The Operation and Effect of the Possessions Corporation System of Taxation

Fourth Report

Department of the Treasury
February 1983

THE OPERATION AND EFFECT OF THE

POSSESSIONS CORPORATION SYSTEM OF TAXATION

FOURTH REPORT

DEPARTMENT OF THE TREASURY

February 1983

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Washington, D. C. 20402

THE SECRETARY OF THE TREASURY

WASHINGTON

February 22, 1983

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 fourth annual report entitled, The Operation and Effect of the Possessions Corporation System of Taxation. This report covers tax return information for 1979 and 1980, and other economic data available through mid-1982.

The Tax Equity and Fiscal Responsibility Act of 1982 provided new rules for the allocation of income between a U.S. parent corporation and an affiliated possessions corporation. The effect of the new provisions, which apply to tax years beginning after December 31, 1982, will be examined in future Annual Reports.

I am sending a similar letter to Robert Dole, Chairman of the Committee on Finance.

Sincerely,

Donald T. Regan

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The Honorable
Dan Rostenkowski
Chairman, Committee on Ways
and Means
United States House of Representatives
Washington, D.C. 20515

Enclosure

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TABLE OF CONTENTS

APPENDICES Page

LIST OF FIGURES AND TABLES

Tables | Page

Tables		Page

Chapter 1

INTRODUCTION AND SUMMARY

This is the fourth report to the Congress on the possessions corporation system of taxation. Possessions corporations, also known as 936 corporations, are U.S.-chartered 1/ companies which are exempt under section 936 of the Internal Revenue Code 2/ from Federal tax on business income and qualified nonbusiness income from Puerto Rico and certain other U.S. possessions. The body of this report covers tax return information for 1980 and other economic data available through mid-1982. Appendix B covers tax return information for 1979.

The U.S. tax exemption for possessions corporations was originally added to the Code in 1921 for the purpose of promoting the competitiveness of U.S. business operating in the possessions. In 1948, Puerto Rico enacted a complementary program of tax exemption under its independent tax law. 3/ This program, called Operation Bootstrap, has been important in creating modern manufacturing and banking sectors in Puerto Rico.

In 1976, Congress denied the benefits of tax exemption for income which possessions corporations derived from foreign countries, but retained the exemption for possession business profits and qualified investment income. In so doing, Congress stated that it wanted to "assist the U.S. possessions in obtaining employment-producing investments by

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1/ Although Puerto Rico and other U.S. possessions are included in some definitions of the United States, for convenience of exposition the term "United States" in this Report includes only the fifty States and the District of Columbia.

2/ Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended (the "Code").

3/ Since 1960, other U.S. possessions have also enacted tax-exemption programs.

U.S. corporations..." 4/ Congress also directed the Treasury Department to review the operations of section 936 corporations:

> The Treasury is to submit an annual report to the Congress setting forth an analysis of the operation and effect of the possessions corporation system of taxation. Among other things, the report is to include an analysis of the revenue effects of the provision as well as the effects on investment and employment in the possessions. 5/

For fiscal year 1980, the reduction in U.S. tax under the possessions corporation system of taxation is estimated at $1,195 million. In making this estimate, it is assumed that in the absence of section 936, the net income of all U.S. corporations in the aggregate would not change. Over 99 percent of the estimated U.S. tax cost of the possessions corporation system was attributable to U.S. corporations operating in Puerto Rico. The remainder, or $2 million, was attributable to U.S. corporations operating in Guam, American Samoa, or other U.S. possessions.

Because the principal impact of section 936 is on Puerto Rico, the body of this report deals almost exclusively with Puerto Rico. The impact of section 936 on other U.S. possessions is described in Appendix A. This Appendix also covers the tax incentive program for corporations operating in the Virgin Islands, which is delimited by section 934(b) of the Code. In 1980, the amount of income tax forgiven under the Virgin Islands tax incentive program was $41 million, of which $38 million was attributable to Virgin Islands subsidiaries of U.S. corporations.

In Puerto Rico, the possessions corporation system is based upon the interaction of the tax laws of the United States and those of the Commonwealth. This report first reviews those tax laws and then undertakes an economic analysis of their impact. Chapter 2 discusses the U.S. tax legislation for possessions corporations and the modifications to the legislation in the Tax Equity and Fiscal

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4/ Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976, p. 274. Similar language is used in the Reports of the House Committee on Ways and Means and the Senate Committee on Finance.

5/ Ibid., pp. 277-8.

Responsibility Act of 1982 (TEFRA). The chapter also describes the U.S. tax law and administrative releases which apply to the transfer of patents, trademarks, and other assets by a U.S. parent corporation to an affiliate, and the rules which relate to the allocation between affiliated corporations of income from intangible assets. Although these tax rules have broader application than the possessions context, they are critical to an understanding of the operations of possessions corporations. Under TEFRA, new rules for the allocation of income from patents, trademarks, and other intangibles will apply to possessions corporations for tax years beginning after December 31, 1982.

Chapter 2 concludes with a review of Puerto Rico's Industrial Incentive Acts, under which grants of partial and total exemption from Puerto Rican income, property, and excise taxes have been offered as incentives to corporations to establish manufacturing plants in Puerto Rico. Chapter 2 also discusses Puerto Rico's tollgate tax on dividends paid out of Puerto Rican source income to U.S. parent corporations.

Chapter 3 surveys Puerto Rican economic growth since 1948, and the impact of the U.S. and Puerto Rican tax exemptions in shaping that growth. From the late 1940s to the early 1970s, the combined effect of tax exemption, low wages relative to the United States, and exemption from U.S. tariffs contributed to a sustained high rate of Puerto Rican economic growth. In the 1948-1973 period, Puerto Rican real gross national product (GNP) grew at an average annual rate of six percent, and real GNP per capita grew by five percent per year.

Since 1973, however, the average annual rate of growth of real GNP in Puerto Rico has fallen to one-third the rate in the 1960s. The annual flow of private investment in new plant and equipment in 1980 and 1981, measured in constant dollars, was about 70 percent of its value in 1973. 6/

6/ The trend in annual investment in Puerto Rico between 1973 and 1981 is unchanged when private refinery construction is excluded. Private refinery construction represented 30 percent of total private investment in Puerto Rican plant and equipment in the period 1970-72, but dropped to 4 percent in 1973 and most subsequent years. The short-lived boom of the Puerto Rican petrochemical industry was based on Puerto Rico's large allocation of U.S. oil import quotas for foreign oil (which before 1973 was cheaper than domestic oil). See p. 38 below.

Employment growth also has slowed. Between 1970 and 1981, employment fell by 54,000 jobs in Puerto Rican construction and agriculture. These losses were offset by employment gains in government, services, and manufacturing, but the aggregate increase did not keep pace with population growth. Unemployment, which declined steadily through the 1960s to just over 10 percent of the measured labor force, has been at 17 percent or above since 1975, and rose to 23.5 percent in the year ending June 30, 1982.

In part, the decline in investment and in the growth of employment in Puerto Rico is traceable to the U.S. economy, which was in recession in 1974-1975 and has not grown rapidly since. In addition, Puerto Rico's ability to compete for investment has been hurt by Federal minimum wage laws. As a result of successive increases in the minimum wage rates applicable to Puerto Rico and the expansion of Puerto Rican coverage between 1966 and 1976, the U.S. mainland minimum wage applied to virtually all Puerto Rican manufacturing and non-manufacturing industries by 1981. In many Puerto Rican industries, including apparel and leather goods, the hourly wage paid to most workers is at, or near, the legal minimum and has risen as the minimum wage has increased.

The competitiveness of Puerto Rican products also has been undercut by structural changes in the world economy. Increases in investment in developing countries have created new manufacturing centers there. After the Kennedy round of tariff reductions in 1967, exports of manufactures from developing countries were able to penetrate the U.S. market and compete successfully with Puerto Rican-produced goods.

Chapter 4 reviews the ways in which the tax exemption affects the kind of operations attracted to Puerto Rico. The relative tax advantages of a Puerto Rican location vary for physical and financial investments and for the holding of intangible assets. 7/ Puerto Rico is, on tax grounds, a

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7/ "Physical investment" consists of expenditures to buy newly produced capital goods, plant, equipment, and inventories. "Financial investment" means the purchase of securities, such as stocks and bonds and certificates of deposit (CDs). Some "intangible assets," such as patents and know-how, are produced by investment in research and development and training; other intangibles, such as trademarks, acquire value because of expenditures on advertising and promotion.

more attractive location than the United States for plant and equipment and other operating assets. But the tax advantages of a Puerto Rican location for physical assets may not be significantly better than those available in a low-tax developing country. On the other hand, Puerto Rico offers special advantages for financial assets, such as deposits, bonds, and other securities. Section 936 provides that qualified possession source investment income (QPSII) is free of U.S. tax. For most U.S. taxpayers, no alternative to Puerto Rico exists for receiving tax-free, high-yield returns on financial investments.

Chapter 4 also describes how some U.S. corporations have sought to increase the attractiveness of Puerto Rico as an investment location by transferring patents, trademarks, and other intangible assets to Puerto Rico. Assets can be transferred between U.S. corporations on a tax-free basis under section 351 of the Code. Since a 936 corporation is a U.S., not a foreign corporation, U.S. parent corporations have relied on section 351 to effect tax-free transfers of patents and other intangibles to their 936 affiliates. If the income attributable to the intangibles is treated as earned by the 936 corporation, rather than the parent, the effect of the transfer will be to increase the pool of tax-exempt Puerto Rican income earned by the 936 corporation and thus augment the incentive for investing in Puerto Rico. The Internal Revenue Service has contested the claimed allocation to 936 corporations of returns on the transferred intangibles on the ground that it distorts the income of the parent corporations. The controversy is in litigation in the U.S. Tax Court, and has been largely resolved for future years by the amendments to section 936 under TEFRA.

While the Code generally allows assets to be transferred tax-free between related domestic corporations, the right to transfer assets free of tax to a controlled foreign corporation is limited. In particular, administrative guidelines under section 367 of the Code impose a tax (a toll charge) on the transfer from a U.S. corporation to a foreign corporation of the U.S. rights to an intangible, e.g., a patent to produce goods which will ultimately be sold in the United States. Based on this distinction in U.S. tax law between domestic (including 936) and foreign corporations, and depending on the ultimate resolution of the Tax Court litigation, Puerto Rico has offered a significant advantage over foreign low-tax jurisdictions for holding patents, trademarks, and other intangibles. Under the amendments to section 936 in TEFRA, a Puerto Rican location will continue to offer unique advantages with respect to intangibles.

The mix of assets in Puerto Rico reflects the differing tax incentives offered to physical and financial investments and the holding of intangible assets. In 1980, fixed assets (plant, equipment, and land) represented 12 percent of the total book assets of 936 manufacturing corporations, compared to 37 percent for manufacturing corporations operating in the United States. The share of fixed assets in total assets was smaller for 936 companies than for companies operating in the United States in all but one of the industries for which data are available. The 12 percent share of 936 fixed assets in total 936 book assets increases to about 15 percent if all property owned by the Puerto Rican government for lease to investors is counted as assets of 936 firms.

Chapter 4 also analyzes the impact of intangible and financial assets on Puerto Rican growth. Some intangible assets, such as management techniques, contribute to Puerto Rican growth by increasing productivity in much the same way as physical capital. With respect to other intangibles, in particular patents, trademarks and trade names, a distinction can be drawn between the right to use the intangibles and ownership of the intangibles. The right to use patents, trademarks and other product-specific intangibles increases the productivity of Puerto Rican workers by giving them an opportunity to participate in the production of advanced products. Transferring the ownership title to a product-specific intangible may also benefit Puerto Rico. Provided the transfer is accompanied by additional investment in physical assets and additional employment in Puerto Rico, it will increase Puerto Rican productivity and growth. The impact of the transfer of product-specific intangibles on Puerto Rican economic development will be closely related to the volume of physical investment that accompanies the transfer of such intangibles.

By restricting to Puerto Rican source income the tax exemption on financial investments, the Tax Reform Act of 1976 induced possessions corporations to bring to Puerto Rico the large pool of funds that had been invested in the Eurodollar market. The intent of the QPSII provision in section 936 was to lower interest costs and promote real private and public investment in Puerto Rico. In an attempt to realize this objective, the Puerto Rican government has issued a series of regulations designed to isolate Puerto Rico from world capital markets so as to interfere with the normal equalization of financial returns among markets.

Chapter 4 notes that at least through mid-1981, this objective has been frustrated. Total Puerto Rican financial assets held by exempt possessions corporations at year-end 1981 were $7.6 billion. However, these assets tended to flow out again through the banking system, or to result in shifts in the ownership of Puerto Rican government debt and in investments abroad by Puerto Rican government corporations. Thus, the return to possessions corporations on tax-exempt certificates of deposit in banks in Puerto Rico was close to the Eurodollar interest rate. On December 17, 1981, the Puerto Rican Treasury issued new regulations, effective February 1, 1982, which substantially tightened the rules governing the use of 936 funds by bankers, brokers, and Puerto Rican borrowers. As a result of the new regulations, the interest rate on 936 deposits relative to Eurodollar deposits fell in March and April of 1982. The new regulations also appear to have resulted in a rise in the growth of Puerto Rican commercial loans between February and May 1982.

Chapter 5 presents background statistical information on 936 corporations, including balance sheet, income statement, and employment and payroll data by industry. In 1980, the pharmaceutical industry accounted for approximately one-half of total net income of 936 manufacturing corporations. The next largest industry in terms of income was electrical and electronic equipment, which accounted for one-fifth of the total net income.

In enacting section 936, Congress sought to assist Puerto Rico in obtaining employment-producing investments. Matching income tax return information with Federal unemployment insurance tax returns for individual 936 corporations provides one indication of the extent to which this objective has been realized. Based on the sample of corporations for which employment information is available, it is estimated that in 1980, employment in all possessions corporations in manufacturing industries was approximately 72,000. This represents 9 percent of total employment in Puerto Rico and one-half of all employees in Puerto Rico's manufacturing sector.

Possessions corporations' tax benefits in relation to their employment varied substantially by industry. In 1980, the tax savings per employee averaged $59,000 in the pharmaceutical industry and $4,000 in the low-technology, labor-intensive industries. Over all manufacturing industries, corporate tax savings per Puerto Rican employee averaged $17,000, as compared to average compensation of possessions corporation employees of $12,000.

Chapter 6 reviews the impact of the 1976 Tax Reform Act and recent changes in Puerto Rican law on dividend repatriations and Puerto Rican tax revenues. Until 1976, possessions corporations paid virtually no dividends to their U.S. parents, since pre-1976 law subjected such dividends to U.S. tax. Between 1978 and 1981, however, possessions corporations repatriated one-third to one-half of each year's earnings. In 1976, Puerto Rico modified its tollgate tax to apply to dividends repatriated by possessions corporations. That tax yielded $56 million in revenues in the year ending June 1981. Puerto Rico also modified its income tax-exemption program in 1978, to provide that new investors would be eligible for only partial income tax exemption and that the amount of the exemption would decline over the life of each firm's tax-exemption grant. The combined effective rate of Puerto Rican tollgate and income taxation in 1981 was approximately 3.5 percent of the net income of 936 manufacturing corporations. The average Puerto Rican tax rate will rise somewhat in future years as more firms become subject to only partial tax exemption and as the amount of the exemption provided to each firm declines.

Chapter 2

UNITED STATES AND PUERTO RICAN LAW

The possessions corporation system of taxation consists of a set of rules under which a U.S. manufacturing corporation deriving qualifying income from Puerto Rico pays no tax on that income to the United States and currently pays,on average, less than 5 percent of that income in taxes to Puerto Rico.

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 dividends received from a wholly owned 936 subsidiary with a 100 percent dividends-received deduction, which frees the dividend income from Federal tax.

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. corporations, citizens, and residents. 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 are described first.

I. United States Tax Provisions

A. Historical Background. The main elements of the possessions corporation tax exemption became part of U.S. law as section 262 of the Revenue Act of 1921. Proponents of this legislation had sought tax exemption for the foreign source income of any domestic corporation deriving at least 80 percent of its income from foreign sources. They stressed the tax-induced disadvantage of U.S. firms operating abroad in competition with British firms. British law deferred taxation on foreign income of British firms until it was remitted to Great Britain, while the United States taxed the foreign income of U.S. corporations as it was earned. 1/ The proponents of exemption, chiefly U.S. corporations doing business in the Philippines, ultimately settled for an exemption for the foreign source income of U.S. persons deriving at least 80 percent of their income from U.S. possessions. 2/

The possessions corporation exemption continued unchanged from 1921 until 1976. To qualify for the exemption on income derived from sources outside the United States, a U.S. corporation had to meet two gross income tests. The corporation had to derive 80 percent or more of its gross income from the possessions, and 50 percent or more of its gross income from the active conduct of a trade or business in the possessions. These gross income tests had to be satisfied in the tax year in which the exemption was claimed, and also in the two preceding tax years if the corporation had conducted a trade or business in a possession during that period. A corporation which met the 80-50 income tests was known as a "possessions corporation." Such a corporation was usually organized as a special purpose subsidiary of a U.S. parent company in order to

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1/ Under U.S. law at that time, foreign incorporation also deferred the taxation of foreign source income until profits were remitted to the United States. 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.

2/ The possessions until 1946 included the Philippines, and the exemption orginally applied to U.S. citizens as well as U.S. corporations doing business in the possessions. Currently, the possessions include Puerto Rico, American Samoa, Guam, the Northern Mariana Islands, and certain other insular areas. The Virgin Islands was specifically excluded from the definition of "possession" under the 1921 Act, presumably because the U.S. income tax laws were in force in the Virgin Islands under the Naval Appropriations Act of 1922 (enacted July 12, 1921). Since foreign and U.S. corporations operating in the Virgin Islands were alike subject to U.S. income tax laws under that Act, U.S. corporations operating there did not suffer any tax-induced disadvantage. Including the Virgin Islands in the definition of "possession" would have placed foreign corporations operating in the Virgin Islands at a sharp competitive disadvantage relative to U.S. corporations.

ensure that the 80-50 income tests were met. Since the income of the possessions corporation from sources outside the United States was exempt from tax until it was remitted to the United States through the payment of a dividend, the possessions corporation enjoyed the same benefits of deferral as did foreign firms operating in the U.S. possessions.

