The Operation and Effect of the Possessions Corporation System of Taxation

Third Annual Report

Department of the Treasury

June 1980

The Operation and Effect of the Possessions Corporation System of Taxation

THIRD ANNUAL REPORT

Department of the Treasury

June 1980

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THE SECRETARY OF THE TREASURY
WASHINGTON

30 JUN 1980

Dear Mr. Chairman:

The Report of the Committee on Finance 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 third (1978) annual report entitled, "The Operation and Effect of the Possessions Corporation System of Taxation."

A similar letter is being sent to Senator Russell B. Long, Chairman of the Committee on Finance.

Best wishes.

Sincerely,

G. William Miller

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

Enclosure

ERRATA

Page 28, 2nd paragraph, line 8:	The word "over" should be deleted.
Page 43, 2nd paragraph, line 3:	Forty-four percent of these retained earnings, or $3.3 billion, 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 chemical industry, NOT the pharmaceutical industry.
Page 64, 3rd paragraph, line 4:	Dividend distributions by possessions corporations were $1.15 billion 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 4.1 percent, NOT 4.5 percent.
Page 71, Note:	Dollar amounts are in thousands.

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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 1

INTRODUCTION AND SUMMARY

This is the third annual report to the Congress on the possessions corporation system of taxation. Possessions corporations are companies incorporated in the United States 1/ but exempt under section 936 and related provisions of the U.S. Internal Revenue Code from Federal tax on income from operations in Puerto Rico, American Samoa, or Guam. 2/ Possessions corporations operate primarily in Puerto Rico, where they are typically exempt from tax on 90-100 percent of their income. The percentage of their exemption will, however, decline somewhat over time, as provided by the Puerto Rico Industrial Incentive Act of 1978.

Table 1 shows that the estimated Federal tax expenditure for the possessions corporation provisions was $826 million in calendar year 1978, and is projected to be $1 billion in calendar year 1981. Over 99 percent of this tax expenditure is attributable to Puerto Rico.

The provisions and legislative history of the possessions corporation system of taxation are reviewed in Chapter 2. The treatment of possessions corporations under pre-1976 law and the changes made by the Tax Reform Act of 1976 are summarized. The 1976 changes affected primarily possessions corporations' dividend pay-out policies and their portfolio investments, not the level of their real investment in Puerto Rico. Congress left intact the effective exemption from Federal tax on income from operations in a possession for the stated purpose of "assist[ing] the U.S. possessions in obtaining employment-producing investments by U.S. corporations..." 3/

1/ Although Puerto Rico, American Samoa, and Guam are included in some definitions of the United States, for convenience of exposition the term "United States" in this Report inclues only the fifty States and the District of Columbia.

2/ Until October 1, 1979, section 936 also applied to operations in the Panama Canal Zone.

3/ <u>General Explanation of the Tax Reform Act of 1976</u>, page 274.

Table 1

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	Reduction in Fiscal Year Tax Liabilities 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	612	602	3	492	489	3
1977	675	658	4	641	637	4
1978	826	822	4	743	739	4
1979	863	859	4	842	838	4
1980	949	945	4	902	898	4
1981	1,044	1,040	4	992	988	4
1982	1,149	1,144	5	1,091	1,086	5
1983	1,264	1,259	5	1,201	1,196	5
1984	1,390	1,385	5	1,320	1,315	5
1985	1,529	1,524	5	1,453	1,448	5

Office of the Secretary of the Treasury
Office of Tax Analysis

1/ The 1973 through 1975 figures are estimates based on book income data taken primarily from election forms (Form 5712). The 1976 and 1977 estimates are based on net income data taken primarily from Federal income tax forms (Form 1120). The 1978 figures are based on qualified possession taxable income taken from possessions credit computation forms (Form 5735). Figures for 1979 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 on income of 936 manufacturing firms; 936 non-manufacturing firms are assumed to pay an effective Puerto Rican income tax of at least 38 percent. Note that the section 936 credit, which applies in 1976 and subsequent years, is based on tax liabilities computed without regard to tax preferences, such as the investment tax credit, and without 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.

To put the economic activities of possessions corporations in perspective, Chapter 3 provides a brief overview of the development of the Puerto Rican economy between 1947 and the present. From 1947 to 1972, Puerto Rico achieved an average annual growth rate of 6 percent in real terms. Manufacturing rose from 9 percent of total employment in 1950 to 19 percent in 1970, the same share that it provided in 1979. In the 1950's and 1960's, the dual attraction of tax exemption and low wages induced large U.S. investment in labor-intensive industries, such as apparel, leather goods, and tobacco products. However, as Puerto Rican wages have risen relative to the U.S. average and structural changes in the world economy have increased the attractiveness to U.S. investors of low-wage foreign countries, the kind of firms investing in Puerto Rico has changed. Between 1968 and 1979, there was a shift in the manufacturing sector from labor-intensive industries toward high technology industries. The unemployment rate, after declining to 10 percent in 1970, rose sharply to almost 20 percent in fiscal year 1977. Although the Puerto Rican economy has recovered substantially from the 1973-1977 recession, with real GNP growing at an annual rate of roughly 5 percent in 1978 and 1979, unemployment stood at 17 percent of the labor force in 1979.

Chapter 4 relates the estimated tax expenditure on the possessions corporation system of taxation to the amount of employment and investment of possessions corporations in Puerto Rico. Largely because of the change in the industry composition of possessions corporations -- from the traditional, labor-intensive industries to the high-technology industries -- the tax expenditure per Puerto Rican employee rose from $2,300 in 1973 to $12,700 in 1978. As of year-end 1978, the book value of real investment in Puerto Rico by all 936 manufacturing firms was $1.2 billion. Whether a scaling back of the possessions corporation system of taxation would actually lead to a reduction in Puerto Rican employment and investment and/or increased tax collections by the Federal or Commonwealth governments depends on how possessions corporations would respond to changes in the tax law.

The Tax Reform Act of 1976 limited a possessions corporation's tax exemption to income earned in the possession in which an active trade or business was conducted, with income earned elsewhere subject to the normal U.S. tax rates. The main effect of this limitation was to induce possessions corporations to bring to Puerto Rico the large pool of funds that had been invested in the Eurodollar market. Chapter 5 expands the analysis in previous <u>Annual Reports</u> of the impact of this pool of funds -- <u>approximately $5 billion</u> at year-end 1979 -- on real investment in Puerto Rico. The Chapter first reviews the

U.S. and Puerto Rican legislation which determines the investments that are exempt from both U.S. and Puerto Rican tax. This review includes a description of the Puerto Rican regulations governing banks' use of 936 funds that were in effect before April 1, 1980, and also a description of the new regulations that are designed to remedy the shortcomings of the old ones.

Chapter 5 then proceeds with a statistical analysis of the impact of 936 funds on investment in plant and equipment, housing, and inventories in Puerto Rico. It concludes that the large inflow of financial assets of possessions corporations after the enactment of section 936 had a virtually imperceptible impact on net capital flows into Puerto Rico. While there was a large inflow of 936 assets, there were offsetting flows out of Puerto Rico, mainly through the banking system. A review of the ways in which banks in Puerto Rico have used 936 deposits, which amounted to 34 percent of all commercial bank deposits at the end of 1979, finds that bank loans grew much more slowly than the rate of growth in assets made possible by the inflow of 936 deposits. The impact of 936 funds on the market for Commonwealth of Puerto Rico debt is compared with the impact on the market for U.S. government-guaranteed securities backed by Puerto Rican mortgages (GNMAs). The effect on the GNMA market was much more significant because they normally carry a high yield similar to other taxable issues, and the supply of Puerto Rican source GNMA's is small compared to the pool of 936 funds. The Chapter concludes that it will be difficult for Puerto Rico to absorb the large volume of 936 funds because there will be a tendency for money to flow out to areas with a higher rate of return. The new banking regulations may, however, reduce this outflow to some degree.

Appendix A of this Report describes the possessions corporation 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.

CHAPTER 2

UNITED STATES AND PUERTO RICAN TAX LAW

I. Introduction

The possessions corporation system of taxation consists of a complex set of rules under which a U.S. manufacturing corporation deriving most of its income from Puerto Rico typically pays less than 5 percent of that income in taxes to either Puerto Rico or the United States. The system is complex because, in principle, both the income earned by a "936" corporation and the dividends paid to its shareholders (typically a U.S. parent corporation) are taxable in Puerto Rico and in the United States. The Puerto Rican rules for exempting part or all of the 936's income from tax and for reducing the "tollgate" tax on dividends paid to a U.S. parent vary according to whether the 936 corporation was awarded an exemption grant before or after June 1978. Moreover, corporations with "old" exemption grants had the option until December 31, 1979, to petition to "convert" from total to partial exemption and be subject to tax under rules which differ from the terms of either the old or the new exemption grants.

Like other U.S. corporations, a 936 corporation is subject to Federal tax on its worldwide income. However, a special credit available under section 936 fully offsets the Federal tax on income from a trade or business in Puerto Rico or from "qualified possession source investment income" (QPSII). A U.S. parent corporation can, in turn, offset a dividend received from a wholly owned 936 subsidiary with a 100 percent dividends-received deduction, which removes the dividend income from Federal tax. The particular way in which the near total exemption from Puerto Rican and Federal taxes is structured directly affects the form and substance of a 936's behavior, so these rules need to be described in some detail.

II. United States Tax Provisions

A. Historical Background

Puerto Rico has primary jurisdiction to tax Puerto Rican source income; the United States has secondary jurisdiction to tax the Puerto Rican source income of U.S. citizens, residents and corporations. However, because the Puerto Rican rules have been fashioned to take maximum advantage of the Federal rules and have changed when the Federal rules have changed, the Federal rules should be described first.

The predecessor of section 936 appears in the Revenue Act of 1921. As first introduced into the House of Representatives out of the Ways and Means Committee, the bill exempted from Federal tax the foreign source income of U.S. "foreign traders" and "foreign trade corporations," which were defined to be U.S. citizens and corporations, 80 percent or more of whose gross income was derived from foreign sources. The United States taxed the foreign income of U.S. citizens and corporations as it was earned, while English law deferred taxation on foreign source income until it was remitted to England. 1/ Thus, U.S. taxpayers doing business in countries that imposed little or no income tax felt that they were handicapped in their business competition with British rivals. The bill as originally proposed would have resolved this problem by exempting from U.S. tax the unrepatriated foreign source income of "foreign traders" and "foreign trade corporations." 2/

On the floor of the House, the benefits of the "foreign trader" exemption were restricted to individuals and corporations which, in addition to deriving 80 percent or more of their income from abroad, derived 50 percent or more of their income from "the active conduct of a trade or business without the United States." The purpose of this amendment was to target the benefits of tax exemption on U.S. businesses and make it more difficult for wealthy Americans with investments in foreign securities to qualify as "foreign traders."

1/ A U.S. firm or a U.S. citizen abroad normally pays taxes to two countries: by virtue of its place of incorporation or citizenship, the taxpayer is subject to U.S. tax on its worldwide income; by virtue of the source of its income, it is also taxed by the host country. To relieve double taxation, the United States allows a dollar-for-dollar foreign tax credit against U.S. tax on foreign source income, so that in effect the taxpayer is subject to tax at a rate which equals the greater of the foreign tax or the U.S. tax on its foreign source income. In contrast, a British corporation or expatriate citizen deriving its income from a foreign country was normally subject to tax only by the host country as long as that income was not brought back to Great Britain.

2/ Under U.S. law, foreign incorporation also defers the taxation of foreign source income until profits are remitted to the U.S. However, U.S. companies at the time generally preferred not to incorporate subsidiaries under foreign laws; foreign operations were typically conducted through either a branch of the U.S. parent or a U.S.-chartered subsidiary.

When the 1921 Revenue Bill was introduced in the Senate, the "foreign trader" exemption was struck. Many Senators could see no reason to depart from established national policy of taxing citizens and domestic corporations based on their ability to pay, regardless of the source of their income. Various Senators stated that while there might be some reason to promote U.S exports, there was no reason to promote U.S. foreign investment, since that would increase employment and wealth abroad at the expense of jobs and development in the United States. Moreover, the exemption created vast opportunities for tax avoidance since any individual or firm having a large foreign business could organize a separate corporation for the foreign business and ensure that 80 percent of the profits of that corporation were derived from foreign sources.

The strongest pressure for the exemption came from U.S. firms and citizens doing business in the Philippines, which at that time was a possession of the United States. To protect those interests, the Senate Finance Committee reintroduced the exemption in a form which reduced its coverage from all "foreign traders" and "foreign trade corporations" to individuals and corporations deriving 80 percent or more of their gross income from a U.S. possession. When the provision reached the floor of the Senate, various Senators proposed to extend the exemption also to taxpayers who met the 80 percent gross income test in China. Supporters of the exemption argued that it would encourage U.S. export trade to the Far East from the U.S. base in the Philippines and would encourage U.S. business with China. One Senator expressed his opinion that:

> "All the amendment means is that an American doing business in the Philippines or Puerto Rico or in China shall not be compelled to pay two taxes, while the British merchant in Hong Kong or in Shanghai doing the same business is only compelled to pay one tax." 3/

As finally enacted in the Revenue Act of 1921, the exemption covered all foreign source income of individuals and corporations which met the 80-50 gross income tests in a possession other than

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3/ 61 Congressional Record, p. 6997.

the Virgin Islands. 4/ However, dividend payments received from a "possessions corporation" by a U.S. shareholder were taxable to the shareholder. The effect of these two provisions was to defer U.S. tax on the foreign source income of a possessions corporation until it was repatriated. A possessions corporation was taxed under the U.S. law of 1921 as if it were a foreign corporation, and received the same benefits of tax deferral as enjoyed under British law by its British rivals in the Philippines and elsewhere.

The possessions corporation exemption continued unchanged from 1921 until 1976. Between 1973 and 1976, the Ways and Means Committee held extensive hearings on the subject of tax reform. The Committee considered repeal of the possessions corporation exemption on the grounds that its original purpose, to expand U.S. trade with the Philippines and the Far East, was no longer being served as the Philippines had ceased to be a U.S. possession. However, proponents of the exemption argued that the possessions corporation system was "the backbone of Puerto Rico's development." 5/ Many U.S. firms had established plants to avail themselves of tax exemption provisions enacted by Puerto Rico in 1948, and these tax-exempt firms were a primary source of jobs in Puerto Rican manufacturing industries. It was argued that the possessions corporation system of taxation counteracted the minimum wage requirement, the requirement to use U.S. flag ships in transporting goods to the United States, and other Federally imposed requirements, and that through the possessions corporation system could Puerto Rico compete with neighboring countries as a site for U.S. investment. Finally, it was argued that the possessions corporation system cost the Federal government

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4/ Why U.S. corporations doing business in the Virgin Islands were denied the benefits of the exemption is not explained by the Congressional Record. Congress in 1921 also denied the benefits of this exemption to U.S. taxpayers in China, pending consideration of a second bill dealing only with China. As enacted in 1922, the China Trade Act exempted qualified corporations from U.S. tax on income from China, Hong Kong, and certain neighboring areas. This exemption was phased out by the Tax Reform Act of 1976.

5/ Public Hearings before the Committee on Ways and Means, House of Representatives, 94th Congress, 1st Session, p. 1654. See also Public Hearings before the Committee on Ways and Means, House of Representatives, 93rd Congress, 1st Session, March 30 - April 2, 1973, pp. 4447-4451.

only $200 - $300 million a year in tax expenditure, 6/ a small price in comparison to the $2 billion spent by the Federal government in direct grants and transfer payments to Puerto Rico. 7/

B. Present Law 8/

Under present Federal law, a possessions corporation must be a U.S. corporation and for the three most recent years have derived 50 percent or more of its gross income from the active conduct of a trade or business in a possession and 80 percent or more of such income from sources in a possession. A corporation meeting those conditions may elect the benefits of section 936. The election may not be revoked for 10 years without the permission of the IRS; as long as the election is in effect, the 936 corporation cannot join affiliated domestic corporations in filing a consolidated return. 9/

A corporation meeting these requirements may claim a credit equal to (and, thus, fully offsetting) the U.S. tax attributable to:

6/ In January 1976, the Federal tax expenditure as a result of the possessions corporation system were estimated at $285 million on the basis of the limited data then available. (See the Special Analysis of the Budget of the United States Government for Fiscal Year 1977, "Special Analysis F, Tax Expenditure," January 1976.) When tax return data on possessions corporations became available as a result of a filing requirement enacted in 1976, the FY 1977 tax expenditure estimate was revised, from $285 million to $663 million. As indicated in Table 1 above, the estimate based on the 1977 returns is $641 million.

7/ See Table 5 on page 29 below for a tabulation of Federal direct aid to Puerto Rico in FY 1977 and 1978.

8/ This Section summarizes U.S. tax rules governing possessions corporations. For a fuller discussion of these rules and a comparison with the taxation of U.S.-owned branches and subsidiaries in foreign countries, see the Second Annual Report, pp. 8-23.

9/ The inability to join a consolidated return means that a loss incurred by a 936 corporation cannot be offset against the income of an affiliated domestic corporation.

-- income from the active conduct of a trade or business in a possession, or from the sale or exchange of substantially all of the assets used by the corporation in the active conduct of such trade or business; and

-- Qualified Possession Source Investment Income (QPSII), which is non-business income derived from the possession in which the corporation has its trade or business 10/ and which is attributable to the investment of funds derived from such trade or business.

The section 936 credit is not available for other income earned by a possessions corporation. However, the regular foreign tax credit may be claimed for foreign (including possession) taxes paid or accrued with respect to income which does not qualify for the 936 credit.

Prior to 1976, dividends paid by possessions corporations were fully taxable to a U.S. shareholder, but amounts received upon liquidation of a possessions corporation were exempt from tax. As a consequence, possessions corporations often accumulated substantial earnings outside the United States in anticipation of a tax-free liquidation. To accelerate the repatriation of earnings, Congress in 1976 allowed U.S. parent corporations to claim a dividends-received deduction for dividends from a 936 corporation. If the 936 is a wholly owned subsidiary (as most are), the deduction equals 100 percent of such income, and, thus, the dividend is free of any U.S. tax. Because the U.S. parent qualifies for a dividends-received deduction, it is denied any foreign tax credit for "tollgate" taxes imposed by Puerto Rico on such dividends (see below).

10/ The requirement that QPSII must be derived from the possession in which the corporation has its trade or business means that a possessions corporation with a trade or business in Puerto Rico cannot convert interest on Eurodollar deposits into possession source income by routing such deposits through a Guamanian bank. Such had been the practice prior to 1976 under section 931.

III. Puerto Rican Tax Provisions

A. Historical Background

The modern history of industrial tax exemption in Puerto Rico begins with the Industrial Tax Exemption Act of 1948. Prior to that year, Puerto Rico's development strategy stressed government ownership and operation of key industries, such as cement, glass, paperboard, and shoes. When the financial burden of such a program was 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 Tax Exemption Act of 1948 offered qualified firms an exemption from income, property and municipal taxes. To qualify for exemption, a manufacturing firm had to produce an item which was not produced on a commercial scale in Puerto Rico prior to 1947, or certain other specified items, including wearing apparel and processed food products. Qualified firms also included hotels. In other legislation enacted in 1948, Puerto Rico exempted from excise tax all raw materials, machinery, and equipment used in manufacturing for export or sold to other manufacturers in Puerto Rico.

In the early 1950's many manufacturing firms established plants in Puerto Rico to benefit from the tax holiday. Apparel was the fastest growing industry, but shoes and other leather goods and assembly of mechanical, electrical and electronic devices were also important. Originally, Puerto Rico contemplated that the period of total exemption would end in 1959, with the amount of exempt income falling to 75 percent, 50 percent, and 25 percent in 1959, 1960 and 1961, respectively. All exemptions were to end in 1962. However, by 1954, the provisions for a 1959-1961 phase-out reduced the incentive for new industries to establish operations in Puerto Rico, and the Industrial Tax Exemption Act was amended.

The 1954 Act provided for a 10-year exemption for new applicants. Because some of the established firms in Puerto Rico were approaching the end of their tax holidays, but a new applicant could qualify for a ten-year exemption, the 1954 Act sought to limit the ability of an old firm to obtain a new grant. If a firm received a new grant of exemption for a product produced under an old grant, the new grant would be terminated if the level of output in the predecessor operation was reduced. In addition, plant, equipment, and other property that had been used in the production of an exempted product could not be used by another enterprise to produce a similar exempt product. Both prohibitions were weakened in 1969, and the Governor had the power to waive them if he deemed it to be in the public interest.

Puerto Rico adopted a third tax exemption act in 1963, which authorized exemptions for 10, 12, 15, 17, or 25 years, depending on the degree of economic development of the zone in which the plant was located. (The number of zones was subsequently reduced, and the maximum exemption period was increased to 30 years.) In addition, a company could elect a partial exemption for up to twice the length of the original grant. It could also postpone the start of the exemption period for up to four and a half years after its first payroll, which permitted it to save the exemption for profitable years rather than wasting it during a period of start-up losses.

In 1973 and 1974, the Puerto Rican economy entered into recession, and the government experienced difficulty financing a large unexpected deficit. To encourage 936 corporations to reinvest a larger portion of their earnings in the Commonwealth, Puerto Rico added section 2(j) to the exemption laws of 1954 and 1963, providing an exemption for interest, rents and dividends earned on funds derived from tax-exempt businesses that were reinvested in specified eligible assets, principal among which were certificates of deposits in qualifying banking institutions. Banks receiving these tax-exempt deposits were in turn required to reinvest such funds in Puerto Rican government obligations and loans to Puerto Rican businesses.

Until 1976, dividends distributed by an exempt company to a parent outside of Puerto Rico were subject to a "tollgate" (or withholding) tax, provided that the parent was able to claim a foreign tax credit for the tax. But since such dividends would have been fully subject to U.S. income tax under pre-1976 law, whereas a liquidating distribution was free of both U.S. and Puerto Rican tax, 931 companies did not ordinarily pay dividends, and the existence of the Puerto Rican tollgate tax was of largely academic interest. In 1976, as noted above, Congress allowed U.S. parent companies a dividends-received deduction, but denied a foreign tax credit for Puerto Rican or other taxes imposed on the dividend. Under pre-1976 Puerto Rican law, the denial of the foreign tax credit would have exempted the dividend from the tollgate tax. However, Puerto Rico at this time eliminated the exemption from the tollgate tax for dividends paid to "nonresident" U.S. corporations. 11/ Thus, the tax-free repatriation of dividends which possessions corporation expected to be able to make after 1976 did not take place.

B. Present System

In 1977, the Governor of Puerto Rico appointed a commission to study the industrial tax exemption program. Out of that commission's work came the Industrial Incentive Act of 1978. This Act replaced full tax exemption for new firms with partial exemption. It also offered possessions corporations the option to repatriate earnings at the regular tollgate tax rate of 10 percent or at significantly lower rates if specified portions of earnings were reinvested in designated local investments. This new law did not change former tax exemption commitments, but it did provide incentives to firms operating under "old" full tax exemption commitments to "convert" to partial tax exemption under the new Act. This Section discusses, in turn, Puerto Rican taxation of non-exempt corporations, taxation under an old exemption contract, taxation under a "converted" exemption contract, and taxation under a new exemption contract.

1. Taxation of Non-Exempt Corporations

Although 936 manufacturing corporations operating in Puerto Rico normally hold an exemption contract, nonmanufacturing corporations generally do not qualify for an exemption.

Puerto Rico's authority to enact its own tax system derives from the Foraker Act of 1900. In 1954, the legislature adopted its present Internal Revenue laws based on the U.S. Internal Revenue Code of 1939. In the absence of a tax exemption grant, Puerto Rico taxes all Puerto Rican source income earned by U.S. and foreign persons (including corporations), and taxes the worldwide income of all Puerto Rican residents and corporations. Corporate income tax rates are graduated, ranging from 22 percent for taxable income under $25,000 to 45 percent for taxable income in excess of $300,000. Gross income and allowable deductions are defined in much the same way as under the U.S. Internal Revenue Code. However, the Puerto Rican code contains a "flexible

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11/ Puerto Rican tax law makes a distinction between "resident" and "nonresident" firms. Firms that are organized outside of Puerto Rico but conduct a business in Puerto Rico are classed as resident; those that have no such business are non-residents.

depreciation" provision which permits taxpayers to recover the cost of "qualifying property" in any taxable year or years chosen by the taxpayer, up to a limit of 50 percent of total income, without regard to the useful life of the property. Generally, property acquired for use in agriculture, construction, manufacturing, hotels, or shipping qualifies for flexible depreciation.

Dividends paid by a 936 corporation are taxable to a U.S. parent corporation if paid out of Puerto Rican source earnings and profits. If a 936 has both Puerto Rican and non-Puerto Rican source earnings to distribute, the dividend will be considered to consist of 50 percent foreign source income and, thus, the effective rate of tax will be half as large as the rate applicable to a dividend paid entirely from Puerto Rican source earnings.

The method of taxing dividends depends on whether the parent corporation itself is engaged in a trade or business in Puerto Rico. If it is, the parent corporation is a "resident" of Puerto Rico subject to the ordinary corporate tax; the dividend income will, however, qualify for an 85 percent dividends-received deduction, thereby reducing the effective tax rate to a maximum of 6.75 percent (i.e., 15 percent of 45 percent). If the parent corporation is not "resident" in Puerto Rico, the dividend is subject to a 25 percent "tollgate" tax withheld at source.

Upon liquidation, a 29 percent tollgate tax applies to Puerto Rican source income earned by a non-exempt business.

2. <u>Taxation Under an Old Exemption Grant</u>

In general, a firm which has a tax exemption grant under the 1963 Industrial Incentive Act is 100 percent exempt 12/ from tax on business income and interest income on certain designated assets (see below). The firm is also 100 percent exempt from property and municipal license taxes. The duration of the tax exemption grant, which depends on the municipality of Puerto Rico in which the firm locates its plant, ranges from 10 to 30 years.

12/ As of April 1980, approximately 210 corporations -- not all of them 936's -- enjoyed partial tax exemption under the 1963 Act. These represented about 10 percent of all grants still in effect under that Act.

Dividends paid by exempt firms from Puerto Rican source Industrial Development Income 13/ to nonresident U.S. parent corporations are subject to the 10 percent tollgate tax. However, a tax-exempt firm may benefit from reduced rates if it meets certain investment and disbursement conditions. These conditions and rules, summarized below, apply not only to firms with old exemption grants, but also to firms with "converted" or new exemption grants:

-- Dividends paid out of accumulated Puerto Rican source Industrial Development 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 reinvested for 12 months in Puerto Rico.

-- Dividends paid out of Puerto Rican source Industrial Development Income 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 a given year's income is paid out and if at least 25 percent of such income is reinvested in Puerto Rico for a period of eight years.

-- Dividends paid out of interest on government obligations are exempt from tollgate tax. If the government obligation is held for at least eight years, the principal may also be distributed exempt from tollgate tax.

-- 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.

On liquidation, a firm with an old tax exemption grant may distribute all accumulated earnings free of the tollgate tax.

13/ Industrial Development Income (IDI) is the net income earned by an exempt business from the operations declared exempted, and the eligible rents, dividends and interests earned by the investment of IDI in Certain Puerto Rico assets (designated in section 2(j) of the Industrial Incentive Acts.

3. <u>Taxation Under an Old Exemption Grant "Converted" to the 1978 Industrial Incentive Act</u>

The 1978 Industrial Incentive Act does not affect the terms of grants or petitions for tax exemption which were made before June 1978, but it provides opportunities to firms operating under old tax exemption grants to convert to partial tax exemption under the new Act. The election to convert had to be made by December 31, 1979, and two optional conversion plans were available:

Option One. During the years remaining until the end of the existing grant, the exempted business will pay a maximum effective rate of tax from 3 percent to 12 percent of income, with the higher rate applicable to a firm which has fewer years left on its original grant, as follows:

Years Left on Original Grant	Exemption Percentages	Maximum Effective Tax Rate
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 firm electing this option is 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 will be exempt, depending on the location of the plant.

Option Two. A company with six or more years remaining on its current tax exemption may make an alternative election. It may exclude 90 percent of its income from taxation, and credit two thirds of the corporate income taxes actually paid against the tollgate tax on dividends paid from current earnings. A company that elects that second option may aply for a ten-year extension when the current grant expires, but the extension is not automatic.

As a further inducement to firms to convert to partial tax exemption, the 1978 Act provides that under either conversion option, a firm may credit tollgate taxes paid on distributions from pre-1978 earnings against the income taxes due in future years, up to 50 percent of such liability in any given year. In addition, dividend payments by converted firms may benefit from a reduced tollgate tax rate, as follows:

-- Pre-1973 earnings may be distributed subject to a 4 percent tollgate tax, provided that only 50 percent of such amounts is distributed in a given year.

-- Dividends paid out of income earned after 1972, but before 1980, are subject to a tollgate tax of 4 or 5 percent (depending upon the year in which the income was earned), provided that 50 percent of such income is invested for five years in the firm's own capital assets 14/ or in assets designated in section 2(j) of the 1978 Industrial Incentive Act. The designated assets, commonly referred to as 2(j) assets, include Puerto Rican government bonds, loans for the construction of buildings or acquisition of equipment used by a tax-exempt business, mortgages insured by the Puerto Rican Housing Bank and Finance Agency, and fixed-term deposits in certain banks doing business in Puerto Rico. Banks receiving these tax-exempt deposits are in turn required to reinvest the funds within Puerto Rico, although this requirement was not strictly enforced until 1980. 15/

-- On liquidation, pre-1978 earnings of "converted" firms are exempt from tollgate tax.

4. Taxation Under a New Exemption Grant

New grants issued under the 1978 Industrial Incentive Act provide 90 percent exemption from income and property tax in the

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14/ These are defined as investments made for the acquisition of plant or equipment used in manufacturing, or the payment of the outstanding principal of a debt incurred for the acquisition of such property (Industrial Incentive Act of 1978, section 4(h)(1)).

