service or the Courts whether a United States corporation may qualify as an "inhabitant of the Virgin Islands" within the

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3/ A 1978 study by the Department of the Treasury, Effective Income Tax Rates Paid by United States Corporations in 1972, found that the average effective income tax rate was 40 percent, compared to a maximum statutory corporation income tax rate of 48 percent. The maximum statutory rate was reduced to 46 percent by the Tax Revenue Act of 1978. It is estimated that this also reduced the average effective rate by two percentage points.

Table A-1

Income and Estimated Tax Expenditure
by Possession, 1977

Possession	Number of Corporations	Net Income ($000)	Estimated Tax Expenditure ($000)
American Samoa and Guam	4	$2,679	$1,069
Panama Canal	5	2,809	1,121
Total	9	$5,488	$2,190

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meaning of section 28(a). For this reason, most U.S. companies wishing to operate a trade or business in the Virgin Islands and to benefit from tax savings under section 28(a) incorporate subsidiaries under Virgin Islands law.

There is a loss of Federal tax revenue whenever the United States gives up the right to tax income. In the case of 936 corporations, this right is effectively given up through the credit mechanism of section 936. In the case of U.S.-controlled corporations operating in the Virgin Islands, this right is given up through the exemption of "inhabitants of the Virgin Islands" from U.S. tax under section 28(a) of the Revised Organic Act. The amount of the revenue loss to the Federal Treasury under section 28(a) is the difference between the corporate taxes which would have been paid to the United States in the absence of section 28(a) and the actual tax payments to the Virgin Islands. The larger the tax payments to the Virgin Islands, the larger would be the U.S. foreign tax credit in the absence of section 28(a) and, hence, the smaller the Federal tax loss as a result of section 28(a).

The income tax laws in effect in the Virgin Islands are a "mirror image" of those in force in the United States. The U.S. Internal Revenue Code is applied as a local territorial tax code, with the words "Virgin Islands" substituted for the words "United States" wherever they appear in the U.S. Code. The "mirror system" was provided for under the Federal Naval Appropriations Act of 1921 (48 U.S.C. 1397).

Effective for taxable years beginning in 1960, section 934 of the Federal Internal Revenue Code limits the power of the Virgin Islands government to grant relief from territorial income taxes. This section prevents the Virgin Islands from granting rebates for taxes attributable to income derived from sources within the United States. With respect to non-U.S. source income, section 934 limits the Virgin Islands' authority to grant corporate tax rebates to U.S. and V.I. corporations which meet the so-called "80-50 tests," used also in section 936. That is, to qualify for V.I. tax rebates under section 934, a corporation must have derived for the past three taxable years (or applicable part thereof) 80 percent of its gross income from V.I. sources and at least 50 percent of its gross income from the active conduct of a trade or business within the Virgin Islands.

The Virgin Islands Industrial Development Program (Act No. 3748) provides rebates to certain U.S. and V.I. corporations of 90 percent of the V.I. income tax attributable to income derived from the Virgin Islands. 4/ In order to qualify for these rebates, a corporation must meet the requirements of section 934 and certain other requirements. The principal requirements are that it:

(1) invest at least $50,000, exclusive of inventory, in a Virgin Islands industry or business;

(2) agree in writing to give preference in employment and contracting to Virgin Islands residents and V.I. corporations;

(3) obtain approval from the Commissioner of Labor for any nonresident workers prior to a grant of permission to hire such persons; and

(4) conform to ecological standards established by Federal or local law.

In addition to these specific requirements which must be met by an applicant for V.I. tax relief, the Virgin Islands considers applications in light of the following general guidelines:

(1) the extent to which the proposed enterprise may pollute the environment;

(2) the applicant's requirements for utilities, social services, and other resources;

(3) the applicant's capacity to employ Virgin Islands resident labor; and

(4) the proposed industry's compatibility with existing businesses in the Virgin Islands.

Corporations which are beneficiaires of the V.I. Industrial Development Program may receive rebates of 90 percent of corporate income taxes paid, rebates of 90 percent of customs duties, and/or 100 percent exemptions from the V.I. real property tax, gross receipts tax and/or excise tax. Any particular package of benefits is negotiated between the applicant and the V.I. Industrial Development

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4/ These rebates do not apply, however, to Virgin Islands tax on interest income, capital gains, and certain types of rental income.

Commission. Subsidies and exemptions are permitted for 10 years, but the beneficiary may elect partial benefits for up to 20 years in lieu of full benefits for 10 years. The percentage of the benefits available for each term chosen by the taxpayer is given in the following table:

Term	Percent of Subsidy or Exemption
10 years	100.0% 1/
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

1/ For purposes of this table, a benefit percentage of 100 percent corresponds to the 90 percent income tax and customs rebates provided by the Industrial Development Program.

An applicant for benefits is allowed the option of determining when the tax benefits commence, provided they are initiated at some point during the first five years of operating of the business. An additional five years of benefits (or up to 10 years at no more than 50 percent of the benefits) are granted to corporations which locate their business in certain economically depressed areas. Moreover, any beneficiary under the Industrial Development Program may be granted a renewal of those benefits subject to the approval of the Governor of the Virgin Islands.

A corporation which is deemed to be an "inhabitant of the Virgin Islands" within the meaning of section 28(a) of the Revised Organic Act and which qualifies under Code section 934 and the Industrial Development Program for a 10-year subsidy of 90 percent of income taxes, pays a maximum effective corporate income tax rate in the Virgin Islands of 4.6 percent. 5/ The actual effective V.I. tax

5/ The maximum effective corporate rate was 4.8 percent for tax years beginning before 1979, when the corporate tax rate reduction under the Federal Revenue Act of 1978 went into effect.

rate is probably less if the impact of other tax provisions, such as the investment tax credit and accelerated depreciation, is taken into account. Given that the effective U.S. tax rate on domestic income of U.S. manufacturing corporations is 38 percent, 6/ a corporation which qualifies for a tax subsidy and is deemed to be an "inhabitant of the Virgin Islands" is probably subject to an effective rate of income tax in the Virgin Islands of 3.8 percent.

A U.S. corporation is treated as a foreign corporation for purposes of Virgin Islands taxation. Therefore, it is subject to the 30 percent withholding tax on dividends, interest, royalties, and other passive investment income which it may receive from a corporation operating in the Virgin Islands. 7/ This tax cannot be forgiven under section 934 since the tax is upon the U.S. recipient and not upon the company operating in the Virgin Islands. However, a 1977 decision of the United States Court of Appeals for the Third Circuit 8/ has cast serious doubt on the jurisdiction of the Virgin Islands to withhold tax upon payments to U.S. corporations under the "mirrored" Internal Revenue Code. If the 30 percent tax is paid, either at source or directly by the U.S. recipient, it is creditable (subject to limits) against U.S. tax liability.