B. Possessions Corporation Exemption under the Tax Reform Act of 1976. Between 1973 and 1976, the Ways and Means Committee of the House of Representatives held extensive hearings on the subject of tax reform. The Committee considered repealing the possessions corporation exemption on the ground that its original purpose of expanding U.S. trade with the Philippines and the Far East was no longer being served, the Philippines having ceased to be a U.S. possession in 1946. However, proponents of the exemption argued that it had become crucial to the economic development of another U.S. possession, Puerto Rico. Many U.S. firms had established plants in Puerto Rico after 1948, when Puerto Rico enacted a program of tax exemption for manufacturing firms. These tax-exempt firms were an important source of jobs in Puerto Rico. Proponents of continued U.S. tax exemption argued that the possessions corporation system of taxation offset the U.S. minimum wage requirement, the requirement to use U.S. flag vessels in transporting goods to the United States, and other Federally imposed requirements which tended to reduce Puerto Rico's ability to compete with neighboring countries for U.S. investment. Finally, it was argued that the possessions corporation system cost the Federal government only \$200-\$300 million a year in tax revenues, 3/ a small price in comparison to the \$2 billion then being spent by the Federal government in direct grants and transfer payments to Puerto Rico. 4/

3/ In January 1976, the Federal revenue loss as a result of the possessions corporation system was estimated at \$285 million on the basis of the limited data then available. (See Special Analyses 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 the filing requirement enacted in 1976, the FY 1977 tax expenditure estimate was revised from \$285 million to \$663 million. As indicated in Table 5-5 below, the revised estimate (based on tax returns covering 1977) is \$721 million.

4/ See Table 3-6 below for a tabulation of Federal direct aid to Puerto Rico.

The Tax Reform Act of 1976 left intact the exemption for income derived by U.S. corporations from operations in a possession, but eliminated the exemption for income derived from foreign countries. These and other changes in the tax treatment of possessions corporations were effected by removing possessions corporations from section 931 of the Internal Revenue Code and placing them in a newly created Code section 936. The differences between sections 931 and 936 are:

- o <u>Change in the scope of and method of effecting the tax exemption</u>. Before 1976, a possessions corporation was exempt from the U.S. tax on all income derived from sources outside the United States. Under the Tax Reform Act of 1976, the exemption was limited to two kinds of income:

  -- 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

  -- QPSII, which is non-business income derived from the possession in which the corporation has its trade or business 5/ and which is attributable to the investment of funds derived from such trade or business.

  Instead of excluding this income, section 936 provides a credit equal to (and, thus, fully offsetting) the U.S. tax on this income. The section 936 credit is not available for other income earned by a possessions corporation. However, a 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.

5/ 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.

- o Exemption from U.S. tax on income remitted by a possessions corporation to its U.S. parent. 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, 931 corporations accumulated substantial earnings, investing them in the Eurodollar market in anticipation of a tax-free liquidation. 6/ To accelerate the repatriation of earnings, the Tax Reform Act of 1976 allowed U.S. parent corporations to claim a dividends-received deduction for dividends from a 936 corporation. If the 936 company is a wholly owned subsidiary (as most are), the deduction equals 100 percent 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 taxes which may be imposed by Puerto Rico on or with respect to such dividends.

- o Requirement that a possessions corporation elect the benefits of section 936 for 10 years. Under section 931, as construed by a court decision, 7/ a possessions corporation which suffered a loss in a given year could join its parent and other affiliated corporations in filing a consolidated return for such a year. The parent of a 931 corporation thus avoided taxes in profitable years but was able to offset any loss against other taxable income in unprofitable years. Under section 936, a possessions corporation must elect the benefits of section 936, and that election is irrevocable for 10 years. During this period, it cannot join with its parent in filing a consolidated return, although it can delay electing 936 status until profitable years begin.

In explaining the amendments made by the Tax Reform Act of 1976, Congress cited its desire to leave undisturbed the tax exemption of earnings from a trade or business in Puerto

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6/ Because the investment income was not subject to Federal tax as earned, the company was not subject to the U.S. accumulated earnings tax.

7/ Burke Concrete Accessories, Inc., et al. v. Commissioner of Internal Revenue, 56 Tax Ct. 588 (1971). This case overturned Rev. Rul. 65-293, 1965-2 C.B. 323.

Rico or from investments made with those earnings for use in Puerto Rico. At the same time, Congress wished to end the exemption for passive income from funds invested in foreign capital markets and to hasten their repatriation. Congress stated that it sought to:

> assist the U.S. possessions in obtaining employment-producing investments by U.S. corporations, while at the same time encouraging those corporations to bring back to the United States the earnings from these investments to the extent they cannot be reinvested productively in the possession. 8/

C. Source of Income Rules. In determining whether a corporation satisfies the 80-50 gross income tests of section 936, which are described above, it is important to ascertain the source of the income of the corporation. The income of most possessions corporations is derived from the sale of products manufactured by the corporations in Puerto Rico. Therefore, the most important source rule for possessions corporations deals with income from the sale or exchange of personal property.

Under sections 861 through 863, the source of income from the sale or exchange of personal property is generally determined by the place where title to the personal property passes to the purchaser. If a possessions corporation sells goods produced in Puerto Rico to its U.S. parent corporation, with title to the goods passing in Puerto Rico, the income derived from the sales to the parent will be treated as Puerto Rican source income, even if the parent subsequently resells the goods in the U.S. market.

D. Treatment of Income from Intangibles under Pre-1982 Law. Before 1982, there were no explicit statutory guidelines on the allocation to a possessions corporation of income from intangibles, such as patents, trademarks, and tradenames. In a number of instances, U.S. corporations attempted to increase the income which was exempt from tax

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

under section 936 by transferring to an affiliated possessions corporation intangible assets created in the United States. These corporations generally construed the law to require no allocation to the U.S. parent of income generated by the intangibles. The view of the Internal Revenue Service, on the other hand, is that it can reallocate to the U.S. parent all or a portion of the income attributable to the intangibles. This issue is now before the U.S. Tax Court.

The first two sections below describe the most important rules prior to 1982 for the tax treatment of income from intangibles. The chapter then describes the new rules applicable to possessions corporations which were added to the Code by the Tax Equity and Fiscal Responsibility Act of 1982.

1. Intercorporate Transfers of Assets. Section 351 of the Code provides that if a U.S. corporation owns 80 percent or more of a U.S. subsidiary, it may transfer appreciated property, including intangibles such as patents and trademarks, to the subsidiary solely in exchange for stock or securities of the subsidiary without the recognition of gain. The Code permits such tax-free transfers between related U.S. corporations because the income to which the transferred property gives rise generally will be taxed to the subsidiary at the time the income is realized. An important exception arises, however, if the transferee corporation is tax-exempt under section 936.

Although it does business in Puerto Rico, a corporation qualifying for the benefits of section 936 is a U.S. corporation. Thus, a U.S. parent corporation that transferred appreciated property to a 936 corporation could claim a dual tax benefit. First, the parent retained as an offset against other taxable U.S. income the costs incurred in developing the intangibles in the United States. Second, prior to 1982, it could assert that the gross income generated by the transferred property was exempt from tax under section 936. As explained below in the section on income allocation, the Internal Revenue Service challenged some of these claims.

The tax treatment of property transferred between two U.S. corporations contrasts with the tax treatment of property transferred from a U.S. to a foreign corporation. The income of a foreign corporation is normally not subject to current U.S. taxation unless the corporation earns income from a U.S. trade or business or other U.S. source income. Therefore, provision is made in the Code to prevent a U.S. corporation from avoiding tax by transferring property to a foreign subsidiary in a non-recognition transaction. Section 367 of the Code provides that in order to obtain non-recognition treatment, a U.S. corporation making such a transfer must receive a ruling from the Internal Revenue Service that the transfer has not been undertaken for the principal purpose of avoiding U.S. tax. Guidelines issued under section 367 provide that the Internal Revenue Service may in some cases impose a "toll charge" on the transfer of property to a foreign corporation. 9/

In the particular case of a U.S. corporation which transfers to a foreign corporation title to patents, trademarks, or other intangibles used to produce a good which will ultimately be sold in the United States, the U.S. corporation would normally be required to include in its gross income the excess of the value of the intangible over its adjusted basis. If all costs of developing the intangible have been deducted from the U.S. corporation's income, then its basis in the property is zero, and the total value of the intangible must be included in the income of the parent corporation. Section 367 does not apply to transfers of income-producing property from a U.S. parent corporation to its 936 subsidiary, since 936 companies are U.S., not foreign, corporations.

2. Allocation of Income and Deductions. Under section 482 of the Code, the Internal Revenue Service may reallocate income, deductions, or credits among two or more corporations under common ownership so as to prevent evasion of taxes or to clearly reflect the income of any of such corporations. The objective is to place a controlled corporation on the same tax footing as an uncontrolled taxpayer. Section 482 reallocations of income between a U.S. parent and an affiliated possessions corporation have been a subject of controversy since 1955. The principal issue has been the treatment of income from patents, trademarks, and other intangibles developed by a U.S. parent corporation, but related to a product which is manufactured, in whole or in part, by its affiliated possessions corporation.

9/ See Revenue Procedure 68-23, 1968-1 C.B. 821, and subsequent Revenue Procedures modifying Rev. Proc. 68-23.

In a 1955 private letter ruling, the Internal Revenue Service ruled that income derived from sales of goods made by a possessions corporation to its U.S. parent constitutes gross possession source income of the possessions corporation for purposes of section 931. 10/ The ruling did not explicitly address the issue of the sales price charged by the possessions corporation. In the ruling, the taxpayer had represented that sales of manufactured goods from the possessions corporation to the U.S. parent would be priced so as to give to the parent only the profit margin normally earned by an independent distributor. Under such a pricing rule, the affiliated possessions corporation would receive all of the income attributable to any patent, trademark, or customer goodwill for the product it manufactured. In commenting on the pricing issue, the Internal Revenue Service subsequently stated that the 1955 ruling:

> should not be construed to pass upon the propriety of the [particular pricing rule used by the taxpayer] as being an appropriate measure of the allocation of profits between [the taxpayer] and its subsidiary operating in Puerto Rico.

The Internal Revenue Service noted that the proper income allocation rule is a factual question which the 1955 ruling did not address. 11/

In 1963, the Internal Revenue Service provided guidelines in Revenue Procedure 63-10 for the allocation of income from intangibles between a U.S. parent corporation and its affiliated possessions corporation. The Revenue Procedure was prepared after considerable discussion with, and review by, representatives of the Puerto Rican government. The guidelines state that if, under all facts and circumstances, intangibles "belong" to the affiliated possessions corporation, it is entitled to the income produced by the intangibles. The Revenue Procedure cautions that where the U.S. parent corporation is the marketing and servicing organization for products produced by the possessions corporation, "no supportable contention could be made" that certain intangibles, such as "market position,

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10/ Private letter ruling, October 6, 1955.

11/ Private letter ruling, April 8, 1959.

consumer acceptance, or similar factors of good will attributable to the distribution and product servicing activities in the United States" belong, as a matter of substance, to the possessions corporation. The Revenue Procedure does not specifically address the application of section 482 to cases involving intangibles transferred from a U.S. parent corporation to an affiliated possessions corporation, largely because such transfers were not yet common.

> They [the guidelines] do not deal with other problems that may be involved in particular cases, including those which may be present in cases involving the transfer of income-producing intangibles from the United States to an affiliate located in Puerto Rico. 12/

Shortly after the publication of Revenue Procedure 63-10, the Internal Revenue Service also issued Manual Supplement 42G-86. It states that if intangibles "belong" to an affiliated possessions corporation, it is entitled to the return thereon. The Manual Supplement does not define the term "belong" in the case where intangibles have purportedly been transferred to an affiliated possessions corporation, except by reference to the facts and circumstances. In particular, it sets forth various factors the presence of which are evidence that there has not been a transfer in substance to the affiliated possessions corporation, such as lack of formal transfer documents, continued use of the intangibles by the mainland parent in its own operations, and retention by the mainland parent of protective and exploitative activites related to the intangibles. The Manual Supplement requires that cases in which there is evidence that significant income-producing intangibles have been transferred to an affiliated possessions corporation must be referred to the National Office for coordinated examination.

In 1968, the Internal Revenue Service issued regulations under section 482. These regulations provide detailed rules for the setting of transfer prices on transactions between related parties. Like the 1963 guidelines for the allocation of income to possessions corporations, the regulations do not specifically address the question of whether a section 351 transfer of intangibles will be respected for purposes of the allocation of income attributable to those

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12/ Revenue Procedure 63-10, 1963-1 C.B. 490.

intangibles. On the same day that the section 482 regulations were issued, the Internal Revenue Service issued Revenue Procedure 68-22, which provides that taxpayers may use the guidelines set forth in Revenue Procedure 63-10 if the result would be more favorable to the taxpayer than the section 482 regulations.

Since 1963, a number of U.S. parent corporations have transferred intangibles to their possessions subsidiaries under section 351. In computing the proper arm's-length price for sales of goods from a possessions corporation to its U.S. parent, the parent corporations have in some cases asserted that the possessions subsidiaries are entitled to all of the return on the intangibles. The Internal Revenue Service has contested the claimed allocation of the income attributable to the transferred intangibles to the possessions corporations, and has attempted to utilize section 482 to reallocate that return to the parent corporations.

In Technical Advice Memorandum 8040019, issued in July 1980, the Internal Revenue Service took the position, under the particular facts involved, that even though the parent corporation had taken all steps to legally transfer intangibles to its affiliated possessions corporation, the intangibles would not be treated as "belonging" to the possessions affiliate. The Service decided that the transfer lacked substance and was motivated solely by tax avoidance and that section 482 would be applied to reallocate all of the income produced by the intangibles to the parent corporation. In issuing this finding, the Internal Revenue Service noted that, subsequent to the transfer, the U.S. parent corporation continued to perform the same promotional, marketing, and supervisory activities, and also continued to conduct further research with respect to the patented and trademarked product.

The effect of the position enunciated in the Technical Advice Memorandum was to reallocate income to the parent and thereby reduce the income eligible for tax exemption under section 936. In many instances, U.S. corporations have taken the position that the Internal Revenue Service actions are inconsistent with the law and with Revenue Procedure 63-10; three cases concerning the transfer of intangibles are presently before the United States Tax Court.

The 1980 Technical Advice Memorandum and the ongoing litigation have highlighted the uncertainty of the law in this area and may have discouraged U.S. investment in Puerto Rico. The chart below shows that the number of manufacturing plants beginning operations in Puerto Rico was roughly constant between Puerto Rico's fiscal year ending June 30, 1979 and fiscal year 1982. However, there was a sharp drop after fiscal year 1980 in the number of new contractual agreements reached between the Puerto Rico Economic Development Administration and potential investors.

Number of Manufacturing Plant Start-ups and New Tax Exemption Agreements	Fiscal Year 1978	1979	1980	1981	1982
Manufacturing plant start-ups	105	114	110	117	118
Non-local investors	59	71	65	65	58
Local investors	46	43	45	53	60
Contractual agreements reached between the Puerto Rican Economic Development Administration and potential investors *	196	189	215	170	182
Non-local investors	116	112	136	83	97
Local investors	80	77	79	87	85

Source: Puerto Rico Economic Development Administration

* Includes agreements reached with respect to expansions and changes of ownership of existing plants. Does not include conversions of 100 percent tax-exemption grants to partial tax-exemption grants under the Puerto Rican Industrial Incentive Act of 1978.

E. Treatment of Income from Intangibles under the Tax Equity and Fiscal Responsibility Act of 1982. In order to limit abuses under section 936 13/, Congress in 1982 amended

13/ See Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, December 1982, pp. 81-83.

section 936 to provide detailed rules for the allocation of intangibles income between a possessions corporation and its affiliates. The Tax Equity and Fiscal Responsibility Act (TEFRA) adds a new section 936(h) to the Code providing, as a general rule, that income from intangibles is taxable to the U.S. shareholders of the possessions corporation. U.S. corporations may elect out of the general rule and choose between two options for allocating income to a possessions corporation. These two options are a "cost-sharing" option and a "50/50 profit split" option. Once an election to use either the cost-sharing or profit-split option is made, it will be binding unless the consent of the Commissioner of the Internal Revenue Service to revoke the election is obtained.

1. Cost-sharing Option under TEFRA. If a possessions corporation shares, through a cost-sharing payment, in the annual product area research expenditures of its affiliates, it will be deemed to own manufacturing intangibles related to the product or service which it produces, in whole or in part, in a possession. The possessions corporation will be entitled to the full return on these manufacturing intangibles. The applicable income allocation methods provided under section 482 will be utilized for this purpose. The possessions corporation cannot claim a return on marketing intangibles, such as trademarks, trade names, and brand names, under this election. The cost-sharing payment will be a fraction of the current year's worldwide direct and indirect product area research expenditures of the corporations affiliated with the possessions corporation. The fraction will be equal to the same proportion of the product area research expenditures which the gross receipts from sales of the product produced, in whole or in part, in the possession bears to the gross receipts from sales of all products in the product area by the possessions corporation and all affiliated companies.

2. 50/50 Split of Combined Taxable Income under TEFRA. This election provides a 50/50 split of the combined taxable income of the possessions corporation and all U.S. affiliates with respect to a product or service produced, in whole or in part, in a possession. Fifty percent of such profit would be allocated to the possessions corporation. The remainder of the combined taxable income would be allocated to its U.S. affiliates.

For purposes of computing the combined taxable income, all direct and indirect expenses relating to the product, including research and marketing expenses, will be taken into account. The amount of research expenditures which will be allocated to the product will be the greater of allocable research expenditures or the cost-sharing amount described in Option 1.