15/ Puerto Rican regulations in effect through March 31, 1980, permitted banks to "warehouse" 936 deposits outside Puerto Rico for up to six months.

first five years of a firm's operation, and a gradually decreasing rate of exemption during each subsequent five-year period until the expiration of the grant, as follows:

Years of Exemption	Percentage of Exemption from Income and Property Tax	Effective Tax Rate on Income Derived from Manufacturing 16/	
		Minimum	Maximum
1-5	90%	2.20%	4.50%
6-10	75	5.50	11.25
11-15	65	8.75	15.75
16-20	55	9.90	20.25
21-25	50	11.00	22.50

The duration of a firm's grant will vary from 10 to 25 years, depending upon the location of its plant.

The actual effective tax rates will be somewhat lower than those shown because of two additional incentives provided by the 1978 Act to encourage labor-intensive operations and assist small firms. All grants issued under the new Act allow the firm to deduct five percent of production worker payroll from its manufacturing income, up to 50 percent of such income. As an alternative to the payroll deduction, a firm whose profits are less than $500,000 in any given year is allowed a 100 percent tax exemption on the first $100,000 of income.

If a tax-exempt firm reinvests all or part of its earnings in Puerto Rican 2(j) assets, then the dividends, interest, and rents derived from those assets will be 100 percent exempt from income tax. The intent of this exemption of 2(j) earnings from income tax is to induce 936 corporations to reinvest their business earnings in Puerto Rico. However, the main incentive to a firm to retain its earnings in the Commonwealth arises from the tollgate tax provisions of the new Industrial Incentive Act, as follows:

16/ The minimum and maximum tax rates during a given five-year period are computed on the basis of the statutory tax rates, which vary from 22 percent to 45 percent depending on the firm's income.

-- Dividends paid out of income earned by an exempted business are subject to a tollgate tax of 5 percent, provided that 50 percent of such income is invested for five years in 2(j) assets or in the firm's own capital assets. To benefit from the reduced rate, the distribution must take place before June 30, 1980. The 50 percent of income reinvested during this period can be repatriated after the fifth year.

-- On liquidation, undistributed earnings are subject to a tollgate tax of 4 percent, rather than 10 percent, provided that 50 percent of such earnings have been invested in the firm's own capital assets or in 2(j) assets for a period of at least five years.

CHAPTER 3

ECONOMIC DEVELOPMENT IN PUERTO RICO

I. Growth Since 1947

To put the economic activities of possessions corporations in proper perspective, this Chapter provides a brief overview of the development of the Puerto Rican economy. Between 1947 and 1972, Puerto Rican gross national product and GNP per capita grew at the rates of 6 percent and 5 percent per annum, respectively -- see Figure I. 1/ The Puerto Rican economy was badly battered by the sudden increase in oil prices, the jump in interest rates (particularly significant for the construction industry) and the 1973-75 recession of the U.S. economy. The Puerto Rican economy remained in recession until 1977, but has recovered substantially in the last two years with real GNP growing at an annual rate of roughly 5 percent in both years.

II. Industry Composition of Employment

Despite this rapid growth, unemployment has been a major structural problem of the Puerto Rican economy. Unemployment gradually declined to 10 percent of the labor force in 1970, rose sharply to almost 20 percent in 1977, and though it has declined slightly since then, was still at 17 percent in 1979.

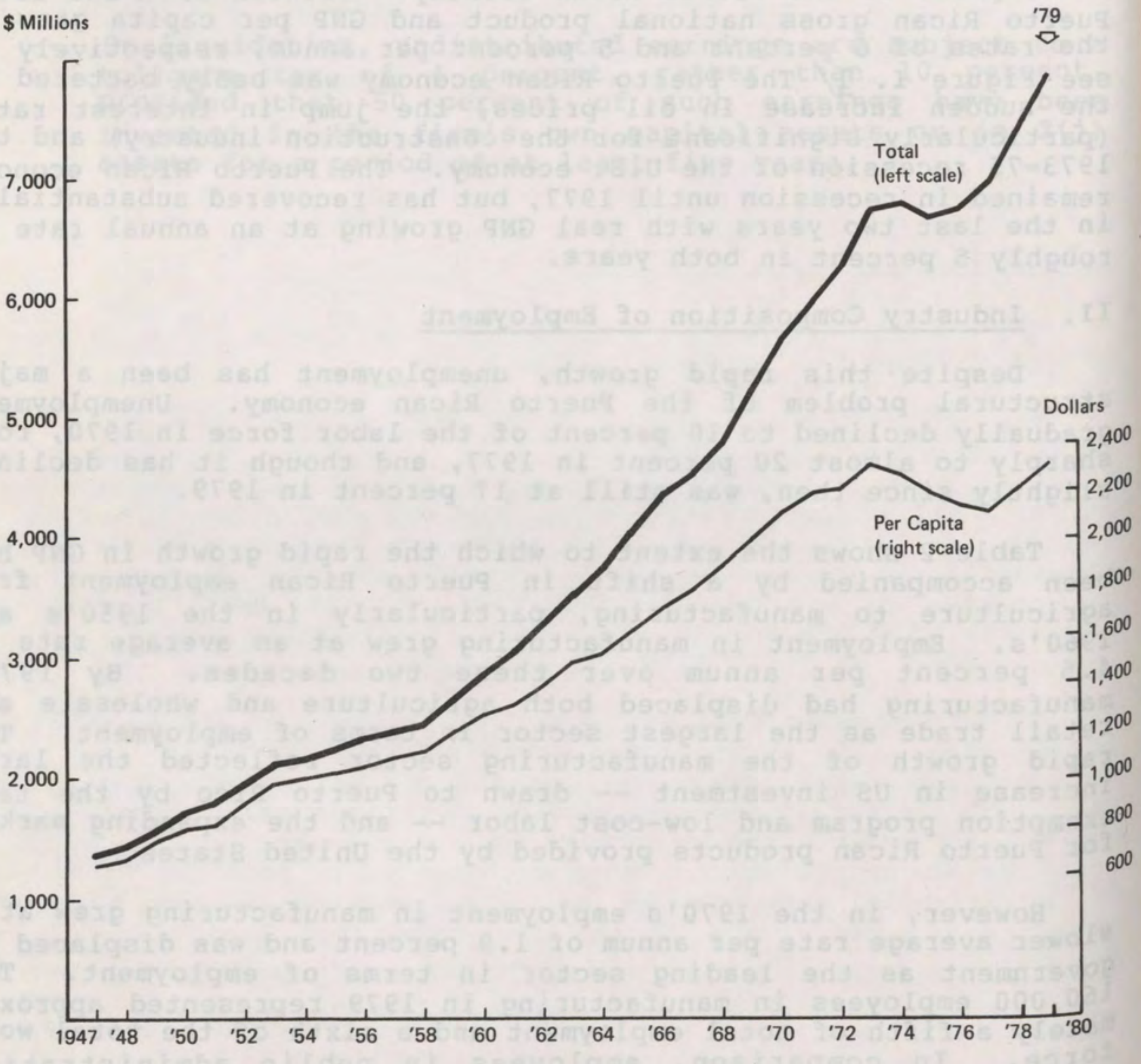
Table 2 shows the extent to which the rapid growth in GNP has been accompanied by a shift in Puerto Rican employment from agriculture to manufacturing, particularly in the 1950's and 1960's. Employment in manufacturing grew at an average rate of 4.5 percent per annum over these two decades. By 1970, manufacturing had displaced both agriculture and wholesale and retail trade as the largest sector in terms of employment. The rapid growth of the manufacturing sector reflected the large increase in US investment -- drawn to Puerto Rico by the tax-exemption program and low-cost labor -- and the expanding market for Puerto Rican products provided by the United States.

However, in the 1970's employment in manufacturing grew at a slower average rate per annum of 1.9 percent and was displaced by government as the leading sector in terms of employment. The 160,000 employees in manufacturing in 1979 represented approximately a fifth of total employment and a sixth of the total work force. In comparison, employees in public administration represented a fourth of total employment.

1/ Throughout this chapter unless otherwise noted, years are Puerto Rican fiscal years; e.g. 1972 means the twelve months ending June 30, 1972.

FIGURE I

Total and Per Capita Gross National Product of Puerto Rico, 1947-1979 (Constant 1974 Dollars)



Source: Puerto Rico Planning Board

Table 2

Puerto Rican Unemployment Rate and Distribution of Employment in Selected Years, 1950 - 1979
(in thousands)

Year	Unemploy-ment Rate	Total Employ-ment	Total Private Employment	Agricul-ture	Manufac-turing	Home Needle-work	Construc-tion	Wholesale and Retail trade	Finance Insurance Real Estate	Transporta-tion and Utilities	Services	Government 1/
1950	12.9%	596	551	214	55	51	27	90	3	28	77	45
1955	14.3	539	489	164	66	29	34	89	n.a.	n.a.	69	50
1960	13.1	543	481	124	81	10	45	97	6	39	75	62
1965	11.7	617	535	107	106	6	56	109	n.a.	n.a.	103	82
1970	10.7	686	580	68	132	*	76	128	13	45	116	106
1971	11.6	700	589	61	132	*	81	134	15	47	117	111
1972	11.9	737	606	58	141	*	79	135	16	49	126	131
1973	11.6	757	614	49	142	*	80	146	18	50	127	143
1974	13.2	775	628	53	147	*	79	148	18	54	128	147
1975	18.1	738	587	49	137	*	69	141	18	49	128	151
1976	19.5	718	560	46	133	*	53	140	18	46	121	158
1977	19.9	739	571	41	144	*	43	145	19	49	127	168
1978	18.1	780	600	40	156	*	44	149	21	49	138	180
1979	17.0	807	618	38	160	*	48	154	21	50	142	189
Annual rate of growth, 1950 -1960		-1.0%	-1.3%	-5.3%	3.9%	-15.0%	5.2%	0.8%	7.2%	3.4%	-0.3%	3.3%
Annual rate of growth, 1960 - 1970		2.4	1.9	-5.8	5.0	--	5.4	2.8	8.0	1.4	4.5	5.5
Annual rate of growth, 1970 - 1979		1.6	0.7	-5.7	1.9	--	-4.5	1.9	4.9	1.1	2.0	6.0

Office of the Secretary
Office of Tax Analysis

1/ Includes only public administration.

* Less than 2,000

n.a. not available

Sources: Puerto Rico Planning Board, Economic Report to the Governor, 1978 - 1979; Puerto Rico Development Administration, Economic Analysis of the Industrial Incentive Program of Puerto Rico, 1978; Institute of International Law and Economic Development, Puerto Rico Industrial Sector Study, Draft Report for the U.S. Department of Commerce, April 1978.

The growth in government employment was made possible in part by the large increase in Federal aid. As shown in Figure II, Federal taxes covered over 2/ plus grants-in-aid to the Puerto Rican Commonwealth and municipal governments increased from $115 million in 1960 to $1,130 million in 1979 (in constant 1974 dollars). Between 1970 and 1979 alone, Federal assistance grew from 26 percent to 36 percent of Puerto Rican government expenditures plus net investment by public enterprises. 3/

Within manufacturing, the industry composition of employment has also been shifting notably. In the 1950's and 1960's, employment in labor-intensive industries -- apparel, textiles, food-processing and leather goods (including footwear) grew rapidly. As shown in Table 3, however, employment in tobacco products, textiles, apparel and leather goods declined substantially after 1968. Their decline was, in turn, offset by rapid gains in employment in high-technology industries: chemicals, including pharmaceuticals, machinery, transportation equipment, electrical and electronic equipment and scientific instruments. Taken together, these five high-technology industries employed 53,800 workers in 1979, which was roughly one third of total manufacturing employment and just under 7 percent of total employment in Puerto Rico.

III. Underlying Factors

What accounts for these structural shifts in the industry composition of Puerto Rican employment? They reflect in part the improved education and training of Puerto Rico's labor force. But the persistence of high unemployment, together with the decline of industries where labor is the major cost of production, suggest that Puerto Rico's labor costs may have been increasing more rapidly than those of competitive locations.

Table 4 present the U.S. minimum wage and average hourly wages in manufacturing in Puerto Rico and the United States between 1950 and 1979. It shows that the annual rate of growth of average wages in Puerto Rico has exceeded the growth rate in the United States in every decade since 1950. This trend reflects not only the changing composition of employment in Puerto Rico towards higher wage industries, but also the impact of Federal minimum wage and income maintenance laws on Puerto

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2/ Includes the Federal excise tax on alcoholic beverages produced in Puerto Rico but transported to the United States.

3/ The sources of this growth between 1968 and 1979 are shown in Table 5, below.

FIGURE II

Distribution of Puerto Rico Government Expenditures by Revenue Source, 1960-1979 (Constant 1974 Dollars)

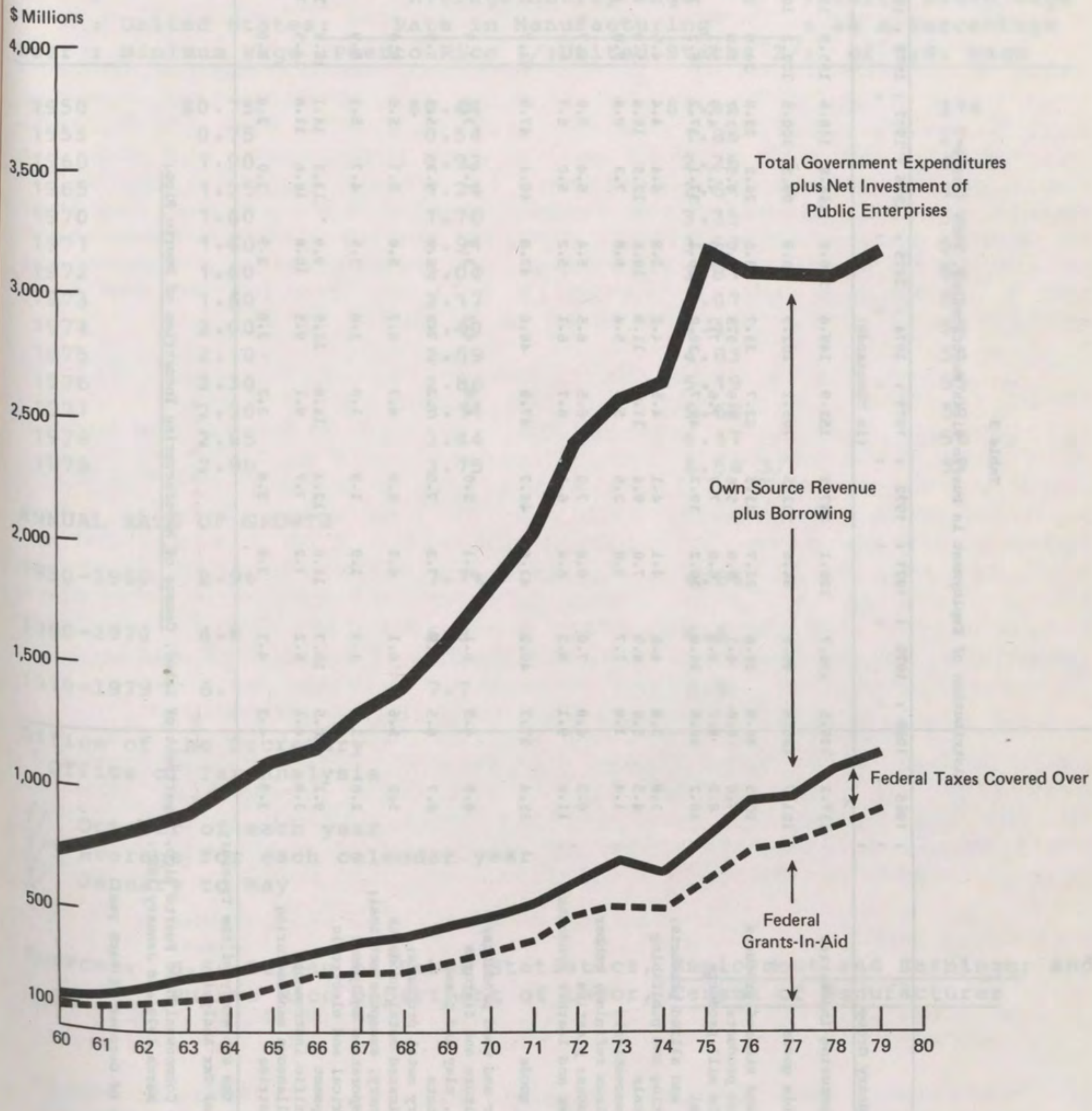

Table 3

Distribution of Employment in Puerto Rican Manufactures, 1968 - 1979*

Industry Group	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	Absolute Change 1968-1979	Percentage Change 1968-1979
						(in thousands)								
All Manufacturing Industries	137.1	138.5	136.7	138.1	147.2	152.9	149.6	136.6	144.8	148.6	155.9	157.7	20,600	15%
Nondurable goods	101.7	100.8	96.5	94.6	102.5	105.1	102.9	93.9	98.3	100.6	102.2	100.4	-1,300	-1
Food and kindred products	20.5	20.9	20.6	21.7	23.5	22.7	23.7	23.0	24.2	23.9	24.8	24.3	3,800	19
Tobacco products	7.0	6.0	6.1	5.6	5.6	5.6	5.3	5.0	4.5	3.2	2.8	2.2	-4,800	-69
Textile mill products	8.2	8.7	8.9	6.8	7.7	7.6	7.2	4.9	4.3	4.9	5.1	4.3	-3,900	-48
Apparel	40.2	40.5	36.8	36.2	39.2	40.7	38.0	36.1	37.1	37.2	36.2	35.4	-4,800	-11
Paper and allied products; printing and publishing	3.8	3.8	4.0	4.1	4.1	4.5	4.2	3.8	4.4	4.4	4.5	4.8	1,000	26
Chemicals	4.5	5.0	4.9	7.0	9.4	11.0	11.9	10.6	12.5	15.4	15.9	16.3	11,800	262
Pharmaceuticals	1.4	1.8	1.7	3.0	3.5	5.0	5.4	6.0	7.3	8.4	9.8	10.0	8,600	614
Petroleum refining; rubber products; plastics	6.2	6.8	7.0	6.8	7.0	6.5	6.5	5.4	6.4	7.0	6.7	7.1	900	15
Leather and leather products	11.4	9.1	8.3	6.4	6.1	6.7	6.1	5.2	5.0	5.7	6.2	6.0	-5,400	-47
Durable goods	35.4	37.7	40.2	43.6	44.7	47.8	46.6	42.8	46.4	47.9	53.7	57.3	21,900	62
Lumber and wood products; furniture and fixtures	4.9	4.9	5.1	5.1	5.0	4.9	4.2	3.9	3.7	3.6	3.9	4.1	-800	-16
Stone, clay and glass products	6.7	6.5	6.8	7.3	7.5	7.2	7.3	6.2	5.3	5.1	5.5	5.5	-1,200	-17
Primary metal products; fabricated metal products	5.0	5.6	6.1	6.5	6.9	6.7	6.7	5.6	5.7	5.5	6.0	6.0	1,000	20
Machinery, except electrical; transporation equipment	2.0	1.8	1.9	1.9	1.9	1.9	3.8	3.5	4.7	5.3	5.9	6.6	4,600	230
Electrical and electronic equipment	9.1	10.5	10.7	11.8	12.3	14.8	12.5	9.9	13.3	14.1	16.2	17.3	8,200	90
Scientific instruments	3.8	4.1	5.2	7.2	7.7	9.1	9.5	10.8	10.6	11.6	12.5	13.6	9,800	258
Miscellaneous manufacturing industries	3.9	4.3	4.3	3.8	3.4	3.2	2.6	2.9	3.0	2.8	3.8	4.2	300	8

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Source: Commonwealth of Puerto Rico, Department of Labor, Census of Manufacturing Industries of Puerto Rico, March 1978 and January 1980.

* Data as of October of each year

TABLE 4

U.S. Minimum Wage, and Average Hourly Wage Rate
in Manufacturing in Puerto Rico and the United States

Year	United States: Minimum Wage	Average Hourly Wage Rate in Manufacturing: Puerto Rico 1/	Average Hourly Wage Rate in Manufacturing: United States 2/	Puerto Rican Wage as a Percentage of U.S. Wage
1950	$0.75	$0.44	$1.44	31%
1955	0.75	0.54	1.86	29
1960	1.00	0.92	2.26	41
1965	1.25	1.24	2.61	48
1970	1.60	1.78	3.35	53
1971	1.60	1.91	3.57	54
1972	1.60	2.04	3.81	54
1973	1.60	2.17	4.07	53
1974	2.00	2.40	4.41	54
1975	2.10	2.59	4.83	54
1976	2.30	2.86	5.19	55
1977	2.30	3.11	5.68	55
1978	2.65	3.44	6.17	56
1979	2.90	3.75	6.54 3/	57
ANNUAL RATE OF GROWTH				
1950-1960	2.9%	7.7%	4.6%	
1960-1970	4.8	6.8	4.0	
1970-1979	6.1	7.7	6.9	

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1/ October of each year
2/ Average for each calendar year
3/ January to May

Sources: U.S. Bureau of Labor Statistics, Employment and Earnings; and Puerto Rico Department of Labor, Census of Manufactures

Rico. After an initial attempt to enforce the 1938 Fair Labor Standards Act in Puerto Rico imposed widespread dislocation and unemployment, Congress authorized the U.S. Department of Labor to establish minimum wages for Puerto Rico which were below the mainland level. Under procedures provided by law, the Department of Labor appointed committees drawn from industry, labor, and the public and representing both the United States and Puerto Rico to hold hearings and recommend for individual industries "...the highest minimum wage rate...which (1) will not substantially curtail employment in such classification and (2) will not give a competitive advantage to any group in the industry" over mainland sectors of the industry. 4/ In contrast to the single minimum wage prevailing in the United States, Puerto Rico thus came to have industry-specific minimums which served to keep pressure on relatively high-wage as well as low-wage industries. As shown in Table 4, the annual rate of growth of average hourly earnings in Puerto Rico has exceeded the growth rate of U.S. average earnings in every decade since 1950. By the end of 1977, almost two-thirds of non-government employees in Puerto Rico were subject to the U.S. minimum wage. Virtually full application of the U.S. minimum wage to Puerto Rico is to be achieved by 1981.

A second factor which may have increased the real cost of labor in Puerto Rico has been the expansion of Federal income maintenance programs in Puerto Rico. 5/ Such programs may reduce work incentives and raise labor-training costs by inducing higher labor turnover rates. Table 5 provides a breakdown of Federal transfer payments in 1968, 1978, and 1979 by major category. Net Federal transfers to individuals increased from $68 million in 1968 to over $1.5 billion in 1979, a eleven-fold increase in price-deflated dollars. The growth in income maintenance programs was led by the food stamp program, which was not introduced in Puerto Rico until 1975, but reached $734 million in 1979.

At the same time as the real cost of labor in Puerto Rico was being pushed relatively closer to the mainland level and farther away from the level in developing countries, structural changes in the world economy were further undercutting Puerto Rico's position as a low-wage site for U.S. investment. After the Kennedy round of tariff negotiations in the 1960's, the United

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4/ Fair Labor Standards Act of 1938, as amended by the Congressional Act of June 26, 1940 (Pub. Res. No. 88, 76th Congress).

5/ Puerto Rico participates in most, but not all, Federal income maintenance programs. It does not participate in the Supplemental Security Income Program and, in the case of Aid to Families with Dependent Children, payments are limited by a ceiling.

Table 5

Federal Transfer Payments, Grants, and Taxes "Covered Over" to Puerto Rico, Fiscal Years 1968, 1978, and 1979 1/
(millions of dollars)

	FY 1968	FY 1978	FY 1979
Net Federal transfer payments to individuals, total 2/	68	1,321	1,482
Food stamps	--	682	734
Old age, survivors, and disability insurance	1	326	421
Veterans benefits	59	198	202
Unemployment compensation	1	33	21
All other	7	82	104
Federal grants to Puerto Rican Commonwealth and municipal governments, total	129	885	1,020
Child nutrition and special milk programs	5	62	77
Human development 3/	6	36	64
Office of Education programs	--	62	69
Public assistance	31	38	114
Community development block grants	15	56	74
Low rent public housing	11	56	56
Employment and training programs	7	246	262
All other	54	329	304
Federal taxes "covered over" to Puerto Rican treasury, total	93	271	289
Customs duties	27	71	76
Alcoholic beverage and tobacco excises	66	200	213
TOTAL	290	2,477	2,791

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Sources: U.S. Department of the Treasury, Federal Aid to States: Fiscal Year 1979, 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 1976, 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 1979 are 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.

States cut its tariff rates by 40-50 percent on average. As Japanese and other competitors utilizing low-wage foreign labor penetrated the U.S. market, U.S. companies lost their inhibitions about manufacturing in low-wage countries and exporting back to the United States. Such countries' exports are subject to U.S. tariffs and non-tariff trade barriers, and production in such countries does not benefit from the tax exemption provided to U.S. companies under the possessions corporation system. But these disadvantages may, in labor-intensive industries, be more than offset by the low cost of foreign labor.

The rapid growth of employment in the high-technology industries -- chemicals, machinery, transportation equipment, electrical and electronic equipment, and scientific instruments -- is, as the next Chapter shows, attributable to increasing investment in these industries by U.S. corporations. As explained more fully below, companies in these industries are typically willing to pay wages substantially higher than the Federally mandated minimum. They are attracted to Puerto Rico not by the low cost of labor, but by the low tax on profits.

The difference between the expanding and declining industries within the Puerto Rican manufacturing sector is highlighted in Table 6, which is based on employment, payroll and value-added statistics for 1972 and 1977, the two most recent years in which a census of manufactures was conducted in Puerto Rico. This period coincided roughly with the recession, which accounts for the lower than average growth rates of employment, payroll, and value-added. The Table illustrates the impact which the shift in industry composition had on labor's share in total value-added. The last three rows of the Table show that industries with expanding employment were those whose payroll represents the lowest percentage of Puerto Rican value-added, and that the payroll/value-added percentage decreased between 1972 and 1977. By contrast, industries with declining employment had high payroll/value-added percentages, and those percentages increased slightly between 1972 and 1977. Largely because of the change in industry composition, manufacturing employment declined slightly between 1972 and 1977, while manufacturing payroll increased by 60 percent, and manufacturing value-added (which includes profit) increased by 130 percent.

Table 6

Employment, Payroll and Value Added of Puerto Rican Manufacturing Industries, 1972 and 1977

	1972				1977				Percentage Change in Payroll as Percent of Value Added 1972 - 1977
	Employment (000)	Payroll ($ Million)	Value Added ($ Million)	Payroll as Percent of Value Added	Employment (000)	Payroll ($ Million)	Value Added ($ Million)	Payroll as Percent of Value Added	
All Manufacturing Industries	149.7	616.8	1,915.4	32.2%	146.2	998.5	4,449.1	22.4%	-30.4%
Food and kindred products	27.7	121.2	343.4	35.3	20.6	143.3	495.1	28.9	-18.1
Tobacco products	4.5	16.0	46.4	34.5	4.6	24.5	144.9	16.9	-51.0
Textile mill products	7.8	27.9	67.1	41.6	5.7	29.9	33.1	90.3	117.1
Apparel and other textile products	39.6	124.1	252.5	49.1	37.9	172.4	299.6	57.5	17.1
Lumber and wood products	1.2	4.5	8.3	54.2	.9	3.9	9.3	41.9	-22.7
Furniture and fixtures	3.2	13.0	29.3	44.4	2.3	12.3	26.7	46.1	3.8
Paper and allied products	1.6	8.2	17.9	45.8	1.3	11.8	24.3	48.6	6.1
Printing and publishing	3.0	16.7	41.8	40.0	3.0	28.7	72.2	39.8	0.1
Chemical and allied products	9.0	58.8	451.2	13.0	15.1	154.1	1,885.1	8.2	-36.9
Petroleum and coal products	2.2	20.7	91.7	22.6	2.4	36.8	135.7	27.1	19.9
Rubber and miscellaneous plastics products	3.5	14.0	27.4	51.1	6.0	44.1	151.4	29.1	-43.1
Leather and leather products	6.6	20.4	39.3	51.9	6.3	29.3	57.1	51.3	-1.2
Stone, clay and glass products	6.3	29.0	73.1	39.7	4.9	39.3	101.3	38.8	-2.3
Primary metal industries	1.0	5.3	14.3	37.1	1.6	12.9	45.7	28.2	-24.0
Fabricated metal products	5.2	27.6	78.2	35.3	4.4	33.9	89.3	38.0	7.6
Machinery, except electrical	2.2	12.8	37.6	34.0	3.9	33.0	173.5	19.0	-44.1
Electric and electronic equipment	14.7	50.4	169.6	29.7	15.8	114.9	459.3	25.0	-15.8
Transportation equipment	.7	3.1	6.8	45.6	1.1	8.2	29.0	28.3	-37.9
Instruments and related products	6.1	29.0	84.2	34.4	6.1	46.9	167.7	28.0	-18.6
Miscellaneous manufacturing industries	3.7	14.1	35.3	39.9	2.4	18.5	48.8	37.9	-5.0
Industries with expanding employment 1/	33.3	165.1	798.6	20.7	45.9	404.0	2,879.7	14.0	-32.4
Industries with declining employment 2/	102.9	390.0	944.4	41.3	86.7	494.6	1,184.6	41.8	1.2
Industries with constant employment 3/	13.6	61.7	172.4	35.8	13.7	100.1	384.8	26.0	-27.4

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Source: U.S. Department of Commerce, preliminary figures for the 1977 Economic Census of Outlying Areas, Manufactures, Puerto Rico, and 1972 Economic Census of Outlying Areas, Manufactures, Puerto Rico.

1/ Includes chemicals, petroleum, rubber products, primary metal industries, machinery, electric and electronic equipment, and transportation equipment.

2/ Includes food products, textiles, apparel, lumber, furniture, paper, leather products, stone and clay and glass products, fabricated metal products, and miscellaneous manufacturing industries.

3/ Includes tobacco products, printing and publishing, and instruments and related products.