6/ See footnote 3.

7/ The tax is imposed unless the dividends are paid by a V.I. subsidiary which derives less than 20 percent of its gross income from V.I. sources or by a U.S.(or other foreign) corporation which derives less than 50 percent of its gross income from V.I. sources. Neither corporation would qualify for an income tax subsidy by virtue of the section 934 eighty and fifty percent source requirements.

8/ Vitco, Inc. vs. Government of the Virgin Islands.

Dividends paid by a U.S. subsidiary operating in the Virgin Islands qualify for the 85 percent dividends-received deduction for purposes of computing the parent company's United States tax liability. However, the United States does not allow a U.S. parent to take the dividends-received deduction for dividends received from a subsidiary incorporated in the Virgin Islands. 9/ Thus, even though the profits of a qualifying 934 subsidiary may be 90 percent tax-free in the Virgin Islands, the profits will be subject to the normal U.S. corporate rate of income tax once they are repatriated.

There are four principal differences between the tax treatment accorded to a U.S. parent corporation of a subsidiary deemed an "inhabitant of the Virgin Islands," and that accorded to a U.S. parent of a 936 corporation in Puerto Rico. Although many questions are unresolved regarding the proper tax treatment of a U.S. corporation which claims to be an "inhabitant of the Virgin Islands," for purposes of this discussion the questions will

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9/ This follows from the treatment of V.I. corporations as foreign corporations for purposes of U.S. income taxation. The general rule with respect to foreign corporations is that a U.S. corporate shareholder is allowed the dividends-received deduction only if more than 50 percent of the foreign corporation's income has been derived, for the past three years, from a U.S. trade or business, and in that case, only with respect to dividends distributed from U.S.-source income. Dividends from V.I.-source income would therefore not qualify for the deduction. A corporation which met the so-called "80-50 source tests" required to be eligible for V.I. tax subsidies would not qualify for the deduction even with respect to dividends from U.S. source income (Code section 245(a)).

Although both the Code definition of the United States (section 7701(a)(9) and 7701(a)(4)) and judicial precedent for the Virgin Islands have established that V.I. entities are foreign with respect to the U.S. income tax jurisdiction, this treatment is at issue in a pending Internal Revenue Service ruling.

tentatively be answered in the way most favorable to the taxpayer. 10/

(1) Tax on repatriated earnings. Dividends paid by a V.I. subsidiary to a U.S. parent corporation are subject to the normal rate of U.S. tax upon receipt by the parent. Dividends paid to a U.S. parent by a U.S. subsidiary in the Virgin Islands are taxable at only 15 percent of the normal corporate rate, since they qualify for an 85 percent dividends-received deduction. Dividends paid by a Puerto Rican 936 subsidiary to its U.S. parent are not taxable in the United States. (They qualify for a 100 percent dividends-received deduction.) Before the 1977 decision in the *Vitco* case (discussed above), the Virgin Islands imposed a 30 percent withholding tax on outflows of dividends, with no rebates of the withheld tax. Puerto Rico imposes a maximum 10 percent tollgate tax on outflows of dividends; special provisions reduce the average effective rate of this tax to five percent.

(2) Eligibility for foreign tax credit. A parent with a subsidiary operating in the Virgin Islands, whether incorporated under U.S. or V.I. law, may claim a foreign tax credit for V.I. taxes paid with respect to repatriated earnings. A U.S. parent of a 936 corporation *cannot* claim a foreign tax credit for tax withheld on repatriated earnings or for Puerto Rican taxes on income with respect to which the U.S. tax liability is forgiven under section 936.

(3) Consolidation with the U.S. parent. A U.S.-incorporated "inhabitant" of the Virgin Islands may be a member of an affiliated group for purposes of filing a consolidated return, although the law is untested by the courts. A corporation which elects the benefits of section 936 *cannot* join with its parent in filing a consolidated return for the 10-year period for which the election is made.

10/ The question of whether a U.S. corporation can be an "inhabitant of the Virgin Islands" is the subject of a pending I.R.S. revenue ruling. The purpose of this discussion is to illustrate the consequences of a ruling which supported the U.S. corporation's claim to be an "inhabitant of the Virgin Islands."

However, it can delay electing 936 status until its operations return a profit.

(4) Treatment of liquidating distributions. In order to avoid the 30 percent withholding tax and at the same time "repatriate" V.I.-source earnings, the U.S. parent may permit its subsidiary to accumulate its earnings in the Virgin Islands and then liquidate the subsidiary. If the liquidating subsidiary was incorporated in the United States and at least 80 percent owned by a U.S. corporation, gain on the distribution of the subsidiary's assets would be exempt from U.S. tax. However, it would not be possible for the subsidiary to be liquidated free of V.I. tax unless it received a ruling from the Virgin Islands that the liquidation did not have a tax avoidance purposes. Likewise, in Puerto Rico, it would not be possible for a U.S. parent corporation to avoid the tollgate tax by liquidating its 936 subsidiary.

It is clear from the above that the incentives to U.S. investment in the Virgin Islands which obtain under section 28(a) of the Revised Organic Act depend significantly on whether a U.S. parent corporation can sustain the burden of proving that its U.S. subsidiary is an "inhabitant of the Virgin Islands." It is not settled whether a U.S. corporation may be an "inhabitant of the Virgin Islands" within the meaning of section 28(a). Assuming that it could qualify, the U.S. parent corporation would enjoy tax benefits more favorable than those enjoyed by a U.S. parent of a 936 corporation and also more favorable than those foreseen by the Congress when it enacted section 28(a) of the Revised Organic Act. The parent of the V.I. "inhabitant" would pay no U.S. tax on the income of its subsidiary, yet could claim a foreign tax credit for any withholding taxes and income taxes paid to the Virgin Islands with respect to earnings repatriated to the parent. This credit could offset U.S. tax liability on income sourced in low-tax countries which had not been fully offset by the foreign tax credit for those countries.