3. Eligibility. To be eligible to elect either of these options with respect to a product produced, in whole or in part, in a possession, a possessions corporation must perform a significant portion of the manufacturing activity with respect to that product, as follows:

- o The possessions corporation must incur production costs (other than the cost of materials) with respect to the product which are not less than 25 percent of the difference between (a) the gross receipts from sales of the product to unrelated parties by the possessions corporation or its affiliates, and (b) the direct costs of materials purchased by the possessions corporation or its affiliates from unrelated parties in connection with the manufacture of the product. This test is equivalent to a 25 percent value-added requirement.

- o Alternatively, the possessions corporation must incur, for labor services performed in the possession, at least 65 percent of the total labor costs incurred by the possessions corporation and its affiliates in producing the product or service during the taxable year.

- o In addition, to be eligible to elect the "50/50 profit split" option, the possessions corporation must substantially transform the materials it purchases from other parties. The substantial transformation test cannot be met by mere packaging, labelling, or minor assembly operations.

These business presence tests need not be met until 1986 in the case of a product or service which was produced by a possessions corporation as of August 17, 1982.

4. Other Changes under TEFRA in the Tax Treatment of Possessions Corporations. In addition to the new guidelines on the allocation of income from intangibles, TEFRA made the following additional changes in the possessions corporation system of taxation:

o <u>Passive Income Limitation</u>. The Act raises from 50 to 65 percent the share of its gross income that a corporation must derive from the active conduct of a possessions trade or business in order to qualify for the section 936 credit. This increase is phased in so that the percentage rises to 55 percent for taxable years beginning in 1983, and to 60 percent for taxable beginning in 1984. As under prior law, the gross income test must be met for the three-year period immediately preceding the close of the taxable year. The greater level of required active business income will mean that less passive investment income can be earned by a corporation still wishing to qualify for effective tax exemption under section 936.

o <u>Transfers of Intangibles by Possessions Corporations</u>. The Act generally subjects to tax transfers of intangibles abroad by a possessions corporation or a former possessions corporation. Under prior law, such a transfer would, in many instances, not have been subject to tax if, for example, the intangible was related to a product manufactured by a foreign corporation and sold abroad for final consumption outside the United States.

II. <u>Puerto Rican Tax Provisions</u>

A. <u>Historical Background</u>. 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 rents, cash grants to cover start-up costs, and low interest loans.

The Industrial Tax Exemption Act of 1948 offered qualified manufacturing firms and hotels exemption from tax on their operating income, property, and gross receipts. 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. 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 1950s, 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 had 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 1959, 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 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 possessions 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, extending the benefits of tax exemption to interest, rents and dividends earned on funds derived from tax-exempt manufacturing operations 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.

Under pre-1976 law, Puerto Rico imposed a "tollgate" tax on dividends distributed by an exempt company to a parent outside of Puerto Rico, provided that the parent was able to claim a foreign tax credit for the tax. But since such dividends were fully taxable to the parent under U.S. law in effect until 1976, whereas a liquidating distribution was free of both U.S. and Puerto Rican tax, possessions corporations did not ordinarily pay dividends, and the existence of the Puerto Rican tollgate tax was of largely academic interest. In the Tax Reform Act of 1976, described 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 dividends. 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. 14/ As a result, the tax-free repatriation of dividends which possessions corporations expected to be able to make after the passage of the Tax Reform Act of 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 Incentives Act of 1978. This Act reduced the rate of tollgate tax on dividends paid by tax-exempt firms provided that they reinvested specified portions of their earnings in designated Puerto Rican assets. The 1978 Act also replaced 100 percent tax exemption for new firms with

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14/ 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.

partial exemption of income from manufacturing operations. The Act did not change former tax exemption commitments, but it provided incentives to firms operating under "old" full tax exemption commitments to "convert" to partial tax exemption under the 1978 Act.

This section discusses, in turn, Puerto Rican taxation of non-exempt corporations, taxation under an old (pre-1978) exemption contract, taxation under a "converted" exemption contract, and taxation under a new exemption contract.

1. Taxation of Non-Exempt Corporations. Although section 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 income tax system derives from the Organic Act of 1917, known as the Jones Act. In 1954, the legislature adopted its present income tax system, 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 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 net 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 out of Puerto Rican source earnings and profits to a U.S. parent corporation are subject to Puerto Rican tax. 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 payor of the dividend is a Puerto Rican corporation. If the parent corporation is a "nonresident" of Puerto Rico, the dividend will generally be subject to a 25 percent tollgate tax withheld at source. The rate of tollgate tax will be reduced to 10 percent if the dividend is paid out of income derived from the operation of a hotel, manufacturing, or shipping business. Upon liquidation, a 29 percent tollgate tax applies to any Puerto Rican source gain received by a parent corporation which is not a "resident" of Puerto Rico.

2. Taxation under an Old Exemption Grant. In general, a firm which has a tax exemption grant under the 1963 Industrial Incentive Act 15/ is 100 percent exempt from tax on business income and investment income from certain designated assets (see below). This tax-exempt income is called Industrial Development Income. The firm is also 100 percent exempt from property and gross receipts 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.

The assets which give rise to tax-exempt investment income -- generally known 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 thePuerto Rican Housing Bank and Finance Agency, and certificates of deposit in certain banks doing business in Puerto Rico. Banks receiving these tax-exempt deposits are required to reinvest the funds within Puerto Rico, although this requirement was not strictly enforced until 1980. 16/

Dividends paid out of Industrial Development Income to "nonresident" U.S. parent corporations are subject to a 10 percent tollgate tax. However, the rate is reduced where the tax-exempt firm meets certain investment and disbursement conditions. These conditions and rules, summarized below, apply not only to firms with pre-1978 exemption grants, but also to firms with grants issued under the 1978 Industrial Incentives Act:

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

16/ Puerto Rican regulations which were in effect through March 31, 1980, permitted banks to "warehouse" 936 deposits outside Puerto Rico for up to six months. Puerto Rican rules regarding tax-exempt financial investments are explained in Chapter 4, below.

-- Dividends paid out of accumulated Puerto Rican source Industrial Development Income earned in tax years beginning before 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 any 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 in tax years beginning after September 30, 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 more than 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.

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

<u>Option One</u>. 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 apply 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 are distributed in a given year, and not more than 10 percent of such earnings are distributed in each of the succeeding five years.

-- 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 (a) 50 percent of such income is invested for five years in the firm's own capital assets 17/ or in assets designated in section 2(j) of Puerto Rico's tax exemption acts 18/ and (b) not more than 10 percent of such earnings are distributed in each of the succeeding five years.

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 Incentives Act provide 90 percent exemption from income and property tax in the 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 19/	
		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

17/ 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 Incentives Act of 1978, section 4(h)(1)).

18/ Section 2(j) assets are listed in Section III of Chapter 4, below.

19/ 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.

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 the tax exemption for 2(j) earnings 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 Incentives Act, as follows:

-- Dividends paid out of income earned by a tax-exempt business are subject to a tollgate tax of 5 percent, provided that (a) 50 percent of such income is invested for five years in 2(j) assets or in the firm's own capital assets, and (b) not more than 10 percent of the net income is distributed in each of the succeeding five years. 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

Puerto Rico is a small, crowded island with few natural resources. It shares a very close economic and political interdependence with the United States. Puerto Rico and the United States have a common currency and common external tariffs. There are no barriers to the free flow of goods, labor, or capital between the two economies. Most non-local sales of Puerto Rican goods are to the United States, and most goods which enter the island are from the United States. Nearly all investments in Puerto Rico by non-Puerto Rican firms have been made by U.S. companies. Federal statutes other than the internal revenue laws generally apply to Puerto Rico, some (such as the minimum wage legislation) with large economic impacts. Most Federal grant programs for State and local governments and most Federal income maintenance programs for individuals also apply to Puerto Rico. Residents of Puerto Rico participate fully in the Social Security and Unemployment Insurance programs. However, Puerto Rico, unlike the States, administers nutritional assistance (such as Food Stamps) under a block grant. In addition, the Federal contribution to Puerto Rico's program of Aid to Families with Dependent Children is subject to a ceiling, whereas Federal contributions to such programs in the States are not capped.

All of the ties between Puerto Rico and the United States have helped shape the push for Puerto Rican industrial development that began in 1948. This chapter briefly surveys Puerto Rican economic growth since 1948, and the impact of the combined U.S. and Commonwealth tax exemptions in shaping that growth.

The recent history of Puerto Rican economic development can be roughly divided into two periods. In the period 1948-1972, there was a sustained rise in private investment which created a modern manufacturing sector. GNP and GNP per capita grew rapidly. In the period 1973-1981, however, Puerto Rican economic progress slowed. Average annual growth in employment in the manufacturing sector fell from 4.4 percent in the years 1950-1972, to 1.1 percent in the post-1972 period, as the loss of jobs in low-technology industries offset much of the job increases in high-technology industries. GNP fell sharply during the 1974-76 recession, and despite a recovery in GNP growth, GNP per capita has changed little since 1974. Private investment in plant and equipment in 1977 (excluding private refinery construction) was only 72 percent of the peak reached in 1973; between 1977 and 1981, it has remained roughly constant.

In part, the decline in Puerto Rico's economic performance is traceable to the U.S. economy, which was in recession in 1974-75 and has not grown rapidly since. Puerto Rican growth has also been reduced by the gradual erosion of the U.S.-Puerto Rican wage differential, U.S. tariff and tax cuts, and structural changes in the world economy. These developments have reduced Puerto Rico's competitiveness as a location for U.S. manufacturing investment.

I. Growth Since 1948 1/

Puerto Rico's economic growth in the two decades after 1948 has often been called an "economic miracle." As demonstrated in Figure I and Table 3-1, Puerto Rican GNP (expressed in constant 1972 dollars) increased at an average annual rate of 5.3 percent in the 1950s, and 7.0 percent in the 1960s. Table 3-1 also shows that emigration from Puerto Rico was substantial in this 20-year period, presumably in response to the introduction of cheap air fares and the slow growth in employment opportunities in Puerto Rico relative to the U.S. mainland. 2/ Emigration averaged nearly 50,000 persons per year from 1950 to 1960 (or about 2 percent of total population), and 20,000 per year in the following decade (or under 1 percent of total population). Per capita GNP, which reflects the emigration from Puerto Rico, rose at an average annual rate of 4.7 percent in the 1950s and 5.5 percent in the 1960s. By any historical or international yardstick, the growth in total and per capita GNP was remarkable. 3/

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

2/ Historical employment figures for Puerto Rico are shown in Table 3-2. Between 1950 and 1970, total employment grew by 15 percent in Puerto Rico, compared to a 35 percent increase in civilian employment in the United States.

3/ Over the same 20 years, real GNP in the United States grew at an annual rate of 3.7 percent, and real GNP per capita at a rate of 2.2 percent.

FIGURE I

Total and Per Capita Gross National Product of Puerto Rico, 1947-1981 (Constant 1972 Dollars)

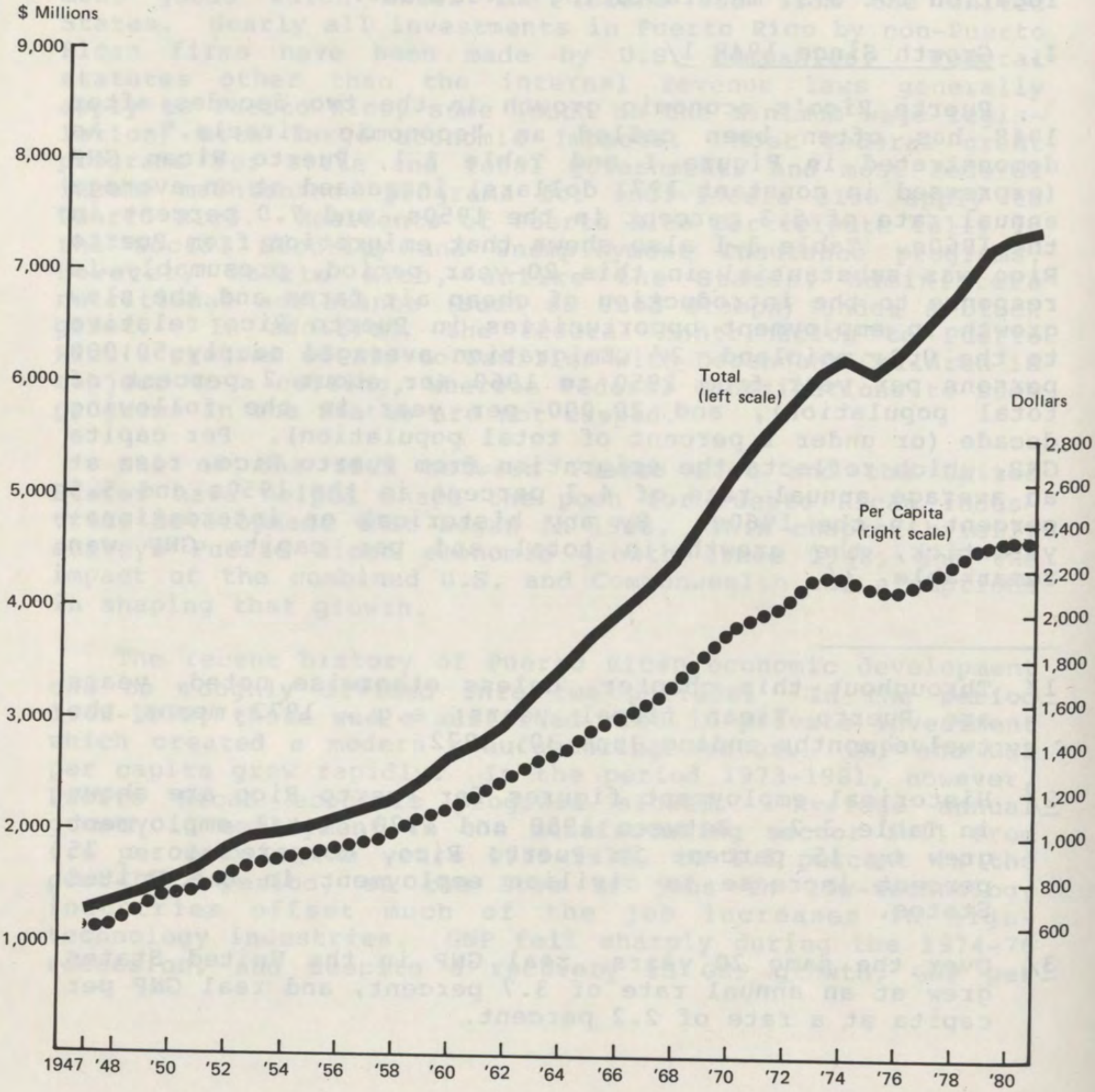

Table 3-1

Total and Per Capita Gross National Product of Puerto Rico, and Net Migration of the Resident Population 1947-1981

Fiscal Year	GNP (millions)	GNP per capita 1/
	(constant 1972 dollars)	
1947	1,256.0	584
1948	1,304.1	600
1949	1,457.7	665
1950	1,564.8	709
1951	1,647.2	740
1952	1,809.1	811
1953	1,925.6	869
1954	1,966.7	890
1955	2,027.4	908
1956	2,111.5	938
1957	2,175.8	965
1958	2,240.9	983
1959	2,428.3	1,051
1960	2,623.4	1,121
1961	2,783.0	1,169
1962	2,998.7	1,237
1963	3,242.3	1,312
1964	3,452.7	1,368
1965	3,738.2	1,453
1966	3,990.0	1,529
1967	4,165.9	1,582
1968	4,372.3	1,646
1969	4,779.6	1,775
1970	5,166.7	1,901
1971	5,477.0	1,997
1972	5,726.8	2,031
1973	6,144.2	2,144
1974	6,221.3	2,162
1975	6,094.4	2,094
1976	6,221.9	2,092
1977	6,503.2	2,139
1978	6,814.7	2,205
1979	7,216.2	2,304
1980	7,383.1	2,324
1981	7,432.3	2,307

1/ Based on population as of January 1.

Estimated Net Migration of the Total Resident Population of Puerto Rico

	Amount 1/	Annual Rate 2/
April 1, 1950-March 31, 1960	-493,000	-2.19
July 1, 1960-June 30, 1970	-201,000	-.79
July 1, 1970-June 30, 1980	-70,000	-.28
July 1, 1980-June 30, 1982	-43,757	-.67

1/ Estimated from intercensal population change, births, and deaths.

2/ Per 100 mid-period population.

Source: Puerto Rico Planning Board, Economic Report to the Governor, 1980-1981, Table 1; U.S. Bureau of the Census, Current Population Reports, Series P-25, Nos. 80, 336, and Puerto Rico Planning Board.

A number of factors contributed to Puerto Rico's economic growth in the two decades after 1948. Exemptions from local taxes played a key role in inducing U.S. firms to locate plants in Puerto Rico. U.S. manufacturers found Puerto Rico attractive because of low-cost Puerto Rican labor. Puerto Rico also had the advantage, compared to low-wage foreign countries, that it was inside the U.S. tariff wall and offered a more stable political and economic climate than countries in Latin America or the Far East. As shown in Table 3-2, Puerto Rico gained 77,000 jobs in manufacturing industries and 49,000 jobs in construction in the period 1950-1970. Although the growth in manufacturing and construction jobs was not strong enough to offset the decline in agriculture, the overall unemployment rate fell as Puerto Ricans emigrated to the mainland and as new jobs opened up in the Puerto Rican government, trade, and services sectors. By 1970, unemployment had reached its lowest level in the post-war period, at 10.7 percent.

In the period 1974-1975 and again in 1981-82, the Puerto Rican economy was adversely affected by the recession of the U.S. economy and high U.S. interest rates. The Puerto Rican economy was in recession in 1974-1976, grew by an average annual rate of 5.1 percent between 1976 and 1979, and has experienced slower growth since then. Real GNP grew by 2.3 percent in 1980, and 0.7 percent in 1981. Real GNP per capita has also increased since 1976, though by a lesser amount, as a result of natural population growth in excess of the net migration of Puerto Ricans from the island. GNP per capita grew by an average annual rate of 2.7 percent in the 1976-1980 period, and fell by 0.7 percent in 1981.