CHAPTER 4

SECTION 936--TAX EXPENDITURE AND IMPACT ON PUERTO RICAN BUSINESS OPERATIONS

I. Tax Expenditure

A. General Considerations

The Congressional Budget Act of 1974 requires a listing of tax expenditures in the United States budget. The Act defines tax expenditures as:

> "...those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability;..."

Section 936 and other provisions of the possessions corporation system of taxation clearly come within this definition of a tax expenditure.

Congress' request that all tax expenditures be listed and estimated reflects the recognition that a tax expenditure is an alternative to a direct spending program. A 1978 Report of the Senate Budget Committee 1/ explains the intent of listing and measuring Federal tax expenditures, as follows:

> "The listing of a provision as a tax expenditure in no way implies any judgment about its desirability or effectiveness relative to other tax or nontax provisions that provide benefits to specific classes of individuals and corporations. Rather, the listing of tax expenditures, taken in conjunction with the listing of direct spending programs, is intended to allow Congress to scrutinize all Federal programs -- both nontax and tax -- when it develops its annual budget. Only if tax expenditures are included will Congressional budget decisions take into account the full spectrum of Federal programs.

1/ U.S. Senate Committee on the Budget, Tax Expenditures: Relationships to Spending Programs and Background Material on Individual Provisions.

"Because any qualified taxpayer may reduce tax liability through use of a tax expenditure, such provisions are comparable to entitlement programs under which benefits are paid to all eligible persons. Since tax expenditures are generally enacted as permanent legislation, it is important that, as entitlement programs, they be given thorough periodic consideration to see whether they are efficiently meeting the national needs and goals that were the reasons for their initial establishment."

The Senate Budget Committee notes that, because tax expenditures are estimated on the assumption that behavior and other laws remain unchanged, estimates are subject to important limitations.

"In calculating the revenue loss from each tax expenditure, it is assumed that only the provision in question is deleted and that all other aspects of the tax system remain the same...

"...the amounts shown for the various tax expenditure items do not take into account any effects that the removal of one or more of the items might have on investment and consumption patterns or on any other aspects of individual taxpayer behavior, general economic activity, or decisions regarding other Federal budget outlays or receipts...

"However, these tax expenditure estimating considerations are similar to estimating considerations involving entitlement programs. Like tax expenditures, annual budget estimates for each transfer and income security program are computed separately. However, if one program, such as veterans' pensions, were either terminated or increased, this would affect the level of payments under other programs, such as welfare payments. Also, like tax expenditure estimates, the elimination or curtailment of a spending program, such as military spending or unemployment benefits, would have substantial effects on consumption patterns and economic activity that would directly affect the levels of other spending programs."

B. Current Estimates

The calculation of the Federal tax expenditure for the possessions corporation system of taxation reflects not only the amount of credit claimed under section 936, but other related provisions of Federal income tax. The amount of credit claimed under section 936 for tax year 1978 was $1.08 billion; the estimated Federal tax expenditure for the possessions corporation provisions for the 1978 tax year was $840 million. 2/ This figure was computed by multiplying the qualified possession source income of 936 companies (except those in nonmanufacturing industries) 3/ by 40 percent, and then subtracting income and tollgate taxes paid to Puerto Rico. 4/ The 40 percent figure represents the Treasury's necessarily rough estimate of what the effective rate of taxation would have been in the absence of the possessions corporation provisions. 5/ The effective rate is less than 48 percent, the maximum statutory rate in 1978 (and,

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2/ Tax year 1978 includes accounting periods ending between July 1, 1978, and June 30, 1979. Because most possessions corporations have calendar year accounting periods, the $840 million Federal tax expenditure for tax year 1978 corresponds closely to the $826 million reduction in calendar year 1978 tax liabilities, shown on Table 1, above.

3/ It was assumed that 936 companies in nonmanufacturing industries did not qualify for a Puerto Rican tax exemption grant and that the taxes which they paid to Puerto Rico offset 100 percent of their U.S. tax liability. While the Puerto Rican Industrial Incentive Acts do provide exemptions to designated nonmanufacturing industries -- in particular, hotels, medical laboratories, movie production, and, after 1978, various services produced for export -- the total possession source income of 936's in these categories was negligible in 1978. Moreover, a sample of the 1978 Puerto Rican tax returns filed by 936's in nonmanufacturing industries suggests that the average effective Puerto Rican tax rate for such companies was roughly 40 percent.

4/ Puerto Rico estimates that in 1978, $5 million in income taxes were paid by 936 firms which had converted to partial tax exemption. Tollgate tax collections in calendar year 1978 were estimated to be $57 million, the average of collections for the fiscal years ending on June 30, 1978, and June 30, 1979.

5/ See Department of the Treasury, Effective Income Tax Rates Paid by United States Corporations in 1972, May 1978. For 1979 and all subsequent years, the effective Federal corporate tax rate is assumed to be 38 percent, rather than 40 percent, to reflect the statutory U.S. corporate tax rate reduction of two percentage points.

thus, the rate which would apply to most income qualifying for the section 936 credit), 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 eight percentage points.

Whether the $840 million tax expenditure for the possessions corporation system of taxation should be viewed as a Federal or a Puerto Rican expenditure (or both) is ambiguous. In the absence of the special provisions, Puerto Rico would assert its primary, source jurisdiction and the United States its secondary, residence jurisdiction (possessions corporations are chartered in the United States). The United States would allow a foreign tax credit for income taxes paid to Puerto Rico, and if Puerto Rico taxed such income at its normal rates, the residual U.S. tax liability would be small, if any. The incentive to invest in Puerto Rico arises because <u>both</u> the Puerto Rican and the Federal government offer special incentives; if <u>either</u> repealed or scaled back those incentives, the measured tax expenditure would be reduced.

The Puerto Rican tax expenditure on the possessions corporation system of taxation reflects not only its income and tollgate tax provisions, but also exemptions granted for property and municipal taxes. The value of the Puerto Rican property and municipal taxes forgiven to 936 corporations amounted to approximately $110 million in 1978. 6/

6/ The $110 million was computed by multiplying the 3 percent effective real property tax rate by the $1,794 million of net plant and equipment and land owned by possessions corporations, by multiplying the 4.2 percent personal property tax by their $878 million in inventories, and by multiplying the 0.3 percent gross receipts tax by their $6,451 million in business receipts. The asset and income figures used were taken from the U.S. income tax returns filed for 1978 by possessions corporations in manufacturing industries.

II. Characteristics of Possessions Corporations

A. Information from S.E.C. 10-K Reports

Many parent companies must file 10-K Reports with the U.S. Securities and Exchange Commission and these Reports, unlike tax returns, are available to the public. To explain why Federal income tax payments are less than 48 percent (the maximum statutory Federal tax rate prior to 1979) of pre-tax book income, the S.E.C. requires corporations to indicate which provisions of the Internal Revenue Code reduced their tax liability by more than 2.4 percent of pre-tax book income. Information from 10-K Reports, presented in Table 7, shows that 29 parent companies reported tax savings of $464 million in 1978. The average tax savings reported by pharmaceutical parent corporations was $24.7 million; the average tax savings reported by non-pharmaceutical parent companies was $5.2 million.

In interpreting these figures, three points should be kept in mind. First, because the S.E.C has never set forth specific procedures for estimating the dollar value of various tax preferences, the data presented in Table 7 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 corporations with other items (e.g., deferral or DISC). Companies following this practice were excluded from Table 2.

B. Income Tax Return Information

Tables 8 through 12, based on actual U.S. income tax returns filed for tax year 1978 by possessions corporations, present by industry year-end balance sheet figures, income statement data, and estimated Federal tax expenditures. The Federal tax expenditure estimates are based on all 565 corporations which filed as 936 corporations for tax year 1978; the balance sheet and income statement figures cover the 534 corporations for which balance sheets and income statements were available.

Table 7

Major U.S. Manufacturing Corporations Indicating a Tax Savings Under Section 936 on Their SEC 10-K Reports for 1978

Corporation	Industry	Tax Savings: Amount ($ Millions)	Tax Savings: Percent of Book Income (Before Taxes)
Abbot Labs	Pharmaceuticals	$ 24.1	10.6%
American Hospital Supply	Pharmaceuticals	13.5	9.6
Baxter-Travenol	Pharmaceuticals	29.3	24.8
Becton-Dickinson	Pharmaceuticals	5.4	6.1
Eli Lilly	Pharmaceuticals	23.6	5.1
G.D. Searle	Pharmaceuticals	31.5	29.1
Johnson & Johnson	Pharmaceuticals	19.6	3.9
Merck	Pharmaceuticals	25.1	5.1
Pfizer	Pharmaceuticals	52.2	17.1
Richardson-Merrell	Pharmaceuticals	4.7	4.1
Schering-Plough	Pharmaceuticals	54.5	20.3
Smith-Kline	Pharmaceuticals	27.4	10.5
Squibb	Pharmaceuticals	28.0	18.0
Sterling	Pharmaceuticals	3.2	1.8
Upjohn	Pharmaceuticals	26.8	13.4
Warner-Lambert	Pharmaceuticals	27.1	7.7
Subtotal - 16	Pharmaceuticals	$ 395.6	10.0%
Allen Group	Automotive	$ 16.0	13.0%
Blue Bell	Textile/Apparel	6.1	6.5
Conagra	Food Processors	2.4	7.4
Digital Equipment	Office Equipment	17.4	7.9
Esmark	Food Processors	8.8	7.4
Gould	Electronics	1.8	1.1
Hanes	Textile/Apparel	3.4	10.6
H. J. Heinz	Food Processors	9.1	5.1
Insilco	Building Materials	3.4	9.9
Morton-Norwich	Chemicals	3.1	5.3
Motorola	Electronics	9.2	4.3
Perkin-Elmer	Instruments	2.0	3.2
Subtotal - 13	Non-Pharmaceuticals	$ 68.2	5.6%
TOTAL - 29	Manufacturers	$ 464.1	8.9%

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

Assets. Table 8 shows that the total assets of 936 corporations stood at $12.0 billion at year-end 1978, with 79 percent of the assets held by manufacturing companies. Within manufacturing, the pharmaceutical industry accounted for $4.2 billion, or 35 percent of the total, and the electrical and electronic equipment industry for $1.4 billion, or 12 percent of the total.

Net plant and equipment of 936 manufacturing firms, (shown as "net depreciable assets" on Table 8) amounted to $1.2 billion. This represented 13 percent of total assets held by all 936 manufacturing firms. If the value of land (not separately shown in Table 8) is added to net plant and equipment, the total of these real assets as a percentage of total assets is 15.3 percent. For U.S. manufacturers as a whole, the comparable figure was 35.1 percent. 7/ This difference may in part reflect the fact that Puerto Rico leases government owned buildings to a substantial sector of the industrial community. Table 9 compares, by manufacturing industry, the ratio of real assets to total assets for possessions corporations and for all U.S. corporations. This ratio for 936 companies was lower in every manufacturing industry than the comparable ratio for all U.S. firms.

7/ Data for all U.S. corporations are from the Federal Trade Commission, Quarterly Financial Report, Fourth Quarter, 1978. Some of this difference can be attributed to differences between the industry mix of possessions corporations and that of all U.S. manufacturing corporations. To correct for the differing industrial mix, the total assets of possessions corporations in each industry were distributed between real and all other assets in the same manner as were assets of all U.S. corporations in that industry. These amounts were then summed over all industries to get an industry mix corrected amount of real assets. Taking the ratio of this industry mix corrected amount to total assets of 936 manufacturing firms gives 28.6 as the percentage of real to total assets. Thus, the differing industry mix between possessions corporations and all U.S. corporations explains one third (35.1 - 28.6)/(35.1 - 15.3) of the difference between the types of assets held.

Table 8

Selected Balance Sheet Information by Industry, 1978
(Dollar amounts in thousands)

	All Industries	Manufacturing Industries								
		Total	Food & Kindred Products	Tobacco Products	Textile Mill Products	Apparel	Paper	Chemicals		
								Total	Pharmaceuticals	All Other
Number of corporations	534	390	17	4	5	73	4	81	57	24
Total assets	12,008,644	9,455,564	726,761	165,690	40,668	273,812	9,336	5,297,745	4,227,396	1,070,349
Cash	1,696,945	1,633,632	210,775	4,768	2,840	34,390	4,601	856,665	765,837	90,827
Accounts receivable	1,979,401	1,644,857	114,282	47,873	16,327	88,191	1,171	832,388	501,497	330,891
Inventories	1,037,849	901,287	100,839	33,997	4,619	42,243	677	378,779	271,610	107,169
U.S. Government obligations	232,085	230,940	0	0	0	3,735	0	117,823	271,610	21,967
State and local obligations	228,980	228,980	0	0	0	501	0	194,517	171,145	23,372
Other current assets	459,388	435,576	27,605	26,201	589	7,286	14	226,179	218,585	7,593
Mortgage & real estate loans	1,212,273	133,629	0	0	0	3,075	0	9,182	9,100	82
Other investments	2,656,407	2,539,635	58,153	31,997	11,250	38,525	487	1,692,669	1,521,293	171,375
Depreciable assets	2,712,886	1,826,490	169,507	26,992	6,149	37,621	2,583	1,088,468	556,797	531,670
Less: Accumulated depreciation	787,842	604,057	47,595	9,650	2,113	15,097	724	355,091	100,516	254,575
Net depreciable assets	1,925,044	1,222,433	121,912	17,342	4,035	22,524	1,859	733,376	456,281	277,095
Other assets	580,268	494,591	93,191	3,509	1,005	33,338	525	256,163	216,189	39,974
Total Liabilities and Stockholder's Equity										
Accounts Payable	676,982	486,252	61,756	2,452	4,181	30,201	83	199,781	144,882	54,898
Notes Payable in less than 1 year	207,292	94,150	33,966	0	238	2,109	58	32,520	31,072	1,448
Other current liabilities	1,489,015	394,498	56,224	8,271	895	7,471	346	236,169	222,961	13,208
Mortgages more than 1 year	525,359	225,999	3,111	0	0	6,029	293	180,028	169,823	10,205
Other liabilities	198,676	82,754	7,175	781	1,353	477	92	46,746	24,174	22,572
Capital stock	1,495,811	940,458	59,765	43,014	1,595	22,228	3,096	599,093	369,252	229,840
Retained earnings, total	7,415,514	7,231,452	504,761	111,169	32,404	205,294	5,365	4,003,404	3,265,229	738,175
Appropriated	77,644	37,734	0	0	0	3,141	0	2,473	2,265	208
Unappropriated	7,337,869	7,193,718	504,761	111,169	32,404	202,152	5,365	4,000,930	3,262,963	737,966

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Table 8 - continued

	Manufacturing Industries - continued						
	Rubber Products	Leather and Leather Products	Stone, Clay, & Glass Products	Fabricated Metal Products	Machinery, Except Electrical	Electrical and Electronic Equipment	Scientific* Instruments
Number of corporations	10	8	6	19	13	83	28
Total assets	68,631	41,300	72,239	168,252	227,177	1,438,525	251,111
Cash	10,747	10,408	14,209	59,078	28,743	322,142	31,468
Accounts receivable	11,163	9,382	39,095	18,528	63,273	140,715	68,014
Inventory	7,743	5,942	5,008	22,544	60,419	104,193	26,942
U.S. Government obligations	0	3,267	0	0	0	96,977	0
State and local obligations	0	5,032	0	0	850	28,077	0
Other current assets	14,689	915	146	692	3,693	37,795	12,686
Mortgage & real estate loans	0	0	0	0	31,307	90,064	0
Other investments	2,491	5,687	2,164	21,492	13,790	532,561	48,594
Depreciable assets	28,242	1,832	17,002	46,312	39,106	106,263	43,388
Less: Accumulated depreciation	9,081	1,194	7,713	11,858	15,007	37,077	8,763
Net depreciable assets	19,160	638	9,288	34,453	24,098	69,186	34,625
Other assets	2,637	24	2,327	11,461	1,001	16,811	28,780
Total Liabilities and Stockholder's Equity							
Accounts payable	7,245	1,773	1,013	25,992	13,336	67,136	11,823
Notes payable in less than 1 year	187	241	364	962	11,947	2,636	7,703
Other current liabilities	2,080	519	2,619	1,191	5,018	23,924	11,336
Mortgages more than 1 year	286	0	20	565	1,551	13,721	7,358
Other liabilities	22	17	2,005	4,264	1,817	10,852	2,245
Capital stock	11,713	921	729	6,374	3,109	56,970	33,700
Retained earnings total	47,096	37,826	65,485	128,901	190,396	1,263,283	176,943
Appropriated	119	0	0	0	2,641	3,262	0
Unappropriated	46,977	37,826	65,485	128,901	187,754	1,260,020	176,943

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* Includes photographic goods and watches

Table 8 - continued

	All other Manu-facturing	Nonmanufacturing Industries: Total	Construction	Transportation Communications and Utilities	Wholesale Trade	Retail Trade	Finance, Insurance, Real Estate	Services	Miscellaneous and Not Available
Number of corporations	34	142	10	9	21	54	25	20	3
Total assets	210,720	2,549,698	19,445	661,794	46,348	202,338	1,561,919	51,458	6,393
Cash	41,519	63,307	2,723	6,595	1,243	2,578	48,062	1,984	121
Accounts receivable	63,809	333,261	10,223	30,189	12,462	52,834	207,840	15,350	4,360
Inventory	29,723	134,679	783	6,674	16,665	52,484	56,188	1,094	788
U.S. Government obligations	0	1,145	0	0	0	0	1,144	0	0
State and local obligations	0	0	0	0	0	0	0	0	0
Other current assets	1,995	23,811	1,716	4,185	958	6,208	10,024	664	53
Mortgage & real estate loans	0	1,078,644	0	0	0	0	1,078,644	0	0
Other investments	30,355	126,772	20	1,399	1,444	11,707	106,613	5,588	0
Depreciable assets	46,951	886,097	5,203	695,181	17,711	93,056	44,834	29,432	678
Less: Accumulated depreciation	7,993	183,689	2,255	132,249	5,919	32,488	4,980	5,591	204
Net depreciable assets	38,958	702,407	2,947	562,932	11,792	60,567	39,853	23,841	473
Other assets	4,359	85,673	1,031	49,817	1,780	15,963	13,547	2,934	596
Total Liabilities and Stockholder's Equity									
Accounts payable	16,455	188,093	3,261	23,843	10,190	37,538	102,195	10,153	909
Notes payable in less than 1 year	1,213	113,142	689	2,570	1,210	24,028	83,448	805	388
Other current liabilities	7,015	1,094,389	2,652	21,182	3,073	12,064	1,052,501	2,628	288
Mortgages more than 1 year	12,915	299,359	1,287	101,425	19,922	25,374	140,032	11,318	0
Other liabilities	811	115,921	1,939	11,933	1,024	2,168	98,645	203	7
Capital stock	12,260	554,853	135	496,383	9,269	28,154	15,390	5,324	195
Retained earnings total	160,048	183,943	9,480	4,455	1,656	73,015	69,704	21,024	4,605
Appropriated	190	39,791	0	1,212	0	2,962	35,113	502	0
Unappropriated	159,858	144,151	9,480	3,243	1,656	70,052	34,590	20,522	4,605

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Table 9

Possessions Corporations and All U.S. Corporations:
Net Property, Plant and Equipment as a
Pecentage of Total Assets, 1978

Industry	Possessions Corporations 1/	All U.S. Corporations
All Manufacturing Industries	15.3%	35.1%
Food and kindred products	17.4	34.9
Tobacco manufactures	11.3	23.4
Textile mill products	10.8	31.9
Apparel	8.6	n.a.
Paper and allied products	29.6	49.6
Chemicals	17.6	39.4
Pharmaceuticals	14.5	24.8
All other	35.8	47.4
Rubber products	28.7	32.6
Leather products	1.6	n.a.
Stone, clay, glass and concrete products	11.8	43.8
Fabricated metal products	21.3	27.6
Machinery, except electrical	10.8	27.5
Electrical machinery	4.7	23.2
Professional and scientific instruments	15.4	27.3

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1/ Includes possessions corporations operating in American Samoa, Guam and the Panama Canal Zone. These non-Puerto Rican operations account for less than .2 percent of net income of all possessions corporations in 1978.

Source: Tax return Form 1120 filed by possessions corporations; and Federal Trade Commission, Quarterly Financial Report, Fourth Quarter, 1978.

n.a. - not available

The counterpart to relatively little investment in real assets by 936 manufacturing firms is relatively large investment in financial assets. 8/ Possessions corporations in manufacturing industries reported financial assets of $7.2 billion, of which $1.6 billion represented accounts receivable. Possessions corporations in industries other than manufacturing had $1.7 billion in financial assets. 9/

Retained Earnings. The continuing incentive to retain earnings in 936 companies is also clearly reflected in the $7.4 billion of retained earnings they held at year-end 1978. Forty-seven percent of these retained earnings, or $3.5 billion, was held by pharmaceuticals. Retained earnings represented 77 percent of total liabilities and stockholders' equity of all 936 manufacturing corporations. The comparable figure for all U.S. manufacturing corporations was 39 percent. 10/

Total Receipts. Table 10 shows that total receipts of possessions corporations were $7.8 billion in 1978. Nearly 95 percent of total receipts were attributable to business receipts, and the remainder were attributable primarily to interest on non-government securities. Note that interest on Puerto Rican, state and local government securities is excluded from gross income for Federal tax purposes, and therefore is not included in the total receipts shown in Table 10. The amount of such exempt interest income reported by all 936 firms for tax year 1978 was $16 million. One third of the receipts of all manufacturing industries was accounted for by pharmaceuticals. After pharmaceuticals, the industries with the greatest business receipts were electrical and electronic equipment, food products, and chemicals other than pharmaceuticals.

Net Income Per Return. Net income per return (total receipts minus total deductions) amounted to $2.4 billion for all possessions corporations, of which over 90 percent was attributable to manufacturing. The industries with the greatest amount of net income were pharmaceuticals, with 50 percent of the total manufacturing income, and electrical and electronic equipment and food products, which together accounted for an additional 20 percent of net income in manufacturing possessions corporations.

8/ The incentives for 936 firms to accumulate earnings in Puerto Rico are discussed on pages 63 - 64, below.

9/ The breakdown of these financial assets and their impact on real investment in Puerto Rico is the subject of Chapter 5, below.

10/ Using the same procedure described in footnote 7, above, the ratio corrected for industry mix is 41 percent.

Table 10

Selected Income Statement Information and Tax Expenditure by Industry, 1978 1/
(Dollar amounts in thousands)

	All Industries	Manufacturing Industries								
		Total	Food & Kindred Products	Tobacco Products	Textile Mill Products	Apparel	Paper	Chemicals		
								Total	Pharmaceuticals	All Other
Number of corporations	534	390	17	4	5	73	4	81	57	24
Total receipts	7,844,959	6,977,771	697,323	191,682	43,553	339,499	8,729	2,967,174	2,251,405	715,768
Business receipts	7,330,392	6,645,876	677,152	189,414	33,964	331,197	8,425	2,775,242	2,070,659	704,583
Nongovernment interest	337,286	232,902	19,528	2,642	153	3,424	148	132,227	121,980	10,247
Other receipts	177,280	98,991	642	- 374	9,434	4,877	156	59,704	58,766	937
Total deductions	5,913,619	4,981,862	544,520	166,179	38,439	282,723	6,050	1,980,009	1,167,733	812,276
Cost of sales	4,290,670	3,736,487	455,346	153,405	28,684	254,622	5,013	1,109,734	662,366	447,367
All other deductions	1,622,949	1,245,374	89,174	12,774	9,755	28,100	1,036	870,275	505,366	364,908
Estimated net income per return	2,383,263	2,285,487	152,803	25,502	5,113	56,504	2,679	1,277,014	1,083,522	193,491
Estimated net income per books	2,296,644	2,207,006	140,505	30,993	4,966	57,384	2,842	1,241,903	1,064,538	177,364
Tax expenditures 2/	839,342	839,342	50,875	9,545	3,286	22,360	719	465,153	412,286	52,867
Distributions, total	1,151,079	1,100,830	155,241	3,500	37	45,965	0	581,074	501,221	79,852
Cash	1,053,792	1,003,543	123,274	3,500	37	45,475	0	517,292	458,734	58,558
All other	97,287	97,287	31,966	0	0	489	0	63,781	42,487	21,293

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Table 10 - continued

	Manufacturing Industries - continued						
	Rubber Products	Leather and Leather Products	Stone, Clay, & Glass Products	Fabricated Metal Products	Machinery, Except Electrical	Electrical and Electronic Equipment	Scientific 3/ Instruments
Number of corporations	10	8	6	19	13	83	28
Total receipts	55,331	47,800	63,306	122,436	386,855	739,480	194,268
Business receipts	52,837	47,100	51,615	116,084	377,413	688,260	189,994
Nongovernment interest	1,014	687	1,887	2,880	9,208	44,906	3,044
Other receipts	1,478	11	9,803	3,471	233	6,313	1,229
Total deductions	43,001	39,670	47,218	88,007	243,253	419,262	125,339
Cost of sales	33,156	35,977	40,156	79,801	205,511	347,484	92,116
All other deductions	9,844	3,693	7,061	8,205	37,742	71,778	33,222
Estimated net income per return	12,329	8,129	16,087	34,429	143,601	320,218	68,928
Estimated net income per books	12,171	8,169	14,089	32,206	112,659	320,862	71,675
Tax expenditures 2/	4,802	3,206	5,932	17,084	47,720	125,054	26,803
Distributions, total	1,816	40	0	564	162,398	27,903	7,460
Cash	1,816	40	0	564	161,360	27,903	7,448
All other	0	0	0	0	1,038	0	12

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Table 10 - continued

		Nonmanufacturing Industries							
	All other Manu- facturing	Total	Construction	Transportation Communications and Utilities	Wholesale Trade	Retail Trade	Finance, Insurance, Real Estate	Services	Miscellaneous and Not Available
Number of corporations	34	142	10	9	21	54	25	20	3
Total receipts	228,365	1,028,791	39,973	194,649	107,250	497,317	130,631	51,007	7,961
Business receipts	225,107	892,461	38,554	189,364	105,721	484,753	19,655	46,486	7,925
Nongovernment interest	2,196	104,383	337	402	42	11,145	92,316	130	10
Other receipts	1,062	31,946	1,081	4,882	1,486	1,418	18,659	4,391	25
Total deductions	165,221	930,984	35,588	143,593	101,755	483,550	116,427	44,172	5,896
Cost of sales	132,951	554,102	32,378	68,809	74,879	328,841	11,503	33,065	4,624
All other deductions	32,270	376,881	3,209	74,783	26,875	154,709	104,924	11,106	1,272
Estimated net income per return	63,144	97,598	4,384	50,848	5,495	13,766	14,204	6,834	2,064
Estimated net income per books	62,282	89,637	2,586	48,630	5,470	11,419	12,633	6,750	2,147
Tax expenditures 2/	56,803	0	0	0	0	0	0	0	0
Distributions, total	6,406	50,248	497	47,688	0	107	1,650	304	0
Cash	6,406	50,248	497	47,668	0	107	1,650	304	0
All other	0	0	0	0	0	0	0	0	0

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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 0.2 percent of the net income of all possessions corporations in 1978.

2/ Includes an additional 31 tax returns for which qualified possessions source income was available, but income statement and balance sheet information were not available.

3/ Includes photographic goods and watches.

Tax Expenditures. As explained above, the Federal tax expenditures are estimated by applying an assumed 40 percent effective U.S. tax rate to the qualified possession source income reported by each 936 manufacturing company on its U.S. income tax return, and then subtracting income and tollgate taxes paid to Puerto Rico. As explained in footnote 2, above, possessions corporations outside of the manufacturing sector were presumed to pay a rate of income tax to Puerto Rico of at least 40 percent, and thus they do not give rise to any Federal tax expenditure. The pharmaceutical industry accounted for fifty percent of the total tax expenditure. An additional 15 percent was accounted for by the electrical and electronic equipment industry.

Distributions. The final line in Table 10 shows that the 534 possessions corporations for which balance sheets were available reported $1.15 billion of distributions, which was slightly less than 50 percent of their net income in tax year 1978. One half of total distributions, or $581 million, were attributable to the pharmaceutical industry.

C. Payroll and Employment Data

To gain as complete a picture of 936 companies' operations as possible, information from possessions corporations' U.S. income tax returns was matched with payroll and employment data from the companies' Federal unemployment insurance tax returns. Tables 11 and 12 are based on all 936 firms in the manufacturing sector for which 1978 employment and payroll data could be obtained. The coverage represents 80 percent of the number of manufacturing companies included in Tables 8 through 10, and the combined net income of the sample -- $1,941 million -- represents 86 percent of the net income of all manufacturing possessions corporations.

For the manufacturing companies covered, the tax expenditure per employee averaged $12,667, which was 18.4 percent greater than the average employee compensation of $10,697. Using figures shown in Table 11, Figure III illustrates how the Federal tax expenditure per employee varied from one industry to another. In the chemical industry, the tax expenditure was $38,446 per employee, or more than two and a half times the average compensation of the comparatively well paid Puerto Rican chemical employee. By contrast, in the food, textile and apparel industries, the tax expenditure per employee was $3,016, a third of the average wage. Figure III shows that the chemical industry accounted for 57 percent of the total Federal tax expenditure, compared to 20 percent of the total employment. The food, textile and apparel industries, on the other hand, accounted for only 8 percent of the total Federal tax expenditure but provided 34 percent of the total employment.