Table A-2 presents estimates of the effective tax rates on qualified possessions source income which obtain for the U.S. parent of three types of corporations -- a V.I. "inhabitant" organized in the Virgin Islands, a V.I. "inhabitant" organized in the United States, and a 936 corporation operating in Puerto Rico. It is based on the following assumptions:

Table A-2

Overall Tax Rates Repatriated from the Virgin Islands and Puerto Rico

	"Inhabitant" of the Virgin Islands		936 Corporation
	V.I. subsidiary	U.S. subsidiary	in Puerto Rico
U.S. parent able to use full V.I. foreign tax credit against U.S. tax on other foreign source income	46.0% 1/	0.0% 2/	5.0% 4/
U.S. parent limited to V.I. credit only	46.0% 1/	33.2% 3/	5.0% 4/

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1/ Earnings repatriated from a V.I. (or other foreign) subsidiary are subject to the U.S. statutory corporate rate of tax, and a foreign tax credit is granted for V.I. taxes paid with respect to such earnings. For tax years beginning before 1979, the statutory rate was 48 percent.

2/ The net V.I. income tax on, say, \$100 of earnings is \$4.60 under a system of 90 percent income tax rebates. The V.I. tax withheld on repatriated dividends is 30 percent of \$95.40, or \$28.62. The total of V.I. taxes paid on this \$100 is thus \$33.22. The U.S. parent receives an 85 percent dividends-received deduction for the dividend, and has U.S. tax liability of .46 x (.15)(95.40), or \$6.58. This U.S. liability is offset by the \$33.22 of taxes paid to the Virgin Islands. The excess foreign tax credit with respect to V.I.-source income is used to offset U.S. liability on income from other foreign sources. This result is possible because it is assumed that the U.S. parent has U.S. tax liability on income sourced in low-tax countries which has not been fully offset by the foreign tax credit.

3/ The assumptions here are the same as in the preceding case, except that the U.S. parent does not have U.S. tax liability on foreign source income which has not been fully offset by the foreign tax credit. The total of V.I. taxes paid on, say, \$100 of V.I.-source earnings is \$33.22 (see footnote 2). This amount offsets only the U.S. tax liability on this income.

4/ Current beneficiaries of the Puerto Rican tax-incentive program are fully exempt from Puerto Rican income taxes. The average effective Puerto Rican tollgate tax on dividends paid to a U.S. parent is 5 percent. The U.S. tax liability on these earnings is forgiven under section 936.

(1) There is full repatriation of the subsidiary's earnings to its U.S. parent annually.

(2) The V.I. "inhabitant" receives a grant of income tax exemption from the Virgin Islands and elects a 10-year, 90 percent subsidy.

(3) The 936 corporation in Puerto Rico is completely exempt from the Puerto Rican income tax. Dividends paid to the U.S. parent are subjected to a five percent Puerto Rican tollgate tax.

The table shows that an effective tax rate as high as 46 percent may apply to V.I.-source earnings repatriated by a V.I. subsidiary, while an effective tax rate as low as zero percent may apply to V.I.-source earnings repatriated by a U.S. subsidiary. This compares to an effective tax rate of 5.0 percent on earnings repatriated by a 936 corporation in Puerto Rico.

B. Characteristics of Tax-exempt Corporations in the Virgin Islands

As of December 1, 1978, there were approximately 50 active firms which received income tax rebates from the Virgin Islands. Of these, 12 were U.S.-controlled corporations. The most substantial investments of U.S. capital were in the petroleum, mining, and communications industries.

Table A-3 shows the amount of Federal tax expenditure, employment, and compensation for tax-exempt U.S.-controlled subsidiaries. The income and tax data are taken from the most recent tax return which each of these companies filed with the Virgin Islands. 11/ For the tax years covered, the Federal revenue loss (tax expenditure) from section 28(a) of the Revised Organic Act was $13.5 billion. This estimate represents the difference between the U.S. income taxes which would have been paid in the absence of section 28(a) and the actual income taxes paid to the Virgin Islands, net

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11/ Two of these tax returns were filed for calendar year 1976, four for tax years ending in 1977, and four for calendar year 1978. In the case of one U.S. corporation, no return has ever been filed with the Virgin Islands. In the case of two other companies, the businesses have been in operation too short a time to have filed a tax return. Thus, Table A-3 presents data for a total of nine corporations.

Table A-3

Tax Expenditure, Employment, and Compensation of Employees
of U.S.-controlled Tax-exempt Subsidiaries in the Virgin Islands, 1977

	Number of Corporations	Gross Income 1/ ($000)	Tax Expenditure 1/ ($000)	Number of Employees 2/	Compensation of Employees 3/ ($000)	Tax Expenditure per Employee ($)	Tax Expenditure as Percent of Compensation of Employee	Average Employee Compensation ($)
U.S.-controlled subsidiaries	9	2,767,018	13,492	3,146	37,396	4,289	36.1	11,887

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1/ Data are taken from the most recent tax return which each of these companies filed with the Virgin Islands. The tax years covered fall within calendar years 1976 through 1978.

2/ Employment data are taken in most cases from V.I. Form W-3, "Transmittal of Income and Tax Statements," filed by each of these companies for calendar year 1977. In a few cases, data are from information provided by the companies in response to a survey conducted by the V.I. Department of Commerce.

3/ The source of payroll data is the total wages and other compensation reported by these companies on V.I. Form W-3 for calendar year 1977. Total compensation of employees was computed by multiplying 1.212 times payroll. The additional 21.2 percent reflects the employer-paid portion of Federal Social Security, unemployment insurance, and other non-payroll labor costs. The 21.2 percent is the average for all U.S. manufacturing industries in 1977; see the U.S. Department of Commerce, Survey of Current Business, July 1978, Tables 6.5 and 6.6.

of rebates. This difference is measured by the total corporate income tax rebates claimed by U.S.-controlled companies in the Virgin Islands. The $13.5 million estimate overstates the U.S. tax loss from section 28(a) to the extent that V.I. subsidiaries controlled by U.S. parents repatriate their earnings, since such earnings would be subject to the normal U.S. corporate income tax upon receipt by the U.S. parents. The $13.5 million estimate also takes no account of the fact that the parent of a U.S.-incorporated subsidiary may use V.I. taxes to offset U.S. tax liability on other foreign source income, as described above. To the extent that this occurs, the $13.5 million figure understates the Federal tax expenditure.

In 1977, the number of people employed by these nine companies in the Virgin Islands was 3,146, and the total compensation they received was $37.4 million. The average Federal tax expenditure per employee was thus $4,289, or 36.1 percent of the average compensation for these employees. However, there is a wide variation among individual companies in the Federal tax expenditure per employee, from $59,390 for one company to zero in the case of two companies which had net operating losses. The average tax expenditure per employee of U.S.-controlled corporations in the Virgin Islands, estimated at $4,289, compares to an average tax expenditure per employee of 936 corporations in Puerto Rico of $8,222.