Unemployment has continued to be a problem in Puerto Rico. Table 3-2 shows that unemployment, after declining through the 1960s to just over 10 percent of the measured labor force, has been 17 percent or higher since 1975. With the current U.S. recession and the elimination in U.S. fiscal year 1981 of 21,173 public service jobs in Puerto Rico financed through the Federal Comprehensive Employment and Training Program (CETA), unemployment rose to 24.1 percent in August 1982.

II. Investment in Puerto Rico

The basic goal of any economic development program is to increase real income per capita. As indicated in the preceding section, Puerto Rico's development program was

Table 3-2

Puerto Rican Unemployment Rate and Distribution of Employment in Selected Years, 1950 - 1981
(in thousands)

Year	Unemployment Rate	Total Employment	Government 1/	Total Non-Government Employment	Agriculture	Manufacturing	Home Needlework	Construction	Wholesale and Retail Trade	Finance, Insurance, Real Estate	Transportation and Utilities	Other Services
1950	12.9%	596	45	551	214	55	51	27	90	3	28	77
1955	14.3	539	50	489	164	66	29	34	89	n.a.	n.a.	69
1960	13.1	543	62	481	124	81	10	45	97	6	39	75
1965	11.7	617	82	535	107	106	6	56	109	n.a.	n.a.	103
1970	10.7	686	106	580	68	132	*	76	128	13	45	116
1971	11.6	700	111	589	61	132	*	81	134	15	47	117
1972	11.9	737	131	606	58	141	*	79	135	16	49	126
1973	11.6	757	143	614	49	142	*	80	146	18	50	127
1974	13.2	775	147	628	53	147	*	79	148	18	54	128
1975	18.1	738	151	587	49	137	*	69	141	18	49	128
1976	19.5	718	158	560	46	133	*	53	140	18	46	121
1977	19.9	739	168	571	41	144	*	43	145	19	49	127
1978	18.1	780	180	600	40	156	*	44	149	21	49	138
1979	17.0	807	190	618	38	160	*	49	155	21	50	142
1980	17.1	827	202	625	43	157	*	49	152	23	52	149
1981	19.9	833	203	630	41	155	*	49	155	25	53	150
Annual growth rate 1950-1960		-1.0%	3.3%	-1.3%	-5.3%	3.9%	-15.0%	5.2%	0.8%	7.2%	3.4%	-0.3%
Annual growth rate 1960-1970		2.4	5.5	1.9	-5.8	5.0	--	5.4	2.8	8.0	1.4	4.5
Annual growth rate 1970-1981		1.8	6.1	0.8	-4.5	1.5	--	-3.9	1.8	6.1	1.5	2.4

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, 1980-1981, Table 24; 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.

very successful in achieving this goal through the early 1970s. Physical investment leads to an increase in income in two ways: by providing the necessary capital to create new, more productive jobs; and by increasing the productivity of those currently employed. 4/ In Puerto Rico, with traditionally high rates of unemployment, providing the necessary capital for new entrants to the labor force is particularly important. This fact was recognized by Congress in 1976. In explaining the reason for retaining the possessions corporation system, Congress stated that it wanted to "assist the U.S. possessions in obtaining employment-producing investments by U.S. corporations..." 5/

Components of physical investment in Puerto Rico are illustrated in Figure II and Table 3-3 for the years 1960-1981. Private refinery construction is excluded from the total because the boom in this industry between 1970 and 1972 was based on the large allocation to Puerto Rico of U.S. quotas for imported oil (which before 1973 was cheaper than domestic oil) rather than on low wages, locational advantages, or other real factors. The OPEC increase in the price of oil in 1973 and the consequent termination of the Federal quota system eliminated Puerto Rico's previous advantage. In March 1979, the Commonwealth Oil Refining Company (CORCO), the principal oil refiner and the largest private corporation in Puerto Rico, filed for protection under Federal bankruptcy laws. Private refinery construction accounted from almost one-third of total private investment in plant and equipment between 1970 and 1972, but represented only about 4 percent of the total in 1973 and most later years.

It is clear from Figure II and Table 3-3 that total and private investment (expressed in constant 1972 dollars) grew rapidly in the period 1960-73, but dropped off during the 1974-76 recession and again in the late 1970s. Annual private investment in industrial and commercial buildings, excluding refinery construction, rose from $212 million in 1960 to $604 million in 1973, and then fell well below $500 million in each year after 1975. Annual private investment in machinery and equipment exceeded $400 million in the

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4/ A second major contributor to economic growth is investment in human capital -- the formal education and on-the-job training of the labor force.

5/ Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976, p. 274.

FIGURE II

Components of Real Investment in Puerto Rico, 1960-1981 (Constant 1972 Dollars)

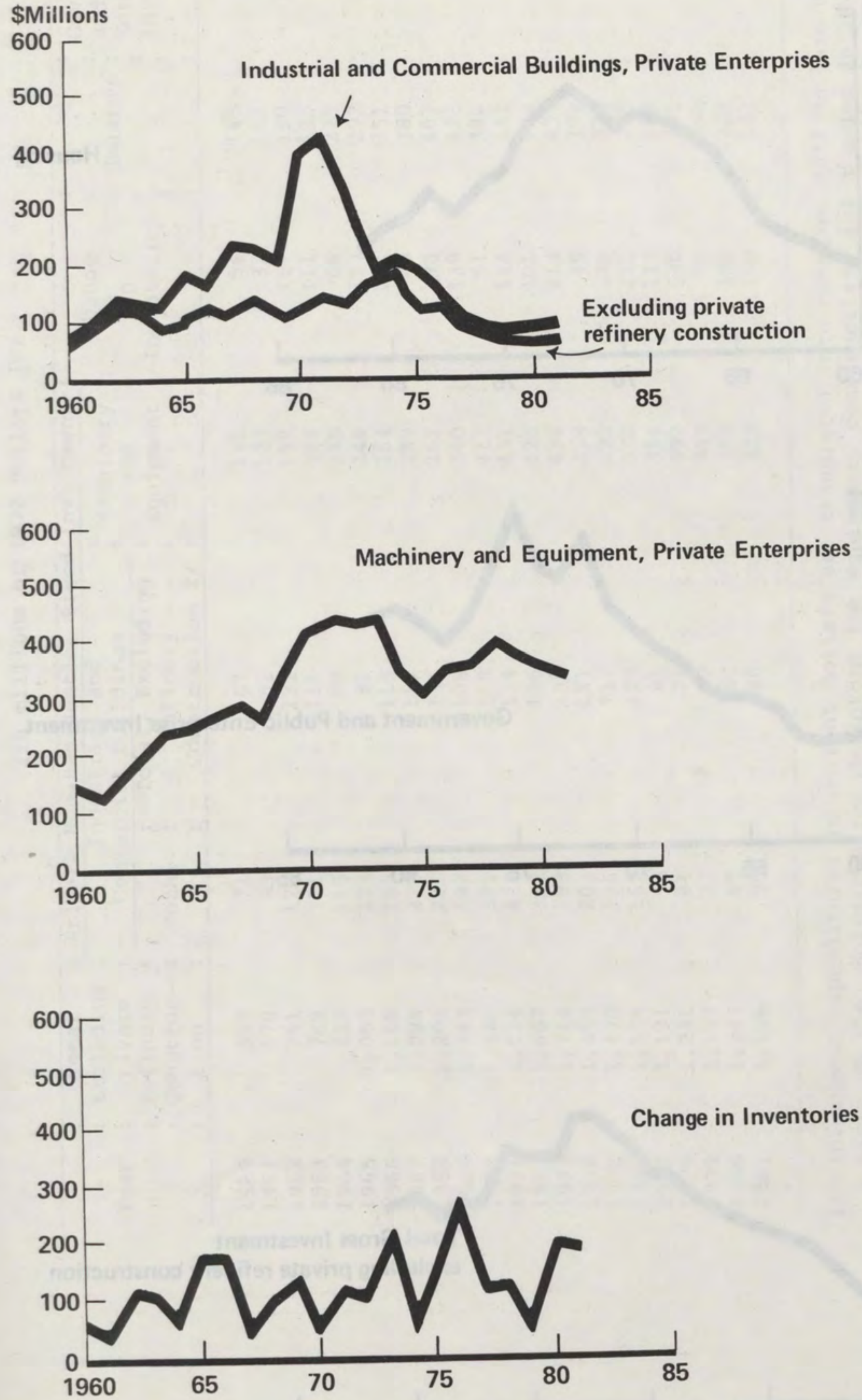

FIGURE II, Continued

Components of Real Investment in Puerto Rico, 1960-1981 (Constant 1972 Dollars)

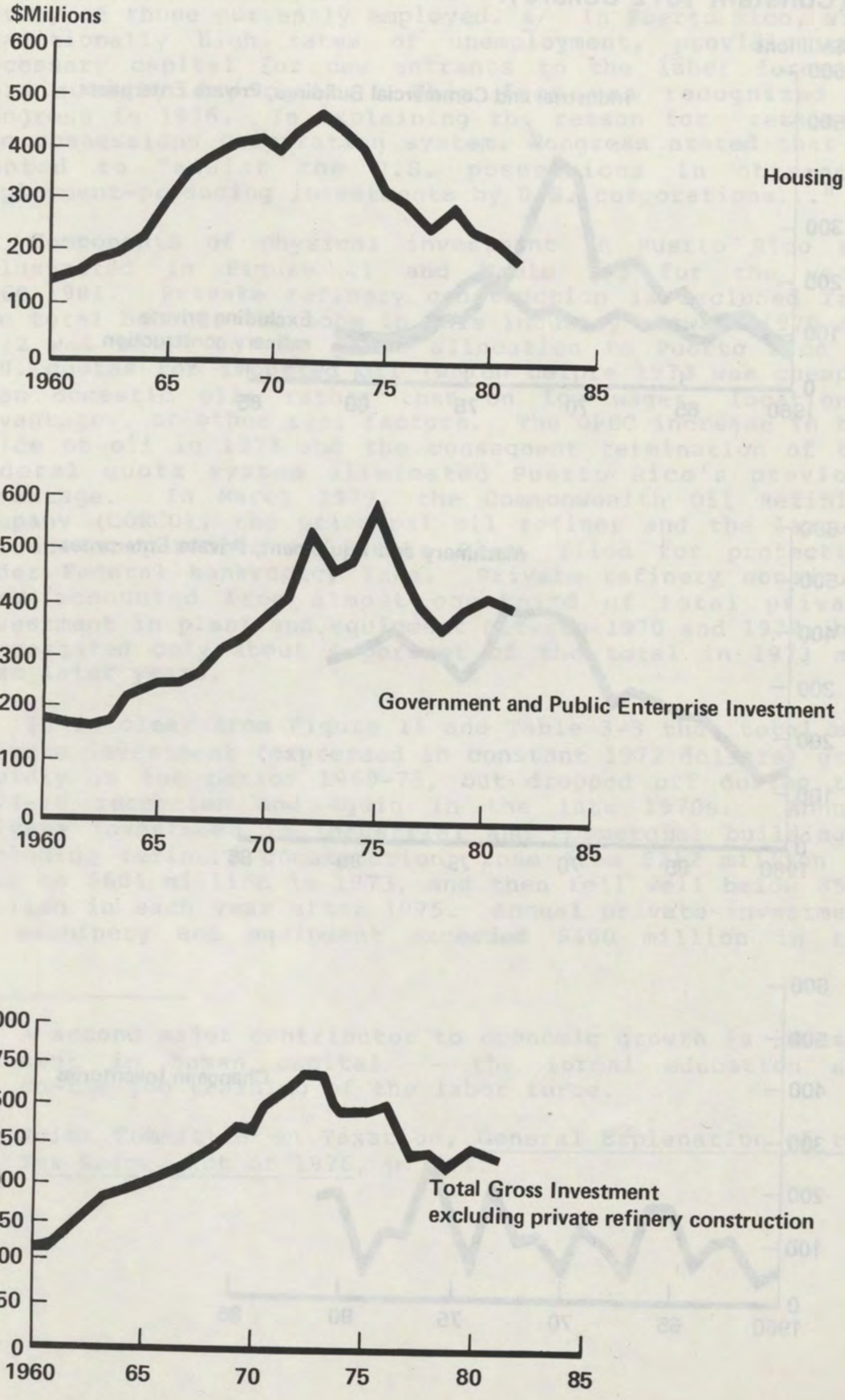

Table 3-3

Components of Real Investment in Puerto Rico
Fiscal Years 1960-1981

(in millions of 1972 dollars 1/)

Year	Total Excluding Private Refinery Construction	Private Non-Residential Fixed Investment: Industrial and Commercial Buildings			Change in Inventories	Housing	Government and Public Enterprise Investment
		Total	Total, Excluding Refinery Construction 2/	Machinery and Equipment			
1960	592	71	67	145	54	145	182
1961	570	89	82	123	32	161	172
1962	751	129	122	158	117	190	164
1963	789	121	114	194	111	195	176
1964	839	115	89	235	64	227	225
1965	1,055	173	94	248	177	292	244
1966	1,158	155	119	264	181	351	243
1967	1,098	222	117	289	49	380	264
1968	1,208	221	134	262	98	407	307
1969	1,342	197	108	340	139	423	333
1970	1,346	391	118	411	51	396	370
1971	1,526	422	134	431	116	441	405
1972	1,667	332	136	426	101	472	532
1973	1,714	193	169	434	214	437	460
1974	1,450	203	181	338	49	398	484
1975	1,470	186	117	298	145	323	587
1976	1,514	152	125	338	272	295	484
1977	1,191	93	81	354	117	249	390
1978	1,231	81	71	390	130	291	349
1979	1,117	77	67	369	44	250	387
1980	1,247	85	64	350	192	228	411
1981	1,196	99	86	333	190	191	395

1/ Investment expenditures in current dollars are translated into constant 1972 dollars on the basis of the implicit price deflators for equipment, construction, and changes in inventories, provided in Table 20 of the source document.

2/ Puerto Rico's large allocation of U.S. oil import quotas for foreign oil led to a boom in refinery construction between 1970 and 1972.

Source: Puerto Rico Planning Board, Economic Report to the Governor, Tables 2, 12, and 20; and unpublished estimates of the Office of Economic Research, Puerto Rico Economic Development Administration.

early 1970s, dropped to about $300 million during the 1974-76 recession, and since then has averaged 85 percent of the annual level of the early 1970s. Housing construction, which rose almost continuously until 1972 to a peak of $472 billion, declined in nearly every year after that.

Figure II also shows the expansion of Puerto Rican government investment since 1960. Total investment by the Puerto Rican government plus investment by public enterprises went from $0.3 billion in 1969 to almost $0.6 billion in 1975. Commonwealth investment was financed largely from external borrowing, in the United States and elsewhere. 6/ In response to rising interest costs, the Commonwealth cut back sharply on borrowing after 1975, and the rate of new investment by government and public enterprises has generally been less than $0.4 billion since 1976.

The last graph in Figure II combines all components of physical investment except private refinery construction. It shows that annual physical investment in Puerto Rico rose in nearly every year between 1960 and 1973. The annual rate of investment declined by 30 percent between 1973 and 1977, from $1.7 billion to $1.2 billion. Since 1977, annual investment has fluctuated around $1.2 billion, roughly equal to annual investment levels in the period 1966-1968.

III. Profitability and Location in Puerto Rico

A. General Considerations. As explained in the previous chapter, manufacturing operations of U.S. corporations in Puerto Rico have generally been exempt from U.S. and Puerto Rican tax since 1948. When Puerto Rico introduced its tax exemption program in 1948, a combination of factors made Puerto Rico a highly competitive location for U.S. firms. These factors included political stability, protection under the U.S. tariff schedule, proximity to the United States, and the general application of Federal statutes (including basic Constitutional protections, banking laws, and certain commercial laws). Perhaps the single most important factor, however, was low unit-labor costs resulting from both low wages and the high produc-

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6/ Of the $7.5 billion in Puerto Rican government debt outstanding on June 30, 1981, approximately $6.5 billion was held outside of Puerto Rico.

tivity of Puerto Rican workers. These factors provided the necessary profit-making opportunities for the tax exemption program to work. Taken together, Puerto Rico's locational advantages and the tax exemption program contributed substantially to the rapid growth of the Puerto Rican economy throughout the 1950s and 1960s. However, Puerto Rico's traditional advantages of cheap labor and tariff protection in the U.S. market have been undermined in the past quarter century.

B. Wage Rates in Puerto Rican Manufacturing Industries. Table 3-4 presents average hourly wages of production workers in Puerto Rican and U.S. manufacturing industries in the period 1955-1980. The table shows that hourly wages in manufacturing industries in Puerto Rico rose much faster than on the mainland between 1955 and 1971, and rose slightly faster than U.S. wages in most industries after 1971. For the industries shown in the table, Puerto Rican average wages rose from 30-39 percent of the U.S. level in 1955, to 48-72 percent of the U.S. level in 1980. In the apparel industry, which remains the largest employer in the manufacturing sector despite a decline since 1973, Puerto Rican wages rose from 35 percent to 72 percent of the U.S. level between 1955 and 1980. In real terms (adjusted for price inflation) Puerto Rican wages in the apparel industry increased 260 percent between 1955 and 1980, and average Puerto Rican wages in all manufacturing industries increased 280 percent.

The increase in Puerto Rican real wage rates was due in part to the growth in investment and the increase in education and on-the-job training in the 1950s and 1960s. As investment increased, labor became more productive. The rise in Puerto Rican wages also reflects the phase-in of the U.S. minimum wage between 1940 and 1981 to Puerto Rico.