Table 11

Tax Expenditure, Employment and Compensation of Employees by Industry, 1978

	Number of Corporations	Qualified Possession Net Income ($000) 1/	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 Manufacturing Industries	301	1,941,130	726,907	100.0	54,306	100.0	586,864	100.0	12,667 3/	118.4 3/	10,697 3/
Food and kindred	13	102,793	36,591	5.0	6,787	12.5	69,656	11.9	5,391	52.5	10,263
Meat and dairy	3	11,159	2,762	*	2,688	4.9	26,094	4.4	1,027	10.5	9,707
All other	10	91,634	33,829	4.7	4,099	7.5	43,562	7.4	8,252	77.6	10,627
Tobacco manufactures	3	20,043	7,781	1.1	931	1.7	9,977	1.7	8,357	77.9	10,716
Textile mill products	3	3,185	1,263	*	522	1.0	5,064	1.0	2,419	24.9	9,701
Apparel	60	50,407	18,304	2.5	11,312	20.8	89,284	15.2	1,618	20.5	7,892
Men's and boy's	13	10,278	2,662	*	2,589	4.8	20,476	3.5	1,028	13.0	7,908
Women's and children's	25	17,379	6,663	0.9	4,123	7.6	32,102	5.5	1,616	20.7	7,786
Hats, caps, etc.	7	2,488	982	*	1,303	2.4	10,620	1.8	753	9.2	8,150
All other	15	20,262	7,997	1.1	3,297	6.1	26,086	4.4	2,425	30.6	7,912
Paper	3	1,069	425	*	99	*	1,113	*	4,292	38.1	11,242
Chemicals	59	1,096,256	413,027	56.8	10,743	19.8	154,502	26.3	38,446	267.3	14,381
Industrial chemicals, plastics	7	88,453	34,935	4.8	1,591	2.9	31,903	5.4	21,957	109.5	20,052
Pharmaceuticals	42	968,090	363,178	50.0	8,395	15.4	114,328	19.5	43,261	317.6	13,618
Soaps, cleaners, etc.	3	13,257	5,130	0.7	431	0.8	4,288	0.7	11,902	119.6	9,948
All other	7	26,456	9,784	1.3	326	1.0	3,983	0.7	30,012	245.6	12,217
Rubber	8	6,099	2,324	*	689	1.3	6,492	1.1	3,373	35.7	9,422
Leather	7	7,541	2,994	*	1,098	2.0	8,663	1.5	2,726	34.5	7,889
Footwear	4	4,946	1,963	*	773	1.4	5,920	1.0	2,539	33.1	7,658
All other	3	2,595	1,031	*	325	0.6	2,743	0.5	3,172	37.5	8,440
Stone, clay and glass	5	13,977	5,557	0.8	642	1.2	6,035	1.0	8,655	92.0	9,400
Fabricated metal products	15	35,388	14,041	1.3	1,209	2.2	14,753	2.5	11,613	95.1	12,202
Metal cans and containers	5	18,581	7,361	1.0	363	0.7	4,554	0.8	20,278	161.6	12,545
Cutlery, hand tools, screws, bolts	4	11,277	4,484	0.6	442	0.8	6,346	1.1	10,144	70.6	14,357
All other	6	5,530	2,196	*	404	0.7	3,853	0.7	5,435	56.9	9,537

Table 11 - Continued

	Number of Corporations	Qualified Possession Net Income ($000) 1/	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 ($)
Machinery, except electrical	10	138,536	46,376	6.4	3,550	6.5	39,648	6.8	13,063	116.9	11,168
Office, computing, and accounting	4	106,479	33,646	4.6	2,947	5.4	33,066	5.6	11,417	101.7	11,220
All other	6	32,057	12,730	1.8	603	1.1	6,582	1.1	21,111	193.4	10,915
Electrical machinery	70	287,951	113,652	15.6	10,665	19.6	113,512	19.3	10,656	100.1	10,643
Radio, TV, communication	7	37,090	14,746	2.0	1,182	2.2	11,121	1.9	12,475	132.5	9,408
Electronic components	19	55,695	21,742	3.0	3,131	5.8	36,134	6.2	6,944	60.1	11,540
All other	44	195,166	77,164	10.6	6,352	11.7	66,257	11.3	12,147	116.4	10,430
Instruments, photographic goods and watches	19	36,400	14,392	1.4	1,697	3.1	17,117	2.9	8,480	84.0	10,086
Scientific instruments	7	7,784	3,040	*	517	1.0	4,871	0.8	5,880	62.4	9,421
All other	12	28,616	11,352	1.6	1,180	2.2	12,246	2.1	9,620	92.6	10,377
All other manufacturing 4/	26	141,485	50,180	6.9	4,362	8.0	51,048	8.7	11,504	98.3	11,703

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* Less than 0.5%

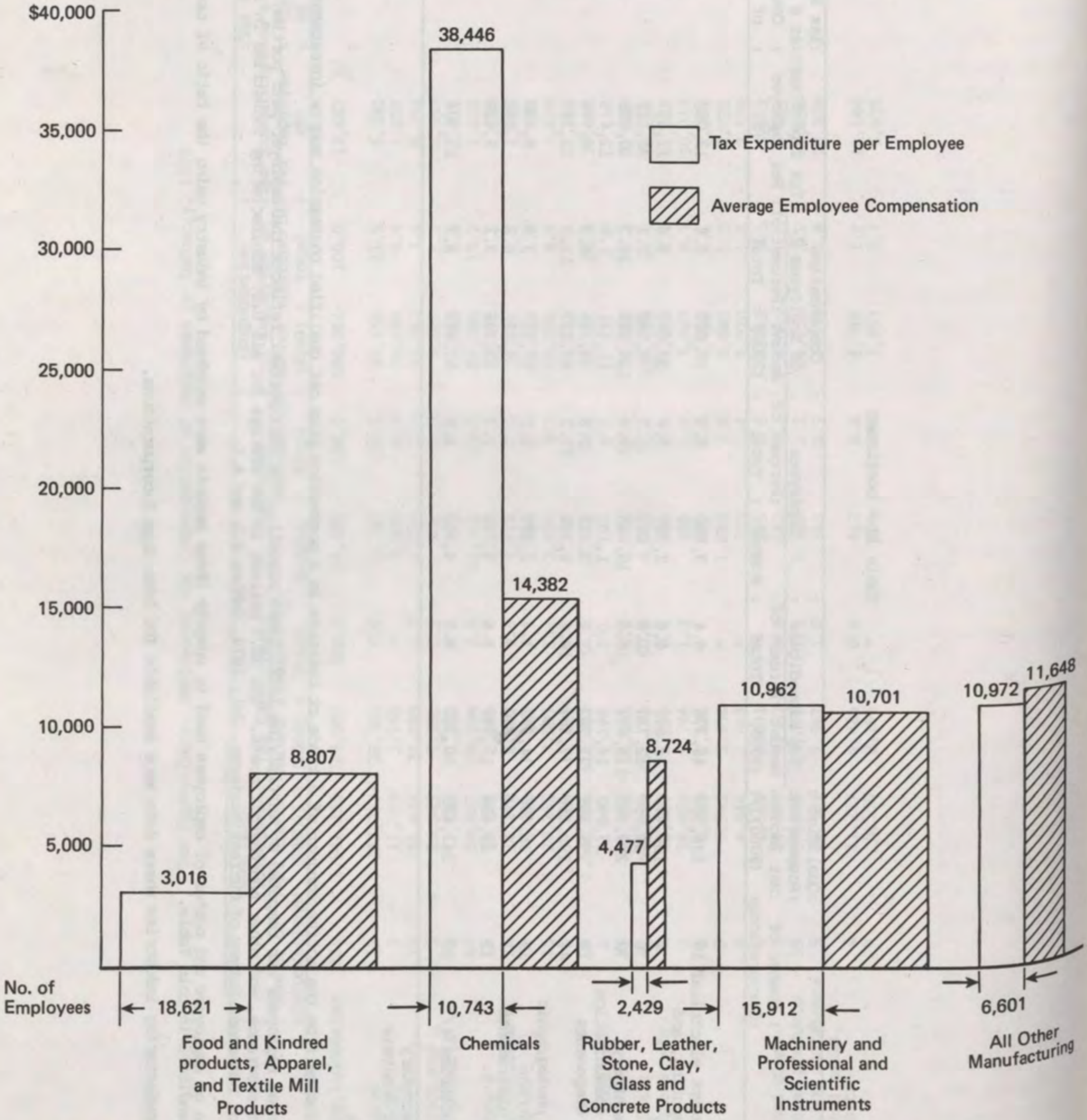
1/ Equals net income from the active conduct of a trade or business in a possession plus net qualified possession source investment income.

2/ Compensation of employees was computed by multiplying 1.221 times payroll. The 22.1 percent reflects the employer-paid portion of social security, unemployment insurance, and other non-payroll costs. The 22.1 percent is the average for all U.S. manufacturing industries in 1978; see the U.S. Department of Commerce, Survey of Current Business, July 1979, 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 10 and tax expenditure in this Table.

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

FIGURE III
Tax Expenditure Per Employee and Average Employee Compensation for Selected Manufacturing Industry Groups, 1978



Note: The height of the bars indicates the tax expenditure per employee and the average compensation per employee. Because the width of the bars indicates the number of employees, the area indicates total tax expenditure and total compensation.

Figure III also indicates a direct relationship between a company's tax expenditure 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. The chemical industry, which provided 20 percent of the total jobs in 936 manufacturing firms, paid 26 percent of the total employee compensation.

The industries in which tax expenditure per employee were the highest (pharmaceuticals, electrical and electronic equipment, scientific instruments, and non-electrical machinery) tended to be the same industries in which total employment has been growing during the past decade. Conversely, industries in which tax expenditure per employee were the lowest (tobacco products, textiles, apparel, leather products) tended to be those whose employment was declining -- see Table 6, above.

Table 12 is based on the same 301 possessions corporations shown in Table 11, but ranked according to the Federal tax expenditure per employee. At the top of the ranking were nine companies for which the Federal tax expenditure represented more than $100,000 per Puerto Rican employee; at the low end were the companies which incurred losses and thus derived no immediate tax benefit from section 936. The top nine possessions corporations accounted for 11.4 percent of the tax expenditure but only 1.3 percent of the employment of the 301 manufacturing companies for which employment data were available. The top 28 possessions corporations, those for which tax savings per employee exceeded $50,000 in 1978, collectively accounted for 37.4 percent of the total tax expenditure and 6.1 percent of total employment.

D. <u>Arthur D. Little Study</u>

Compensation and number of jobs are not the only measures of the benefits provided by 936 corporations to Puerto Rico. Other measures include the skill level of the jobs, the opportunity for individual employees to upgrade their skills, and the security of employment. A study by the Arthur D. Little Company 11/ undertaken on behalf of clients in the pharmaceutical industry concludes that:

11/ Arthur D. Little, Inc., "A Statistical Profile and Evaluation of the Employment Impacts of the Pharmaceutical Industry on Puerto Rico," and "Socioeconomic Aspects of Employment Opportunities in Puerto Rico's Pharmaceutical Industry," Cambridge, Massachusetts, 1980.

Table 12

Tax Expenditure, Employment and Compensation of Employees by Size of Tax Expenditure Per Employee, 1978

Size of Tax Expenditure per Employee	Number of Corporations	Qualified Possession Net Income ($000) 1/	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	301	1,941,130	726,907	100.0	54,306	100.0	586,864	100.0	12,667 3/	118.4 3/	10,697 3/
$100,000 or more	9	213,816	83,012	11.4	708	1.3	10,698	1.8	117,248	775.9	15,110
$ 50,000 under $100,000	19	508,281	188,677	26.0	2,616	4.8	36,579	6.2	72,124	515.8	13,982
$ 10,000 under $ 50,000	97	925,030	343,113	47.2	16,854	31.0	218,659	37.3	20,357	156.9	12,973
$ 5,000 under $ 10,000	47	142,083	56,144	7.7	7,908	14.6	81,493	13.9	7,099	68.8	10,305
$ 1,000 under $ 5,000	93	137,905	52,397	7.2	18,648	34.3	176,325	30.0	2,809	29.7	9,455
$ 500 under $ 1,000	11	8,449	2,983	0.4	3,415	6.3	30,326	5.2	873	8.9	8,880
$ 100 under $ 500	17	1,457	568	0.1	2,649	4.9	20,802	3.5	214	2.7	7,852
$ 1 under $ 100	5	40	13	*	340	0.6	2,800	0.5	38	0.4	8,235
No tax expenditure	3	4,069	—	—	1,168	2.2	9,182	1.6	—	—	7,861

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1/ Equals net income from the active conduct of a trade or business in a U.S. possession plus net qualified possession source investment income.

2/ Compensation of employees was computed by multiplying 1.221 times payroll. The additional 22.1 percent reflects the employer-paid portion of social security, unemployment insurance, and other non-payroll labor costs. The 22.1 percent is the average for all U.S. manufacturing industries in 1978; see the U.S. Department of Commerce, Survey of Current Business, July 1979, 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 10 and tax expenditure in Table 7.

* Less than 0.1% percent

-- Pharmaceutical jobs are above average in skill level. As shown in Table 13, 38 percent of pharmaceutical jobs in Puerto Rico may be classed as "skilled," compared to 11 percent in the apparel industry and 34 percent in the food industry.

-- The pharmaceutical industry contributes more to "human capital formation" -- i.e., the development of the skills and knowledge of the labor force -- than do other industries in Puerto Rico. In a 1979 survey of 23 U.S.-owned pharmaceutical firms, 15 had one or more "families" of jobs in which movement from a low-skilled to a high-skilled position occurs when an employee successfully completes a company-sponsored program. In addition, several of the pharmaceutical companies surveyed indicated that they had provided technical assistance on an informal basis to a number of their suppliers.

-- By virtue of its high profits, employment in the pharmaceutical industry is more secure than in the apparel, leather goods and other industries which are threatened by low-cost foreign imports.

III. Estimates of Linkages and Multiplier Effects

The preceding Section related the tax expenditure of the possessions corporation system of taxation to the employment and payroll of those companies. In addition to creating jobs directly, this system of taxation may bring indirect benefits to Puerto Rico. The development of one industry may encourage the growth of other industries that are users of the products which it manufactures, a phenomenon called "forward linkage." For example, the building of a petroleum refinery facilitates the growth of petrochemical manufacturers. Manufacturing also gives rise to backward linkages. Production requires raw materials, intermediate goods and services, a portion of which are supplied by the local economy. Investment in plant and equipment creates jobs in the construction and capital equipment industries. Workers in all industries spend their salaries on goods and services, which has a "multiplier" effect on the Puerto Rican economy. 12/

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

Table 13

Distribution of Employment between Skilled and Unskilled Occupational Groups, by Industry in Puerto Rico, 1975

	Professional, Technical, Administrative, and Sales Personnel	Craftsmen and Foremen	"Skilled"	Operators	Laborers	Clerical and Service Personnel	"Unskilled"	Total Employment *
Food and Kindred Products	14%	20%	34%	44%	11%	11%	66%	22,950
Tobacco Products	4	13	17	67	8	7	82	4,980
Apparel and Textile Mill Products	3	8	11	83	2	4	89	40,973
Paper and Allied Products: Printing, Publishing, etc.	32	27	59	25	3	14	42	3,812
Chemicals and Allied Products (Excluing Drugs)	27	15	42	38	7	13	58	4,651
Drugs	27	11	38	42	6	14	62	5,964
Petroleum Refining and Related Industries; Rubber and Plastics	11	21	32	52	8	8	68	5,364
Leather and Leather Products	4	12	16	75	4	6	85	5,161
Stone, Clay, and Glass Products	12	18	30	48	14	9	71	6,169
Metal Products	11	20	31	55	8	6	69	5,597
Machinery (Except Electrical)	18	30	48	38	4	11	53	3,469
Electrical Machinery	10	14	24	62	5	9	76	9,919
Transportation Equipment	12	27	39	49	4	9	62	414
Professional Instruments	7	17	24	60	4	11	75	10,829
Miscellaneous Manufacturing	9	13	22	64	5	9	78	2,888

* Total employment in all manufacturing industries in 1975 was 136,617. Employment figures are for October.

Source: La Demanda por Recursos Humanos en la Economia de Puerto Rico: Requisitos Actuales y Projecciones para 1985, Consejo Asesor del Gobernador Sobre Politica Laboral, San Juan, 1978, Appendices; and Puerto Rico Department of Labor and Human Resources, 1975 Census of Manufacturing Industries of Puerto Rico. Reprinted from Arthur D. Little, Inc., "A Statistical Profile and Evaluation of the Employment Impacts of the Pharmaceutical Industry on Puerto Rico," Cambridge, Massachusetts, 1980, p. 40.

A. Forward Linkages

"Forward linkages" are usually evaluated by examining the percentage of total sales to various types of customers. When one industry sells a substantial part of its output to another local industry, it is plausible that forward linkages have occurred. Conversely, where an industry produces a consumer good (e.g., apparel) or where it sells most of its output abroad, it is unlikely that the industry is an important stimulant to the development of local "downstream" (customer) industries.

The latest year for which Census data on the destination of Puerto Rican shipments are available is 1972. Table 14 shows the percentages of manufacturing industries' shipments in 1972 to Puerto Rico, the United States, and foreign countries, respectively, but does not distinguish between sales to individual consumers and sales to manufacturers. For manufacturing as a whole, 41.2 percent of shipments went to Puerto Rico, 54.2 percent to buyers (including parent companies) in the United States, and 4.5 percent to foreign purchasers. If indirect exports (i.e., goods sold to other Puerto Rican manufacturers who, in turn, were exporting to the United States or foreign countries) could be estimated separately, Puerto Rico's dependence on export markets would appear larger than Table 14 indicates.

Table 14 shows that some industries' forward linkages with other sectors of the Puerto Rican economy are stronger than others. The lumber and wood industry sells its limited output to Puerto Rican users, and its primary customers -- the furniture and paper industries -- also sell almost exclusively to the local market. By contrast, the pharmaceutical industry and electrical and electronic equipment industry sold 1 percent and 11 percent, respectively, of their total production to Puerto Rican buyers. Because pharmaceuticals and electrical and electronic equipment account for 80 percent of the business receipts of all 936 firms in the manufacturing sector, the evidence of Table 14 would suggest that possessions corporations are not generally an important stimulant to the development of "downstream" industries.

B. Backward Linkages

Backward linkages refer to the generation of income in "upstream" (supplier) industries as a result of an industry's purchases of local goods and services. In order to estimate the amount of purchases in Puerto Rico by possessions corporations, information on the total purchases of individual industries was compiled from preliminary data for the 1977 Economic Census of Manufactures, Puerto Rico. Rather than assuming that every

Table 14

Destination of Shipments by Puerto Rican
Manufacturing Industries, 1972
(Percentage of total)

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

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

1/ Includes shipments to the Virgin Islands.

* Less than 0.05 percent.

industry's propensity to import was the same as that of the Puerto Rican economy as a whole, each industry's 1977 expenditure was apportioned using coefficients published in a recent study based on 1963 data. 13/ Between 1963 and 1977, the ratio of imported capital equipment, raw materials and intermediate products to gross domestic output increased substantially 14/, so this procedure may overstate possessions corporations' dependence on the local economy. Moreover, because the operations of a possessions corporation are generally integrated with those of its U.S. parent, the linkage of possessions corporations with the Puerto Rican economy may be somewhat weaker than the linkage for all Puerto Rican manufacturers.

The results of this procedure indicate that for all manufacturers the total expenditures on labor, materials, plant and equipment in Puerto Rico made up 42.2 percent of the value of production -- see column 1 of Table 15 and Table B-1, line 9. The results also show that some Puerto Rican industries depend much more than others on locally produced inputs. For example, food, furniture, paper, printing, stone, clay and glass manufacturers' expenditures on Puerto Rican inputs represent more than half of the total value of their own production. At the opposite extreme, the chemical and machinery industries spent less than 30 percent of the value of production on Puerto Rican inputs. The low chemical and machinery percentages reflect a high return on capital plus overhead costs as well as a slightly heavier than average dependence on imported versus locally purchased materials. (The chemical and machinery industries are estimated to import 45 percent and 32 percent, respectively, of their total inputs, compared to the 49 percent average for all manufacturing industries.)

C. 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

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13/ Richard Weisskoff and Edward Wolff, "Development and Trade Dependence: The case of Puerto Rico, 1948-1963," Review of Economics and Statistics, November 1975, Table 2, p. 474.

14/ Between 1963 and 1974, the ratio of Puerto Rican imports of capital goods, raw materials and other intermediate goods to gross output increased from 29 percent to 41 percent.

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. According to standard textbook macroeconomic analysis, the size of the multiplier for an increase in spending (assuming, as seems reasonable in the case of Puerto Rico, that the government cannot change the rate of interest or credit conditions) is:

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

The symbols s and m represent the fraction of an increase in GNP which is saved or is spent on imports, respectively. Saving and importing represent "leakages" -- the opposite of "linkages" -- from the spending-income cycle; the greater these leakages are, the more quickly the impact of increased spending is dissipated, and the smaller the multiplier is.

In Puerto Rico, the propensity to save appears to be small, and the propensity to import high. Gross internal savings by government, business and households in Puerto Rico has been negative since 1970. In 1978, imports of goods and services equaled 87 percent of gross national product; between 1976 and 1978 the increase in the dollar value of imports equaled 91 percent of the increase in the dollar value of gross national product. If the marginal propensity to save, s, is assumed to be zero and the marginal propensity to import, m, to be .90, then the formula given above indicates a multiplier of 1.11. That is to say, if spending increases by $1.00, an additional $.11 in local spending will be subsequently generated, so the total increase in income is $1.11. 15/

15/ The First and Second Annual Reports computed the value of m using merchandise imports only, and on this basis arrived at a multiplier of 1.33. However, it is appropriate to compute m on the basis of imports of services as well as merchandise. Had this been done, the value of the multiplier would have been between 1.0 and 1.1. In El Modelo Economico de Puerto Rico (San Juan, Inter American University Press, 1979), Jorge Freyre estimates the value of the Puerto Rican "export multiplier" in 1975 to have been 1.06. That is, a one dollar increase in the demand for exports would have led to a total increase in Puerto Rican GNP of $1.06.

D. Direct, Indirect and Total Effects

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

An assumption implicit in this new, broader measure is that all Puerto Rican resources used by the possessions corporations in their production have no alternative economic use -- they would be unemployed but for the possessions corporations. Although this may be a reasonable assumption for the Puerto Rican labor used, other Puerto Rican factors may be scarce. Water and land are scarce in Puerto Rico; their use by possessions corporations precludes their use in other sectors. Some purchased inputs such as gas, oil, sugar, wood, or alcohol are standard commodities which must be bought, or could be sold, overseas. Waste disposal, transportation facilities, judicial services and other government services may also have economic costs. If employee compensation by possessions corporations is too narrow a measure of the benefits they bring Puerto Rico, the total income associated directly or indirectly with those corporations is probably too broad a measure.

Table 15 shows for various manufacturing industries Federal tax expenditures as a percentage of (a) direct labor costs, (b) total direct expenditures on Puerto Rican inputs, and (c) Puerto Rican income directly or indirectly associated with those expenditures, respectively. The first percentage (in column 2) is identical to that in Table 11 above, the second (in column 4) is obtained by multiplying the first by the ratio of compensation of employees to total direct expenditures in Puerto Rico, and the third (in the fifth column) by dividing the second by the multiplier. Finally, the last column is simply the inverse of the fifth column -- Puerto Rican expenditures directly or indirectly generated by possessions corporations per dollar of Federal tax expenditure.

Table 15 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 $3.50. In some industries (e.g., food products, apparel), the amount is between $9.00 and

Table 15

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

Industry	Total Expenditures on Materials, Plant and Equipment in Puerto Rico as a Percent of Value of Production 1/	Tax Expenditure as a Percent of Compensation of Employees 2/	Ratio of Compensation of Employees to Total Direct Expenditures in Puerto Rico 3/	Tax Expenditure as a Percent of Total Direct Expenditures in Puerto Rico 4/	Tax Expenditure as Percent of Total Direct and Indirect Expenditures in Puerto Rico 5/	Total Direct and Indirect Expenditures in Puerto Rico Divided by Tax Expenditure 6/
Manufacturing industries	42.2	118.4	.265	31.4	28.3	3.5
Food and kindred products	64.9	52.5	.180	9.5	8.6	11.6
Textile mill products	41.6	24.9	.457	11.4	10.3	9.7
Apparel	48.3	20.5	.596	12.2	11.0	9.1
Chemicals	29.0	267.3	.197	52.7	47.4	2.1
Rubber products	36.4	35.7	.604	21.6	19.4	5.2
Leather and leather products	38.6	34.5	.725	25.0	22.5	4.4
					40.4	2.5
Fabricated metal products	39.4	95.1	.472	44.9	44.7	2.2
Electrical and electronic equipment	33.8	100.1	.497	49.7		
Scientific instruments, photographic goods, and watches	34.0	84.0	.568	55.3	49.8	2.0

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1/ From Table B-1, line 9
2/ From Table 11, column 10
3/ From Table B-1, line 10
4/ Column (2) times column 3
5/ Column (4) divided by 1.11
6/ Inverse of column 5

$12.00, reflecting a low level of tax-exempt income and/or substantial purchases of goods and services from the Puerto Rican economy. In other industries the ratio is quite low, usually because the tax-exempt income is high and local purchases are only average.

IV. Net Cost and Net Benefit

As noted on page 32 above, the net cost and net benefit of the possessions corporation system should take into account any effects that the removal or restructuring of the Federal provisions would have on Puerto Rican tax law and on the behavior of U.S. corporations currently (or potentially) investing in Puerto Rico. The net cost and benefit should also take into account the effect of these changes on the suppliers of possessions corporations and on the level of employment and investment in Puerto Rico that would have occurred in the absence of the possessions corporation system.

To illustrate both the importance of these issues and the difficulty of their resolution, Table 16 sets forth five possible reactions of U.S. corporations to reductions in Federal and Puerto Rican tax benefits provided to possessions corporations. The Table assumes not only that the Federal tax benefits are reduced, but also that Puerto Rico "mirrors" those changes in its tax law to ensure that any Federal tax liability on a U.S. corporation doing business in Puerto Rico is satisfied by a foreign tax credit for taxes actually paid to Puerto Rico. The Table assumes that present tax incentives are maintained for Puerto Rican-chartered subsidiaries of U.S. corporations because foreign (including Puerto Rican) subsidiaries are not subject to U.S. tax on their unrepatriated foreign source income. These are the type of assumptions one must make to determine the net cost and net benefit of the present tax system.

The possible reactions of U.S. corporations which are considered in Table 16 are: (1) no behavioral or legal change, (2) reincorporating under Puerto Rican law, (3) moving operations to a foreign country (e.g., Ireland) and incorporating under foreign law, (4) moving operations back to the United States, and (5) ceasing operations altogether. From the companies' point of view, each of these options has distinct disadvantages: the first and the fourth option result in paying taxes to Puerto Rico and the United States, respectively; the second and the third may subject the corporation to substantial Federal toll charges on transfers of property (including intangibles) to a foreign

Table 16

Possible Impact of Parallel Reductions in Federal and Puerto Rican
Tax Benefits Provided to Possessions Corporations

Option	Impact on Federal Tax Collections	Impact on Puerto Rican Tax Collections	Impact on Employment and Investment in Puerto Rico
1. No change in behavior	None	Increased by amount of present tax expenditure	No change in present pattern
2. Reincorporate as Puerto Rican corporation	Increased by the toll charge on transfers of appreciated property and the tax on income remitted to the U.S.	None	No change in present pattern
3. Move operations to foreign country; reincorporate as foreign corporation.	Increased by the toll charge on transfers of appreciated property and the tax on income remitted to the U.S.	Lose present tollgate and income taxes	Employment and investment lost (to foreign country)
4. Move operations to the United States	Increased by amount of present expenditure plus amount of tollgate and income taxes presently paid to Puerto Rico	Lose present tollgate and income taxes	Employment and investment lost (to the U.S.)
5. Cease operations	None	Lose present tollgate and income taxes	Employment and investment lost (to everyone)

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Note: It is assumed that Puerto Rican tax law regarding U.S. corporations (but not regarding Puerto Rican-incorporated subsidiaries of U.S. corporations) "mirrors" U.S. law, so that taxes paid to Puerto Rico will offset (via the foreign tax credit) any U.S. tax liability.

corporation, 16/ and result in an indefinite deferral of, but not a permanent exemption from, Federal taxes. Whether Federal or Puerto Rican tax collections actually increase depends on which option a corporation selects: Puerto Rico collects additional taxes under the first option; the Federal government may collect toll charges and income tax on profits remitted to the United States under the second and third option and collects the ordinary tax on income under the fourth. Finally under the first two options, Puerto Rico continues to benefit from the investment and employment brought by U.S. investors, but loses those benefits under the last three. The only way of determining to what extent the measured tax expenditure represents taxes actually foregone by the Federal and Commonwealth governments, respectively, and the measured employment and investment represent economic benefits which Puerto Rico would otherwise not obtain, is first to determine the extent to which corporations would choose each of these options above the others.

16/ The toll charge is the tax on the appreciation in value (market value less the basis in the hands of the transferor) of an asset transferred by a U.S. corporation to a foreign corporation.

V. Impact of Changing from Section 931 to Section 936 and of Recent Changes in the Puerto Rico Tollgate Tax and Industrial Incentive Program

As explained in Chapter 2, the possessions corporation system was modified in the period 1976 - 1978 by the Federal Tax Reform Act, the new Puerto Rican tollgate tax rules, and the 1978 Industrial Incentive Act. Because all three sets of legislative changes were made within a relatively short period, their effects are difficult, if not impossible, to disentangle from one another. This Section evaluates the impact of these changes on dividend repatriation, the Federal tax expenditure, and Puerto Rican tax revenues. Chapter 5, below, analyzes the effect of these changes on real investment in Puerto Rico.

A. Dividend Repatriation

Under section 931, the incentive to liquidate at the end of the exemption period was strong for possessions corporations; that was the only way for them to repatriate their earnings to their U.S. parent free of Puerto Rican and U.S. tax. The adoption of section 936 reduced the incentive to liquidate by eliminating the Federal tax on distributed earnings.