Appendix B -- Sources and Limitations of the Data, and Detailed Tabulations for 1973-1976

This Appendix includes tables covering data for 1973-1976 similar to text Tables 6, 7, and 8 covering data for 1977, and a discussion of the sources and limitations of the data. Tables B-1 through B-4 correspond to Table 6 in the text and provide data for 1976, 1975, 1974, and 1973 in that order. Similarly, Tables B-5 through B-8 correspond to Table 7 in the text, and Tables B-7 through B-12 to Table 8. Tables B-5 through B-12 are limited to those corporations for which both income and employment data were available. Although these tables present data for less than the number of corporations included in Tables B-1 through B-4, their coverage in terms of income and tax expenditure are over 80 percent for 1975 and 1976, and nearly 70 percent for 1974. The coverage for 1973, however, is considerably less extensive because employment data were less readily available.

All of the data in the text and Appendix tables are based on corporations that either excluded income under section 931 in one or more of the years 1973, 1974, 1975 and 1976, or have made an election under section 936 for 1976 or 1977. 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

Income statement and balance sheet data for 1977, and some income data for 1976, are from Form 1120, "U.S. Corporation Income Tax Return"; additional income data are from Form 5735, "Computation of Possessions Corporation Tax Credit Allowed Under Section 936." (Appendix C contains copies of all tax forms from which data included in this Report were obtained.)

The primary source of income data for 1973-1975 and some data for 1976 was Form 5712, "Election to be Treated as a Possessions Corporation Under Section 936". 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 was reported on the Form. One problem with this data is that the income for all years beginning in 1973-1975 was reported even though the corporation may not have excluded income under section 931 in all 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 available on an individual company basis were obtained from income tax returns (Forms 480.20) filed with the Puerto Rican Government.

The employment and payroll data for all years 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 included in at least one year for several reasons. Some corporations were organized after 1973, in some cases as late as 1977, and therefore do not appear in tables for the years prior to their establishment. Similarly, some firms were liquidated (or became inactive) before 1977, 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 were not available for all years 1973-1975.

The number of corporations included in tables covering 1976 and 1977 is less than the number included in tables covering 1975, for several reasons. The 1977 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 benefitted 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 therefore do not appear in the 1976 tables and will not appear even in complete 1977 data. For example, there were 87 corporations included in the 1975 tables that have not elected under section 936, compared with only 5 in 1976. (The 1976 tables include 122 corporations which had accounting periods beginning before January 1, 1976, and which therefore could still claim the benefits of section 931. Of these 122, 117 have since elected under section 936.) A number of section 931 corporations classified as non-manufacturing did not make an election under section 936. As a result, relatively fewer non-manufacturing corporations are present in the 1976 and 1977 data.

Table B-1

Income and Estimated Tax Expenditure by Industry, 1976 1/

Industry Group	Number of Corporations	Net Income Per Return ($000)	Estimated Tax Expenditure ($000)
All industries	528	1,627,213	651,348
Manufacturing industries	395	1,551,677	621,190
Food and kindred products	22	95,870	38,535
Tobacco products	6	10,175	4,067
Textile mill products	5	-267	190
Apparel	93	65,474	26,226
Chemicals, total	76	912,793	365,069
Pharmaceuticals	52	779,954	311,948
All other chemicals	24	132,839	53,121
Rubber products	8	1,578	629
Leather and leather products	11	6,745	2,692
Stone, clay and glass products	5	10,715	4,282
Fabricated metal products	26	21,419	8,563
Machinery, except electrical	7	2,824	1,128
Electrical and electronic equipment	81	323,249	129,400
Transportation equipment	4	1,597	637
Scientific instruments	24	46,208	18,471
All other manufacturing	27	53,297	21,301
Nonmanufacturing	133	75,536	30,158
Transportation, communications and utilities	11	40,283	16,106
Wholesale trade	14	2,972	1,182
Retail trade	52	17,138	6,842
Finance, insurance, real estate	21	3,184	1,268
Services	13	3,572	1,421
Miscellaneous and not available	22	8,387	3,339

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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 3).

Table B-2

Income and Estimated Tax Expenditure by Industry, 1975 1/

Industry Group	Number of Corporations	Book Income ($000)	Estimated Tax Expenditure ($000)
All industries	595	1,108,881	446,863
Manufacturing industries	394	1,055,060	425,213
Food and kindred products	23	71,746	28,652
Tobacco products	7	26,805	10,744
Textile mill products	8	-3,051	265
Apparel	88	43,557	17,675
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	571
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	23	25,709	10,448
Nonmanufacturing industries	201	54,059	21,612
Transportation, communications and utilities	9	30,006	10,062
Wholesale trade	12	3,144	1,258
Retail trade	98	12,302	5,164
Apparel	80	1,844	1,037
Finance, insurance, real estate	28	1,398	633
Savings and loans	9	808	307
Services	16	-107	1,623
Miscellaneous and not available	38	7,316	2,872

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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 3).

Table B-3

Income and Estimated Tax Expenditure by Industry, 1974 1/

Industry Group	Number of Corporations	Book Income ($000)	Estimated Tax Expenditure ($000)
All industries	596	852,058	372,507
Manufacturing industries	399	813,057	352,908
Food and kindred products	26	65,123	26,517
Tobacco products	6	12,472	4,938
Textile mill products	8	-66,071	624
Apparel	94	42,052	17,542
Chemicals, total	65	478,329	190,683
Pharmaceuticals	44	405,355	161,341
All other chemicals	21	72,974	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	66,872
Transportation equipment	5	1,100	440
Scientific instruments	25	27,452	11,044
All other manufacturing	26	36,998	15,090
Nonmanufacturing industries	197	39,002	19,599
Transportation, communications and utilities	7	16,701	6,750
Wholesale trade	10	1,708	704
Retail trade	103	11,994	5,002
Finance, insurance, real estate	21	2,117	926
Services	14	-457	580
Miscellaneous and not available	42	6,939	5,637

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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 3).