The U.S. minimum wage was enacted in the Fair Labor Standards Act of 1938 (FLSA). The U.S. minimum of 1938 applied to Puerto Rico, where it produced massive closing of farms and businesses. To moderate the impact of the minimum wage in Puerto Rico, Congress amended the FLSA in 1940 to allow for differential minimum wages and more limited coverage in Puerto Rico than on the mainland. The 1940 amendments provided for industry committees, convened by the U.S. Department of Labor, which would recommend minimum wages for a particular Puerto Rican industry or industry part. The committees, which were drawn from business, labor, and the public and which represented both the United States and Puerto Rico, were instructed by Congress to recommend for individual industries,

Table 3-4

Average Hourly Earnings 1/ of Production Workers 2/
in Puerto Rico and the United States, Selected Industries, 1955-1980

(dollars per hour)

	October					
	1955	1960	1966	1971	1975	1980
Food and Kindred Products						
Puerto Rican earnings	.69	.99	1.40	1.94	2.60	4.08
United States earnings	1.77	2.18	2.52	3.38	4.65	6.95
P.R. earnings as a percentage of U.S.	38	45	56	57	55	59
Tobacco						
Puerto Rican earnings	.37	.63	1.05	1.56	2.21	3.69
United States earnings	1.25	1.62	2.08	3.00	4.27	7.69
P.R. earnings as a percentage of U.S.	30	39	50	52	52	48
Textile Mill Products						
Puerto Rican earnings	.55	.97	1.23	1.71	2.15	3.59
United States earnings	1.41	1.62	2.00	2.59	3.53	5.27
P.R. earnings as a percentage of U.S.	39	60	62	66	61	68
Apparel						
Puerto Rican earnings	.47	.86	1.18	1.70	2.14	3.40
United States earnings	1.36	1.59	1.93	2.51	3.24	4.73
P.R. earnings as a percentage of U.S.	35	54	61	68	66	72
Chemicals						
Puerto Rican earnings	.73	1.19	1.64	2.36	3.64	5.43
United States earnings	2.01	2.53	3.03	4.00	5.50	8.53
P.R. earnings as a percentage of U.S.	36	47	54	59	66	64
Leather						
Puerto Rican earnings	.48	.75	1.08	1.59	2.02	3.35
United States earnings	1.42	1.66	1.96	2.64	3.25	4.65
P.R. earnings as a percentage of U.S.	34	45	55	60	62	72
Metal Products						
Puerto Rican earnings	.66	1.15	1.60	2.17	2.95	4.56
United States earnings	2.02	2.47	2.92	3.77	5.19	7.69
P.R. earnings as a percentage of U.S.	33	47	55	58	57	59
Electrical & Electronic Equipment						
Puerto Rican earnings	.64	1.20	1.47	2.01	2.82	4.27
United States earnings	1.90	2.32	2.67	3.50	4.66	7.18
P.R. earnings as a percentage of U.S.	34	52	55	57	61	59
Stone, Clay & Glass						
Puerto Rican earnings	.69	1.13	1.69	2.27	2.93	4.30
United States earnings	1.88	2.30	2.76	3.75	5.02	7.74
P.R. earnings as a percentage of U.S.	37	49	61	61	58	56

Office of the Secretary of the Treasury
Office of Tax Analysis

1/ Earnings are the actual return to the worker, including premium pay for overtime and late-shift work and changes in output of workers paid on an incentive plan.

2/ Includes all nonsupervisory employees and working supervisors engaged in production or services closely associated with production--recordkeeping, maintenance, sales, etc.

Source: Puerto Rican Department of Labor, Census of Manufacturing Industries, various years; and U.S. Department of Labor, Bureau of Labor Statistics and Employment Standards Administration, Employment and Earnings, various years.

> ...the highest minimum wage rate ... which (1) will not substantially curtail employment in such [industry] classification and (2) will not give a competitive advantage [relative to the mainland] to any group in the industry. 7/

This system of industry-specific minimums ended in the 1970s. In 1974 and again in 1977, Congress provided a schedule of annual automatic increases in the minimum wage rates for Puerto Rican industries until the mainland minimum was reached. As a result of these increases and the doubling between 1966 and 1976 of the number of industry classifications covered by the FLSA, 8/ the U.S. mainland minimum wage applied to virtually all Puerto Rican industries by 1981.

Actual hourly wages paid to most workers in many Puerto Rican industries, including apparel, food products, and leather goods, are at, or near, the legal minimum. Table 3-5 illustrates the clustering of average hourly earnings around the minimum in the period 1975-1977. The data are taken from individual wage studies prepared by the U.S. Department of Labor for use at industry committee reviews, and cover those industries where the FLSA rate was below the mainland statutory level. The table shows, for example, that about 60 percent of workers in food products were paid not more than 20 cents per hour above the legal minimum. The corresponding percentages for filler tobacco processing were 99 percent; women's outerwear, 78 percent; leather belts, 81 percent; rubber and plastic footwear, 37 percent

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

8/ Of the 470,000 workers covered in 1976, only 210,000 would have been covered before 1966, an additional 100,000 would have been covered as a result amendments of 1966, and an additional 160,000 were covered by amendments of 1974. Simon Rottenberg, "Minimum Wages in Puerto Rico", in the Economics of Legal Minimum Wages, Simon Rottenberg, ed., American Enterprise Institute (Washington, D.C., 1981), p. 328. Rottenberg cites U.S. Department of Labor, Wage Structure and Fringe Benefits in Puerto Rico, 1979, p. 187.

Table 3-5

Percentage of Workers in Various Industry Classifications in Puerto Rico Earning Exactly the FLSA Minimum and Certain Specified Rates Above It, 1975-77

	Survey date	FLSA minimum rate	Average hourly earnings	Percentage of workers earning: Exactly the FLSA minimum	Not more than: 10 cents above minimum	Not more than: 15 cents above minimum	Not more than: 20 cents above minimum
Food and kindred products, pre-1966 coverage:							
Milk processing and distribution	May 1976	2.05	2.37	37.7	47.8	55.0	61.7
Candy and gum products, 1961 coverage	May 1976	2.00	2.23	0	60.6	60.6	60.6
Other products and activities	May 1976	2.15	2.47	32.7	39.4	51.2	58.6
Tobacco, pre-1961 coverage:							
Filler tobacco processing	Aug 1976	1.56	1.56	97.6	99.0	99.0	99.0
Wrapper tobacco processing	Aug 1976	1.82	1.93	72.8	78.0	78.7	78.7
Machine threshing other products	Aug 1976	2.04	2.37	25.0	39.3	39.3	46.4
Other products and activities	Aug 1976	2.11	2.25	40.4	57.5	68.9	78.7
Textile mill products, pre-1961 coverage:							
Hooked rugs	Nov 1975	1.57	2.25	0	0	0	0.6
Other products and activities	Nov 1975	1.75	2.18	20.6	26.2	28.9	38.7
Gloves and mittens, pre-1961 coverage:							
Other products and activities	May 1977	2.21	2.37	48.5	65.0 1/	n.a.	78.4 2/
Hosiery, pre-1966 coverage:							
Women's hosiery	May 1977	2.18	2.42	30.0	50.0	55.0	63.0
Other hosiery	May 1977	1.97	2.30	8.5	27.1	34.0	38.3
Sweater and knit swimwear	May 1977	2.28	2.49	50.7	64.8	70.0	72.0
Handkerchiefs, scarves, and art linens, pre-1961 coverage:							
Other products	May 1977	1.70	1.79	70.5	74.8	79.9	82.3
Women's outerwear, needlework and fabricated textile products, 1966 coverage	May 1977	2.29	2.48	43.8	72.9	77.0	78.0
Children's dress and related products, pre-1966 coverage:							
Other operations	May 1975	1.90	2.08	30.6	47.0	74.9	78.6
Women's and children's underwear, pre-1961 coverage	May 1977	2.20	2.42	39.7	47.8	67.8	70.9
Corsets and brassieres, pre-1961 coverage	May 1977	2.28	2.57	17.9	18.5 3/	57.4 4/	66.1 5/
Men's and boy's clothing, pre-1961 coverage:							
Work clothing and separate trousers	May 1977	2.22	2.46	43.3	50.1 6/	55.0 7/	63.4 8/
Other products and activities	May 1977	2.15	2.39	42.3	48.4	58.3	65.0
1961 coverage	May 1977	2.15	2.27	74.4	78.6	80.9	83.9
1966 coverage (trousers and other products)	May 1977	2.22	2.33	38.3	86.7 6/	88.4 7/	90.1 9/
Furniture and fixtures and lumber	Aug 1976	2.10	2.39	39.0	48.9	49.3	56.1
Leather goods pre-1961 coverage:							
Belts	May 1977	2.28	2.43	2.3	68.9 10/	79.0 11/	80.6 12/
Other products and activities	May 1977	2.10	2.36	38.1	55.2	62.0	66.4
Non-rubber footwear, pre-1966 coverage	Nov 1975	1.75	2.02	35.3	42.3	50.6	62.0
Rubber and plastic footwear	Nov 1975	1.75	2.25	9.5	19.9	28.1	36.5
Stone, clay, and glass, pre-1961 coverage:							
Art pottery	Aug 1976	1.67	2.16	0	40.0	45.0	45.0
Vitreous and semi-vitreous china	Aug 1976	2.13	2.39	0.4	0.8	57.6	68.9
Jewelry and miscellaneous industries, pre-1961 coverage:							
Straw and hair products	Aug 1976	1.85	1.98	0	67.9	79.8	88.1
Other products and activities	Aug 1976	2.05	2.28	39.1	43.0	64.8	68.4

Source: U.S. Department of Commerce, Economic Study of Puerto Rico, 1979, Vol. II, p. 619.

1/ Within 9 cents of minimum.
2/ Within 19 cents of minimum.
3/ Within 2 cents of the minimum.
4/ Within 12 cents of the minimum.
5/ Within 22 cents of the minimum.
6/ Within 8 cents of the minimum.
7/ Within 13 cents of the minimum.
8/ Within 18 cents of the minimum.
9/ Within 23 cents of the minimum.
10/ As much as 7 1/2 cents above the minimum.
11/ As much as 12 1/2 cents above the minimum.
12/ Estimated.

and china manufacture, 69 percent. This clustering of workers at or near the minimum, combined with the fact that the minimum wage increased more than average actual wages in many Puerto Rican industries between 1973 and 1977, 9/ indicates that changes in the minimum wage in Puerto Rico have tended to increase Puerto Rican wages.

Wage rates are only one of the factors determining Puerto Rico's competitive position. Whether that position is damaged as a result of wage increases depends on the rate of advance in labor productivity. A comparison of unit labor costs in Puerto Rico, the United States, and elsewhere is beyond the scope of this Report. Two factors bearing on this issue should, however, be noted. The percentage of the Puerto Rican population age group 6-18 attending school increased from 48 percent in 1941 to 86 percent in 1971, and the comparable percentage for the age group 19-22 increased from 3 percent to 29 percent. 10/ The high rate of increase in educational enrollment has tended to increase the skills and therefore productivity of the Puerto Rican labor force. On the other hand, the expansion of Federal income maintenance programs in Puerto Rico may have increased the real cost of labor. 11/ Such programs may reduce work incentives and, by inducing higher labor turnover rates, raise labor-training costs. Table 3-6 provides a breakdown of Federal transfer payments (together with other Federal assistance to Puerto Rico) in selected years between 1968 and 1981. Net Federal transfers to individuals increased from $64 million in 1968 to $1,793 million in 1981, a twelve-fold increase in real (price-deflated) terms. The growth in income maintenance programs was led by the food stamp program, which was not introduced in Puerto Rico until 1975, but reached $860 million in 1981.

C. Reductions in U.S. Tariffs and the Expansion of Industry in Developing Countries. The competitiveness of Puerto Rican production also has been undercut by structural

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9/ U.S. Department of Commerce, Economic Study of Puerto Rico, 1979, Vol II., pp. 636-637.

10/ Ibid., p. 718.

11/ Puerto Rico participates in most, but not all, Federal income maintenance programs. It does not participate in the Supplemental Security Income Program. In the case of Aid to Families with Dependent Children and, beginning in 1982, the food stamp program, payments are limited by a ceiling.

Table 3-6

Federal Grants-in-Aid and Taxes Transferred
to Puerto Rico, Selected Fiscal Years 1968-1981 1/
(millions of dollars)

	1968	1978	1979	1980	1981
Net Federal transfer payments to individuals, total 2/	64	1,321	1,477	1,697	1,793
Food stamps	--	682	734	812	860
Old age, survivors, and disability insurance	1	355	386	401	585
Veterans benefits	59	198	202	223	231
Unemployment compensation 3/	-3	33	16	3	-14
All other	7	91	102	123	131
Federal grants to Puerto Rican Commonwealth and municipal governments, total	129	885	1,020	1,126	1,033
Child nutrition and special milk programs	5	62	77	106	85
Human development	6	36	64	50	30
Office of Education programs	--	62	69	80	97
Public assistance	31	38	114	106	135
Community development block grants	15	56	74	96	115
Low-rent public housing	11	56	56	79	96
Employment and training programs	7	246	262	304	237
All other	54	329	304	305	238
Federal taxes transferred to Puerto Rican treasury, total	93	271	289	304	319
Customs duties	27	71	76	76	82
Alcoholic beverage and tobacco excises	66	200	213	228	236
TOTAL	286	2,477	2,786	3,127	3,145

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Office of Tax Analysis

Sources: U.S. Department of the Treasury, Federal Aid to States, various years; U.S. Department of the Treasury, Statistical Appendix to the Secretary's Annual Report for 1968; and Puerto Rico Planning Board, Economic Report to the Governor, Table 19, (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 remained unchanged. With the exception of certain Federal transfer payments to individuals, data for 1979-1981 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 Social Security.

3/ Revised figures. Includes the excess (if any) of withdrawals over deposits in the Federal Unemployment Trust Fund, plus Federal extended benefits.

changes in the world economy. After the Kennedy round of tariff negotiations in the 1960s, the United States cut its tariff rates by 40-50 percent on average, which exposed Puerto Rican (and U.S.) manufacturers to more vigorous import competition. Foreign competitors utilizing low-wage labor penetrated the U.S. market, and U.S. companies also started manufacturing in low-wage countries and exporting back to the United States. Apparel and other industries in Puerto Rico which have historically paid average hourly wages that were close to the minimum were caught in a wage-price squeeze as a result of increased foreign competition. In 1965, 30 percent of all U.S. imports of clothing originated in Puerto Rico, 14 percent in Hong Kong, 1 percent in Korea, and 2 percent in Taiwan. By 1976, Puerto Rico's share had fallen to 9 percent, and the share of Hong Kong had risen to 32 percent, of Korea to 17 percent, and of Taiwan to 16 percent. 12/

Other international developments have had a favorable effect on Puerto Rico's competitive position. Between 1977 and 1981, the Orderly Marketing Agreements limited shoe exports to the United States from South Korea and Taiwan. Since 1973, the Multifiber Arrangement has limited textile and apparel exports from developing countries. The United States is in the process of renegotiating the agreements under the Multifiber Arrangement with the major apparel-exporting countries, and it is expected that these agreements will be tightened.

D. Changes in U.S. Tax Law. At the same time that changes were taking place in the underlying competitiveness of Puerto Rico, a series of changes to the U.S. Internal Revenue Code had an indirect effect on the relative profitability of locating in Puerto Rico. The top Federal corporate tax rate, which stood at 38 percent in 1947, rose to 52 percent in 1952 and remained at that level until 1963. Thereafter, with the exception of the surtax years of 1968-70, the top rate has been reduced in several steps to its current level of 46 percent. The investment tax credit was introduced in 1962 and has generally been in effect since then. Its terms have been liberalized on several occasions, and the rate increased from an initial 7 percent to the current level of 10 percent. In 1971, the asset

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12/ U.S. Department of Commerce, Economic Study of Puerto Rico, Vol. I, p. 109.

depreciation range (ADR), a major liberalization of the period over which assets could be depreciated for Federal tax purposes, was introduced.

These three changes in U.S. tax law since 1962, the investment tax credit, lower statutory rates, and ADR, combined to lower significantly the overall effective tax rate on income earned from physical capital in the United States. As these U.S. effective tax rates fell, the attraction of tax exemption for physical investment in Puerto Rico diminished. The tax benefits for investment in Puerto Rico declined further in 1981-1982 because of the tax reductions for U.S.-based investments in the Economic Recovery Tax Act of 1981 (ERTA). The ERTA tax reductions include accelerated cost recovery allowances for physical investment, an increase in the kinds of property that qualify for the full 10 percent investment credit, and liberalized leasing rules designed to secure the benefits of the investment incentives to businesses which do not have sufficient tax liability to absorb these deductions and credits. These benefits were curtailed, but not eliminated, by the Tax Equity and Fiscal Responsibility Act of 1982 (see Table 5-6 below).

In summary, many fundamental changes have taken place in the Puerto Rican, U.S., and world economies which have had a direct and substantial bearing on the competitiveness of Puerto Rico as a location for U.S. investment. As suggested above, one result of these changes has been a decline in the 1970s in the rate of investment in Puerto Rican plant and equipment. A second result, which emerges from the data in Tables 3-7 and 3-8, is that Puerto Rican business expansion in the 1970s was concentrated in four high-technology industries, chemicals, scientific instruments, electrical and electronic equipment, and machinery.

IV. Composition of Puerto Rican Manufacturing by Industry, 1960-1981

Table 3-7 shows that between 1960 and 1970, the industry composition of Puerto Rican manufacturing income changed relatively little. Only the food industry lost as much as 6 percentage points in this period; only chemicals gained as many as 8 percentage points. Between 1970 and 1981, however, the industry composition of manufacturing income changed dramatically. Chemicals became the largest industry by far, growing from 11.4 percent to 37.3 percent of the total income originating in Puerto Rican manufacturing.

Table 3-7

Net Income Originating in Puerto Rican Manufacturing

Fiscal Years 1960, 1970, and 1981

(dollars in millions)

	1960		1970		1981	
	Amount of Net Income	Percent of Total	Amount of Net Income	Percent of Total	Amount of Net Income	Percent of Total
All Manufacturing Industries	288.8	100.0%	957.6	100.0%	4,453.7	100.0%
Food and kindred products	66.7	23.1	161.3	16.8	457.0	10.3
Tobacco products	10.4	3.6	36.4	3.8	56.0	1.3
Textile mill products	13.9	4.8	41.1	4.3	47.9	1.1
Apparel	50.7	17.6	172.0	18.0	356.2	8.0
Furniture and wood prodcts	8.8	3.0	26.2	2.7	33.5	0.8
Printing and publishing	11.2	3.9	22.6	2.4	67.5	1.5
Chemicals	9.8	3.4	109.3	11.4	1,663.3	37.3
Stone, clay and glass products	18.8	6.5	49.1	5.1	97.6	2.2
Machinery and metal products	54.7	18.9	191.5	19.4	1,261.6	28.3
Other manufacturing	43.7	15.1	148.0	15.5	413.1	9.3

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Source: Puerto Rico Planning Board, Economic Report to the Governor, 1980-1981, Table 7.