There has been a clear response in the repatriation of earnings. Before 1978, possessions corporations paid virtually no dividends to their U.S. parents. In tax year 1978, however, possessions corporations distributed $1.5 billion in dividends to their U.S. parents. Of this amount, approximately $950 million represented Puerto Rican source earnings and approximately $200 million consisted of earnings on Eurodollar deposits. The 1978 dividends represented one sixth of the $7.2 billion in retained earnings reported by 936 corporations, and 50 percent of current earnings -- see Tables 8 and 10, above. Puerto Rico estimates that annual dividend repatriations in the years ending June 1979 and June 1980 were $1.4 billion.

Thus, while 936 corporations have repatriated substantial dividends since 1976, they do continue to accumulate earnings in the possessions corporation. Qualified Possession Source Investment Income is effectively exempt from Federal and Puerto Rican tax, whereas income on comparable investments by the U.S. parent is not. Both U.S. and Puerto Rican law, moreover, exempts possessions corporations from the accumulated earnings tax. In addition, the Puerto Rican tollgate tax can be reduced by reinvesting earnings in Puerto Rican assets and can be avoided altogether in many cases by a liquidation. 17/

B. Federal Tax Expenditure and Puerto Rican Tax Revenue

If the changes in U.S. and Puerto Rican law made the possessions corporation system more attractive to U.S. firms and thereby encouraged more to locate in Puerto Rico than would have done so under prior law, the Federal tax expenditure would have increased. If, on balance, they led to less investment in Puerto Rico, the tax expenditure would have decreased. In addition, the net tax expenditure would be reduced by the income and tollgate taxes paid to Puerto Rico under the new Puerto Rican laws.

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 adoption of section 936 in place of section 931 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 joining in a consolidated return. 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, and not just a tax-free liquidation.

Table 17 presents data on the number of companies that have made an election under section 936. As of June 1980, 750 corporations had filed a section 936 election form. Taken together, these companies accounted for over 99 percent of the income excludable under section 931 in 1975. Since June 1979, 14 additional U.S. firms have become possessions corporations. Almost half of the new electors were in electrical and electronic equipment. These elections were reacting to changes in Puerto Rican law and to underlying Puerto Rican locational advantages as well as to the adoption of section 936. No implication can be drawn as to whether the number electing possessions corporation status was higher or lower than it would have been under section 931.

17/ The tollgate tax does not apply to liquidating distributions by companies with "old" exemption grants or to liquidating distributions paid out of pre-1978 earnings by "converted" firms.

Table 17

Elections under Section 936

Industry	Total as of June 1979	New Elections*	Total as of June 1980
All Industries	736	14	750
All Manufacturing Industries	564	11	575
Electrical and Electronic Equipment	109	6	115
All Other Manufacturing	455	5	460
Non-Manufacturing	172	3	175

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* To alleviate hardship caused by the filing deadline set by temporary section 936 regulations, the final regulations allow a corporation which has made its election before April 9, 1980, to revoke that election for the first taxable year to which the election applies. No adjustment has been made to reflect cases in which corporations revoked prior elections. At least six corporations filed revocations, but several of these simultaneously filed new elections for later tax years.

The main result of the complex changes made in Puerto Rican law -- both the tollgate tax and the new Industrial Incentive Act -- was to impose additional taxes on possessions corporations. Puerto Rico estimates that by 1983, the tax revenues generated by the partially exempt manufacturing sector currently operating or establishing operations in Puerto Rico will be $160 million. Because the effective rate of tax, at least initially, is very low for most firms, these new taxes may provide little disincentive to investment in Puerto Rico.

For some firms the new Industrial Incentive Act offers incentives not available under prior law. In particular, export-oriented service industries, which had been fully taxable under prior law, can qualify for 50 percent 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, 18/ whereas under prior law extensions (or the availability of a new grant) were not guaranteed. Firms in the textile, apparel, and shoe industries whose grants are scheduled to expire before 1983 are also to be allowed an additional five-year exemption of 90 percent of income taxes.

Collections under the tollgate tax amounted to $49.1 million in the year ending June 30, 1978, which represents an effective rate of about 4.5 percent on $1.2 billion of Puerto Rican source earnings. (The tax does not apply to the $.2 billion in repatriated earnings from foreign countries.) Puerto Rico's tollgate tax receipts in FY 1979 were $65.0 million, and are anticipated to be $80 million in FY 1980.

In addition to tollgate tax collections, Puerto Rico has begun to receive tax revenues from companies operating under the new Industrial Incentive Act, which provides for only a partial exemption from income tax for new or old "converted" firms. As of December 31, 1979, 531 firms had filed petitions to convert to partial tax exemption. The number of applications filed represented approximately 30 percent of all grants approved (for 936 and local Puerto Rican companies) and still in effect under the prior Puerto Rican tax exemption laws. It is estimated that

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18/ As explained in Chapter 2, above, the 10-year automatic extension provides for exemption from 50 percent of income tax during the initial five-year period and between 35 and 45 percent during the second five-year period.

converted firms paid $15 million in income taxes to Puerto Rico in the year ending June 1979. Total income taxes due from all firms with partial tax exemption grants are estimated to be $25 to $30 million in the year ending June 1980.

Combining the above estimates of Puerto Rican tax collections from the tollgate tax and the income tax under the 1978 Industrial Incentive Act, it appears that together they will amount to slightly less than 4 percent of the qualified possession source net income of all manufacturing possessions corporations in calendar year 1979, and will rise somewhat in later years. Accordingly, the projected Federal tax expenditures for the period 1979-1984, shown in Table 1 above, have been reduced by 5 percentage points, or from 38 percent to 33 percent of pretax income.

CHAPTER 5

THE EFFECT OF 936 FUNDS ON THE PUERTO RICO CAPITAL MARKET

I. Introduction

The creation of section 936 by the Tax Reform Act of 1976 induced U.S. possessions corporations in Puerto Rico to bring back the large pool of funds that had been invested in the Eurodollar market. These funds are enormous by Puerto Rican standards. At the end of 1979, for example, 936 corporations had \$2.9 billion in exempt CD's in Puerto Rican banks, which amounted to 34 per cent of all deposits in commercial banks. 936 deposits grew by \$880 million in 1979, which would have been enough to finance more than 40 per cent of all gross investment in Puerto Rico. In total, financial investments in Puerto Rico by 936 corporations enjoying exemption from Puerto Rican tax amounted to about \$4.6 billion at the end of 1979. The equivalent on a U.S. scale would be in excess of \$500 billion.

Table 18 gives the financial portfolios of <u>all</u> 936 corporations in Puerto Rico. The financial assets listed do not include working capital used in their own operations. Table 18-A presents the financial portfolios of 936 corporations in manufacturing, that is, those also enjoying an exemption from Puerto Rican tax. The assets in Table 18-A are the principal focus of this chapter because the interest and dividends they generate can potentially be free both from U.S. and Puerto Rican tax.

This Chapter attempts to evaluate the impact of 936 funds, which are continuing to grow because of unrepatriated earnings, on investment in Puerto Rico. There will first be a description of the section 936 provisions regarding Qualified Possession Source Investment Income (QPSII) and of the Puerto Rican rules on the investment of Industrial Development Income. These together determine the financial investments that are exempt from both Puerto Rican and U.S. taxes. Because deposits in eligible Puerto Rican banks are one of the important investments that are exempt under Puerto Rican and U.S. law, the regulations on the banks' use of 936 funds will be discussed. The U.S. and Puerto Rican rules have changed the way in which 936 corporations and banks invest their financial assets. Further changes can be expected because of the new Puerto Rican regulations on banks' use of 936 funds, which became effective April 1, 1980. The remainder of the Chapter will attempt to trace the effect of this rearrangement of financial assets on real investment in Puerto Rico, that is, on new plant and equipment, home building, and increased inventories.

Table 18

Estimated Composition of the Financial Investments of Possessions Corporations at Year-end 1979

Investment	$ billions
Total investments	6.3+
Investments in Puerto Rico, total	5.9+
Deposits in Puerto Rican banks	2.9*
Puerto Rican source GNMA mortgages	1.0
Loans to other possessions corporations .	.1+
Puerto Rican government obligations	.2+
Repurchase - Resale agreements	.3
Mortgage and Real Estate Loans	1.2
Other investments in Puerto Rico	.2+
Investments Outside of Puerto Rico including U.S. municipals and preferred stock of U.S. corporations	.4

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*This includes about 75 million in savings banks. Some of the funds referred to as 936 deposits may include deposits by exempt firms who have not made a 936 election e.g. local exempt firms. These, however, are likely to be a small part of the total.

Table 18-A

Estimated Composition of the Financial Investments of Possessions Corporations in Manufacturing (enjoying PR tax exemption) at Year end 1979

Investment :	$ billions
Total investments	5.0+
Investments in Puerto Rico, total	4.6
Deposits in Puerto Rican banks	2.9
Puerto Rican source GNMA's	1.0
Loans to other possessions corporations .	.1+
Puerto Rican government obligations	.2+
Repurchase - Resale agreements	.2+
Mortgages and Real Estate Loans	.1+
Other investments in Puerto Rico	.1
Investments Outside of Puerto Rico	.4

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Note: The Puerto Rican Treasury Department has made available the following balance sheet information for the 374 corporations whose data are given in Table 8 in Chapter 4.

Cash (CD's) (Total - $1,589,740	$1,500,000
U.S. Obligations	
(GNMA SBA Federal project Notes)	228,189
PR Government Ogligations	228,930
Other current Assets (CD's, Repos)	432,359
Mortgages or Real Estates Loans (GNMA, Repo)	126,670
Other Investments (CD's, Repos, GNMA, etc.)	2,517,426
	$5,033,574

The link between a switch in financial holdings by 936 corporations and an increase in real investment in Puerto Rico is not straightforward. A 936 corporation may, for example, switch from Eurodollar deposits to a deposit in a bank operating in Puerto Rico. In turn, the receiving bank will invest the funds. The rules described below identify the "eligible" uses of these funds. The principal categories excluded are consumer loans, and assets and loans outside of Puerto Rico. Depending on the rigidity of the rules in force, and on whether it has more "eligible" assets than 936 deposits already, the bank will invest either in U.S. money market assets and consumer loans, or in "eligible" assets such as Puerto Rican government obligations or loans to businesses operating in Puerto Rico. If the bank invests in more "eligible" assets, the story does not, however, end there. For example, a firm receiving a loan might otherwise have obtained the funds from the U.S. money market. Receiving the money from a bank in Puerto Rico may therefore not necessarily affect its investment behavior. Further, the proceeds of a loan can be used for various purposes including increased financial investments. A large multinational borrower might also use the funds to finance investments outside of Puerto Rico. If the bank lends to the Puerto Rican government, the real impact is also not immediately clear. One possibility is that this lending may simply replace purchases of tax-free Puerto Rican debt by U.S. residents, without much impact on the market for Puerto Rican government obligations. On the other hand, it may have the effect of lowering the interest costs of the Puerto Rican government and, perhaps, encouraging public investment.

Because of this complexity in the relationship between financial investment by 936's and real investment in Puerto Rico, it will be useful to look at the issue from several vantage points. The empirical analysis begins with an examination of the change in capital flows into Puerto Rico in response to section 936. These net flows are the result of both the acquisition of Puerto Rican assets by nonresidents and the acquisition of foreign (including U.S.) assets by residents of Puerto Rico. The relevance of these flows is that they should reflect the large inflow of funds brought about by section 936. If these funds in fact lead to an increase of investment in Puerto Rico, there would be an increase in net capital flows to Puerto Rico over what there otherwise would have been. The contribution of net capital inflows to capital formation in Puerto Rico would be expected to rise.

The empirical analysis then proceeds with a review of how 936 funds have affected the banking system in Puerto Rico. Banks are intermediaries for the investment of about 60 percent of 936 funds. As we shall see in the review of relevant statutes and regulations, this is in part due to the strategic position they are given in the Puerto Rican rules. Because of banks' importance in channelling 936 funds, the change in their portfolios in response to the inflow of 936 deposits will be examined. In other words, how was the increase in assets distributed among business loans, investments in Commonwealth of Puerto Rico obligations, and investments in the Eurodollar or U.S. money market?

In addition to the look at bank portfolios, other areas of bank behavior are reviewed. One is the competitiveness of the market for 936 deposits. Deposits by 936 corporations are concentrated in a relatively small number of banks. What determines the interest rate that banks pay on 936 certificates of deposit? Are banks able to maintain a substantial discount on the rate they pay compared to regular deposits, or does the 936 rate respond to market forces? Further, when banks are able to get 936 deposits at a much lower cost than other sources of funds, is this reflected in the interest paid by Puerto Rican borrowers? These questions are relevant because they cast further light on whether 936 funds reduce the cost of capital for investment in Puerto Rico.

In addition to causing a large flow of funds into exempt bank deposits, section 936 and the related Puerto Rican legislation have also resulted in a shift of funds into other exempt assets. Two important categories are obligations of the Commonwealth of Puerto Rico and U.S. government guaranteed securities backed by Puerto Rican mortgages (GNMA's). The effect of 936 funds on the market for each of these assets, which differs because of their differing attractiveness as 936 investments, are examined in turn.

After this examination of the markets for specific types of exempt assets, the empirical analysis returns to an overall look at investment flows in Puerto Rico. Specifically, is it likely that the large volume of 936 funds could be absorbed by the Puerto Rican economy in the form of increased real investment? That is, are there enough profitable investment opportunities available to prevent a leakage of 936 funds to higher rate of return areas?

Finally, the Chapter concludes with a discussion of the possible impact of the new regulations, effective April 1, 1980, governing the use of 936 funds by banks.

II. LEGAL BACKGROUND

A. Qualified Possession Source Investment Income Under Section 936

Section 936, among other things, grants a credit which offsets the Federal tax on Qualified Possession Source Investment Income (QPSII) earned by a U.S. corporation making a 936 election. As explained in Chapter 2 above, QPSII is defined as gross income which is (a) from sources within a possession in which a trade of business is conducted, and (b) is attributable to the investment of funds derived from the active conduct of a trade or business in that possession.

Section 936, in this respect, was an important change from the earlier section 931 which exempted all non-U.S. source income of possessions corporations. Financial investments by 931 firms were therefore made outside of Puerto Rico because the investment income would thereby be free from both U.S. and Puerto Rican taxes. For this investment income to continue to be free from U.S. taxes, section 936 required that they be invested in Puerto Rico.

Final comprehensive regulations on QPSII have not been issued by the U.S. Treasury. A regulation covering deposits by 936's in Puerto Rican financial institutions has been issued. It exempts interest from deposits if they qualify for exemption from Puerto Rican tax under regulations issued by the Secretary of the Treasury of Puerto Rico, as in effect September 28, 1976, under authority of the Industrial Incentive Act. These Puerto Rican regulations are the subject of the next section.

B. Puerto Rico Tax Exemption of Eligible Income Invested in Certain Assets

The Puerto Rico Industrial Incentive Act of 1978 grants a tax exemption from Puerto Rican tax for investment income derived from the investment of Industrial Development Income in certain specified investments. For most investments, this exemption had existed in prior law as well. The investments that generate exempt interest, rents, and dividends (so-called 2(j) investments) are:

-- Puerto Rico Government obligations and loans to the Government Development Bank or other government agencies,

-- Mortgage loans or loans guaranteed by an agency of the Federal or Puerto Rico government,

-- Loans to other exempt businesses,

-- Loans to the maritime industry,

-- Loans to small businesses operating in Puerto Rico which are guaranteed by the Puerto Rican or US governments,

-- Obligations issued by the Conservation Trust of Puerto Rico,

-- Capital obligations issued by Puerto Rican banks as authorized by the Puerto Rico Banking Law,

-- Investments in public buildings including schools and hospitals,

-- Nonredeemable preferred stock of banking institutions organized under the laws of Puerto Rico, and

-- Fixed-term deposits in qualifying banking institutions,

Although this appears to be an impressive list, apart from the last item the opportunities for financial investments afforded to 936's are relatively limited. Puerto Rican government or agency bonds bear yields that are linked to the tax-free municipal market in the U.S. 936's do get the benefit of deferred and sometimes lower tollgate taxes by investing in Puerto Rican government obligations rather than repatriating their profits. But, because interest on such bonds is generally exempt from Federal tax, they don't realize the main potential benefits of the QPSII exemption, namely the tax exemption of a yield which is high because it is taxable to other investors. U.S. government-guaranteed securities (GNMA's) backed by Puerto Rican mortgages are very desirable investments for 936's because they carry a high taxable (to others) return. However, new Puerto Rican GNMA issues amounted to only about $100 million in 1979, which compares to a growth of 936 funds of about $1 billion. Finally the market for loans by 936's to other 936's or local exempt companies seems to be limited because exempt companies can get funds for long-term fixed investments at a tax-free rate derived from the Puerto Rican version of Industrial Development Bonds. One agency that offers loans of this type is AFICA (the Industrial, Medical, and Environmental Pollution Control Facilities Financing authority).

The banks in Puerto Rico, therefore, have a strategic position as intermediaries because Puerto Rican rules specifically allow them to take 936 funds and make any loan in Puerto Rico apart from a consumer loan. One example would be loans to Puerto Rican importers, wholesalers, or retailers, which a 936 could not make directly because trade is not an exempt activity. Banks can, therefore, make a much wider array of financial investments than 936's can themselves.

Banks would, of course, be important intermediaries even without any legal advantages because of their experience in credit analysis, their willingness to put their capital at risk, and their ability to use their customers' liquidity balances. The U.S. flow of funds data published by the Federal Reserve Board indicates that there is a relatively modest amount of direct lending from ultimate lender to the ultimate borrower. A change in the rules may therefore not have much effect on the banks' postion as intermediaries. Still, the possiblity of direct loans by 936's to ultimate borrowers might have some effect on interest charges for bank loans.

C. The Rules for Banks' Investment of 936 Funds Effective before April 1, 1980

The Secretary of the Treasury in Puerto Rico can declare a depositary institution to be eligible to receive Industrial Development Income funds from exempted businesses. In order to assure that the 936 funds were used for the benefit of Puerto Rico, constraints were imposed on the banks. First, 20 percent of the funds had to be invested in obligations of the Puerto Rican government or its agencies, although banks were able to use their existing investments to satisfy this requirement. Two incremental constraints were imposed to prevent banks from using the remainder to make consumer loans or investments outside of Puerto Rico, which were classified as ineligible assets. First, the increase in consumer loans plus investments outside of Puerto Rico could not exceed the increase in non-936 funds. Second, the increase in 936 deposits had to be invested in an increase in eligible (i.e. nonconsumer and non-foreign) assets. 1/ The base period for each of these was April 30, 1975, the date exempt CD's were introduced under the Industrial Incentive Acts. In addition, Citibank and Chase were not permitted to reduce the amount of borrowing from their respective head offices from the level on April 30, 1975.

1/ These two constraints appear essentially equivalent.

However, there were several features of the way in which the banking regulations operated before April 1, 1980, which diluted the impact of the incremental rules:

1. Warehousing. The Puerto Rican authorities realized that the sudden influx of 936 funds in 1976 could not immediately be absorbed within the economy. They, therefore, gave a bank 90 days to invest 25 percent of a new deposit in eligible assets and 180 days to invest 75 percent. Furthermore, because many CD's were less than 180 days in term and were continually rolled over, they appeared to be amenable to the interpretation that they were "new" 936 deposits. The warehousing might therefore last indefinitely. (It is not clear whether any banks availed themselves of this interpretation.)

2. End-of-the-month reporting. Compliance with the pre-April 1, 1980, rules was in terms of end-of-the-month levels. It was therefore possible for a bank to offer a CD for 29 days yielding a month's interest, and let it disappear on the last day of the month.

3. Repos (Securities sold under repurchase agreements). A banker could sell a Puerto Rican government obligation in its portfolio to a 936 under a repurchase agreement (usually through an investment banker). 2/ The funds received by the bank were not considered 936 deposits. To the 936, the Puerto Rican Municipal was an eligible (2j) investment. Furthermore, the bond that was "repod" could still count as one of the banks' eligible assets. It would therefore count twice. 3/ (There was some question as to

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2/ Under the usual terms of a repo, the seller (the bank) agrees to buy it back at a fixed date. It is therefore in essence a short term secured loan from the 936 to the bank. In Puerto Rican Treasury rulings, the character of the repo interest is the same as the coupon interest for the purposes of the 2(j) exemption. The sale and repurchase price are therefore set to reflect the accruing interest during the repo, and to make the interest equivalent to a short-term yield. Since investment bankers in Puerto Rico are frequently intermediaries, there are in fact two back-to-back repos -- first between the bank and investment banking house, and then between the investment banker and the 936 company.

3/ In April 1980 repos by all banks, including savings banks, amounted to $240 million, or about 7.5 percent of total 936 funds in commercial banks.

whether the bank or the 936 could claim the tax-free interest. Apparently, in some cases, both did.) 4/

4. Assets acquired from insolvent banks did not increase the base.

Puerto Rico experienced a significant banking crisis in the mid 1970's. The most significant liquidation was Banco Credito which was the second largest bank at the end of 1975, with almost $800 million in assets. It was declared insolvent and its assets were taken over by other banks in Puerto Rico. Banks who acquired eligible assets from a liquidating bank could regard them as incremental. That is, the assets did not bring an addition to the base at the same time. The acquiring banks could therefore report an increase in eligible assets even though eligible assets in the banking system as a whole had not increased.

In addition to these technical reasons for the dilution in the impact of increased 936 funds, there is the possibility that the incremental rules, even if strictly adhered to, would not affect banks' investments. The incremental rules would be effective only if the increase in 936 funds exceeded the increase in eligible investments that banks would have wanted to make anyway. If total 936 funds failed to increase, as occurred in calendar 1978, the normal growth in eligible loans would have made the incremental rule ineffective. Looking at this another way, the incremental rules don't have an impact if the growth in non-936 deposits relative to 936 deposits is greater than the "normal" growth in consumer and offshore loans relative to "eligible" loans. For example, if 25 percent of any growth in assets would be in the form of consumer and offshore loans in the absence of section 936, and non-936 funds represent more than 25 per cent of the growth of assets, then the incremental rules impose no constraint. The ineligible loans could, in short, all be made from non-936 funds.

4/ A prospective 936 corporation would not claim the tax-free income if it were close to failing the 80 percent of gross income test because the tax-free interest is not included in gross income. However, if it could safely pass the 80 percent test, it would prefer to have any exempt interest regarded as tax-free Puerto Rican government interest, because it has the added advantage of not being subject to the Puerto Rican tollgate tax when repatriated.

In addition, these are opportunities for arbitrage by other borrowers. For example, a Puerto Rican firm which gets an "eligible" loan at preferred rates may choose to reinvest it at higher rates in U.S. CD's. The Government Development Bank may also avail itself of a similar opportunity. These various opportunities for arbitrage will be discussed later in this chapter.

D. The New Banking Regulations Effective April 1, 1980

In early 1980, the Puerto Rican Treasury Department announced new regulations on banks use of 936 funds that were designed to deal with some of the problems described in the previous Section. The main substantive changes were:

1. A virtual end to warehousing opportunities. Ninety-five percent of 936 funds will have to be invested at all times in eligible assets.

2. Compliance based on average daily balances during the month rather than end-of-the-month levels.

3. Direct and indirect repos with 936 companies would be classified as 936 deposits for the purpose of the investment regulations.

4. In addition to the former requirement that 20 percent of eligible funds be invested obligations of the Puerto Rican government, a further 10 percent has to be deposited with the Government Development Bank. Banks will receive credit for existing loans to the GDB and repos to the GDB, which expects a net inflow of deposits of only about $50 million.

The possible consequences of these new regulations will be discussed at the end of this Chapter.

III. Empirical Analysis

A. The Inflow of 936 Funds and Net Capital Flows into Puerto Rico

The Tax Reform Act of 1976, which created section 936, caused U.S. possessions corporations in Puerto Rico to bring back to Puerto Rico the very large pool of funds that had been invested in the Eurodollar market. As noted above, these funds amounted to about $3 billion in bank deposits by December 31, 1979, and perhaps, $5 billion in total. If this inflow caused a net increase in investment in Puerto Rico, it should have been reflected in a net increase in capital flows into Puerto Rico. The net contribution of external investment to the financing of investment in Puerto Rico would be expected to increase over what it otherwise would have been.

Table 19 presents net flows in the Puerto Rican Capital Account. It reflects both changes in foreign holdings of assets in Puerto Rico and changes in Puerto Rican holdings abroad. The data in Table 19 are for fiscal years ending June 30. Because section 936 became law on October 4, 1976, the main impact might be expected in fiscal year 1977 (July 1, 1976 to June 30, 1977), although there might have been some flow back in anticipation of passage in the previous year. In any case, regardless of whether fiscal year 1977 or 1976 is taken as the beginning year for section 936 to have an impact, the net inflow of 936 funds is hardly visible in the net capital balance. Total inflows in the last 4 years starting with fiscal 1976 are almost identical to the flows in the prior 4 years, even in nominal terms. Where did the $4-5 billion in 936 funds go?

The answer is given on Table 20, which presents selected components of the capital account. The inflow of 936 funds is clearly reflected in the increase in direct investment, which is where it would be classified. The total for the last four years is $3.8 billion higher than the total for the 4 prior years, or about the magnitude one would expect.

The large increases in direct investment flows were offset in part by changes in banking flows. The three short-term banking flows given in the table are changes in the foreign holding of non-deposit liabilities of Puerto Rican banks, changes in short-term investments by Puerto Rican abroad, and changes in foreign

Table 19

NET CAPITAL INFLOWS INTO PUERTO RICO*

YEAR ENDING June 30	NET CAPITAL FLOWS (millions)
1970	891
1971	1,156
1972	1,323
1973	1,266
1974	1,329
1975	1,838
1976	1,695
1977	1,459
1978	1,478
1979	1,212

*SOURCE: Puerto Rico Planning Board, Bureau of Economic Accounts and Censuses

deposits in Puerto Rican banks. Increases in holdings by foreigners of short-term non-deposit liabilities diminished substantially in 1976, and turned into liquidations in 1977 and 1978. Furthermore, there were very large increases in investments by Puerto Rican banks in foreign capital markets, particularly in 1977 and 1979. Presumably, these investments were made up of Eurodollar or U.S. bank deposits.

Changes in the holdings of Puerto Rican government obligations were another offsetting factor. The foreign (largely U.S.) accumulation of Puerto Rican government obligations diminished substantially in FY 1976. In part this was due to smaller total borrowing by the government. However, the creation of section 936 must have played an important role. Some 936 corporations acquired Puerto Rican government debt. More significant were acquisitions by banks. As noted above, 20 percent of 936 deposits had to be invested in government obligations according to rules in force before April 1, 1980, when the requirement was raised to 30 percent.

Table 20

COMPONENTS OF THE PUERTO RICO CAPITAL ACCOUNT

(in millions of dollars)

[(+) reflects increased investment in Puerto Rico by nonresidents and liquidation of foreign assets by Puerto Ricans. (-) reflects sale of Puerto Rican assets by nonresidents or Puerto Rican purchase of assets abroad]

YEARS ENDING JUNE 30	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979
Direct investment in Puerto Rico	330	686	626	792	343	539	1,276	1,838	1,954	1,064
Net short term banking flows	182	32	-25	114	39	306	59	-544	-211	-440
Foreign holdings of bank debts	45	20	102	248	227	453	48	-91	-72	198
Investment by PR banks abroad	-110	79	-4	-174	-25	-168	70	-457	-197	-763
External deposits in Puerto Rican banks	247	-67	-123	40	-163	21	-59	4	58	125
Net foreign investment in long term Puerto Rican Government obligations	181	307	448	404	590	896	208	353	-195	498
PR investment in U.S. Government securities	-15	-20	66	15	111	14	-32	-303	128	-94
Net foreign investment in short term debts of PR public corporations	25	67	42	64	15	153	-37	105	- 6	-23
Short term investment abroad by public corporations	- 7	- 2	-15	8	-26	-96	-19	-48	-199	73
All other	195	86	181	-131	257	26	240	65	7	136
Total Net	891	1,156	1,323	1,266	1,329	1,838	1,695	1,455	1,478	1,212

Other offsetting flows that were significant in some years include large Puerto Rican purchases of U.S. government securities in fiscal year 1977, and large short-term foreign investments by Puerto Rican public corporations in fiscal year 1978.

The overall picture presented by these balance of payments statistics is that, at least between June 30, 1976 and June 30, 1979, section 936 and the related Puerto Rican regulations failed to lead to any visible net inflow of capital into Puerto Rico. Section 936 did bring substantial funds back to Puerto Rico, but these just appear to have flowed back out through the banking system and switches in the ownership of Puerto Rican public debt.

B. <u>The Change in Bank Portfolios in Response to the Inflow of 936 Funds</u>

936 deposits amounted to $2,862 million on December 31, 1979, which was 34 per cent of all deposits in commercial banks. 5/ How did commercial banks respond to this large inflow of deposits? To what extent did they increase loans and to what extent did they make other adjustments in their portfolios?

Table 21 presents the balance sheet for all commercial banks in Puerto Rico on December 31, 1979, for the purpose of introducing an analysis of banks' portfolios. While there is no precise match of the listed assets with the category of "eligible" loans and investments, it is possible to form a good idea of where particular items fall. The large item in the first group of cash assets, "balance due from other banks," is largely deposits by banks in the U.S. or the Eurodollar market. Only a small portion can be deposits in other Puerto Rican commercial banks because under "liabilities," we see that "deposits due to other banks" are relatively small and even these may include deposits by banks outside of Puerto Rico. Deposits with the Government Development Bank, which are also included in "balance due from other banks" appear to be less than 10 percent of the total. On December 31, 1979, the GDB listed certificates of indebtedness issued to banks of $158 million. "Bonds and other investments" include bonds issued by both the Commonwealth of Puerto Rico and by the various levels of governments in the U.S. Only the former, issued by the Commonwealth or its agencies, are "eligible" assets. Information on this eligible category is available separately and is also discussed below. Proceeding to the loan items, the first three categories are predominately eligible assets. The one important category which includes many ineligible assets are loans to individuals.