Table B-4

Income and Estimated Tax Expenditure by Industry, 1973 1/

Industry Group	Number of Corporations	Book Income ($000)	Estimated Tax Expenditure ($000)
All industries	568	650,515	258,278
Manufacturing industries	385	591,724	242,116
Food and kindred products	24	60,939	21,960
Tobacco products	8	15,265	6,119
Textile mill products	16	-4,539	1,190
Apparel	93	36,991	15,245
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	9	6,273	2,505
Fabricated metal products	24	15,465	6,828
Machinery, except electrical	4	1,830	732
Electrical and electronic equipment	64	116,277	46,749
Transportation equipment	3	601	240
Scientific instruments	23	22,176	8,794
All other manufacturing	27	45,689	18,372
Nonmanufacturing industries	183	58,792	16,162
Transportation, communications and utilities	6	6,952	2,843
Wholesale trade	10	29,834	541
Retail trade	96	10,689	4,430
Finance, insurance, real estate	18	2,603	1,081
Services	16	-6,960	408
Miscellaneous and not available	37	15,674	6,859

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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 3).

Table B-5

Tax Expenditure, Employment and Compensation of Employees by Industry, 1976

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 a Percent of Compensation of Employees	Average Employee Compensation ($)
All industries	363	1,430,118	572,583	100.0	60,357	100.0	507,445	100.0	8,762 2/	105.7 2/	8,293 2/
Manufacturing industries	302	1,366,192	547,041	95.5	49,752	82.4	402,685	79.4	10,181 2/	127.4 2/	7,988 2/
Food and kindred products	16	56,311	22,716	4.0	5,007	8.3	38,883	7.7	4,536	58.4	7,765
Tobacco products	5	6,344	2,535	.4	1,882	3.1	13,365	2.6	1,346	19.0	7,101
Textile mill products	4	-319	170	*	209	.3	1,549	.3	512	11.0	7,411
Apparel	74	52,463	21,019	3.6	14,208	23.5	82,830	16.3	1,479	25.4	5,829
Chemicals, total	56	827,085	330,798	57.7	9,150	15.2	108,387	21.4	36,152	305.2	11,845
Pharmaceuticals	39	708,280	283,287	49.4	6,757	11.2	74,453	14.7	41,925	380.5	11,018
All other chemicals	17	118,804	47,511	8.3	2,393	4.0	33,934	6.7	19,854	140.0	14,180
Rubber products	6	1,461	583	.1	219	.4	1,662	.3	2,789	35.1	7,589
Leather and leather products	7	6,023	2,405	.4	1,363	2.3	8,648	1.7	1,764	27.8	6,344
Fabricated metal products	19	14,844	5,936	1.0	1,099	1.8	9,035	1.8	5,401	65.7	8,221
Electrical and electronic equipment	62	299,725	120,003	20.9	12,482	20.7	104,530	20.6	9,614	114.8	8,374
Scientific instruments	21	41,318	16,516	2.8	2,069	3.4	16,051	3.2	7,982	102.9	7,757
All other manufacturing 3/	29	60,927	24,360	4.2	2,074	3.4	17,746	3.5	11,740	137.3	8,550
Nonmanufacturing industries	61	63,926	25,542	4.4	10,605	17.6	104,760	20.6	2,263 2/	23.4 2/	9,688 2/
Transportation, communications, utilities	7	63,926	15,265	2.6	5,582	9.2	55,215	10.9	2,913	27.7	9,892
Wholesale trade	8	2,500	955	.1	416	.7	3,395	0.7	2,391	29.3	8,161
Retail trade	14	15,046	6,023	1.0	2,683	4.4	25,941	5.1	2,249	23.7	9,669
Finance, insurance, real estate	11	1,710	676	.1	681	1.1	6,084	1.2	992	11.1	8,933
Services	9	3,349	1,334	.2	440	.7	7,360	1.5	3,031	18.1	16,727
Miscellaneous and not available	12	3,146	1,249	.2	803	1.3	6,762	1.3	1,555	18.5	8,420

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1/ Compensation of employees was computed by multiplying 1.203 times payroll. The additional 20.3 percent reflects the employer-paid portion of social security, unemployment insurance, and other non-payroll labor costs. The 20.3 percent is the average for all U.S. manufacturing industries in 1976; see the U.S. Department of Commerce, Survey of Current Business, July 1978, 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.

* Less than .05 percent

Table B-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 a Percent of Compensation of Employees	Average Employee Compensation ($)
All industries	395	941,161	377,256	100.0	49,617	100.0	392,309	100.0	6,164 2/	81.3 2/	7,582 2/
Manufacturing industries	285	896,458	359,414	95.3	37,422	75.4	287,619	73.3	7,566 2/	103.2 2/	7,335 2/
Food and kindred products	16	32,863	13,138	3.5	5,362	10.8	39,450	10.1	2,450	33.3	7,357
Tobacco products	5	5,487	2,271	.6	861	1.7	4,607	1.2	2,638	49.3	5,351
Textile mill products	4	345	168	.0	104	.2	700	.2	1,615	24.0	6,731
Apparel	66	24,096	9,883	2.6	7,409	14.9	40,510	10.3	1,334	24.4	5,477
Chemicals, total	52	573,579	229,243	60.8	8,083	16.3	86,941	22.2	28,361	263.7	10,756
Pharmaceuticals	37	518,326	206,534	54.8	5,953	12.0	59,710	15.2	34,694	345.9	10,030
All other chemicals	15	55,253	22,709	6.0	2,130	4.3	27,231	6.9	10,662	83.4	12,785
Rubber products	10	1,380	532	.1	666	1.3	4,487	1.1	799	11.9	6,737
Leather and leather products	11	6,733	2,695	.7	1,628	3.3	9,259	2.4	1,654	29.1	5,687
Fabricated metal products	18	21,156	8,578	2.3	1,248	2.5	10,429	2.7	6,873	82.3	8,357
Electrical and electronic equipment	57	177,645	71,340	18.9	8,459	17.0	63,674	16.2	8,434	112.0	7,527
Scientific instruments	22	25,912	10,478	2.8	1,956	3.9	13,637	3.5	5,357	76.8	6,972
All other manufacturing	24	27,262	11,088	2.9	1,646	3.3	13,925	3.5	6,736	79.6	8,460
Nonmanufacturing industries	110	44,702	17,842	4.7	12,195	24.6	104,690	26.7	1,326 2/	15.7 2/	8,436 2/
Transportation, communications and utilities	6	28,133	9,312	2.5	4,486	9.0	38,465	9.8	2,076	24.2	8,574
Wholesale trade	8	2,291	916	.2	393	.8	3,957	1.0	2,331	23.1	10,069
Retail trade	52	11,105	4,627	1.2	2,789	5.6	25,579	6.5	1,659	18.1	9,171
Finance, insurance, real estate	15	930	465	.1	869	1.8	7,608	1.9	535	6.1	8,755
Savings and loans	8	785	298	.1	799	1.6	6,924	1.8	373	4.3	8,666
Services	14	-156	1,604	.4	2,282	4.6	18,614	4.7	703	8.6	8,157
Miscellaneous and not available	15	2,399	918	.2	1,376	2.8	10,467	2.7	667	8.8	7,607

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1/ Compensation of employees was computed by multiplying 1.191 times payroll. The additional 19.1 percent reflects the employer-paid portion of social security, unemployment insurance, and other non-payroll labor costs. The 19.1 percent is the average for all U.S. manufacturing industries in 1975; see the U.S. Department of Commerce, Survey of Current Business, July 1978, 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.