Income originating in machinery and metal products (including electrical and electronic equipment) grew from 19.4 percent to 28.3 percent of the total income in Puerto Rican manufacturing. Major industries whose share of the total income declined were apparel and food products, with declines of 10 percentage points and 6.5 percentage points, respectively.

Table 3-8, which shows the distribution of employment in Puerto Rican manufacturing, provides further evidence of Puerto Rico's shift away from traditional labor-intensive to high-technology industries. Between 1968 and 1981, employment declined substantially in apparel, tobacco, textiles, leather goods, wood products, and stone, clay and glass products. The combined share of these industries in total manufacturing employment fell from 57 percent in 1968 to 34 percent in 1981. Their decline was offset by modest gains in jobs in the food-processing, paper, and plastics industries and large employment increases in four high-technology industries -- chemicals (including pharmaceuticals), electrical and electronic equipment, scientific instruments, and machinery. Taken together, these high-technology industries employed 58,100 workers in 1981, which was 38 percent of manufacturing employment (and 9 percent of total non-government employment) in Puerto Rico.

Because of the shift in the composition of the Puerto Rican manufacturing sector, increases in the income and capital stock of Puerto Rican manufacturing industries have produced less than proportionate increases in manufacturing payroll and employment. Table 3-9, which is based on the two most recent manufacturing censuses in Puerto Rico, shows for various industries the share of payroll costs in total value-added. Value-added for a given enterprise is defined as the market price of goods completed less the cost of materials purchased from others. The chemical industry, the most rapidly growing Puerto Rican industry in the 1970s, had the lowest share of payroll in industry value-added, 11.0 percent in 1977. In all industries whose employment expanded in the 1972-1977 period, payroll represented only 16.2 percent of value-added in 1977, or less than one-half the 37.4 percent share of payroll in value-added for industries with declining employment. The last column of Table 3-9 shows that substantial decreases have also occurred in the share of payroll in value-added <u>within</u> given manufacturing industries, including tobacco, machinery,

Table 3-8

Distribution of Employment in Puerto Rican Manufacturing, 1968 - 1981*

Industry Group	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	Absolute Change 1968-1981	Percentage Change 1968-1981
	(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	154.6	151.7	14,600	11%
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	97.4	93.2	-8,500	-8
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	23.4	21.8	1,300	6
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	2.1	1.7	-5,300	-76
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	3.4	3.2	-5,000	-61
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	33.6	33.6	-6,600	-16
Paper and allied products, and 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	5.1	4.9	1,100	29
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	15.6	15.8	11,300	251
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	11.0	11.7	10,300	736
Petroleum refining, rubber products, and 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	7.7	7.0	800	13
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	6.6	5.2	-6,300	-55
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	57.2	58.4	23,000	65
Lumber and wood products and 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	3.6	3.4	-1,500	-31
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	4.8	4.3	-2,400	-36
Primary metal industries and 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	5.3	4.8	-200	-4
Machinery, except electrical; and transportation 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	7.9	9.4	7,400	370
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	18.0	19.8	10,700	118
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	13.6	13.1	9,300	245
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	3.9	3.6	-300	-8

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* Data as of October of each year.

Source: Commonwealth of Puerto Rico, Department of Labor, Census of Manufacturing Industries of Puerto Rico, Table 4, various years.

Table 3-9

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%	146.9	997.0	4,097.4	24.3%	-24.5%
Food and kindred products	27.7	121.2	343.4	35.3	21.4	149.0	485.6	30.7	13.0
Tobacco products	4.5	16.0	46.4	34.5	3.7	24.5	122.0	20.1	-41.7
Textile mill products	7.8	27.9	67.1	41.6	6.0	29.5	108.9	27.1	-34.9
Apparel and other textile products	39.6	124.1	252.5	49.1	35.3	151.8	278.9	54.4	10.8
Lumber and wood products	1.2	4.5	8.3	54.2	.8	3.9	9.1	42.9	-20.8
Furniture and fixtures	3.2	13.0	29.3	44.4	2.4	12.1	26.1	46.4	4.5
Paper and allied products	1.6	8.2	17.9	45.8	1.5	11.8	21.7	54.4	18.8
Printing and publishing	3.0	16.7	41.8	40.0	4.0	28.8	68.9	41.8	4.5
Chemical and allied products	9.0	58.8	451.2	13.0	15.7	162.5	1,476.5	11.0	-15.4
Petroleum and coal products	2.2	20.7	91.7	22.6	2.5	36.9	143.4	25.7	13.7
Rubber and miscellaneous plastics products	3.5	14.0	27.4	51.1	6.0	43.4	147.6	29.4	-42.5
Leather and leather products	6.6	20.4	39.3	51.9	6.2	29.3	55.7	52.6	1.3
Stone, clay and glass products	6.3	29.0	73.1	39.7	5.0	39.8	102.7	38.8	-2.3
Primary metal industries	1.0	5.3	14.3	37.1	1.6	12.7	48.6	26.1	-29.6
Fabricated metal products	5.2	27.6	78.2	35.3	4.7	33.7	84.2	40.0	13.3
Machinery, except electrical	2.2	12.8	37.6	34.0	4.1	32.8	161.2	20.3	-40.3
Electric and electronic equipment	14.7	50.4	169.6	29.7	14.8	106.9	403.1	26.5	-10.8
Transportation equipment	.7	3.1	6.8	45.6	1.1	8.2	28.1	29.2	-36.0
Instruments and related products	6.1	29.0	84.2	34.4	6.8	52.1	257.3	20.2	-41.3
Miscellaneous manufacturing industries	3.7	14.1	35.3	39.9	3.5	27.3	67.8	40.3	1.0
Industries with expanding employment 1/	27.7	160.4	755.0	21.2	41.8	377.4	2,331.6	16.2	-21.7
Industries with declining employment 2/	105.8	397.8	972.9	40.9	89.0	500.9	1,341.0	37.4	-9.4
Industries with constant employment 3/	16.3	58.6	187.5	31.3	16.3	118.7	424.8	27.9	-22.1

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* Revised from last year's Annual Report on the basis of published 1977 Census figures.

Source: U.S. Department of Commerce, 1977 Economic Censuses of Outlying Areas, Manufactures, Puerto Rico, and 1972 Economic Censuses of Outlying Areas, Manufactures, Puerto Rico.

1/ Includes printing and publishing, chemicals, petroleum, rubber products, primary metal industries, machinery, transportation equipment, and instruments and related products.

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

3/ Includes paper and allied products and electric and electronic equipment. Includes industries where employment change was 100 employees or less.

instruments, and chemicals. The combined effect between 1972 and 1977 of the shift in the composition of industry and in the share of payroll in value-added within individual industries, was that while manufacturing value-added rose from $1.9 billion to $4.1 billion, (a real increase of 72 percent), manufacturing payroll rose from $0.6 billion to $1.0 billion (a real increase of 24 percent).

Chapter 4

IMPACT OF POSSESSIONS CORPORATIONS ON PUERTO RICAN ECONOMIC GROWTH

Chapter 3 demonstrated that the reduced competitiveness of Puerto Rican labor and the fall in U.S. tariffs on imports from competing developing countries decreased the non-tax incentives for locating in Puerto Rico. Exemption from U.S. and Puerto Rican taxation is therefore a principal factor attracting firms to the Commonwealth. Since the advantages of a Puerto Rican location vary for different kinds of assets, it is useful to examine the impact of tax exemption on three distinct types of assets:

-- Physical plant and equipment and inventories;

-- Intangible assets, such as patents, trade secrets, trademarks, and "know-how"; and

-- Financial assets, such as tax-exempt certificates of deposit in Puerto Rican banks.

This chapter discusses the impact of section 936 and the complementary Puerto Rican tax exemption program on the attractiveness of a Puerto Rican location for each of these kinds of assets. It presents data on the relative importance of each category of assets in 936 operations, and evaluates the contribution which each type of asset makes to Puerto Rican growth. The chapter also discusses in detail the regulations issued by Puerto Rico to channel tax-exempt financial investments of 936 companies into physical assets in Puerto Rico, and the empirical evidence on the impact of these funds on the Puerto Rican economy. At year-end 1981, accumulated tax-exempt financial assets of possessions corporations amounted to approximately $7.6 billion.

I. Operations Attracted to Puerto Rico by Tax Exemption

The mix of physical, intangible, and financial assets in Puerto Rico is directly affected by the way in which the near total exemption from Federal and Puerto Rican tax is structured, and by the tax savings which exemption provides relative to tax benefits available in the United States and foreign countries.

A. Physical Assets. The exemption provided by section 936 gives Puerto Rico a substantial tax advantage relative to the United States as a location for physical assets. The effective U.S. tax rates for selected industries on income from new depreciable assets used in the United States varied from 29-47 percent under pre-1981 law, and will range from 18-32 percent under law in effect after 1982 (see Table 5-6). But Puerto Rico does not offer substantially greater tax savings for real investment than many low-tax developing countries. Although dividends from a 936 corporation to its U.S. parent are not taxable in the United States, while dividends from a foreign affiliate are, the U.S. tax on foreign earnings is generally deferred as long as the foreign affiliate retains its income abroad. Moreover, many U.S. multinationals have excess foreign tax credits that can be used to offset the U.S. tax on dividends from low-tax foreign countries. 1/

B. Patents, Trademarks, and Know-how. Some U.S. corporations have sought to increase the attractiveness of Puerto Rico as an investment location by transferring patents, trademarks, and other intangible assets to Puerto Rico. Many of these transfers were made under section 351 of the Code. As explained in Chapter 2, that section allows property to be transferred from one U.S. corporation to a second U.S. corporation which is controlled by the first, without requiring a taxable gain to be recognized on the transfer. Under pre-1982 law, a U.S. corporation which transferred intangible assets to a controlled 936 corporation (also a U.S. corporation) could assert that the gross income earned by the assets was income of the possessions corporation and thus exempt from U.S. tax under section 936. While the interpretation of the pre-1982 rules regarding income from intangibles is controversial 2/, the rules have

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1/ The amount of foreign tax credits which a corporation may claim under the Code is limited to the amount of U.S. tax due on all foreign source income. This limitation is computed on an aggregate basis rather than a country-by-country basis, so that a taxpayer who pays income taxes to one or more foreign countries at an effective rate higher than U.S. rate and to one or more foreign countries at an effective rate lower than the U.S. rate averages the foreign tax rates. The foreign tax credit for taxes paid to the high-tax countries will shelter from U.S. tax income received from low-tax foreign countries.

2/ As noted in Chapter 2, three cases are before the U.S. Tax Court, each involving the claim of a possessions corporation to income from intangibles that were developed by its U.S. parent and subsequently transferred to the possessions corporation.

been clarified and amended by TEFRA. Effective for tax years beginning after December 31, 1982, the amendments under TEFRA provide two alternative elections under which certain income from intangibles that are related to products manufactured, in whole or in part, in Puerto Rico, shall be treated as income of the 936 corporation eligible for the possessions credit.

While the Code allows any asset to be transferred tax-free between affiliated domestic corporations, the right to transfer assets free of tax to a foreign corporation is limited. In particular, administrative guidelines under section 367 of the Code impose a toll charge on the transfer from a U.S. corporation to a foreign corporation of the U.S. rights to an intangible, e.g., a patent to produce goods which will ultimately be sold in the United States. Based on the distinction in U.S. tax law between a transfer to a U.S. (including a 936) and a foreign corporation, and based on the amendments to section 936 under TEFRA, Puerto Rico still offers a significant advantage over foreign low-tax jurisdictions for locating patents, trademarks, and other intangibles.

C. <u>Financial Assets</u>. Section 936 and Puerto Rican law provide that QPSII is free of tax. For U.S. parent companies, the QPSII exemption makes Puerto Rico a very advantageous location for financial investments compared to the United States. For many U.S. parent corporations, Puerto Rico is also a better location than low-tax foreign countries.

If a U.S. corporation organizes a subsidiary in a low-tax foreign jurisdiction in order to receive passive investment income, such as Eurodollar interest, the parent would be subject to the Subpart F, foreign personal holding company, or foreign investment company provisions of the Code, with the consequence that the income derived by the foreign subsidiary may be required to be included in the gross income of the U.S. corporation, whether or not such amount is actually distributed. The U.S. corporation might be able to avoid this problem by putting the financial assets in an operating subsidiary located in either a low-tax country or in a country with a territorial tax system which permits foreign interest to be received tax-free. The Subpart F provisions do not, for example, cause passive income to be subject to U.S. taxation if the income is less than 10 percent of the foreign subsidiary's gross income. Puerto Rico is an advantageous location for financial assets if the U.S. company does not have an operating affiliate in a low-tax country or if the 10 percent rule is limiting. The fact that 936 corporations have retained a large pool of financial assets in Puerto Rico, even when the return was at a substantial discount from Eurodollars, indicates that some U.S. companies do not have other locations available for receiving tax-free interest income.

D. Asset Composition of Puerto Rican Investment. Physical, intangible, and financial assets are, of course, related to each other. The transfer to Puerto Rico of title to patents and trademarks must be accompanied by operating, physical investment if the income attributable to the intangibles is to qualify for exemption from Puerto Rican tax. In a sense, the ability to transfer intangibles to Puerto Rico increases the incentive to place physical capital there. Also, funds used to make financial investments in Puerto Rico must be derived initially from the profits of an active business there if the interest is to qualify for tax exemption. Notwithstanding the relationships between physical, intangible, and financial assets, the relative shares of the three types of assets in any operation can vary. As is shown below, the mix of assets in Puerto Rico reflects the incentives which the possessions corporation exemption provides relative to tax benefits available elsewhere.

Table 4-1, which is based on corporate balance sheets filed as part of U.S. tax returns, indicates that in 1980, plant, equipment, and property represented 12.4 percent of the total book assets of 936 manufacturing corporations, compared to 36.6 percent for manufacturing corporations operating in the United States. The relatively small share of fixed assets in total book assets of possessions companies was borne out in all but one of the industry groups for which data are available. The one manufacturing group for which this pattern did not hold, rubber products, accounted for only 0.5 percent of the aggregate book assets of 936 manufacturing firms. A detailed distribution of the book assets of 936 manufacturing corporations shows that the cash assets category, by itself, exceeded physical plant and equipment net of depreciation (see Table 5-1 below).

While it is difficult to identify precisely the passive financial investments of 936 manufacturing corporations, data from various official and bank sources indicate that at year-end 1980 they were approximately $6 billion, and rose to $7.6 billion at year-end 1981. (See Table 4-4 below.) The $6 billion in passive investments in 1980 were four times the value of 936 manufacturing corporations' physical plant and equipment net of depreciation. New investment in plant and equipment by 936 manufacturing corporations was approximately $300 million in tax year 1980. New investment in financial assets was over $1 billion.

Table 4-1

Possessions Corporations and Corporations Operating in the U.S. -- Net Plant, Equipment and Land as a Percentage of Total Assets, Year-end 1980

Industry	936 Assets by Industry as a Percent of All 936 Assets 1/	Net Plant, Equipment and Property as a Percent of Total Assets by Industry: 936 Corporations	Net Plant, Equipment and Property as a Percent of Total Assets by Industry: Corporations Operating in the U.S.	Column 2 ÷ Column 3
All Manufacturing Industries	100.0%	12.4%	36.6% 2/	33.9%
Food and kindred products	7.4	14.7	34.1	43.1
Textile mill products	0.9	4.0	33.7	11.9
Apparel	2.9	5.0	n.a.	--
Paper and allied products	0.1	27.7	54.4	50.9
Chemicals	54.2	13.3	39.5	33.7
Pharmaceuticals	46.4	11.5	24.9	46.2
Rubber products	0.5	41.2	35.0	117.7
Leather products	0.6	3.2	n.a.	--
Stone, clay, and glass products	0.1	17.1	49.2	34.8
Fabricated metal products	1.8	21.1	29.5	71.5
Machinery, except electrical	1.4	6.9	29.9	23.1
Electrical and electronic equipment	16.0	4.5	24.5	18.4
Instruments and related products	2.8	12.5	28.7	43.6

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1/ The percentages by industry sum to 89 percent, rather than 100 percent, since data for industries with fewer than three firms are not shown separately. All manufacturing firms are, however, included in the aggregate data shown in row 1.

2/ The average for all corporations, with no adjustment made for the differing industrial mix between possessions corporations and corporations operating in the U.S.

n.a. - not available

Source: Tax return Form 1120 filed by possessions corporations; and Federal Trade Commission, Quarterly Financial Report, First Quarter, 1981.

It also is difficult to specify accurately the value of intangible assets of 936 corporations. Frequently, these assets are the result of R&D and sales promotion activities conducted by the U.S. parent corporations. Because R&D and sales promotion are expensed when performed, intangible assets are generally carried on the books of the U.S. parent or its affiliated corporation at a zero basis. Intangible assets are not routinely bought and sold in exchanges between unrelated parties and, thus, cannot be easily valued by reference to independent party transactions. To assess the value of intangible assets that have been acquired by a possessions corporation in a section 351 transfer, one would ideally compare the profit margin of the possessions corporation to profit margins earned by corporations performing similar functions but not holding intangibles which they had acquired pursuant to section 351. Detailed data of this type are not generally available. It is possible, however, to obtain a general indication of the importance of intangible assets which have been transferred to possessions corporations by comparing 936 profits to those of all U.S. mainland corporations.

Table 4-2 does this by comparing, for possessions corporations and mainland firms, industry ratios of operating profits to operating assets. The table attempts to exclude both income and assets associated with financial investments. Columns A and B list net operating income, which includes the return to intangibles, as a percentage of operating assets, which include property, plant and equipment, inventories, and net receivables. The table indicates that in 1980, the before-tax return on operating assets was 52.3 percent for possessions corporations, compared to 12.7 percent for manufacturing operations in the United States. Net operating income in relation to the number of employees by industry, shown in columns C and D, was 5.9 times greater in possessions corporations than in mainland corporations.