5/ There is some question whether this total is understated in view of the possibility of repos, mentioned earlier. On the other hand, the totals may be overstated because of redeposits in that the same 936 deposit is counted both in the bank receiving the deposit directly and in the bank in which it is redeposited. The data that are now available for the month of April 1980, indicate that these two almost exactly offset each other. In commercial banks there were $185.5 million in repos and $224.4 million in redeposits. For the purposes of this Section on overall portfolios, the "unadjusted" data will be used. Data on repos and redeposits is presented in the next Section.

Table 21

Consolidated Report of the Condition of All Commercial
Banks Operating in Puerto Rico at the close of Business December 31, 1979

(millions)

Assets Totals	9,922 :	Liabilities Totals	9,922 :
Cash & Due From Banks	2,087	Total Deposits	8,344
a) Currency & Coin	108	Public Funds	598
b) Checks on Bank in Puerto Rico	136	a) Secretary of the Treasury	108
c) Other Cash Items	11	b) PR Government Instrumentalities	292
d) Balance due from other Banks	1,831	c) Municipal Government of PR	101
		d) Court of Justice	39
Bonds and Other Investments	1,467	e) U.S. Government Including Postal Savings	14
Loans & Discounts:		f) Others	44
a) Real Estate	1,181	Private Funds	7,746
b) Agricultural	174	a) Demand Deposits	1,320
c) Commercial & Industrial	2,297	b) Time Deposits:	
d) Loans to Individuals	1,320	Savings Accounts	1,312
e) Overdrafts	102	Certificate of Deposits	1,122
f) All other	419	Time Deposits Open Accounts	156
Total Loans & Discounts	5,494	936 Funds	2,862
Less: Valuation Reserve	(40)	c) Certified, Dividend Officers	
Total Loans & Discounts, Net	5,494	Checks & Other Deposits	201
Bank Premises Owned	62	d) Foreign Accounts	237
Real Estate Other Than Bank Premises	111	e) Due to Other Banks	537
Furniture Fixture & Equipment	18		
Customers Liability on Acceptances		Bills Payable & Rediscounts	606
Letters of Credit and of Guaranty	117	Liability of these Banks on Acceptances,	
Interest in transit with branches	36	Letters of Credit and of Guaranty	117
Interest Earned but not collected	112	Items in transit with branches	86
Due from head office of branches	199	Interest collected but not earned	156
Other Assets	256	Due to head office	129
Net balance from current period		Other liabilities	154
Operations	4	Other valuation Reserve	0
		Capital Notes	48
		Capital Accounts	283

Source: Government Development Bank for Puerto Rico

The liability side of the balance sheets displays the various sources of funds to the banks. 936 funds stand out as an important item and are 37 percent out of all private deposits. It should be noted that banks are not simply passive recipients of funds but can attract various types of deposits by offering higher interest rates or providing better facilities. Two categories which are particularly susceptible to bank control are regular certificates of deposit and deposits by other banks.

In order to see how the inflow of 936 funds affected bank portfolios, Table 22 presents balance sheet information for the banks on June 30, 1975, and on December 31, 1979. Total deposits, including 936 CD's, increased by 78.2 percent. But even this large increase understates the increase in potentially available funds because banks chose to reduce deposits by other banks from $817 million to $537 million over this period. Further, regular CD's increased modestly, presumably because banks didn't have to bid agressively for them with all the 936 funds available.

Total loans increased by 36.0 percent, which is about equal to the rate of increase in regular demand and savings deposits in the period. In other words, total loans increased much less than the increase in total deposits, including 936 CD's. How much would loans have increased without the inflow of the 936 funds? It is difficult to believe that the increase would have been much less than actually occurred. Total loans of all U.S. commercial banks increased by more than 60 percent in the same period, in part because of the strong cyclical recovery. The 36 percent increase in loans also seems moderate in view of the 40 percent increase in nominal Puerto Rican GNP in the four years from fiscal year 1975 to fiscal year 1979.

Some of the other balance sheet changes are worth noting. The most dramatic is the increase in balances with other banks, which as noted above are primarily CD's in U.S. banks. This is entirely consistent with the data on capital flows described in the previous Section.

Banks operating in Puerto Rico increased their holdings of Puerto Rican government obligations by 149.8 percent, which is more in line with the expansion of resources resulting from the inflow of 936 funds. Not only are these eligible assets but, as indicated earlier, Puerto Rican regulations required that 20 percent of 936 funds be invested in Puerto Rican government debt.

It is also worth noting that loans to individuals, which might be expected to grow slowly because of the restrictions on the use of 936 funds for consumer loans, in fact grew much faster than commercial and industrial loans. This might reflect the relative importance of the demand for various kinds of loans and of their profitability, compared to the role of the incremental regulations.

Table 22 also indicates that while the rules governing the use of 936 funds may have imposed some constraints, they left substantial flexibility. Total holdings of Puerto Rican government obligations and of all loans (including consumer loans) grew by a total of $1.9 billion from June 30, 1975 to December 31, 1979. There may also have been an increase of $200-$300 million in eligible assets in other categories, including deposits with the GDB. On the other hand, some of the loans are ineligible. Eligible assets probably rose by at most $2.0 billion. This compares with a growth of 936 deposits of $2.9 billion. The growth in "eligible" assets was therefore substantially less than the growth in 936 funds.

This is not to say that Puerto Rican banks abused the opportunities available to them in the pre-April 1, 1980 regulations. It was apparently not difficult for them to comply with the <u>new</u> regulations. Data that are now available from the new reporting system for banks indicates that commercial banks reported an increase of $3.4 billion of "eligible" assets between May 1, 1975 and April 1980. This is very close to the total amount of 936 funds including repos. There are several reasons, besides timing, for the discrepancy between this $3.4 billion increase reported by banks and the $2.0 billion we estimate using Table 22. One is that Table 22 looks at the banking system as a whole. On the other hand, a Puerto Rican bank can record an increase in eligible assets by taking over assets from a bank in liquidation, even through aggregate eligible assets have not increased. These liquidations have been very significant since 1975. Another reason for the discrepancy is that banks may choose not to report write-offs of bad loans for the purpose of reporting compliance with the regulations to the Puerto Rican Treasury because it would reduce the amount of "incremental" assets. There appears to have been significant write-offs in Puerto Rico, particularly of real estate and constructions loans.

Summing up, it appears that the $2.86 billion inflow of 936 funds had at most a modest impact on the expansion of non-government loans by banks operating in Puerto Rico. The growth in loans of about 7 percent per year was much less than the rapid growth in total funds made possible by 936 deposits.

Table 22

Selected Assets and Liabilities of All

Commercial Banks in Puerto Rico

	June 30, 1975 :	Dec 31, 1979 :	Percent Change
Total Assets	5,782	9,922	+71.6
Balances Due from Other Banks	441	1,831	315.2
Total Obligations of Commonwealth of PR and Political Subdivision *	275	687	149.8
Total Loans and Discounts	4,009	5,454	36.0
Demand and Savings Deposits	1,893	2,632	39.0
Total Deposits	4,682	8,344	78.2
Deposits Due to Other Banks	817	537	-34.3
Non 936 CD's	991	1,122	13.2
Total Deposits Excluding Due to Other Banks	3,865	7,807	102.0
Total non 936 Deposits	4,682	5,482	17.1
Commercial and Industrial Loans	1,586	2,297	44.8
Loans to Individuals	654	1,320	101.8

* Does not include deposits with GDB, which are included in "balance due from other banks."

One reason given for the restrained growth in loans by Puerto Rican banks, even with huge inflow of 936 funds, is the need to restore their liquidity position after the 1975 recession and the banking crises that followed. This may have been true at first, but by now the liquidity position of Puerto Rican banks is far superior to that of U.S. banks. On December 31, 1979, cash items including deposits in other, mainly U.S., banks were 21 percent of total assets in Puerto Rican banks, compared to 14 percent in US banks. Loans and investments were 69.8 percent of total assets in Puerto Rican banks, compared to 83.7 in U.S. banks. 6/ It appears that Puerto Rican banks have historically maintained a relatively liquid asset position. Nevertheless, as a percentage of assets, cash items are now higher, and loans and investments much lower, than at the beginning of the 1970's.

Another reason frequently given by bankers for their reluctance to use 936 funds for loans to Puerto Rico business is that they view 936 deposits as "short-term" money. The 936 deposits come in big blocks, mostly for ninety days or less, and may quickly be withdrawn because of the parent's investment needs. The Puerto Rican bankers seem to be very sincere in this view, but it bears some examination. First, 936 deposits have continued to grow and no bank has suffered significant withdrawals. Moreover, long-term deposits are not completely insignificant. In May 1980, deposits with terms of 5 or more years (some with floating rates) amounted to $589 million, or more than 18 percent

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6/ If the 83.7 percent ratio were applied to total assets in Puerto Rican banks, it would mean about 1.4 billion more in loans and investments or about half of the 936 deposits. We have also seen that total assets would have been larger if banks had maintained their balances due other banks. Under normal circumstances, loans would therefore have been at least $1.5 billion larger. If one further remembers the increase in investment in government obligations, one concludes that only a relatively small increase in nongovernment loans took place due to 936 funds.

of 936 funds. Also, why don't banks make floating rate loans linked to the 936 CD rate? If the 936 funds are suddenly repatriated, the 936 CD interest rate will become equivalent to the regular CD rate, which in turn tends to be linked to the Eurodollar rate. In other words, funds would always be available, although sometimes not a discount from the regular cost of funds. It appears that there are more likely explanations for the modest growth in loans. Either banks are unwilling to link their lending rates to the costs of 936 funds, or there aren't sufficient creditworthy loans available, or banks have more profitable uses for the funds.

C. The Distribution of 936 Funds Among Banks in Puerto Rico

The banks operating in Puerto Rico are diverse in character. On the one hand there are branches of stateside U.S. banks -- Citibank, Chase, and since 1978, Bank of America. Another group are the Puerto Rican Banks, the largest of which by far is Banco Popular with $2.4 billion in assets at the end of 1979. Even then, Banco Popular would only be about 50 in the size ranking of U.S. banks. A further category includes branches of the Canadian banks, the Royal Bank and Bank of Nova Scotia, which have long histories of operating in the Carribean. There are also foreign-controlled banks which are organized as Puerto Rican subsidiaries and are classified as domestic Puerto Rican banks. These include Banco de Santander and Scotiabank de Puerto Rico.

Treasurers who invest 936 funds in Puerto Rico are reputedly very conservative and are unwilling to deposit funds in banks with capital below some threshold. 7/ This high degree of risk aversion may not be surprising or irrational in view of the Puerto Rican bank failures in the mid-1970's. 8/ Whatever its cause, the conservative financial policy is reflected in the concentration of 936 funds that is evident in Table 23. The Chase and Citibank branches, which have their parents' capital behind them, alone account for 46 percent of all 936 deposits although they only have 27 percent of non-936 deposits. By contrast, the local banks have a much smaller share of 936 deposits than of total deposits.

In addition to direct deposits by 936 corporations, the local commercial banks also get redeposits of 936 funds from national banks with insufficient eligible loans. These redeposits are included in the distribution of 936 funds in Table 23. Local

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7/ $100 million is a common threshold that is cited. Banco Popular crossed this level at the end of 1978 and doubled its 936 deposits in the following year.

8/ Banco Credito, the second largest local bank at year-end 1975, was declared insolvent and its assets were distributed to other banks. Banco Central also became insolvent and was eventually taken over by a Spanish bank. The surviving bank is Banco Central y Economias. In each of these two cases, there was a "purchase and assumption" by the Federal Deposit Insurance Corporation with the result that no depositor lost any money. Finally, there were also failures of three small banks affiliated with unions.

Table 23

Distribution of Bank Deposits
in Puerto Rican Banks, December 31, 1979
(dollars in millions)

Bank	936 Deposits	Total Deposits	936 Deposits as a Percentage of Total Deposits	936 Deposits as a Percentage of 936 Deposits in all Banks
Chase	629	1,466	42.9	22.0
Citibank	686	1,327	51.7	24.0
Bank of America	261	329	93.3	9.1
Subtotal: National Banks	1,576	3,122	50.5	55.1
Banco Popular	348	1,955	17.8	12.2
Banco de Ponce	201	912	22.0	7.0
Scotiabank de PR	228	426	53.5	8.0
Subtotal: All Domestic Commerical	886	4,546	19.5	31.0
Royal Bank of Canada	191	459	41.6	6.7
Bank of Nova Scotia	209	216	96.8	7.3
Subtotal: Canadian Banks	400	675	59.3	14.0
Total: All Commercial Banks	2,862	8,344	34.3	100

Note: Deposits of the smaller domestic banks are not displayed individually on the table. Their deposits are reflected in the subtotal for domestic commercial banks.

banks can also attract funds from 936's by offering repos (repurchase agreements). These local banks, which tend to have an excess of eligible loans, do not need repos for the purpose of dealing with the banking regulations discussed earlier. But the security which is used for the repo provides collateral to the 936 corporation. If the bank should fail, the 936 will be left with the underlying security. 9/

Table 24, which is based on the reporting system for banks under the new regulations, reveals the significance of repos and redeposits for each type of bank. It is clear that the local commercial banks were the prime beneficiaries of repos and redeposits. About one third of their total 936 funds come through these channels. The smaller local banks, which are not individually listed, received $200 million of their $300 million in 936 funds through redeposits and repos.

Even though Chase and Citibank account for almost half of total 936 deposits, there are a number of other banks with substantial deposits. Furthermore, the combined Citibank and Chase share has been falling in the past two years. In December 31, 1977, they had 59.4 percent of all 936 deposits, compared to 46 percent at the end of 1979. This erosion in their position is the result of several forces. One is the entry in 1978 of the Bank of America, which had acquired $261 million in 936 funds by the end of 1979. 10/ Another is the growing strength of Banco Popular, which crossed the $100 million in capital threshold in 1978 and bid agressively for 936 deposits in 1979. The Canadian banks are also becoming more prominent. Their parents are large international banks with capital sufficient to reassure the treasurers of 936 companies. The Bank of Nova Scotia now has a Puerto Rican subsidiary (Scotiabank de Puerto Rico), as well as a branch, and the Royal Bank is seeking approval for the acquisition of the Banco de San Juan. For these reasons it appears that the market for 936 deposits has become more competitive. This may have contributed to the virtual elimination, for a time, of the interest rate differential between 936 and regular CD's in early 1979. This differential is discussed more fully in the next Section.

9/ However, repos are not entirely satisfactory from the banks point of view because the margins have to be split with investment bankers, who usually arrange the repos or are used as intermediaries.

10/ Bank of America is confined by law to wholesale banking. That is, it cannot take deposits smaller than $300,000.

Table 24

Distribution of 936 Funds from All Sources

Average Daily Balances, April 1980
(preliminary data)

(in millions)

Bank	Direct Deposits	Funds Obtained by Repurchase Agreements	Redeposits	Total 936 Funds
Chase	654	-	-	654
Citibank	734	-	-	734
Bank of America	310	-	-	311
Subtotal:				
National Banks	1,698	-	-	1,699
Banco Popular	358	86	7	450
Banco de Ponce	215	14	21	250
Scotia Bank de PR	125	-	59	184
Subtotal:				
All domestic Commercial	789	185	209	1,183
Royal Bank	258	-	-	258
Bank of Nova Scotia	212	-	15	227
Subtotal:				
Canadian Banks	470	-	15	486
Total:				
All Commercial Banks	2,957	185	224	3,142 *

Source: Department of the Treasury of Puerto Rico

* Includes only direct deposits and repurchase agreements. Including redeposits would count the same funds twice for the banking system as a whole.

In April 1980, savings banks had $31 million of redeposits, $47 million through repos, and $3 million of redeposits. All banks, including savings banks therefore had a total of $3,220 in 936 funds.

D. The Interest Rate Differential Between 936 Deposits and Regular CD's: Is the Market for 936 Deposits Competitive?

The interest rate that 936 corporations are able to obtain on their deposits in Puerto Rico banks is the result of several factors:

1. Other investment opportunities available to 936's. As we have seen, the opportunities for non-bank investments are relatively limited. Puerto Rico source GNMA's are desirable because of their guarantee and their yield, but the supply is inadequate relative to the volume of 936 funds. The one alternative market for 936's which is liquid and very large is the Eurodollar market. However, Eurodollar interest would be taxable in the U.S. although it would be free from the Puerto Rican tollgate tax. We can see approximately how large the return on 936 deposits would have to be compared to the Eurodollar interest rate in order for banks to continue to attract 936 funds. For example, assume a marginal U.S. corporate tax rate of 46 percent, a Puerto Rican tollgate tax of 10 percent, and repatriation of the proceeds after one year. Then 90 percent of the 936 CD return would be left after tollgate taxes but only 54 percent of the Eurodollar return after Federal income taxes. Therefore the 936 rate would only have to be 60 percent of the Eurodollar return, that is .54 divided by .9, in order to be an acceptable alternative.

2. The constraints on the use of 936 funds imposed by law and regulations, and the ratio of "eligible" loans to 936 deposits. Section 936 and the Puerto Rican rules set guidelines on how 936 funds can be used. The effectiveness of these legal constraints is reflected in how closely 936 funds and "eligible" loans have to be matched. If they have to be matched closely, then banks' ability to bid for 936 deposits depends on the availability of creditworthy "eligible" loans. If the supply of "eligible" loans is large relative to 936 deposits, then the banks will bid the 936 CD interest rate up. Conversely, if there is a large growth in 936 funds without a simultaneous growth in "eligible" loans, then banks will be unwilling to bid agressively for these funds because they wouldn't be able to place them. The 936 CD interest rate would therefore begin to drop. That, in turn, would accelerate repatriation. Banks may also be induced to make more "eligible" loans as the cost of funds drop. Further, more 936 funds may flow to the smaller local banks which usually have an excess of eligible assets.

3. The degree of competition by banks for 936 funds. If banks are competitive in bidding for 936 funds, they will bid for deposits as long as they have eligible assets and the 936 CD rate gives them at least a "normal" spread. If there were an excess of eligible loans, the 936 rate would approach the regular CD rate. On the other hand, if a single bank or limited number of banks had dominant positions, they would be able to obtain 936 funds as long as they paid marginally above the after-tax Eurodollar rate. They would maintain the spread between 936 and regular CD's even if the banking regulations imposed no effective constraint on the use of the money.

Table 25 presents data on interest rates for 936 CD's and for regular CD's. (The rate on regular deposits differs from the Eurodollar rate by only a small margin). The percentage difference between 936 and regular CD interest rates was relatively stable between December 31, 1976 and June 30, 1978. The differential then started to drop and virtually disappeared by March 1979. It proceeded to widen again in the following 12 months.

This movement in the differential between 936 and regular CD rates is consistent with the growth in loans relative to the growth in 936 deposits. They are given in Table 26. Loans grew pretty steadily over this period at the rate of $400-$500 million per year. (Because there is a seasonal element in loans, it is better to compare levels in the same month of the year.) On the other hand, 936 deposits were relatively stable from December 31, 1977 to December 31, 1978, growing by only about $250 million. Therefore, over the period banks had many additional uses for 936 deposits, but deposits had not grown much. They therefore bid the interest rate on 936 CD's up close to the rate on regular CD's. By contrast, between the end of 1978 and the end of 1979, 936 deposits grew by almost $900 million, much faster than the growth in loans. The most rapid growth was in the last nine months of the year. As 1979 progressed, therefore, banks received many more deposits than they could put to use in eligible loans. They were therefore unwilling to pay high rates for additional 936 funds, which explains the widening differential after March 1979.

The conclusions that can be drawn from these data:

1. The market for 936 deposits appears to be relatively competitive. The banks could not maintain the discount for 936 deposits that existed in 1976 and 1977, but saw it almost disappear in early 1979. If the market for 936 funds was tightly controlled, the banks would have been able to maintain a discount on 936 deposits that would leave a return just slightly higher than the after-tax Eurodollar rate. Table 25 indicates that this has not been the case.

Table 25

Comparison of 936 and Regular CD Interest Rates

(3 Month Deposits)

Beginning of Month	(A) 936 CD Rate	(B) Regular CD Rate	Ratio of A to B
12/76	3.10	4.50	.69
3/77	3.125	4.75	.66
6/77	3.50	5.25	.67
9/77	3.75	5.875	.64
12/77	4.30	6.25	.69
3/78	4.125	6.50	.63
6/78	4.875	7.20	.68
9/78	5.75	7.875	.73
12/78	7.75	9.00	.86
3/79	8.90	9.375	.95
6/79	8.875	9.50	.93
9/79	9.125	10.25	.89
12/79	10.75	12.875	.83
1/80	10.75	12.875	.83
2/80	10.75	14.00	.77
3/80	12.125	16.00	.76
4/80	13.375	17.00	.79

Source: Banco Popular de Puerto Rico. Rates in other banks usually differ by no more than 1/8 or 1/4 of a point. There could be a substantial difference if one or more banks do not have available eligible assets. Virtually the same pattern appears in data provided by the Puerto Rican Treasury on the differential between interest on 936 CD's and U.S. certificates of deposit.

Table 26

936 Deposits and Loans by Commercial Banks

(Dollars in Millions)

End of Month	936 Deposits	Total Loans and Discounts
6/77	1,472	4,580
12/77	1,745	4,661
6/78	1,839	5,078
12/78	1,998	4,955
6/79	2,414	5,425
12/79	2,878	5,454

Source: Government Development Bank for Puerto Rico.

The competitiveness of the 936 deposit market that is reflected in the virtual closing of the differential in early 1979 may have been a temporary phenomenon. The period of the narrowing of the differential did coincide with the first year of the Bank of America's operaion in Puerto Rico. It quickly acquired almost $200 million in 936 deposits, apparently by bidding agressively, i.e., offering a premium for them. Competitive pressures may have abated because its deposits did not rise much after August 1979. Still, we noted above that there are other signs of increased competition. Banco Popular, the largest local bank, started to bid aggressively for deposits in the latter part of 1979 and almost doubled its total of $185 million at year end 1978. The Canadian banks are also becoming more significant. The increase in 936 deposits relative to loans, and not reduced competiveness, explains the widening differential in 1979. If there should again be a substantial increase in "eligible" loans while 936 deposits remain unchanged, active bidding for deposits can be expected. Further, the nature of 936 deposits is conducive to competitive behavior. Each deposit is very large and it is therefore very profitable to seek out the best rate. The market for 936 deposits is therefore quite different from the market for loans, where borrowers are very heterogeneous and may require intensive credit analysis, or have long-term banking relationships that they are reluctant to disrupt.

2. The old regulations governing the use of 936 funds seem to have imposed some real constraints. In other words, despite the opportunities that apparently existed before April 1, 1980, for circumventing the rules on the use of 936 funds, the restrictions did have some bite. The reason for this conclusion is that it would otherwise be difficult to explain the substantial widening of the differential after it had virtually dissappeared in early 1979. We have concluded that there was no overall reduction in the competitivenss of the market for 936 deposits. If anything, in 1979 the market probably became more competitive as the number of banks that could effectively bid for deposits increased. However, when the total 936 deposits grew much faster than loans in 1979, the differential between 936 and non-936 deposits widened substantially. If banks had felt no constraints in the use of 936 funds, they presumably would have continued to be willing to pay a high price for them. The widening of the differential therefore suggests that their inability to find an adequate volume of "eligible" loans restricted their profitable uses of the 936 deposits.

E. The Market for Loans in Puerto Rico: How Much do Borrowers Benefit from Low-Cost 936 Funds?

We have seen in earlier sections that 936 deposits are frequently much cheaper sources of funds than regular certificates of deposits. 11/ How does the availability of this large pool of relatively inexpensive deposits affect interest rates charged to borrowers? In an earlier Section it appeared that the inflow of 936 funds did not lead to an appreciable increase in bank lending. Information on borrowing costs would add further clues to the impact of 936 funds on investment in Puerto Rico. If banks lower the interest rates charged to borrowers, there is more likely to have been an expansion in Puerto Rican investment due to the presence of 936 funds. It may be that banks do not lower their lending rates but are more willing to extend loans. Still, one would expect an adjustment in both directions, in lower interest charges and more loans. Furthermore, the extent to which banks lower interest rates is interesting even if it doesn't increase investment demand because it will indicate how the benefits of 936 funds are distributed among various economic groups in Puerto Rico.

Direct information on bank spreads is unfortunately difficult to obtain. It is necessary to rely on the views of experienced participants in the Puerto Rican capital market. Some bankers stated that they were passing through the lower costs of funds fully. Others conceded that they benefited from the opportunity for larger spreads provided by 936 funds. (Both could, of course, be right.) One phenomenon that was frequently alluded to was "match funding" of 936 deposits with loans of the same maturity extended to large multinationals, with the interest rates based on the 936 CD rate. Apparently the multinationals are able to get lower cost loans because of their willingness to accept short terms and, consequently, the prospect of having to repay after 90 days if there is a withdrawal of 936 deposits. They are in a position to repay the loans if necessary because they can fall back on their ability to borrow from U.S. banks. That is, they have access to the U.S. capital market. However, this increases the likelihood that the loan by a Puerto Rican bank simply replaces a loan from a stateside bank. The low cost funds in Puerto Rico may not encourage more investment there because the multinational would be reluctant to invest in projects with a low rate of return in Puerto Rico when it has better opportunities

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11/ If a bank has a large retail operation, it may have substantial low-cost demand and savings deposits which are cheaper than 936 money. On the other hand this may involve large investments in facilities and processing costs.

elsewhere. It would attempt, where feasible, to arrange financial flows among its affiliates to increase investment where the return is highest.

Investment bankers were also not entirely consistent in their views. One leading investment banker said that he knew of many cases in which local borrowers got lower cost funds. Another investment banker stated that of more than a hundred cases which he knew about, banks offered lower terms in only a single instance. This difference in perceptions was perhaps due to the fact that the first investment banker's experience was based on the larger local companies.

Attorneys and accountants who specialized in 936 companies seemed the most skeptical that 936 funds were changing investment patterns. One leading specialist in 936 expressed the view that borrowers received better terms only if they had first linked up with prospective 936 depositors and brought the deal to the bank.

The pattern that emerges is that there is a wide range of types of borrowers with differing abilities to negotiate lower borrowing costs. Each borrower has some bargaining power in that he can threaten to take his business elsewhere and deprive the bank of an "eligible" asset. Since we have seen that even under the pre-April 1, 1980 rules, a bank's ability to acquire 936 deposits was somewhat constrained by the amount of eligible loans, a loss of an eligible asset would be costly to the bank. However, the credibility of the threat to go to another bank will vary a great deal. At one extreme are large multinational companies with well known credit standings who are able to negotiate with several banks having 936 funds. They apparently get substantial reductions in interest costs. At the other extreme are small Puerto Rican firms having long-term banking relationships with only one or two banks which they, the Puerto Rican firms, don't want to jeopardize. A new bank would require an extensive credit analysis before extending a loan. Also, the local firm's only effective alternative may be one of the smaller domestic banks which don't have many 936 deposits and therefore don't have "cheap" money to offer. This kind of small local borrower, therefore, finds it difficult to negotiate better terms. The larger Puerto Rican firms are somewhere between these extremes. Some of them seem to be getting lower cost funds, but it is difficult to know how many.

There does appear to be increasing competitiveness in the loan market. The "back to back" kind of loans referred to earlier seem to be a growing phenomenon. In 1978, a leading investment banker started to arrange these deals in which he links a 936 depositor with a Puerto Rican borrower. They then approach a bank. Another leading investment banking house has also entered into the business of arranging similar matches. The banks are understandably disturbed by the prospect of borrowers and depositors knowing each other, but some seem to be willing to agree to the arrangement. The total volume of these kinds of "back to back" deals may now amount to almost $500 million. In most cases the borrowers are "eligible" but not exempt firms so that a bank is required as an intermediary according to the Puerto Rican rules. However, the banks provide other intermediary services as well, including credit analysis and willingness to put their capital at risk.

It should also be noted that the operation of the "incremental" rules makes it difficult for the banks to be very mechanical in offering lower terms to borrowers. Banks can only use 936 deposits to finance loans in excess of the base level on April 30, 1975. However, if new borrowers get lower interest rates, those in the base may insist on them as well. The "old" loans may in fact threaten to go to another bank where they would be "incremental" loans. Borrowers will therefore sort themselves out in some sort of equlibrium in which large borrowers with several alternative sources of financing will probably benefit most irrespective of whether or not they are in the base. It is of some interest that one of the banks which gets high marks from many observers for its pass-through of lower interest costs, the Bank of America, operates almost exclusively with 936 funds and has no base problem because the branch was established in 1978. 12/

12/ The rules will probably mean that bad debts in the base are never written off because doing so would reduce the amount of loans that are considered incremental. One attorney is of the opinion that write-offs for tax purposes don't require them for 936 purposes.

F. The Puerto Rico Government and the Mortgage Market as Beneficiaries of 936 Funds

1. Commonwealth of Puerto Rico Obligations

In an earlier Section on the balance of payments, we saw that the introduction of section 936 led to a shift in the ownership of Puerto Rican government obligations. The analysis of bank portfolios revealed an increase in their holdings of Puerto Rican Government obligations of more than $400 million between June 30, 1975 and December 31, 1979. Possessions corporations have also made some direct purchases of Commonwealth of Puerto Rico obligations.

This increased demand for Commonwealth of Puerto Rico obligations does not, however, appear to have resulted in a significant reduction in net interest costs on public issues. Table 27 gives net interest costs for public offerings from 1975 through early May 1980. Column 4 is the Bond Buyer's index of interest yields on tax-free municipals. There seems to have been a moderate decline in the differential between net interest costs on Puerto Rican issues and the Bond Buyer index. The differential in the five latest issues was about .50 percentage points lower than in 1975 or 1976. This may, however, have been due largely to the widespread perception of Puerto Rico's improved financial management and to the much slower growth in Puerto Rican public debt in fiscal years 1978 and 1979.