Table B-7

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 a Percent of Compensation of Employees	Average Employee Compensation ($)
All industries	379	586,887	265,495	100.0	49,976	100.0	355,415	100.0	4,567 2/	64.8 2/	7,051 2/
Manufacturing industries	257	561,350	251,606	94.8	38,187	76.4	261,593	73.6	5,609 2/	81.5 2/	6,878 2/
Food and kindred products	17	28,635	12,125	4.6	4,803	9.6	32,689	9.2	2,524	37.1	6,806
Tobacco products	6	12,472	4,937	1.9	1,435	2.9	9,215	2.6	3,440	53.6	6,442
Textile mill products	4	-67,136	199	.1	2,492	5.0	19,314	5.4	80	1.0	7,750
Apparel	64	27,823	11,820	4.5	9,534	19.1	51,270	14.4	1,240	23.1	5,378
Chemicals, total	32	371,490	146,918	55.3	5,378	10.8	53,430	15.0	27,318	275.0	9,935
Pharmaceuticals	24	321,941	127,094	47.9	3,750	7.5	33,608	9.5	33,892	378.2	8,962
All other chemicals	8	49,549	19,824	7.5	1,628	3.3	19,822	5.6	12,177	100.0	12,176
Rubber products	12	2,158	922	.3	644	1.3	3,894	1.1	1,432	23.7	6,047
Leather and leather products	12	4,121	1,775	.7	1,482	3.0	7,836	2.2	1,198	22.7	5,287
Fabricated metal products	18	17,382	6,981	2.6	1,123	2.2	7,854	2.2	6,216	88.9	6,994
Electrical and electronic equipment	49	102,125	40,789	15.4	7,357	14.7	49,090	13.8	5,544	83.1	6,673
Scientific instruments	18	20,169	8,058	3.0	2,063	4.1	12,042	3.4	3,906	66.9	5,837
All other manufacturing 3/	25	42,111	17,082	6.4	1,876	3.8	14,959	4.2	9,106	114.2	7,974
Nonmanufacturing industries	122	25,536	13,889	5.2	11,789	23.6	93,823	26.4	1,051 2/	13.8 2/	7,632 2/
Transportation, communications and utilities	4	14,759	5,973	2.2	4,170	8.3	37,113	10.4	1,432	16.1	8,900
Wholesale trade	6	1,064	445	.2	236	.5	2,250	.6	1,886	19.8	9,534
Finance, insurance, real estate	8	1,362	578	.2	241	.5	2,137	.6	2,398	27.0	8,867
Services	10	-761	465	.2	1,086	2.2	8,117	2.3	428	5.7	7,474
Miscellaneous and not available 4/	94	9,112	6,428	2.4	6,056	12.1	44,206	12.4	1,061	14.5	7,300

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-3 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-8

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 a Percent of Compensation of Employees	Average Employee Compensation ($)
All industries	232	190,463	70,899	100.0	19,663	100.0	116,945	100.0	2,118 2/	35.3 2/	6,001 2/
Manufacturing industries	193	156,765	68,561	96.7	17,734	90.1	102,774	87.8	2,287 2/	38.9 2/	5,871 2/
Food and kindred products	9	5,907	2,299	3.2	871	4.4	5,724	4.8	2,639	40.2	6,572
Tobacco products	5	2,339	918	1.2	562	2.8	2,870	2.4	1,633	32.0	5,107
Textile mill products	11	-7,200	128	.1	2,949	14.9	14,767	12.6	43	.9	5,007
Apparel	53	9,538	4,292	6.0	5,107	25.9	27,034	23.1	840	15.9	5,294
Chemicals, total	26	108,220	45,919	64.7	2,095	10.6	15,067	12.8	21,918	304.8	7,192
Pharmaceuticals	17	99,315	42,357	59.7	1,555	7.9	11,233	9.6	27,239	377.1	7,224
All other chemicals	9	8,905	3,562	5.0	540	2.7	3,834	3.3	6,596	92.9	7,100
Rubber products	10	2,016	767	1.0	545	2.7	3,088	2.6	1,407	24.8	5,666
Leather and leather products	11	2,396	948	1.3	947	4.8	4,902	4.1	1,001	19.3	5,176
Fabricated metal products	13	3,476	1,382	1.9	491	2.4	3,179	2.7	2,815	43.5	6,475
Electrical and electronic equipment	26	22,241	8,745	12.3	2,920	14.8	18,315	15.6	2,995	47.7	6,272
Scientific instruments	12	5,219	2,011	2.8	483	2.4	2,985	2.5	4,164	67.4	6,180
All other manufacturing 3/	17	2,613	1,152	1.6	764	3.9	4,843	4.1	1,508	23.8	6,339
Nonmanufacturing industries	39	33,698	2,338	3.2	1,929	9.8	14,171	12.1	1,007 2/	14.7 2/	6,853 2/
Wholesale trade	5	29,345	343	.4	338	1.7	2,654	2.2	1,015	12.9	7,852
Finance, insurance, real estate	7	2,031	812	1.1	202	1.0	1,626	1.3	4,020	49.9	8,050
Services	9	534	378	.5	566	2.8	4,279	3.6	668	8.8	7,560
Miscellaneous and not available 4/	18	1,788	805	1.1	823	4.2	5,612	4.8	978	14.3	6,819

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-4 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-9