Several factors explain the high returns of 936 operations relative to mainland operations. First, the government of Puerto Rico owns land and buildings which it leases to tax-exempt manufacturing firms. The Puerto Rican government reports that many companies in the electrical and electronic equipment industry, in particular, use government -owned buildings. In 1980, total land and buildings owned by the Commonwealth for lease to 936 corporations and Puerto Rican tax-exempt firms amounted to $346.3 million. 3/ No data are available on the amount of government-owned property which is under lease to 936 firms. Assuming, for

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3/ Puerto Rico Industrial Development Corporation, Annual Report, 1981.

Table 4-2

Possessions Corporations and Corporations Operating in the United States: Before-tax Operating Income in Relation to Operating Assets and Employment, 1980 1/

Industry	Gross Sales of 936 Corporations		Operating Income as a Percentage of Operating Assets			Operating Income Divided by Number of Employees		
	Amount ($millions)	Percent of Total 2/	(A) 936 Operations 3/	(B) Mainland Operations	Column A ÷ Column B	(C) 936 Operations 3/	(D) Mainland Operations	Column C ÷ Column D
All Manufacturing Industries	9,075	100.0%	52.3%	12.7%	4.1	$37,332	$6,352	5.9
High-Technology Industries								
Electrical and electronic equipment	1,274	14.0	94.2 (75.6*)	13.6	6.9	27,188 (29,657*)	5,041 (4,467*)	5.4
Household appliances	0	0.0		15.1*			5,184*	
Radio, TVs, communications equipment	161	1.8	110.2 (170.6*)	7.8*	21.9*	26,492 (36,395*)	2,371*	15.4*
Electronic components	329	3.6	47.2 (51.2*)	13.1*	3.9*	22,844 (28,070*)	5,520*	5.1*
Other	784	8.6	129.1 (77.2*)	11.1*	7.0*	29,028 (29,059*)	5,315*	5.5*
Chemicals	3,490	38.5	53.7	13.1	4.1	102,998	12,342	8.3
Pharmaceuticals	2,625	28.9	73.1	16.0	4.6	117,849	11,867	9.9
Rubber products	46	0.5	34.8	8.2	4.2	25,492	2,395	10.6
Machinery, except electrical	137	1.5	60.2	14.8	4.1	32,704	6,640	4.9
Instruments and related products	253	2.8	65.7	18.5	3.6	26,594	6,729	3.9
Low-Technology Industries								
Apparel	421	4.6	38.6 (34.5*)	13.1*	2.6*	5,903 (4,789*)	1,492*	3.2*
Textile mill products	47	0.5	31.3	11.9	2.6	8,907	2,758	3.2
Stone, clay and glass products	16	0.2	26.9	10.7	2.5	19,557	4,320	4.5
Food and kindred products	789	8.7	31.2	14.4	2.2	16,601	7,475	2.2
Fabricated metal products	165	1.8	30.4	13.8	2.2	18,216	3,836	4.7
Paper and allied products								
Leather	102	1.1	31.3 (29.2*)	23.4*	1.2*	4,523 (5,488*)	4,688*	1.2*

Office of the Secretary of the Treasury, Office of Tax Analysis

* 1979 data are reported, since 1980 data on corporations operating in the U.S. are not available.

1/ Operating income is defined as gross sales less cost of goods sold and less all other deductions except taxes, interest, and charitable contributions. Operating assets include property, plant and equipment, inventories, and net accounts receivable.

2/ The percentages by industry sum to 74 percent, rather than 100 percent, since data for industries with fewer than three 936 firms, or for which no U.S. comparable mainland data are available, are not shown separately.

3/ The data for 936 corporations include only those firms for which employment data are available. See Table 5-3.

Source: Tax return Form 1120 filed by possessions corporations; Federal Trade Commission, Quarterly Financial Report, First Quarter, 1981; U.S. Department of Labor, Supplement to Employment and Earnings, June 1982, and Internal Revenue Service, Source Book, Statistics of Income 1979.

the sake of illustration, that three-fourths of the $346.3 million in government-owned property was provided to 936 firms, and treating such leased property as "936 operating assets," would reduce the ratio of 936 operating income to operating assets in all manufacturing industries from 52.3 percent to 49.0 percent. If it is further assumed that all such leased property was used in the electrical and electronic equipment industry, then that industry's income-to-asset ratio would fall from 94.2 percent to 55.2 percent, compared to 13.6 percent in the United States. The operating assets of possessions corporation will also be understated by the amount of any property, plant, and equipment leased by a 936 firm from a non-936 firm.

The difference in the ratios in Table 4-2 between 936 and mainland operations may also reflect the fact that 936 corporations generally include only those corporations which have passed beyond the period of start-up losses, while the sample of mainland firms includes companies in all stages. In order to offset start-up losses in Puerto Rico against other income subject to taxation, a U.S. parent company will not make a 936 election for its subsidiary until the subsidiary is earning net income. If all loss corporations are excluded from the sample of mainland corporations, then the ratio of U.S. operating income to operating assets is increased from 12.7 percent to approximately 14.4 percent.4/

Possessions corporations and Stateside firms also operate in a different economic environment and face different prices. Prices for utilities and transportation tend to be higher in Puerto Rico than in the United States. On the other hand, average wages within Puerto Rican manufacturing industries are lower. If the payroll of

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4/ Since the Federal Trade Commission, Quarterly Financial Report, does not separately present balance sheet and income statement data for corporations with net income, the discrepancy between profit margins of all corporations and corporations with net income was computed from the Internal Revenue Service, Source Book, Statistics of Income, Active Corporations, Income Tax Returns, July 1979-June 1980. In accounting periods ending between July 1979 and June 1980, operating income as a percentage of operating assets for U.S. corporations with net income was 15.0 percent, or 13.6 percent higher than the comparable figure for all U.S. corporations, which was 13.2 percent.

possessions corporations 5/ is increased by the same proportion that U.S. average hourly earnings exceed Puerto Rican average hourly earnings in that industry 6/, then 936 rates of return are reduced as follows:

1980		
Industry	Before-Tax Operating Income as a Percentage of Operating Assets	
	Actual	Adjusted for Puerto Rican-U.S. Wage Differentials
Selected Manufacturing Industries, listed below	52.9%	44.4%
Electrical and electronic equipment	94.2	67.4
Chemicals	53.7	48.8
Textile mill products	31.3	15.6
Stone, clay and glass products	26.9	2.5
Food and kindred products	31.2	17.1
Fabricated metal products	30.4	14.5
Apparel	38.6	16.9
Leather	31.3	7.4

This table shows that when 936 operating income is reduced to eliminate the Puerto Rican-U.S. wage differential, the income-to-asset ratios for the principal manufacturing industries, taken together, fall 8.5 percentage points. In low-technology industries, the income-to-asset ratios fall to a level comparable to or even below the U.S. mainland levels, listed above on Table 4-2. However, in high-technology industries, electrical and electronic equipment and chemicals, the adjusted income-to-asset ratios are 67.4 percent and 48.8 percent, respectively, which are still more than triple the mainland rates of return.

5/ See Table 5-3.

6/ See Table 3-4.

Taken together, the impact of leasing, U.S. loss corporations, and lower Puerto Rican wage rates may account for up to one-third of the difference between 936 and mainland rates of return. While the rest of the difference cannot be attributed exclusively to the transfer of intangibles to possessions corporations by their mainland affiliates, such transfers appear to be an important factor. This is underscored by the fact that the difference between 936 and mainland rates of return is much greater in high-technology industries than in low-technology industries. 7/

Table 4-2, above, lists major industry categories in descending order by the size of the gap between 936 and mainland rates of return. The electrical and electronic equipment industry, the pharmaceutical industry, and other high-technology industries appear at the top of the table, with 936 rates of return from 35 to 129 percent. The low-technology industries appear at the bottom of the table, with 936 rates of return from 21 to 39 percent. In contrast to the skewed pattern of 936 rates of return in high- and low-technology industries, U.S. rates of return are relatively constant across all industries, with an average return of 12.7 percent.

The industries in which the gap between 936 and mainland rates of return is largest are those where U.S. spending on R&D is high. According to the Federal Trade Commission, the U.S. industry categories with the greatest firm-financed R&D as a percentage of sales were prescription drugs and electronic computing equipment. 8/ Total expenditures on R&D and sales promotion in these two lines of business were 30.6 percent of sales (for prescription drugs) and 24.7 percent of sales (for electronic computing equipment).

Although precise data are not available on the expenditures by possessions corporations on R&D and sales promotion, there are indications that possessions

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7/ High-technology industries in Table 4-3 are defined as those industries where R&D as a percentage of capital spending by U.S. firms is above the average for all U.S. manufacturing industries. Data are for 1980, from Annual McGraw-Hill Survey of Business' Plans for Research and Development Expenditures, 1981-94, June 1981, Tables VI and VII.

8/ Federal Trade Commission, Annual Line of Business Report, 1976, May 1982, Table 2-5.

corporations spend little in these areas. Of all employees in the Puerto Rican high-technology industries listed in Table 4-2, only 18 percent performed work other than production operations in 1977, compared to 35 percent of all workers in these industries in the United States. 9/ Another indication is that expenditures for purchased advertising represented .002 percent of sales for 936 pharmaceutical firms (compared to 13 percent of sales in the mainland pharmaceutical industry). In the electrical and electronic equipment industry, 936 firms' spending on advertising was .008 percent of sales (compared to 1 percent for the mainland industry). The fact that the gap between 936 and U.S. rates of return is largest in the electrical and electronic equipment, pharmaceutical, and other high-technology industries suggests that U.S. parent corporations have responded to the incentives under the possessions corporation exemption by allocating income from U.S. patents, trademarks, and other intangibles to their 936 corporations.

II. How Does Each Asset Contribute to Puerto Rican Growth?

The contribution to Puerto Rican growth of physical assets, such as plant and equipment or inventories, is direct and straightforward. Physical investment increases income in two ways: by providing the necessary capital to create more productive new jobs; and by providing additional capital to, and thereby increasing the productivity of, those currently employed.

Some types of intangible assets, such as management techniques, contribute to Puerto Rican growth and add to productivity in much the same way as physical capital. With respect to other, product-specific types of intangibles, in particular, patents, trademarks, and trade names, a distinction can be drawn between the right to use the intangible and the ownership of the intangible.

9/ Production workers include workers (up through the working foreman level) engaged in fabricating, inspecting, shipping (but not delivery), maintenance, and other services closely associated with production operations at a manufacturing establishment. U.S. Department of Labor, Supplement to Employment and Earnings, Revised Establishment Data, September 1980; and U.S. Department of Commerce, 1977 Economic Census of Outlying Areas, Manufactures, Puerto Rico.

If a U.S. parent wants to move the production of a patented product to Puerto Rico, it can license the 936 corporation to produce the product, in whole or in part, without also giving it title to the intangible. The production license adds to the productivity of Puerto Rican workers because it gives them an opportunity to participate in the production of advanced products. The license enables the marginal product of labor and capital used in Puerto Rico to be as high as that of labor and capital used in the United States.

Transferring the ownership title to an intangible may also benefit Puerto Rico. Provided the transfer is accompanied by additional investment of physical assets in Puerto Rico, it will increase Puerto Rican productivity and growth. If the income attributable to the intangible is treated as earned by the 936 corporation, rather than the U.S. parent, the pool of tax-exempt Puerto Rican earnings will increase. A corporation contemplating an investment decision may find that the benefits of a tax-free return on intangibles provide sufficient incentive to make a real physical investment in Puerto Rico. The precise impact of the transfer of intangibles on Puerto Rican productivity and growth will be closely related to the volume of physical investment that accompanies the transfer of intangibles. Manufacturing processes differ in the extent to which the various stages are integrated. In some cases, it may be difficult to separate phases of the production process, and the U.S. parent corporation will have a strong incentive to move a substantial operation to Puerto Rico in order to attempt to obtain the benefits of a tax-free return on its intangibles. In other cases, it may be possible to move a relatively small part of the whole production process to Puerto Rico.

The data on the modest fixed capital requirements of 936 corporations indicate that, in general, only a relatively small segment of the production process of U.S. corporations has been moved to Puerto Rico. As shown in Table 4-1, above, fixed assets represent 12.4 percent of the total book assets of 936 manufacturing corporations, compared to 36.6 percent for manufacturing corporations operating in the United States. However, those 936 operations which have been established in Puerto Rico add up to a substantial amount of economic activity. Table 3-8 indicates that the high-technology industries of chemicals, electrical and electronic equipment, and instruments provide 32 percent of total employment in Puerto Rico's manufacturing sector and have accounted for three out of every four new jobs in those Puerto Rican manufacturing industries which have experienced an increase in employment since 1968.

The tax benefits that U.S. parent corporations have claimed through the transfer of U.S. intangibles to Puerto Rico may eventually have another favorable, but indirect, effect on Puerto Rico. The increased after-tax returns in high-technology industries may stimulate additional R&D to develop new products. After the products are developed, their production may, at least in part, be located in Puerto Rico.

The benefits to Puerto Rico of financial investment in Puerto Rico by 936 corporations are also much more indirect than the benefits from physical investment. Because of the complexity of the rules involving tax-exempt financial investment, a separate section devoted to the issue makes up the remainder of this chapter.

III. The Impact of 936 Financial Assets on Puerto Rican Growth

Before 1976, the United States exempted all non-U.S. source income of possessions corporations until the income was repatriated in the form of dividends, and tax could be avoided altogether by distributing accumulated profits upon the liquidation of the possessions corporation. In order to avoid tax, possessions corporations ordinarily did not pay dividends and instead invested their profits in the Eurodollar market. By limiting the tax exemption to QPSII and to income effectively connected with a possession trade or business, the Tax Reform Act of 1976 created an incentive for possessions corporations operating in Puerto Rico to invest the large pool of funds that had been invested in the Eurodollar market in the Puerto Rican capital market, instead.

Congress' intention in limiting the tax exemption to QPSII was to facilitate the financing of local government development programs and private investment in the possessions. 10/ The increased pool of assets, it was believed, would reduce the cost of capital to investors in Puerto Rico, compared to the cost of funds to investors in the United States, thus leading to additional physical investment in Puerto Rico. The purpose of the Puerto Rican and U.S. regulations relating to QPSII is to maintain a separation between the Puerto Rican capital market (where

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10/ S. Rep. No. 94-938, 94th Cong., 2d Sess. 280 (1976).

936 corporations can earn tax-free returns) and world capital markets by preventing arbitrage between them. This section assesses whether the Puerto Rican financial market has been amenable to this separation and control.

The Puerto Rican authorities have recognized the difficulties in directing 936 financial assets into additional physical investment in Puerto Rico. In early 1980, for example, the President of the Government Development Bank, in announcing the new regulations to be implemented on April 1, 1980, stated that "there have been many loopholes, and many factors, that precluded the optimum economic impact of the 936 funds in our economy." In April 1981, the Secretary of the Treasury of Puerto Rico circulated a letter to members of the financial community asking them to report on their operations and to respond to various possible changes in the regulations governing 936 funds. He commented that,

> the implementation by the banks of the pooling of funds and fungibility of money concepts have resulted in a reduction of accountability, to the extent that the exact utilization of these 936 deposits sometimes cannot be determined by the department.

The concern by Puerto Rican officials that 936 funds may not finance new investment in Puerto Rico is reflected in the series of changes made in the regulations governing the use of 936 funds. The most recent amendments to these regulations were issued on December 17, 1981, and went into effect on February 1, 1982.

The funds that flowed into the Puerto Rican financial market after the enactment of section 936 in 1976 were enormous by Puerto Rican standards. Before 1976, financial investments in Puerto Rico by possessions corporations amounted to no more than $200 million because income from offshore investments was free from both U.S. and Puerto Rican tax. By December 1981, however, there were $5.3 billion in tax-exempt deposits and repurchase agreements in Puerto Rican banks, which was more than 30 percent of total commercial bank liabilities. In total, financial investments in Puerto Rico made by 936 manufacturing corporations (enjoying exemption from both U.S. and Puerto Rican income tax) amounted to about $7.6 billion at the end of 1981. The equivalent on the scale of the U.S. economy would exceed $500 billion.

Table 4-3 presents the financial portfolios of all 936 corporations in Puerto Rico. The financial assets listed do not include accounts receivable or other financial working capital. Table 4-4 presents the financial portfolios of 936 corporations in manufacturing. The assets in Table 4-4 are the principal focus of this section because the interest and dividends they generate are potentially free from both U.S. and Puerto Rican income tax.

The first part of this section will describe the U.S. provisions for QPSII and the Puerto Rican rules on the investment of section 936 funds. Together these determine the financial investments that are exempt from both U.S. and Puerto Rican income tax. Because interest on deposits in certain Puerto Rican banks qualifies for income tax exemption, the regulations on the banks' use of 936 funds are an important instrument by which Puerto Rico seeks to ensure that 936 funds are used within Puerto Rico. The second part of this section will attempt to trace the effect of the QPSII provisions and Puerto Rican regulations on real investment in Puerto Rico.

A. Legal Background

1. Qualified Possession Source Investment Income under Section 936. Section 936 grants a credit which offsets the Federal tax on QPSII earned by a U.S. corporation which has made a 936 election. As explained in Chapter 2, there are three requirements for investment income to qualify as QPSII: (1) the income must be from sources within a possession in which a trade or business is conducted, which basically means that the payor of the investment income must be a resident of Puerto Rico; (2) the funds invested must be derived from the active conduct of a trade or business in that possession; and (3) the funds must be invested in the possession, for use therein. The third requirement goes beyond the first because a Puerto Rican payor of interest might not necessarily use the funds for investment in Puerto Rico.

Section 936 was an important change from pre-1976 law, which exempted all non-U.S. source income of possessions corporations. To obtain the highest return on their financial investments, possessions corporations before 1976 invested their funds in the Eurodollar market, either directly or through Guamanian banks in order to satisfy the 80 percent possession source gross income requirement. In either case, the investment income was free from both U.S. and Puerto Rican tax. For this investment income to continue to be free from U.S. tax, the Tax Reform Act of 1976 requires that the funds be invested in Puerto Rico.