The reason for this small, if any, effect on interest rates is that most of the Puerto Rican government debt is still held in the United States. It, therefore, has to compete in yield with other tax-free obligations. Section 936 increased the Puerto Rican demand for Puerto Rican government debt by perhaps one billion dollars. This compares with a gross stock outstanding on June 30, 1979, of $6.4 billion. The data on the foreign investment position of Puerto Rico provided by the Puerto Rican Planning Board indicate that more that $5 billion of government debt was held abroad, presumably in the United States. Because Puerto Rican issues are a relatively small percentage of the total tax-free U.S. market, interest costs will depend primarily on the perceived risk of default and will not be much affected by a small shift in the amount available to U.S. investors. 13/

13/ The Puerto Rican press and government have emphasized this importance of mainland investors and of the Puerto Rican budget deficit in determining the success of a bond issue. The $300 million issue in May 1980 at favorable rates was reported as a reflection of the appeal of Puerto Rican bonds to mainland investors. Furthermore, the President of the Government Development Bank stated that the narrowing interest differential since mid-1977 "speaks very well of the success that Governor Romero has had in putting our financial house in order."

Table 27

Interest Costs on Bond Issues Sold *
1975 - 1979

	Agency	(1) Amount	(2) Date	(3) Net Interest Cost	(4) Bond Buyer Index	(Col. 3 -- Col-4)
1975	Commonwealth of P.R.	80,000,000	1-29-75	8.00	6.54	1.46
	PR Urban Research & Housing Corp.	67,000,000	2-26-75	7.98	6.40	1.58
	PR Telephone Authority	75,000,000	4-17-75	9.13	6.86	2.27
	Commonwealth of PR	75,000,000	5-22-75	9.00	7.09	1.91
	PR Highway Authority	50,000,000				
	PR Water Resources	50,000,000	11-13-75	9.92	7.43	2.49
1976	PR Highway Authority	35,000,000	2-27-76	9.96	6.98	2.98
	PR Telephone Authority	50,000,000	5-13-76	8.99	6.71	2.28
	University of Puerto Rico	22,650,000	8-18-76	9.15	6.60	2.55
	PR Water Resources	60,000,000	10-13-76	8.23	6.33	1.90
	PR Aqueduct & Sewer	35,000,000	12-10-76	7.88	5.96	1.92
1977	PR Highway Authority	62,500,000	2-18-77	7.61	5.86	1.75
	Commonwealth of Puerto Rico	300,000,000	4-14-77	7.89	5.70	2.19
	PR Highway Authority	75,000,000	8-10-77	6.99	5.63	1.36
	Puerto Rico Ports	29,500,000	11-17-77	7.33	5.45	1.88
1978	PR Public Buildings	110,000,000	2-14-78	7.72	5.61	2.11
	PR Industrial Dev. Co.	40,000,000	3-31-78	7.98	5.69	2.29
	PR Telephone Authority	100,000,000	6-29-78	7.99	6.31	1.68
	PR Water Resources	125,000,000	9-26-78	7.70	6.12	1.58
	PR Telephone Authority	25,000,000	11-15-78	7.56	6.11	1.45
	Commonwealth of Puerto Rico	100,000,000	11-17-78	7.98	6.11	1.87
1979	PR Public Buildings	125,000,000	4-05-79	7.90	6.28	1.62
	PR Telephone Authority	110,000,000	6-06-79	7.56	6.09	1.47
	PR Water Resources Authority	100,000,000	10-18-79	9.07	7.18	1.89
	PR Telephone Authority	50,000,000	1-24-80	8.95	7.33	1.62
1980	Commonwealth of Puerto Rico	300,000,000	5-7-80	9.37	7.96	1.41

* All information provide by Government Development Bank for Puerto Rico

There may have been larger interest savings on direct loans by banks to government agencies. Deposits by banks in the Government Development Bank have grown substantially since 1975 and are expected to grow by a further $50 million because of the new regulations. The interest paid on these deposits is the after-(corporate) tax Eurodollar rate, which is less than banks pay for 936 CD's and on average may be less than the market rate on Puerto Rican public issues.

Another important vehicle for direct bank financing of the Puerto Rico government is the Note Purchase Agreement. This was entered into on December 28, 1978, by the Government Development Bank and nine designated government corporations, on the one hand, and six major mainland banks and six Puerto Rican banks on the other. Under the Agreement, the banks have both a term commitment and a revolving commitment to purchase notes issued by the designated coporations to the Government Development Bank. A total of about $300 million of debt was outstanding under the Agreement on December 31, 1979.

How has the Puerto Rican government used the proceeds from its loans? In particular, is arbitrage one of the uses? The Government Development Bank did have investments of $476 million in U.S. money markets on June 30, 1979. However, this was apparently only temporary and due to the anticipation of large withdrawals by government agencies. The money market investments decreased to $120 million on December 31, 1979. It is difficult to tell whether the GDB's role as fiscal agent justifies its volume of money market investments. These investments do seem to have risen in recent years.

2. GNMA's -- Mortgage-Backed Securities Guaranteed by the U.S. Government

GNMA's are securities issued by mortgage lenders which are backed by a pool of mortgages and whose interest and principal are guaranteed by the U.S. Government. The mortgages in the pool have to be government-insured. The securities are issued with a coupon 50 basis points (.5 percentage points) below the FHA mortgage rate. The price of any GNMA at issue depends on market rates and the special features of any particular pool, e.g. some may have a faster rate of principal repayments.

GNMA's backed by Puerto Rican mortgages are different from debt of the Commonwealth in that they are very desirable investments for 936's and their supply is small compared to total 936 funds. GNMA's are more desirable than the government of Puerto Rico debt because, before 936, they carried a high yield similar to other taxable (in the U.S.) issues. The principal demand had been by U.S. investors. When the introduction of section 936 ended the tax exemption for 936 investments in the Eurodollar market, GNMA's became one of the few high-yield investments that were still tax-exempt. Not surprisingly, the 936's bought up virtually all the available stock. On March 31, 1980, total outstanding GNMA issues orginating in Puerto Rico amounted to $1.20 billion dollars. As a result of the 936 demand, and their limited supply, Puerto Rican GNMA's now sell at a substantially higher price than U.S. GNMA's with with same coupon. For example, in April 1980, when U.S. GNMA's with a 12.5 percent coupon were selling at 85, Puerto Rican GNMA's with the same coupon were selling at par. The interest yield on US GNMA's was more than 2 percentage points higher. In June 1980, GNMA's with an 11 percent coupon were selling at par if they were U.S. source and at 106.5 if Puerto Rican. This implies a yield differential of about one percentage point.

This substantially lower interest rate on Puerto Rican source GNMA's is probably passed on, at least in part, to Puerto Rican homebuyers who qualify for insurance. There are a large number of potential GNMA issuers, including mortgage companies, commercial banks, and saving banks. It also appears that a significant portion of Puerto Rican home mortgages would fit under the FHA size limits and could therefore qualify for insurance. However, interest rates on conventional mortgages do not seem significantly lower than in the U.S. According to the Government Development Bank, the rate on conventional mortgages in the middle of June 1980, was 12.5 percent plus a one-time fee of 3 percent, which implies an annual interest cost only about 1/4 of 1 percent lower than in the U.S.

It is difficult to know whether any reduction in mortgage costs that may have taken place has had an impact on home building. The dollar level of investment in private dwellings was very stable from 1972 through 1979. In the years immediately following the introduction of section 936, GNMA issues were as high as $250 million per year. In the 1979 depressed housing market of 1979, they amounted to only about $100 million.

G. The Volume of 936 Funds in Puerto Rico: Can they be Absorbed?

As indicated in Table 18-A at the beginning of this Chapter, financial investments in Puerto Rico by exempt 936's amounted to approximately $4.6 billion at the end of 1979. Approximately $2.9 billion was in CD's in Puerto Rican banks. Another one billion dollars was probably in Puerto Rican source GNMA's out of a total stock outstanding of $1.2 billion. Direct loans to other exempt corporations, purchases of capital notes of Puerto Rican banks, bonds of the Commonwealth of Puerto Rico, and bonds issued by schools and hospitals may have equaled another $700 million.

The approximately $5 billion in 936 funds that have flowed into Puerto Rico is an enormous amount for Puerto Rico to absorb. The gross national product of Puerto Rico was $10 billion in the year ending June 30, 1979. Annual gross domestic investment, including new plant, equipment, and housing construction, both private and government, was equal to $1.9 billion, which is about what it had been in each of the prior 4 years. The absorption of the $5 billion in 936 funds in the less than five years since the institution of section 936 would therefore have required an increase in gross investment of more than 50 percent per year.

It is conceivable that investment in Puerto Rico could have increased by this much, but it would have required a very sharp drop in the cost of capital to bring it about. It is difficult to be very specific about the decrease in the cost of capital that would have been necessary because the elasticity of investment with respect to the cost of capital is one of the more controversial areas of economic analysis. However, it is possible to get an idea of the magnitude by using a report recently prepared for the U.S. Treasury. 14/ The report simulated the effect on U.S. investment of various tax changes using six leading econometric models. These tax changes affect investment by changing the cost of capital, which is the annualized cost of using capital and reflects acquisition costs, interest costs, depreciation, and any tax credits or charges. In the simulation in which investment is most responsive to a change in the cost of capital, a reduction of the cost of capital of 10 percent induced, with a lag, an increase in annual investment of 15 percent. If the economic relationship held in Puerto Rico, a 50 percent expansion in investment would require a fall in the cost of capital of more than 30 percent.

14/ Robert S. Chirinko and Robert Eisner, The Effect of Tax Parameters in Investment Equations of Macroeconomic Econometric Models, Preliminary Draft, May 1980.

The cost of capital is basically made up of two components. One is the interest paid on the investment. The other is economic depreciation reflecting the declining value over time of the capital. In order for the overall cost of capital to fall by 30 percent, the interest component has to fall by a larger percentage because the depreciation component remains constant. In other words, a fall in interest costs of 40-50 percent is required, under the most optimistic assumptions, in order to increase investment by 50 percent.

A fall of interest costs of this magnitude would create very large opportunities for arbitrage between the low-cost Puerto Rico market and the U.S. or Eurodollar market. The ability to arbitrage varies among the various economic groups. It is very inexpensive for banks but their activities are, at least in part, restricted by the Puerto Rican Treasury regulations. Borrowers from a Puerto Rico bank can also arbitrage if they get low-cost funds, but it is more expensive for them because of the bank's spread on its cost of funds. A drop in interest costs of 40 to 50 percent would, however, certainly make arbitrage profitable even after paying the bank's spread. It is, therefore, apparent that interests rates would not fall enough to induce full absorption of 936 funds in Puerto Rico because arbitrage to the U.S. market would intervene.

Much of the absorption problem was of course due to the sudden influx of $3 billion or more in a short time after 936 was passed. Furthermore, the problem was recognized by the Puerto Rican authorities and was reflected in the warehousing opportunities that existed until April 1, 1980. The annual increase in 936 funds may, however, continue to be substantial, at least in some years. For example, 936 deposits in Puerto Rican banks increased by $900 million from year-end 1978 to year-end 1979.

H. The Effect of the New Puerto Rico Regulations, Effective April 1, 1980

The new Puerto Rico regulations, effective April 1, 1980, appear to constrain the banks' use of 936 funds much more severely. Under the new regulations the banks will only be able to take in 936 deposits if they have eligible assets to put them in. It appears that the end of warehousing opportunities will be the most significant change. Table 24 above indicates that repos amounted to about 6 percent of total 936 funds in commercial banks in April 1980. Also, compliance based on end of the month deposits apparently did not lead to much distortion because the totals in Table 24, which are based on average daily balances, are only slightly higher than the total reported on December 31, 1979.

The effect of the new regulations will depend on the rate of new inflow of 936 deposits compared to regular funds because banks appeared in May 1980 to have an approximate balance between eligible assets and 936 deposits. They reported an increase in eligible assets since May 1, 1975 of $3.4 billion, which is very close to their 936 funds including repos. One reason for this balance is banks' ability to report assets acquired from insolvent banks in the incremental category. If inflows of 936 deposits in 1980 equal the $900 million in 1979, the new regulations will probably restrict banks freedom to use the funds. On the other hand, if there is a modest growth in 936 deposits, the "normal" growth in eligible assets would be sufficient for compliance.

If there is an inflow of 936 funds larger than the "normal" growth in eligible assets, one result will be that banks will reduce their demand for 936 funds. This will have the effect of driving down the interest rate on 936 CD's compared to regular CD's. The closer match between deposits and eligible assets mandated in the new regulation will also have the effect of increasing eligible assets,including loans. An eligible asset will now be more valuable in enabling a bank to bid for deposits. However, it is impossible to predict to what extent the closer match is accomplished by reducing the demand for 936 funds and to what extent it is achieved by increasing eligible assets. In part this depends on the response of 936 corporations to lower returns on their deposits. If they don't reduce them by increasing repatriation or shifting to the Eurodollar market, an expansion of bank loans is more likely.

The effect on bank profitability is also uncertain. Banks may make a somewhat higher spread on eligible bank loans. We have seen that the cost of 936 deposits will probably go down. In the section on the interest charged by banks for loans, it appreared that while many borrowers appeared to benefit from low cost funds the pass through by banks of the discount in 936 interest rates was not complete. Many borrowers pay interest rates based on "high cost" money. A reduction in the interest cost to banks of 936 funds compared to regular money market rates may therefore increase the spread on loans. On the other hand, there may be pressure to lower the spread in order to obtain more eligible assets. Furthermore, banks will be hurt by the reduced opportunities for warehousing and the resulting profits from arbitrage.

The smaller local banks would appear to benefit from the new regulations. Since the "upper tier" banks will find their ability to attract 936 deposits restricted, more 936 funds may flow to the smaller banks which ordinarily have an excess of eligible assets. However there are some signs that the national banks will reduce their redeposits of 936 funds in the smaller local banks. The reason for this is not clear.

The new regulations may also have some effect on decisions by prospective 936 corporations to invest in Puerto Rico. Some may be discouraged by the reduced return on their financial investments although others who need capital may be attracted by the availability of cheap funds.

One factor that has colored the financial behavior of 936 companies in the past few years is regulatory uncertainty. At first, 936 corporations hoped that the tollgate tax would be removed. This has not happened but there have been a number of changes. Because of this uncertainty over the rules for repatriating income, 936's have been unwilling to commit themselves to long-term financial investments in Puerto Rico. The rules on the various ways of achieving lower tollgate taxes have also been very complex. As 936's get more experience with them, their financial planning may be more long term in nature.

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 (before October 1, 1979), 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 possession source net 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 is estimated that the average effective rate of tax paid by 936 corporations was 10 percent on income derived from Guam and zero percent on income derived from American Samoa and the Canal Zone. The combined Federal tax expenditure for all three possessions was approximately $1.9 million in tax year 1978.

The second Section of the Appendix compares the tax treatment accorded to 936 companies with that accorded to corporations operating in the Virgin Islands. Corporations which are "inhabitants" of the Virgin Islands are exempt from U.S. tax under section 28(a) of the Revised Organic Act of the Virgin Islands. In 1978, the income tax expenditure associated with section 28(a) and the Virgin Islands tax-incentive program was $18.6 million, of which $16.4 million was attributable to U.S.-controlled corporations. Firms which have Virgin Islands tax incentive grants benefit, as well, from exemption from property, customs, excise, and gross receipts tax. The V.I. gross receipts tax expenditure

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1/ Other territories to which section 936 benefits apply are the Northern Mariana Islands and Wake and Midway Islands. As of 1978, no 936 corporations were operating in these territories.

in 1978 was approximately $57 million. The $57 million figure was computed by multiplying the business receipts of all tax-exempt firms in the Virgin Islands by 2 percent, the rate of the gross receipts tax. Available data do not permit the estimation of the taxes foregone under other local V.I. taxes.

I. American Samoa, Guam and the Panama Canal Zone

A. Federal and Possessions Taxation

American Samoa and Guam, like Puerto Rico, constitute income tax jurisdictions separate and distinct from that of the United States. American Samoa and Guam have primary jurisdiction to tax U.S. corporations operating there, and the United States has secondary jurisdiction.

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 name "American Samoa" or "Guam" substituted for the name "United States" wherever it appears 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 by 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."

Unlike Puerto Rico, Guam does not impose a withholding tax on dividends paid from Guam-source income to U.S. parent companies. Special provisions 2/ of the "mirrored" Internal Revenue Code, enacted by Congress in 1973, exempt a U.S. parent corporation from tax on dividends and other passive income derived from Guam. Under section 935(c) of the "mirrored" Internal Revenue Code, a U.S. individual is similarly exempt from tax on payments derived from Guam.

2/ Internal Revenue Code sections 881(b) and 1442(c).

No Federal provision explicitly limits the authority of American Samoa or Guam to provide income tax relief with respect to possession 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 an average effective tax rate of 10 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. 3/ Many of these corporations enjoyed, in addition, 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.

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. For 1979 and all subsequent years, the effective Federal corporate tax rate is assumed to fall from 40 percent to 38 percent to reflect the statutory U.S. corporate tax rate reduction of two percentage points.

The Panama Canal Zone imposed no local territorial income tax. Prior to October 1, 1979, 4/ a Federal agency (the Panama Canal Company), administered the Canal Zone and financed its expenditures through toll collections. Possessions corporations operating in the Canal Zone were effectively exempt from any tax on income derived from operations in the Panama Canal Zone.

B. Characteristics of Possessions Corporations

Table A-1 shows that in 1978, there were four active 936 corporations in American Samoa and Guam. These corporations had qualified possession net income of $858,000. Under section 936, they obtained tax savings of $257,000. These figures compare with 1977 qualified possession net income in excess of $2 million and tax savings of $1.1 million for four 936 corporations.

There were seven 936 corporations operating in the Panama Canal Zone in 1978. They had qualified possession net income of $4.1 million and accounted for a Federal revenue loss of $1.6 million under section 936. These figures compare with 1977 qualified possession net income of nearly $3 million and tax savings of $1.1 million for five 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

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4/ Pursuant to the Panama Canal Treaties of 1977, the United States ceased to have jurisdiction over the Canal Zone on October 1, 1979. On that date, the Canal Zone also ceased to be a possession for purposes of section 936.

Table A-1

Income and Estimated Tax Expenditure
by Possession, 1978

Possession	Number of 936 Corporations	Qualified Possession Net Income ($000)	Estimated Tax Expenditure ($000)
American Samoa and Guam	4	858	257
Panama Canal Zone	7	4,115	1,646
Total	11	4,973	1,903

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income. All corporations chartered in the Virgin Islands are considered to be "inhabitants" of the Virgin Islands. In Revenue Ruling 80-40, published on February 19, 1980, the Internal Revenue Service ruled that a United States corporation may also under certain circumstances qualify as an "inhabitant" of the Virgin Islands within the meaning of section 28(a).

Before the I.R.S. issued this ruling, it was unclear whether U.S. corporations could qualify as V.I. "inhabitants." Thus, U.S. parent companies operating a trade or business in the Virgin Islands normally did so through V.I.-chartered subsidiaries.

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 name "Virgin Islands" substituted for the name "United States" wherever it appears 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 its income tax. 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 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. 5/ In order to

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

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 beneficiaries of the V.I. Industrial Development Program generally receive rebates of 75 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 Commission.

In general, the duration of a tax exemption grant is 10 years. A firm 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 75 percent of income taxes, pays an average effective corporate income tax rate in the Virgin Islands of approximately 10 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. 6/ 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 7/ 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.

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

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6/ 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.

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

deduction for dividends received from a subsidiary incorporated in the Virgin Islands. 8/ Thus, even though the profits of a qualifying 934 subsidiary may be 75 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.

(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 less than five percent.

8/ 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)).

(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. 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 on repatriated V.I.-source earnings, the U.S. parent may accumulate earnings in the Virgin Islands and then liquidate the subsidiary at the expiration of its tax exemption grant. 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. In Puerto Rico, liquidating distributions by firms with tax exemption grants under the 1978 Industrial Incentive Act are subject to the tollgate tax, but firms with grants under the 1963 Act may be liquidated tax-free.

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. Assuming that it can, the U.S. parent corporation enjoys 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 possession 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:

(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, 75 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 percent on earnings repatriated by a 936 corporation in Puerto Rico.

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

In 1978, there were 54 active firms which were eligible for income tax rebates from the Virgin Islands. Table A-3 shows selected tax return information as well as the amount of Federal tax expenditure and employment for all tax-exempt firms in the Virgin Islands. The employment data were taken from Form W-3, "Transmittal of Income and Tax Statements," used by V.I. employers to transmit wage and income tax withheld statements to the Virgin Islands Treasury.

Table A-2

Overall Tax Rates on Earnings 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 $11.50 under a system of 75 percent income tax rebates. The V.I. tax withheld on repatriated dividends is 30 percent of $88.50 or $26.55. The total of V.I. taxes paid on this $100 is thus $38.05. The U.S. parent receives an 85 percent dividends-received deduction for the dividend, and has U.S. tax liability of .46 x (.15)(88.50), or $6.11. This U.S. liability is offset by the $38.05 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 $38.05 (see footnote 2). This amount offsets only the U.S. tax liability on this income.

4/ Firms with Puerto Rican tax exemption grants under the 1963 Industrial Incentive Act are typically 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. Type of Corporation

Of the total of 54 tax-exempt firms which conducted operations in the Virgin Islands in 1978, 17 were U.S.-chartered or U.S.-controlled corporations; 33 were locally controlled V.I. corporations; and 4 were foreign-controlled V.I. corporations.

2. Total Assets

Total assets of tax-exempt firms were $1.4 billion, of which over 95 percent were owned by U.S.-controlled corporations. Net plant and equipment (shown as net depreciable assets), represented 34 percent of total assets.

3. Tax Expenditure

The total income tax expenditure for all exempt firms in the Virgin Islands was $18.6 million and the total gross receipts tax expenditure was $57 million. Locally controlled Virgin Islands-chartered corporations accounted for a V.I. income tax expenditure of $1.6 million, and a gross receipts tax expenditure of $996,000. By comparison, U.S.-controlled corporations accounted for an income tax expenditure of $16.5 million and a gross receipts tax expenditure of $56 million. The $16.5 million estimate overstates the U.S. tax loss from section 28(a) of the V.I. Revised Organic Act to the extent that the U.S.-controlled V.I. subsidiaries repatriated their earnings, since such earnings would be subject to the normal U.S. corporate income tax upon receipt by the U.S. parents. The $16.4 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 $16.4 million figure understates the Federal tax expenditure.

4. Relationship Between Tax Expenditure and Employment

The last line of Table A-3 shows that the average income tax expenditure per employee of V.I. tax-exempt firms was $2,738. This tax expenditure per employee was nearly $4,000 for U.S.-controlled V.I. firms, compared to $747 for V.I. corporations with no parent firm. The comparable figures for the two U.S. corporations and five V.I. corporations with a foreign parent company (shown in the last column) was $1,002.

Table A-3

Virgin Islands - Selected Income Statement and Balance Sheet Items, Tax Expenditure, and Employment by Type of Corporation, 1978

	All Corporations	V.I. Corporations with a U.S. Parent	V.I. Corporations--No Parent	V.I. Corporations with a Foreign Parent & U.S. Corporations
Number of corporations	54	15	33	6
Total assets ($000)	1,386,811	1,339,984	44,177	12,650
Inventories ($000)	268,080	261,801	4,521	1,750
Depreciable assets ($000)	763,760	738,721	17,770	7,288
Accumulated depreciation ($000)	253,232	246,939	5,299	994
Net depreciable assets ($000)	478,098	459,038	12,493	6,297
Net intangible assets ($000)	893	677	175	41
Total receipts ($000)	2,880,290	2,816,425	50,974	12,891
Business receipts ($000)	2,867,609	2,805,257	49,817	12,535
All other receipts ($000)	12,681	11,168	1,157	356
Total deductions ($000)	2,814,478	2,759,371	42,723	12,384
Cost of sales and operations ($000)	2,628,757	2,585,967	34,806	7,984
All other deductions ($000)	185,721	173,404	7,917	4,400
Taxable income ($000)	55,386	56,240	926	72
Tax expenditure ($000)	18,606	16,520	1,589	497
Number of employees	6,796	4,173	2,127	496
Tax expenditure per employee ($)	2,737	3,959	747	1,002

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Table A-4 shows that there was also a wide variation in the Federal tax expenditure by industry. The tax expenditure per employee ranged from $12,020 in the chemical industry (roughly 120 percent of total compensation of employees) to zero in the recreation industry.

Table A-5 ranks all corporations which have V.I. tax exemption grants according to the income tax expenditure per employee. At the top of the ranking were three companies for which the average tax expenditure per employee was $40,000. The seven corporations which had a tax expenditure per employee of $5,000 or more collectively accounted for 98 percent of the total income tax expenditure and 38 percent of total employment. These seven firms paid average employee compensation of $20,000, substantially higher than the average employee compensation of $12,000 for all tax-exempt firms in the Virgin Islands.

Table A-4

Virgin Islands - Tax Expenditure, Employment and Compensation of Employees by Industry, 1978

	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 ($000)	Compensation of employees 1/: Percent of total	Tax Expenditure per employee	Tax Expenditure as a percent of compensation	Average Employee Compensation ($)
All Industries	54	55,386	18,606	100.0	6,796	100.0	81,302	100.0	2,737	22.9	11,962
Chemicals	4	2,821	1,166	6.3	97	1.4	963	1.2	12,020	121.0	9,932
Watches	16	2,022	807	4.3	1,125	16.6	7,568	9.3	717	10.6	6,726
Other manufacturing 2/	7	41,371	14,635	78.7	2,465	36.3	49,850	61.3	5,937	29.3	20,222
Transportation	5	-1,485	5	*	391	5.8	3,667	4.5	12	0.6	9,377
Utilities and communication	3	16,155	1,931	10.4	473	7.0	8,875	10.9	4,082	21.8	15,579
Hotels	15	-4,590	62	0.3	2,073	30.5	9,492	11.7	29	0.6	4,579
Recreation	4	-908	0	0	170	2.5	888	1.1	0	0	5,221

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*Less than 0.05 percent.

1/ Compensation of employees was computed by multiplying 1.221 times payroll. The 22.1 percent reflects the employer-paid portion of social security, unemployment insurance, and other non-payroll costs. The 22.1 percent is the average for all U.S. manufacturing industries in 1978; see the U.S. Department of Commerce, Survey of Current Business, July 1979, Tables 6.5 and 6.6.

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

Table A-5

Virgin Islands - Tax Expenditure, Employment and Compensation of Employees by Size of Tax Expenditure per Employee, 1978

Size of Tax Expenditure per employee	Number of Corporations	Net 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	54	55,386	18,606	100.0	6,796	100.0	81,302	100.0	2,737	22.9	11,962
$5,000 or more	7	60,002	18,156	97.6	2,582	38.0	50,857	62.6	7,031	35.6	19,696
$500 under $5,000	5	738	235	1.3	206	3.0	1,882	2.3	1,140	12.4	9,133
$100 under $500	7	656	124	0.7	396	5.8	2,033	2.5	313	6.1	5,133
$ 1 under $100	6	2,157	91	0.5	1,283	18.9	13,945	17.2	70	0.6	10,868
Loss corporations	29	-8,167	-	-	2,329	34.3	12,586	15.5	-	-	5,403

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1/ Compensation of employees was computed by multiplying 1.221 times payroll. The 22.1 percent reflects the employer-paid portion of social security, unemployment insurance, and other non-payroll costs. The 22.1 percent is the average for all U.S. manufacturing industries in 1978; see the U.S. Department of Commerce, Survey of Current Business, July 1979, Tables 6.5 and 6.6.

Appendix B -- Expenditures on Puerto Rican Inputs as a Percentage of the Value of Production, Selected Puerto Rican Industries

Table B-1, discussed on pages 55-57, above, shows the breakdown of the value of production in selected Puerto Rican manufacturing industries between the cost of imported materials, the cost of Puerto Rican materials, and labor costs. All statistics are expressed as a percentage of value added plus cost of materials.

Table B-1

Expenditures on Materials, Labor, Plant, and Equipment
as a Percentage of the Value of Production by Manufacturing Establishments in Puerto Rico, 1977**

	All Manufacturing Industries	Food and Kindred Products	Tobacco Products	Textile Mill Products	Apparel	Lumber and Wood Products
Cost of Materials from All Sources 1/	58.7	66.6	40.1	82.6	58.7	56.3
Cost of Materials from Puerto Rico 2/	28.8	51.3	12.8	22.3	18.8	18.0
Value Added 1/	41.3	33.4	59.9	17.4	41.3	43.7
Labor Costs 3/	11.2	11.7	12.3	19.0	28.8	22.2
Return on Capital and Overhead Costs 4/	30.1	21.7	47.6	- 1.6	12.5	21.5
Expenditures on New Plant 5/	2.1	1.1	.1	.1	.1	.2
Expenditures on New Equipment 5/	2.2	3.2	2.2	.9	.8	1.0
Expenditures on Used Equipment 5/	*	.3	.5	*	.4	*
Total Expenditures on Materials, Labor, Plant, and Equipment in Puerto Rico 6/	42.2	64.9	26.2	41.6	48.3	40.6
Ratio of Labor Costs to Total Expenditures in Puerto Rico	.265	.180	.469	.457	.596	.547

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* Less than 0.05 percent

** All figures except expenditures on plant and equipment are based on preliminary data to be published in the 1977 Economic Census of Outlying Areas, Manufactures, Puerto Rico. See footnotes 1 and 2 at the end of the table.

Table B-1 continued

	Rubber Products	Leather and Leather Products	Stone, Clay and Glass Products	Primary Metals	Fabricated Metal Products	Machinery Except Electrical
Cost of Materials from All Sources 1/	37.6	55.0	56.8	49.8	59.6	46.5
Cost of Materials from Puerto Rico 2/	12.0	10.5	48.3	26.9	19.1	14.9
Value Added 1/	62.4	45.0	43.2	50.2	40.4	53.5
Labor Costs 3/	22.0	28.0	20.3	17.2	18.6	12.3
Return on Capital and Overhead Costs 4/	40.4	17.0	22.9	33.0	21.8	41.2
Expenditures on New Plant 5/	.2	*	1.6	1.1	1.4	.2
Expenditures on New Equipment 5/	.2	.5	4.2	5.4	2.4	1.6
Expenditures on Used Equipment 5/	2.2	*	.2	—	.1	*
Total Expenditures on Materials, Labor, Plant, and Equipment in Puerto Rico 6/	36.4	38.6	71.0	46.1	39.4	27.7
Ratio of Labor Costs to Total Expenditures in Puerto Rico	.604	.725	.286	.373	.472	.444

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* Less than 0.05 percent.