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

Size of Tax Expenditure per Employee	Number of Corporations	Net 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 a Percent of Compensation of Employees	Average Employee Compensation ($)
All corporations	363	1,430,118	572,583	100.0	60,357	100.0	507,445	100.0	8,762 2/	105.7 2/	8,293 2/
$ 100,000 or more	10	236,563	94,619	16.5	744	1.2	10,846	2.1	127,176	872.4	14,578
$ 50,000 under $100,000	15	309,350	123,732	21.6	1,726	2.9	19,829	3.9	71,687	624.0	11,488
$ 10,000 under $ 50,000	80	596,726	238,642	41.7	12,458	20.6	132,370	26.1	19,156	180.3	10,625
$ 5,000 under $ 10,000	43	100,509	40,174	7.0	5,916	9.8	50,845	10.0	6,791	79.0	8,594
$ 1,000 under $ 5,000	124	169,794	67,844	11.8	25,254	41.8	190,518	37.5	2,686	35.6	7,544
$ 500 under $ 1,000	50	15,710	6,254	1.1	8,658	14.3	64,977	12.8	722	9.6	7,505
$ 100 under $ 500	24	3,282	1,297	.2	4,234	7.0	29,509	5.8	306	4.4	6,970
$ 1 under $ 100	6	60	21	*	593	1.0	3,541	.7	35	.6	5,971
Loss corporations	11	-1,876	-	-	774	1.3	5,009	1.0	-	-	6,472

Office of the Secretary of the Treasury
Office of Tax Analysis

1/ Compensation of employees was computed by multiplying 1.203 times payroll. The additional 20.3 percent reflects the employer-paid portion of social security, unemployment insurance, and other non-payroll labor costs. The 20.3 percent is the average for all U.S. manufacturing industries in 1976; see the U.S. Department of Commerce, Survey of Current Business, July 1978, 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-5.

* Less than 0.05 percent

Table B-10

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 a Percent of Compensation of Employees	Average Employee Compensation ($)
All corporations	395	941,161	377,256	100.0	49,617	100.0	392,309	100.0	6,164 2/	81.3 2/	7,582 2/
$100,000 or more	6	73,694	29,477	7.8	229	.5	2,464	.6	128,721	1,196.3	10,760
$ 50,000 under $100,000	16	283,096	113,242	30.0	1,605	3.2	17,630	4.5	70,556	642.3	10,984
$ 10,000 under $ 50,000	54	328,239	130,122	34.5	6,026	12.1	55,213	14.1	21,593	235.7	9,162
$ 5,000 under $ 10,000	41	128,577	51,418	13.6	6,831	13.8	67,726	17.3	7,527	75.9	9,915
$ 1,000 under $ 5,000	144	128,115	46,999	12.5	18,784	37.9	135,453	34.5	2,502	34.7	7,211
$ 500 under $ 1,000	39	9,068	3,585	1.0	4,810	9.7	31,091	7.9	745	11.5	6,464
$ 100 under $ 500	35	5,863	2,345	.6	7,067	14.2	52,730	13.4	332	4.4	7,461
$ 1 under $ 100	8	459	68	*	981	2.0	6,265	1.6	69	1.1	6,386
Loss corporations	52	-15,949	-	-	3,284	6.6	23,738	6.1	-		

Office of the Secretary of the Treasury
Office of Tax Analysis

1/ Compensation of employees was computed by multiplying 1.191 times payroll. The additional 19.1 percent reflects the employer-paid portion of social security, unemployment insurance, and other non-payroll labor costs. The 19.1 percent is the average for all U.S. manufacturing industries in 1975; see the U.S. Department of Commerce, Survey of Current Business, July 1978, 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-6.

* Less than .05 percent

Table B-11

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 ($000)	Tax Expenditure		Employees		Compensation of Employees 1/		Tax Expenditure Per Employee ($)	Tax Expenditure as a Percent of Compensation of Employees	Average Employee Compensation ($)
			Amount ($000)	Percent of Total	Number	Percent of Total	Amount ($000)	Percent of Total			
All corporations	379	586,887	265,495	100.0	49,976	100.0	355,415	100.0	4,567 2/	64.8 2/	7,051 2/
$ 50,000 or more	11	159,709	63,884	24.1	933	1.9	8,999	2.5	68,472	709.9	9,645
$ 10,000 under $ 50,000	39	311,328	123,606	46.6	5,634	11.3	54,802	15.4	21,939	225.6	9,720
$ 5,000 under $ 10,000	33	54,770	21,882	8.2	2,938	5.9	22,144	6.2	7,448	98.8	7,537
$ 1,000 under $ 5,000	135	126,607	50,420	19.0	21,407	42.8	142,013	40.0	2,355	35.5	6,634
$ 500 under $ 1,000	37	8,380	3,378	1.3	4,363	8.7	24,553	6.9	774	13.8	5,627
$ 100 under $ 500	40	6,288	2,264	.9	7,345	14.7	51,714	14.6	308	4.4	7,041
$ 1 under $ 100	14	3,710	61	*	1,469	2.9	9,015	2.5	41	.7	6,137
Loss corporations	70	-83,905	-	-	5,887	11.8	42,176	11.9	-	-	7,153

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-3 and tax expenditure in Table B-7.

* Less than .05 percent

Table B-12

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 ($000)	Tax Expenditure		Employees		Compensation of Employees 1/		Tax Expenditure Per Employee ($)	Tax Expenditure as a Percent of Compensation of Employees	Average Employee Compensation ($)
			Amount ($000)	Percent of Total	Number	Percent of Total	Amount ($000)	Percent of Total			
All corporations	232	190,463	70,899	100.0	19,663	100.0	116,945	100.0	2,118	35.3 2/	6,001 2/
$ 50,000 or more	10	73,732	29,493	41.6	433	2.2	3,544	3.0	68,113	832.2	8,184
$ 10,000 under $ 50,000	19	42,472	16,903	23.8	960	4.9	6,694	5.7	17,607	252.5	6,973
$ 5,000 under $ 10,000	14	25,147	10,028	14.1	1,288	6.6	7,347	6.3	7,786	136.5	5,704
$ 1,000 under $ 5,000	75	28,944	11,408	16.1	4,877	24.8	29,744	25.5	2,453	40.2	6,099
$ 500 under $ 1,000	26	5,635	2,244	3.2	2,952	15.0	16,912	14.5	760	13.3	5,729
$ 100 under $ 500	28	2,156	799	1.1	2,693	13.7	15,499	13.3	289	5.0	5,755
$ 1 under $ 100	16	28,848	45	.1	1,175	6.0	6,754	5.8	38	.7	5,748
Loss corporations	44	-16,470	—	—	5,285	26.8	30,450	26.0	—	—	5,761

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-4 and tax expenditure in Table B-8.

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

Form **1120**

Department of the Treasury
Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 1977 or other taxable year beginning ...., 1977, ending ...., 19........

(PLEASE TYPE OR PRINT)

1977

Check if a—

A Consolidated return ☐

B Personal Holding Co. ☐

C Business Code No. (See Page 8 of instructions)

Use IRS label. Otherwise print or type.

Name

Number and street

City or town, State, and ZIP code

D Employer identification number

E Date incorporated

F Enter total assets from line 14, column (D), Schedule L (See specific Instructions)

$

IMPORTANT—Fill in all applicable lines and schedules. If the lines on the schedules are not sufficient, see instruction N.

GROSS INCOME

1	Gross receipts or gross sales.................................... **Less:** Returns and allowances....................................	1
2	**Less:** Cost of goods sold (Schedule A) and/or operations (attach schedule)	2
3	Gross profit	3
4	Dividends (Schedule C)	4
5	Interest on obligations of the United States and U.S. instrumentalities	5
6	Other interest	6
7	Gross rents	7
8	Gross royalties	8
9	(a) Capital gain net income (attach separate Schedule D)	9(a)
	(b) Net gain or (loss) from line 9, Part II, Form 4797 (attach Form 4797)	9(b)
10	Other income (see instructions—attach schedule)	10
11	TOTAL income—Add lines 3 through 10	11

DEDUCTIONS

12	Compensation of officers (Schedule E)	12
13	Salaries and wages (not deducted elsewhere)	13
14	Repairs (see instructions)	14
15	Bad debts (Schedule F if reserve method is used)	15
16	Rents	16
17	Taxes (attach schedule)	17
18	Interest	18
19	Contributions **(not over 5% of line 30 adjusted per instructions—attach schedule)**	19
20	Amortization (attach schedule)	20
21	Depreciation from Form 4562 (attach Form 4562) ...., less depreciation claimed in Schedule A and elsewhere on return ...., Balance ▶	21
22	Depletion	22
23	Advertising	23
24	Pension, profit-sharing, etc. plans (see instructions) (enter number of plans ▶ ....)	24
25	Employee benefit programs (see instructions)	25
26	Other deductions (attach schedule)	26
27	TOTAL deductions—Add lines 12 through 26	27
28	Taxable income before net operating loss deduction and special deductions (line 11 less line 27)	28
29	**Less:** (a) Net operating loss deduction (see instructions—attach schedule) . . 29(a)	
	(b) Special deductions (Schedule I) . . 29(b)	
30	Taxable income (line 28 less line 29)	30

TAX

31	TOTAL TAX (Schedule J)	31
32	**Credits:** (a) Overpayment from 1976 allowed as a credit	
	(b) 1977 estimated tax payments	
	(c) Less refund of 1977 estimated tax applied for on Form 4466 . ( )	
	(d) Tax deposited with Form 7004 (attach copy)	
	(e) Tax deposited with Form 7005 (attach copy)	
	(f) Credit from regulated investment companies (attach Form 2439)	
	(g) U.S. tax on special fuels, nonhighway gas and lubricating oil (attach Form 4136)	
33	TAX DUE (line 31 less line 32). See instruction G for depositary method of payment	33
34	OVERPAYMENT (line 32 less line 31)	34
35	Enter amount of line 34 you want: **Credited to 1978 estimated tax ▶** **Refunded ▶**	35

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. Declaration of preparer (other than taxpayer) is based on all information of which the preparer has any knowledge.

▶ Signature of officer Date

▶ Paid preparer's signature and identifying number (see instructions)

▶ Title

▶ Paid preparer's address (or employer's name, address and identifying number)

Schedule L Balance Sheets

ASSETS	Beginning of taxable year (A) Amount	(B) Total	End of taxable year (C) Amount	(D) Total
1 Cash				
2 Trade notes and accounts receivable				
(a) Less allowance for bad debts				
3 Inventories				
4 Gov't obligations: (a) U.S. and instrumentalities				
(b) State, subdivisions thereof, etc.				
5 Other current assets (attach schedule)				
6 Loans to stockholders				
7 Mortgage and real estate loans				
8 Other investments (attach schedule)				
9 Buildings and other fixed depreciable assets				
(a) Less accumulated depreciation				
10 Depletable assets				
(a) Less accumulated depletion				
11 Land (net of any amortization)				
12 Intangible assets (amortizable only)				
(a) Less accumulated amortization				
13 Other assets (attach schedule)				
14 Total assets				
LIABILITIES AND STOCKHOLDERS' EQUITY				
15 Accounts payable				
16 Mtges., notes, bonds payable in less than 1 yr.				
17 Other current liabilities (attach schedule)				
18 Loans from stockholders				
19 Mtges., notes, bonds payable in 1 yr. or more				
20 Other liabilities (attach schedule)				
21 Capital stock: (a) Preferred stock				
(b) Common stock				
22 Paid-in or capital surplus				
23 Retained earnings—Appropriated (attach sch.)				
24 Retained earnings—Unappropriated				
25 Less cost of treasury stock		( )		( )
26 Total liabilities and stockholders' equity				

Schedule M-1 Reconciliation of Income Per Books With Income Per Return

1 Net income per books		7 Income recorded on books this year not included in this return (itemize) (a) Tax-exempt interest $	
2 Federal income tax			
3 Excess of capital losses over capital gains			
4 Income subject to tax not recorded on books this year (itemize)			
5 Expenses recorded on books this year not deducted in this return (itemize) (a) Depreciation . . . . $ (b) Depletion . . . . . $		8 Deductions in this tax return not charged against book income this year (itemize) (a) Depreciation . . $ (b) Depletion . . $	
6 Total of lines 1 through 5		9 Total of lines 7 and 8	
		10 Income (line 28, page 1)—line 6 less 9	

Schedule M-2 Analysis of Unappropriated Retained Earnings Per Books (line 24 above)

1 Balance at beginning of year		5 Distributions: (a) Cash	
2 Net income per books		(b) Stock	
3 Other increases (itemize)		(c) Property	
		6 Other decreases (itemize)	
4 Total of lines 1, 2, and 3		7 Total of lines 5 and 6	
		8 Balance at end of year (line 4 less 7)	

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)	(03)		(c) Property	(03)	
	(04)		6. Other decreases (itemize, use rider if necessary)	(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.)		Name of U.S. possession in which trade or business was actively conducted	Periods in which trade or business was actively conducted in a U.S. possession (Dates are inclusive)	
Beginning (a)	Ending (b)	(c)	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.

Department of the Treasury
Washington, D.C. 20220

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