Table B-1 continued

	Furniture and Fixtures	Paper and Allied Products	Printing and Publishing	Chemicals	Petroleum Refining
Cost of Materials from All Sources 1/	47.2	67.6	24.2	42.9	93.6
Cost of Materials from Puerto Rico 2/	25.0	29.1	14.8	19.3	39.3
Value Added 1/	52.8	32.4	75.8	57.1	6.4
Labor Costs 3/	29.5	19.1	36.5	5.7	2.1
Return on Capital and Overhead Costs 4/	23.3	13.3	39.3	51.4	4.3
Expenditures on New Plant 5/	3.7	3.3	3.0	4.3	5.5
Expenditures on New Equipment 5/	1.2	8.1	3.9	3.0	.2
Expenditures on Used Equipment 5/	.2	.2	--	*	*
Total Expenditures on Materials, Labor, Plant, and Equipment in Puerto Rico 6/	58.0	52.7	54.5	29.0	45.8
Ratio of Labor Costs to Total Expenditures in Puerto Rico	.509	.362	.670	.197	.046

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* Less than 0.05 percent.

Table B-1 continued

	Electrical and Electronic Equipment	Transportation Equipment	Scientific Instruments**	Miscellaneous Manufacturing Industries
Cost of Materials from All Sources 1/	44.7	41.5	43.1	64.0
Cost of Materials from Puerto Rico 2/	14.3	13.3	13.8	20.5
Value Added 1/	55.3	58.5	56.9	36.0
Labor Costs 3/	16.8	20.0	19.3	16.5
Return on Capital and Overhead Costs 4/	38.5	38.5	37.6	19.5
Expenditures on New Plant 5/	2.7	*	.5	1.2
Expenditures on New Equipment 5/	1.3	.9	1.8	.6
Expenditures on Used Equipment 5/	.2	.1	.1	.1
Total Expenditures on Materials, Labor, Plant, and Equipment in Puerto Rico 6/	33.8	33.6	34.0	38.2
Ratio of Labor Costs to Total Expenditures in Puerto Rico	.497	.595	.568	.432

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* Less than 0.05 percent.

** Includes photographic goods and watches.

Table B-1 continued

Notes:

1/ Based on preliminary figures from the U.S. Department of Commerce, to be published in the 1977 Economic Census of Outlying Areas, Manufactures, Puerto Rico. All statistics are expressed as a percentage of value added plus cost of materials.

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

3/ Labor costs are estimated by multiplying total payroll, as reported for 1977 by the U.S. Department of Commerce, op. cit., by 1.212. 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.

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

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

6/ Value shown equals the sum of the cost of materials from Puerto Rico, labor costs, 80 percent of expenditures on new plant, 21 percent of expenditures on new equipment and total expenditures on used equipment. The 80 percent of expenditures on new plant corresponds to the estimated ratio of expenditures on Puerto Rican inputs to total expenditures by the construction industry, as reported in Weisskoff and Wolff, op. cit. The 21 percent of expenditures on new equipment corresponds to the ratio of the value of shipments of machinery except electrical with a Puerto Rican destination to total expenditures for new equipment by all manufacturers, as reported for 1972 by the U.S. Department of Commerce, op. cit., Chapter 2, Table 3.

Appendix C - Historical Data and Sources and Limitations of the Data

Historical Data

Table C-1 presents selected data items for 1973-1978. Some of the corporations included in 1973-1975 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 these years. These corporations, for various reasons, have not made an election under section 936 and therefore do not appear after 1975. Since most of the non-electing 931s were in non-manufacturing industries, the number of possessions corporations engaged in manufacturing has remained relatively constant while the number for non-manufacturing dropped sharply from 1975 to 1976. There is no corresponding drop in the income figures, however, because the non-electing 931 corporations were, in general, either inactive or loss corporations.

Table C-2 is similar to Tables 8 and 10 and covers tax year 1977. Table 6 of the Second Annual Report included data for the 479 corporations for which information was available in time for the report. Table C-2 is based on the complete file of 519 corporations benefitting from section 936 in 1977.

Sources and Limitations of the Data

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. Tables for each year are based on corporations' accounting periods ending between July 1 of the given year and June 30 of the following year. For example, tables for 1978 contain data for corporations with accounting periods ending on or after July 1, 1978 and on or before June 30, 1979.

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."

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 1978 Form 940 data was associated with annual accounting periods ending between July 1, 1978 and June 30, 1979.

The number of employees was computed by dividing total taxable wages (line 15(c), Form 940) by $6,000, 1/ 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 $6,000 (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 $6,000 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 suggest that the method used here provides reasonably accurate estimates of full-time equivalent employment.

1/ For 1973-1977, the corresponding amount was $4,200.

Some corporations did not report an amount for total remuneration or reported the same amount as for wages subject to unemployment tax. 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 remuneration may therefore be slightly understated.

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.

Table C-1

Summary Data on Possessions Corporations, 1973-1978 1/

	1973	1974	1975	1976	1977	1978
Number of corporations, all industries	568	596	595	528	519	534
Manufacturing industries	385	399	394	395	385	374
Pharmaceuticals	39	44	47	52	53	55
Electrical and electronic equipment	64	76	76	81	80	80
All other manufacturing	282	279	271	262	252	239
Nonmanufacturing industries	183	197	201	133	134	140
Net income, all industries ($000)	650,515	852,058	1,108,881	1,627,213	1,800,313	2,383,263
Manufacturing industries	591,724	813,057	1,055,060	1,551,677	1,714,321	2,244,528
Pharmaceuticals	251,897	405,355	547,060	779,954	876,576	1,078,478
Electrical and electronic equipment	116,277	167,389	195,593	323,249	231,475	304,889
All other manufacturing	223,550	240,313	312,407	448,474	606,270	861,161
Nonmanufacturing industries	58,792	39,002	54,059	75,536	85,992	97,424
Estimated tax expenditures, all manufacturing industries 2/ ($000)	242,116	352,908	425,213	621,190	685,728	839,342
Pharmaceuticals	103,533	161,341	218,210	311,948	350,630	412,286
Electrical and electronic equipment	46,749	66,872	79,164	129,400	92,590	125,054
All other manufacturing	91,834	124,695	127,839	179,842	242,508	302,002
Tax expenditure per employee, 3/ all manufacturing industries ($)	2,287	5,609	7,566	10,181	9,971	12,667
Pharmaceuticals	27,239	33,892	34,694	41,925	34,966	43,261
Electrical and electronic equipment	2,995	5,544	8,434	9,614	10,058	10,656
All other manufacturing	1,317	3,092	3,544	4,711	3,939	8,568
Tax expenditure as a percent of compensation of employees, 3/ all manufacturing industries	38.9	81.5	103.2	127.4	120.8	118.4
Pharmaceuticals	377.1	378.2	345.9	380.5	291.1	317.6
Electrical and electronic equipment	47.7	83.1	112.0	114.8	112.5	100.1
All other manufacturing	23.8	46.8	49.6	64.3	55.3	84.1

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

2/ Note that the figures shown here differ from the corresponding years shown in Table 1 because Table 1 is based on calendar and (Federal) fiscal years, whereas the data in this and table is based on the taxable years of possessions corporations, as explained more fully in the text.

3/ These figures are based only on those returns for which employment and compensation of employees were available. See text.

Table C-2

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

	All Industries	Manufacturing Industries: Total	Food & Kindred Products	Tobacco Products	Textile Mill Products	Apparel	Chemicals: Total	Chemicals: Pharmaceuticals	Chemicals: All Other	Rubber Products
Number of returns	519	385	18	4	14	77	75	53	22	10
Balance sheet items										
Total assets	10,024,974	7,761,381	643,098	141,173	77,431	303,775	4,266,955	3,639,956	626,999	52,155
Retained earnings	6,216,249	6,063,497	515,793	84,539	65,273	235,274	3,367,155	3,013,579	353,576	38,877
Income statement items										
Business receipts	5,968,255	5,309,106	586,020	187,174	77,746	324,720	2,123,094	1,603,274	529,820	46,894
Cost of sales and operations	3,418,761	3,011,067	390,644	85,075	68,179	251,718	814,628	469,413	345,215	27,811
Non-government interest	261,006	182,600	19,092	2,814	534	2,527	108,328	105,660	2,668	642
Net income per return	1,800,313	1,714,321	115,795	22,541	7,207	61,678	1,008,577	876,576	132,001	8,195
Net income per books	1,795,821	1,727,851	145,144	22,209	6,581	66,146	1,003,116	876,656	126,460	8,070
Estimated tax expenditure	685,728	685,728	46,318	9,016	2,883	24,671	403,431	350,630	52,800	3,278

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Table C-2 - continued

	Manufacturing Industries - continued						
	Leather and Leather Products	Stone, Clay, & Glass Products	Fabricated Metal Products	Machinery, Except Electrical	Electrical and Electronic Equipment	Transportion Equipment	Scientific* Instruments
Number of returns	11	5	16	9	80	5	25
Balance sheet items							
Total assets	44,156	28,452	137,316	73,641	1,137,437	42,857	192,478
Retained earnings	36,352	24,317	112,712	62,557	936,670	36,484	161,967
Income statement items							
Business receipts	42,413	28,054	80,471	63,691	556,909	35,160	154,672
Cost of sales	33,839	18,139	56,088	37,845	304,758	20,750	66,685
Non-government interest	539	462	3,299	1,338	32,971	723	2,642
Net income per return	5,272	6,312	23,591	23,084	231,475	12,647	68,158
Net income per books	5,300	6,400	23,743	23,425	232,340	12,331	68,294
Estimated tax expenditures	2,109	2,525	9,436	9,234	92,590	5,059	27,263

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* Includes photographic goods and watches

Table C-2 - continued

	All other Manu-facturing	Nonmanufacturing Industries						
		Total	Transportation Communications and Utilities	Wholesale Trade	Retail Trade	Finance, Insurance, Real Estate	Services	Miscellaneous and Not Available
Number of returns	36	134	9	24	44	23	15	19
Balance sheet items								
Total assets	620,456	2,263,593	623,912	38,620	110,053	1,400,629	38,560	51,819
Retained earnings	385,527	152,752	3,124	13,514	29,193	58,862	14,057	34,002
Income statement items								
Business receipts	1,002,088	659,149	164,090	77,218	305,292	13,967	34,302	64,280
Cost of sales	834,908	407,694	64,743	53,728	221,059	1,374	18,958	47,832
Non-government interest	6,689	78,406	95	81	203	77,535	74	418
Net income per return	119,789	85,992	43,460	4,876	10,756	9,275	4,912	12,713
Net income per books	104,752	67,970	42,967	3,838	5,437	7,482	4,611	3,635
Estimated tax expenditures	47,916	--	--	--	--	--	--	--

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

Form 1120 — U.S. Corporation Income Tax Return — 1978

Department of the Treasury
Internal Revenue Service

For calendar year 1978 or other taxable year beginning ...., 1978, ending ...., 19......

Check if a—
A Consolidated return ☐
B Personal Holding Co. ☐
C Business Code No. (See Page 8 of instructions)

Use IRS label. Otherwise please print or type.
Name
Number and street
City or town, State, and ZIP code

D Employer identification number (see instruction W)
E Date incorporated
F Enter total assets (see instruction X) $

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 Form 4797, line 11, Part II (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	(a) Salaries and wages .... 13(b) Less new jobs credit .... Balance ▶	13(c)	
14	Repairs (see instructions)	14	
15	Bad debts (Schedule F if reserve method is used)	15	
16	Rents	16	
17	Taxes	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 (subtract line 27 from line 11)	28	
29	Less: (a) Net operating loss deduction (see instructions—attach schedule) 29(a)		
	(b) Special deductions (Schedule I) 29(b)	29	
30	Taxable income (subtract line 29 from line 28)	30	

Tax

31	TOTAL TAX (Schedule J)	31	
32	Credits: (a) Overpayment from 1977 allowed as a credit		
	(b) 1978 estimated tax payments		
	(c) Less refund of 1978 estimated tax applied for on Form 4466 ( )		
	(d) Tax deposited: Form 7004 .... Form 7005 (attach) .... Total ▶		
	(e) Credit from regulated investment companies (attach Form 2439)		
	(f) U.S. tax on special fuels, nonhighway gas and lubricating oil (attach Form 4136)	32	
33	TAX DUE (subtract line 32 from line 31). See instruction G for depositary method of payment. (Check ▶ ☐ if Form 2220 is attached. See page 3 of instructions.) ▶ $	33	
34	OVERPAYMENT (subtract line 31 from line 32)	34	
35	Enter amount of line 34 you want: Credited to 1979 estimated tax ▶ Refunded ▶	35	

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

▶ Signature of officer — Date — ▶ Title

Paid Preparer's Information

Preparer's signature ▶ — Preparer's social security no. — Check if self-employed ▶ ☐

Firm's name (or yours, if self-employed), address and ZIP code ▶ — E.I. No. ▶ — Date ▶

Schedule A Cost of Goods Sold (See instruction 2)

1 Inventory at beginning of year
2 Merchandise bought for manufacture or sale
3 Salaries and wages
4 Other costs (attach schedule)
5 Total
6 Less: Inventory at end of year
7 Cost of goods sold—Enter here and on line 2, page 1
8 (a) Check valuation method(s) used for total closing inventory:
☐ Cost ☐ Lower of cost or market ☐ Other (if "other," attach explanation)
(b) Check if this is the first year LIFO inventory method was adopted and used. (If checked, attach Form 970.) ☐
(c) If the LIFO inventory method was used for this taxable year, enter percentage (or amounts) of closing inventory computed under LIFO
(d) Is the corporation engaged in manufacturing activities? ☐ Yes ☐ No
If "Yes," are inventories valued under Regulations section 1.471–11 (full absorption accounting method)? ☐ Yes ☐ No
(e) Was there any substantial change in determining quantities, cost, or valuations between opening and closing inventory? ☐ Yes ☐ No
If "Yes," attach explanation.

Schedule C Dividends (See instruction 4)

1 Domestic corporations subject to 85% deduction
2 Certain preferred stock of public utilities
3 Foreign corporations subject to 85% deduction
4 Dividends from wholly-owned foreign subsidiaries subject to 100% deduction (section 245(b))
5 Other dividends from foreign corporations
6 Includable income from controlled foreign corporations under subpart F (attach Forms 3646)
7 Foreign dividend gross-up (section 78)
8 Qualifying dividends received from affiliated groups and subject to the 100% deduction (section 243(a)(3))
9 Taxable dividends from a DISC or former DISC not included in line 1 (section 246(d))
10 Other dividends
11 Total—Enter here and on line 4, page 1

Schedule E Compensation of Officers (See instruction 12)

1. Name of officer	2. Social security number	3. Time devoted to business	Percent of corporation stock owned: 4. Common	5. Preferred	6. Amount of compensation	7. Expense account allowances
Total compensation of officers—Enter here and on line 12, page 1						

Schedule F Bad Debts—Reserve Method (See instruction 15)

1. Year	2. Trade notes and accounts receivable outstanding at end of year	3. Sales on account	Amount added to reserve: 4. Current year's provision	5. Recoveries	6. Amount charged against reserve	7. Reserve for bad debts at end of year
1973						
1974						
1975						
1976						
1977						
1978						

Schedule I Special Deductions

1 (a) 85% of Schedule C, line 1
(b) 60.208% of Schedule C, line 2
(c) 85% of Schedule C, line 3
(d) 100% of Schedule C, line 4
2 Total—See instructions for limitation
3 100% of Schedule C, line 8
4 Dividends paid on certain preferred stock of public utilities (see instructions)
5 Western Hemisphere trade corporations (see instructions)
6 Total special deductions—Add lines 2 through 5. Enter here and on line 29(b), page 1

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 **5735**
(Rev. January 1979)
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 within a U.S. possession			Gross qualified possession 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 from the active conduct of a trade or business within a U.S. possession (total 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) From sources without the U.S. from sale or exchange of substantially all of assets used in a possessions trade or business . . . .

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

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

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

7 Applicable deductions (attach schedule):

(a) Definitely allocable deductions (see instructions) . . . .

(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(e) less line 7(c)). If loss, do not complete below . .

9 Loss adjustments (attach schedule):

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

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

(c) Net capital loss or short term capital loss adjustment (see instructions) . . . .

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

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

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

12 Less: Adjustments to taxable income from all sources (see instructions) . . . .

13 Subtract line 12 from line 11 . . . .

14 Line 10 divided by line 13 . . . .

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

16 Section 936 credit (line 14 multiplied by line 15). Enter here and on your tax return . . . . ▶

Instructions

(References are to the Internal Revenue Code)

A. Corporation 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 Rico 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) Income from the Sale or Exchange of Substantially All of the Assets of a Possession Corporation.—Taxable income from sources outside the U.S. from the sale or exchange of substantially all of the assets used by a possessions corporation in the active conduct of its trade or business is qualified taxable income.

(3) Carryover Basis Property.—Qualified taxable income does not include income from the sale or exchange of any asset if the basis of the asset is determined by reference to its basis in the hands of another person. However, if the basis of the asset is determined by reference to its basis in the hands of another person to whom section 931, 936, or 957(c) applied for the entire period the asset was held, then taxable income from the sale or exchange of such asset may qualify. (Section 936(d)(3).)

(4) 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).)

(5) 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).)

(6) 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).

(7) 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. Adjustments for Capital Gains and Losses.—

Line 7(a).—If the corporation had foreign source capital gain net income that is included on line 6(e), enter on line 7(a), in addition to the other definitely allocable deductions, the reduction for the "rate differential portion" of the net capital gain included on line 6(e). (See section 904(b)(2).)

Line 9(c).—If the corporation has any net capital loss or short term capital loss from qualified sources outside the U.S., to the extent taken into account in determining capital gain net income, the loss, decreased by the "rate differential portion" of the excess of net capital gain from non-qualified sources over net capital gain, is used to reduce income against which the credit is allowed. Enter on line 9(c) this reduction and attach computation.

Line 12.—If the taxable income of the corporation includes income from the sale or exchange of capital assets in line 11, enter the reduction for the "rate differential portion" of net capital gain.

I. Coordination with Foreign Tax Credit.—Qualified taxable income is not taken into account in computing the foreign tax credit limitation. (Section 904(b).)

J. 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

1978

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If incorrect, make any necessary change ▶

Name (as distinguished from trade name) — Calendar Year 1978

Trade name, if any — Employer identification number

Address and ZIP code

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—see instructions on page 4) . . . .

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

Exempt Remuneration (See Instructions on Page 4) — (a) New jobs credit wages — (b) Amount paid

12 Exempt remuneration. (Explain each exemption shown, attaching additional sheet if necessary) ▶

13 Remuneration in excess of the first $4,200 in column (a), and the first $6,000 in column (b), paid to individual employees exclusive of exempt amounts entered on line 12. Do not use State wage limitation . . . .

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

15 a New jobs credit total wages (subtract line 12, column (a) from line 11) .

b New jobs credit wages (subtract line 14, column (a) from line 11) . . .

c Total taxable FUTA wages (subtract line 14, column (b) from line 11) . . . .

16 Gross Federal tax (multiply line 15c by .034) . . . .

17 Maximum credit (multiply line 15c by .027) . . . .

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

19 Amount, if any, of wages on line 15c attributable to Rhode Island $.................... × .003 . .

20 Credit allowable (subtract line 19 from line 18) . . . .

21 Net Federal tax (subtract line 20 from line 16) . . . .

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 (subtract line 22 from line 21—this should not exceed $100). Pay to Internal Revenue Service . . . . ▶

24 Overpayment (subtract line 21 from line 22) . . . . ▶

25 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 claimed as a credit was or is to be deducted from the remuneration of employees.

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

Effective January 1, 1978—

(1) Wage base increased to $6,000;

(2) Coverage extended to certain agricultural and domestic service employees; and

(3) U.S. Virgin Islands employers are subject to FUTA.

General Instructions

For more detailed information on which employers must file, the types of payments defined by law as wages, and the kind of services covered by the Federal Unemployment Tax Act (FUTA), see **Publication 15,** Circular E, Employer's Tax Guide. **Publication 539,** Withholding Taxes and Reporting Requirements, has examples and a filled in copy of Form 940. Both publications are available at any Internal Revenue Service office.

Household employers, see **Publication 503,** Child Care and Disabled Dependent care. Publication 503 includes an example and a filled in copy of Form 940 for a household employer.

Purpose of Form 940.—Use it for the annual reporting of tax under FUTA, which **is paid only by the employer.** The tax rate is 3.4 percent on the first $6,000 of wages paid to each employee during 1978.

Who Must File.—In general, every employer who during 1978 or 1977 paid wages of $1,500 in any calendar quarter or at any time had one or more employees in any 20 calendar weeks must file. Count all regular, temporary, and part-time employees. A partnership should not count its partners. If a change of ownership or other transfer of the business occurs during the year, each employer who meets the $1,500 a quarter or one or more employees in 20 weeks tests must file, but neither should report wages paid by the other. Organizations described in section 501(c)(3) are not required to file.

Beginning in 1978, employers who (1) paid cash wages of $20,000 or more to agricultural workers during any calendar quarter beginning on or after January 1, 1978; or (2) employed 10 or more agricultural workers during some portion of a day (whether or not at the same time) for at least one day during any 20 different weeks beginning on or after January 1, 1978. (Aliens admitted to the U.S. on a temporary basis to perform agricultural labor are excluded until January 1, 1980.); or (3) paid cash wages of $1,000 or more in any calendar quarter beginning on or after January 1, 1978, for domestic service in a private home, local college club, or a local chapter of a college fraternity or sorority, will be required to file Form 940.

If you receive a form and are not liable for Federal unemployment tax for 1978, write "Not Liable" across the front and return it to the IRS. If you are no longer in business at the end of the year, write "Final" on line 25.

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, we will send you a preaddressed form near the end of the year. If you do not receive it, request one from any IRS office in time to file.

Due Date.—Form 940 for 1978 is due by January 31, 1979. If you made timely deposits in full payment of the tax due, you have until February 10, 1979, to file.

Where to File.—

If your principal business, office, or agency is located in	File with the Internal Revenue Service Center at
New Jersey, New York City and counties of Nassau, Rockland, Suffolk, and Westchester	Holtsville, NY 00501
New York (all other counties), Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, Vermont	Andover, MA 05501
District of Columbia, Delaware, Maryland, Pennsylvania	Philadelphia, PA 19255
Alabama, Florida, Georgia, Mississippi, South Carolina	Atlanta, GA 31101
Michigan, Ohio	Cincinnati, OH 45999
Arkansas, Kansas, Louisiana, New Mexico, Oklahoma, Texas	Austin, TX 73301
Alaska, Arizona, Colorado, Idaho, Minnesota, Montana, Nebraska, Nevada, North Dakota, Oregon, South Dakota, Utah, Washington, Wyoming	Ogden, UT 84201
Illinois, Iowa, Missouri, Wisconsin	Kansas City, MO 64999
California, Hawaii	Fresno, CA 93888
Indiana, Kentucky, North Carolina, Tennessee, Virginia, West Virginia	Memphis, TN 37501

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 or the U.S. Virgin Islands, file Form 940 with the Internal Revenue Service Center, Philadelphia, PA 19255.

Deposit Requirements.—Deposit Federal unemployment tax in an authorized financial institution or a Federal Reserve bank according to the instructions on the reverse of a preinscribed Federal Tax Deposit Form 508 which must accompany each deposit.

Figure Federal unemployment tax on a quarterly basis. Deposit any amount due by 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 then.)

To determine if you must make a deposit for any of the first three quarters in 1979, compute the total tax by multiplying by .007 that part of the first $6,000 of each employee's annual wages you paid during the quarter.

If the amount subject to deposit (plus the undeposited amount for any prior quarter) 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, deposit the entire amount by January 31. If the tax for the year less any deposits is $100 or less, either deposit it or pay it with Form 940 by January 31.

If you deposited the proper amounts following these rules, the balance due will not exceed $100.

How to Make Deposits.—Follow the instructions on the reverse of the preinscribed Federal Tax Deposit Form 508.

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 for deposits not made are subject to fines and other criminal penalties.

Credit for Contributions Paid into State Funds.—You can claim credit for contributions you pay into a certified State unemployment compensation fund by the due date of Form 940.

"Contributions" mean payments required by 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 employee's remuneration.

You may credit contributions against the tax whether or not made with respect to "employment." You may not take credit for voluntary contributions or for penalties or interest payments 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 had you paid the contributions by 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," which 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.

The total credit allowable 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

(Continued on page 4)

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

Employer's Annual Federal Unemployment Tax Return

1978

YOUR COPY

Calendar Year
1978
Employer identification number

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—	4 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—see instructions on page 4) . . . .
11 Total remuneration (including exempt remuneration) paid during the calendar year for services of employees

Exempt Remuneration (See Instructions on Page 4)	(a) New jobs credit wages	(b) Amount paid
12 Exempt remuneration. (Explain each exemption shown, attaching additional sheet if necessary) ▶		
13 Remuneration in excess of the first $4,200 in column (a), and the first $6,000 in column (b), paid to individual employees exclusive of exempt amounts entered on line 12. Do not use State wage limitation		
14 Total exempt remuneration (line 12 plus line 13)		
15 a New jobs credit total wages (subtract line 12, column (a) from line 11) .		
b New jobs credit wages (subtract line 14, column (a) from line 11) . . .		

c Total taxable FUTA wages (subtract line 14, column (b) from line 11) . . . .
16 Gross Federal tax (multiply line 15c by .034) . . . .
17 Maximum credit (multiply line 15c by .027) . . . .
18 Line 10 or line 17 whichever is smaller . . . .
19 Amount, if any, of wages on line 15c attributable to Rhode Island $.................. × .003 .
20 Credit allowable (subtract line 19 from line 18) . . . .
21 Net Federal tax (subtract line 20 from line 16) . . . .

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 (subtract line 22 from line 21—this should not exceed $100). Pay to Internal Revenue Service . . . . ▶
24 Overpayment (subtract line 21 from line 22) . . . . ▶
25 If no longer in business at end of year, write "Final" here . . . . ▶

Keep This Copy For Your Records

You must retain this copy, and a copy of each related schedule or statement for a period of 4 years after the date the tax is due or paid, whichever is the later. These copies must be available for inspection by the Internal Revenue Service.

(Continued from page 2)

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 and the U.S. Virgin Islands) 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 States 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.—Show the FUTA wages (if any) subject to the unemployment compensation laws of Rhode Island. (If in doubt, ask your local IRS office.) Multiply the wages by .003. This adjustment is required by Internal Revenue Code section 3302(c)(2). If no wages are subject, show "none" 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 FUTA Wages

Line 11—Total remuneration (including exempt remuneration) paid during the calendar year for services of employees.—Show the total remuneration for services you paid employees during the calendar year, even if it is not taxable. Include salaries, wages, commissions, fees, bonuses, vacation allowances, amounts paid to temporary or part-time employees, and the value of goods, lodging, food, and clothing. Show the amount before any deductions.

How you pay the remuneration is not important in determining if it is wages. Thus, you may pay it for piecework or as a percentage of profits, and you may pay it hourly, daily, weekly, monthly, or yearly. You may pay it in cash or some other way, such as goods, lodging, food, or clothing. For items other than cash, use the fair value at time of payment.

Line 12, column (b)—Exempt remuneration.—"Wages" and "employment" as defined for FUTA purposes do not include every payment of remuneration and every kind of service an employee may perform. In general, remuneration excluded from wages and remuneration for services excepted from employment are not included in wages subject to tax. You may deduct these payments from total remuneration paid only if you identify them on line 12.

Show and identify on line 12 such items as (1) agricultural labor if you paid cash wages of less than $20,000 for agricultural labor for each calendar quarter in 1978, and did not employ 10 or more agricultural workers during some portion of a day during any 20 different weeks in 1978; (2) benefit payments for sickness or injury under a workmen's compensation law, insurance plan, and certain employer plans; (3) domestic service if you paid cash wages of less than $1,000 in each calendar quarter in 1978; (4) family employment; (5) certain fishing activities; and (6) any other exempt payments or services. For more detailed information, see Circular E, Employer's Tax Guide.

Line 13, column (b).—Show the total amount of remuneration you paid each employee in excess of $6,000. For example, you have 10 employees whom you paid $8,000 each during the year. Show $80,000 on line 11 and $20,000 on line 13, column (b). The $6,000 wage limitation is for FUTA purposes only. Do **not** use the State wage limitation for this entry.

Computation of New Jobs Credit Wages

Column (a).—If you are eligible for the new jobs credit, complete column (a).

In addition to amounts shown in line 12, column (b), include in line 12, column (a) the total amounts paid to an employee if:

(1) services performed by the employee during more than one-half of any pay period during the year are for agricultural labor; or

(2) more than one-half of the amount paid to the employee during the year is for railroad labor; or

(3) more than one-half of the amount paid to the employee during the year is **not** for services performed in the United States in the trade or business of the employer.

You need not identify these items in line 12; only show the totals in line 12, column (a).

Line 13, column (a).—Show the total amount of remuneration you paid each employee in excess of $4,200. The $4,200 limitation is for the new jobs credit computation only. The $6,000 wage limitation in column (b) is for FUTA purposes only. Do not use the State wage limitation for either entry.

Lines 15a and 15b.—To determine if you are eligible to claim the new jobs credit, enter the amounts from line 15a on line 6 of Form 5884, New Jobs Credit, and from line 15b on line 1 of Form 5884, and complete that form. (If your employees perform agricultural or railroad services, see General Instruction D, Form 5884.)

Department of the Treasury
Washington, D.C. 20220

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