Table 4-3

Estimated Composition of the Financial Investments of Possessions Corporations at Year-end 1981

Financial Investments	$ billions
Total	9.5+
Investments in Puerto Rico, total	9.0+
Deposits in Puerto Rican banks, including repurchase agreements	5.3*
Puerto Rican source GNMA mortgages	1.2
Loans to other possessions corporations	.3+
Puerto Rican government obligations	.4+
Repurchase-Resale agreements not included in bank funds	.4+
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	.5

Office of the Secretary of the Treasury
Office of Tax Analysis

\+ Denotes approximation.

* This includes about $400 million in savings banks. Some of the funds referred to as 936 deposits may include deposits by exempt firms which have not made a 936 election, e.g., local exempt firms. These, however, are likely to be a small part of the total.

Table 4-4

Estimated Composition of the Financial Investments of Possessions Corporations in Manufacturing (enjoying exemptions from Puerto Rican tax) at Year-end 1981

Financial Investments	$ billions
Total	8.1+
Investments in Puerto Rico, total	7.6
Deposits in Puerto Rican banks, including repurchase agreements	5.3
Puerto Rican source GNMAs	1.2
Loans to other possessions corporations	.2+
Puerto Rican government obligations	.3+
Repurchase-Resale agreements not included in bank funds	.4+
Mortgages and real estate loans	.1+
Other investments in Puerto Rico	.1
Investments outside of Puerto Rico	.5

Office of the Secretary of the Treasury
Office of Tax Analysis

\+ Denotes approximation.

Although the U.S. Treasury has not issued final comprehensive regulations on QPSII, it has issued a regulation covering deposits by 936 corporations in Puerto Rican financial institutions. Under this regulation, interest from such deposits is exempt from U.S. tax if it qualifies for exemption from Puerto Rican tax under regulations issued by the Secretary of the Treasury of Puerto Rico, as in effect September 28, 1976. The Puerto Rican regulations are described below.

2. Puerto Rican Tax Exemption of Investment Income. Under the Puerto Rican Industrial Incentive Acts of 1963 and 1978, income derived from the investment of Industrial Development Income 11/ in certain specified assets is free of tax. The investments that generate exempt interest, rents, and dividends (so-called 2(j) investments) are:

-- Puerto Rican 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 Rican government,

-- Loans to other exempt businesses,

-- Loans to the maritime industry,

-- Loans to businesses operating in Puerto Rico which are guaranteed by the Puerto Rican or U.S. government,

-- 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

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11/ Industrial Development Income is the business income of a firm which holds a tax-exemption grant, and also the passive income to which such business income gives rise when it is reinvested in certain designated assets.

-- Fixed-term deposits in qualifying banking institutions.

Although this appears to be a comprehensive list, apart from the last item the opportunities for high-yield financial investments afforded to 936 companies are relatively limited. Puerto Rican government or agency bonds bear yields that are linked to the tax-free municipal market in the U.S. By investing in a Puerto Rican government obligation rather than repatriating its profits, a possessions corporation will benefit from deferred and, in some cases, reduced tollgate taxes. But, because interest received by any U.S. investor in Commonwealth bonds is exempt from Federal tax, the possessions corporation will not realize the main potential benefits of the QPSII exemption, i.e., the tax exemption of a yield which is high because it is taxable to other investors.

Government National Mortgage Association bonds (GNMAs), U.S. government-guaranteed securities backed by Puerto Rican mortgages, are very desirable investments for 936 firms because they carry a high, taxable (to others) return. However, new Puerto Rican GNMA issues, which have recently been about $100 million per year, are much smaller in dollar volume than the annual growth in 936 financial assets. Finally, the market for loans by 936 firms to other 936 firms 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).

Until recently, the banks in Puerto Rico have had a strategic position as intermediaries because Puerto Rican rules allowed them to issue tax-exempt certificates of deposit to 936 companies and to use the funds to make any loan in Puerto Rico apart from a consumer loan. A loan made by a bank to a Puerto Rican importer, wholesaler or retailer, for example, would qualify as an eligible asset, even though the same loan made directly by a 936 corporation would not. The February 1, 1982 regulations, however, now specifically permit brokers to invest 936 funds in the same range of assets that banks can, while at the same time putting them under the same regulatory regime as banks.

Before the new regulations become effective February 1, 1982, investment bankers in Puerto Rico performed a significant role in arranging repurchase agreements between 936 corporations and smaller Puerto Rican commercial and savings banks. In these repurchase agreements, or "repos," a 2(j) asset such as a Puerto Rican municipal bond was used as the underlying asset. The 936 company, which would ordinarily be reluctant to deposit funds in a small Puerto Rican bank, had the underlying asset as added security. The investment banker frequently lowered the risk even further by adding its guarantee to the transaction. Under the new regulations, investment bankers (brokers) can use any asset as the basis for a repurchase agreement with 936 corporations. However, the proceeds of the repo, i.e. the funds received from the 936 corporation, must now be invested in eligible assets under rules similar to those imposed on banks.

3. <u>Rules for Banks' Investment of 936 Funds Effective from May 1, 1975 to April 1, 1980.</u> The Secretary of the Treasury of Puerto Rico can declare a depository institution to be eligible to issue certificates of deposit which are 2(j) assets. In order to ensure that the funds are used for the benefit of Puerto Rico, in 1975 the Secretary imposed a set of constraints on the banks. The regulations required that the banks invest 20 percent of the 936 funds in obligations of the Puerto Rican government or its agencies, although banks were permitted to use their existing investments to satisfy this requirement. To prevent banks from using the remainder of the 936 funds to make consumer loans or investments outside of Puerto Rico, the regulations provided that the increase in a bank's consumer loans plus investments outside of Puerto Rico could not exceed the increase in its non-936 funds. That is, any increase in a banks's 936 deposits had to be invested in eligible (i.e. nonconsumer and non-foreign) assets. The base period for this requirement was April 30, 1975, the date that exempt certificates of deposit (CDs) were introduced under the Industrial Incentive Acts. The regulations also provided that the Puerto Rican branches of Citibank and Chase Manhattan could not reduce their borrowing from outside of Puerto Rico from the level existing on April 30, 1975. There were several features of the way in which the banking regulations operated before April 1, 1980, however, which diluted the impact of the incremental rules:

a. Warehousing. The Puerto Rican authorities realized that the sudden influx of 936 funds in 1976 could not immediately be absorbed within the economy. Consequently, they gave a bank 90 days to invest 25 percent of a new deposit in eligible assets and 180 days to invest the remainder.

b. 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 tax-exempt interest, and let it disappear on the last day of the month.

c. Repos (Securities sold under repurchase agreements). A bank could sell a Puerto Rican government bond in its portfolio to a 936 company under a repurchase agreement (usually through an investment banker). 12/ The funds received by the bank were not considered 936 deposits. To the 936 corporation, however, the Puerto Rican municipal was an eligible (2(j)) investment. Furthermore, the bond that was sold under the repurchase agreement could still count as one of the bank's eligible assets. 13/

d. Assets acquired from insolvent banks. Puerto Rico experienced a banking crisis in the mid-1970s. The most significant liquidation was Banco Credito, which was the second largest bank at the end of 1975, with almost $800

12/ Under the usual terms of a repo, the seller (the bank) agrees to buy the security back at a fixed date. It is therefore in essence a short-term secured loan from the 936 corporation to the bank. In Puerto Rican Treasury rulings, the character of the repo interest is the same as the coupon interest for purposes of the 2(j) exemption. The sale and repurchase price are therefore set to reflect the accruing interest during the life of 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.

13/ In April 1980, the first month of the new reporting system, repos by all banks, including savings banks, amounted to $240 million, or about 7.5 percent of total 936 funds in banks.

million in assets. It was declared insolvent and its assets were taken over by other banks in Puerto Rico. Banks which acquired eligible assets from a liquidating bank could regard them as new assets under the Puerto Rican regulations. That is, the assets did not bring an addition to the bank's base-period eligible assets, nor did they result in a corresponding increase in 936 deposits. 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 of the impact of the Puerto Rican regulations on banks' use of 936 funds, there is the possibility that the incremental rules, even if strictly adhered to, would not have affected the banks' investments. The incremental rules would have been effective only if the increase in 936 deposits had exceeded the increase in eligible investments that banks would have wanted to make anyway. For example, between April 1980 and February 1981, total 936 deposits requiring equivalent eligible assets grew by $572 million, while total eligible assets increased by $675 million. On the margin, there was no incentive for banks to acquire additional eligible assets. For the banking system as a whole, the incremental rules imposed no constraint.

4. Banking Regulations Effective From April 1, 1980 to January 31, 1982. 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 above. The main changes were:

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

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

c. Classification of repos with 936 companies as 936 deposits for the purpose of the investment regulations. However, it appears that when an investment banker obtains a 2(j) asset from a bank under a repo and then repos it in turn to a 936 company, the funds are not considered to be 936 deposits.

d. A requirement that 10 percent of eligible funds be deposited with the Government Development Bank (GDB). This is in addition to the requirement under the earlier regulations that 20 percent of eligible funds be invested in obligations of the Puerto Rican government. Banks received credit for existing loans to the GDB and repos to the GDB, which expected a net inflow of deposits of only about $50 million. In fact, the new deposits required were substantially higher.

Most banks did not appear to have great difficulty in complying with the new regulations. In April 1980, the first month that the new regulations were in effect, aggregate incremental eligible assets exceeded 936 funds in banks by $680 million. Most of the excess eligible assets were concentrated in the smaller commercial banks and in the savings banks. The branches of U.S. and Canadian banks, and the large local banks, had relatively few excess eligible assets, but it appears that they did not have to change their portfolios much in order to conform to the new regulations.

While the April 1, 1980 regulations attempted to limit the opportunites for arbitrage previously available, the empirical evidence presented later in this chapter indicates that they did not significantly increase the contribution of 936 funds to Puerto Rican development. The fact that the banking system as a whole continued to have excess eligible assets meant that new 936 deposits could be received without additional investment in Puerto Rico. Furthermore, even if banks did expand their loans to eligible Puerto Rican borrowers, these borrowers might themselves turn around and invest the funds offshore if yields in the Eurodollar market exceeded the cost of borrowing in Puerto Rico.

5. <u>Banking Regulations Effective February 1, 1982</u>. The regulations which were issued on December 17, 1981, and became effective February 1, 1982, are intended to correct the problems that remained under the April 1980 regulations. They represent an important tightening in the procedures for banks' use of 936 funds. They also expand brokers' ability to act as intermediaries for 936 funds while bringing them under a regulatory regime similar to those applying to banks. The major changes are:

a. The base for the calculation of incremental eligible assets is effectively moved up to July 1, 1981. All excess eligible assets in existence at that date are therefore no longer available for matching with new 936 deposits. There are some exceptions to this rule, including some private placements with the Government Development

Bank, which will preserve their character as an eligible assets, although only to the extent that the bank had excess eligible assets on July 1, 1981. These exceptions are of limited quantitative significance.

b. The regulations now cover the use of funds by the ultimate eligible borrower. The proceeds are not to be used to purchase financial assets to take advantage of any differential between 936 interest costs and regular yields. The banks must be able to establish to the satisfication of the Puerto Rican Secretary of the Treasury that the eligible funds have been properly applied. Evidence of proper use will include, but not be limited to, a representation letter from the enterprise receiving the funds. The enterprise will be able to use 936 funds to refinance its existing nonfinancial assets and liabilities. The opportunites for refinancing existing assets such as plant and equipment would appear to offer substantial leeway in the ultimate use of 936 funds, although such refinancing would not necessarily increase net investment in Puerto Rico.

c. Starting in 1983, 6 percent of a bank's total eligible deposits will have to be invested by the bank in mortgage loans to finance newly constructed housing. In 1982 only 3 percent will be required. It will be possible for banks to receive relief from this requirement if Puerto Rico's Secretary of Housing certifies that sufficient mortgage instruments are not available in the market.

d. Brokers will now be eligible to act as intermediaries for the use of 936 eligible funds. They can obtain the funds by offering a repo to a 936 corporation with any security. The underlying asset in the repo may therefore be other than a 2(j) asset. However, the proceeds of the repo have to be invested in eligible assets with restrictions parallel to the requirements on bank funds. Thirty percent of the proceeds will have to be invested in public debt of the Commonwealth of Puerto Rico. Rules on the use of the 936 funds by the ultimate borrowing enterprise also are associated with the transaction.

e. There has been some clarification of the list of eligible assets. For example, new automobile loans are now specifically eligible.

As part of the new regulations, the Secretary of the Treasury issued an administrative determination clarifying the eligibility of banks' loans to brokers operating in

Puerto Rico. This had been an issue of some importance because loans to brokers had apparently been a significant category of eligible assets. The December 17, 1981 determination stated that loans to brokers could not be used to finance customers' margin debt, and could not be used to acquire an inventory of securities, other than 2(j) assets or obligations issued by firms engaged in trade or business in Puerto Rico for the purpose of funding their island operations.

In addition to advancing the date for the purpose of computing incremental eligible assets, the December 17, 1981, regulations have also changed the way in which the incremental rule operates. The regulations state:

> The application of the above described incremental rule can result in an eligible institution being able to receive additional eligible deposits without generating additional qualified assets when the eligible depository institution has an excess of such assets. This situation should not be interpreted by the eligible depository institution as allowing for the investment outside of Puerto Rico of the eligible funds received.

This apparently means that an eligible institution will have to demonstrate that any additional 936 funds have flowed into new eligible assets, even if it already had excess incremental eligible assets. This appears to be a fundamental change in the incremental rule and a reduction in the opportunities for arbitrage. On the other hand, it may simply mean that banks and other eligible institutions book loans after receiving 936 funds, instead of booking the same loans first and then bidding for funds.

The new regulations had the immediate effect of removing most of the excess eligible assets from the banking system. In January 1982, the month before the new regulations became effective, there were $788 million in excess eligible assets in the banking system. In February 1982, there were $126 million. Much of the decline is accounted for by the fact that none of savings banks elected to be eligible depository institutions in the new regime. However, there was a substantial decline in excess eligible assets in the commercial banks as well, from $339 million in January to $126 million in February. The updating of the base period to July 1, 1981, accounts for almost all of this decline, as it had a net impact of $186 million. The stricter rules on the eligibility of loans, particularly to brokers, do not as yet appear to have had a significant impact on total eligible assets.

B. Empirical Analysis

1. Inflow of 936 Funds and Net Capital Flows into Puerto Rico. One indication of whether the QPSII provision has been successful in increasing investment in Puerto Rico can be found in the capital account component of the Puerto Rican balance of payments. Real investment in any economy can be financed by (a) private domestic saving, (b) government saving, or (c) capital inflows from abroad. The QPSII provision was intended to increase the third source of capital, inflows from abroad. That is, the objective was to increase the flow into Puerto Rico of the large pool of funds that had been invested in the Eurodollar market. Any increase in this source of investment would be reflected in a change in net capital inflows into Puerto Rico.

Table 4-5 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 4-5 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 capital flows into Puerto Rico in the previous year in anticipation of passage of the law. Regardless of whether fiscal year 1977 or 1976 is taken as the beginning year for section 936 to have an impact, the inflow of 936 funds is hardly visible in the net capital balance. Average inflows in the period 1976-1980 are almost identical to the flows in the prior four years, even in nominal terms. The net capital inflow did increase to a new high in 1981, but the increase was still modest in relation to the annual accumulation of 936 financial assets. What explains the failure of the large inflow of 936 financial assets to be reflected in the overall contribution of foreign capital to investment in Puerto Rico?

The answer is given in Table 4-6, which presents selected components of the Puerto Rican 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 four-year period ending June 30, 1979 was $3.7 billion higher than the total for the prior four-year period, or about the magnitude one would expect. This $3.7 billion increase in direct investment must

Table 4-5

Net Capital Inflows into Puerto Rico, 1970-1981

(Millions of dollars)

Year Ending June 30	Net Capital Flows
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	1,234
1980	1,513
1981	2,071

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

Table 4-6

Components of the Puerto Rico Capital Account, 1970-1981

(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.]

YEAR ENDING JUNE 30	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
Direct investment in Puerto Rico	330	686	626	792	343	539	1,276	1,838	1,954	940	2,185	3,147
Net short-term banking flows	182	32	-25	114	39	306	59	-544	-211	-440	-557	-1,362
Foreign holdings of bank debts	45	20	102	248	227	453	48	-91	-72	197	-13	-384
Investment by PR banks abroad	-110	79	-4	-174	-25	-168	70	-457	-197	-763	-490	-1,007
External deposits in Puerto Rican banks	247	-67	-123	40	-163	21	-59	4	58	133	-95	29
Net foreign investment in long-term Puerto Rican Government obligations	181	307	448	404	590	896	208	353	-195	659	470	168
PR investment in U.S. Government securities	-15	-20	66	15	111	14	-32	-303	128	-189	-210	98
Net foreign investment in short-term debts of PR public corporations	25	67	42	64	15	153	-37	105	- 6	-5.0	146	-42
Short-term investment abroad by public corporations	- 7	- 2	-15	8	-26	-96	-19	-48	-199	71	-641	8
All other	195	86	181	-131	257	26	240	65	7	198	120	54
Total, Net	891	1,156	1,323	1,266	1,329	1,838	1,695	1,455	1,478	1,234	1,513	2,071

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Source: Puerto Rico Planning Board, Bureau of Economic Accounts and Censuses represent almost exclusively an increase in financial assets in Puerto Rico, since gross private investment in plant and equipment showed no sustained upward trend between 1971 and 1979, and amounted in 1977 and 1978 to only one-third of the total direct investment inflow in those two years. (See Table 4-2.) The level of direct investment rose sharply in 1980, after a drop in 1979 when the major inflow of 936 financial assets seemed about over. It rose again in 1981 by almost another billion dollars. The large increases in the flow of direct investment in 1980 and 1981 apparently reflect the large retained earnings of U.S. corporations. Table 4-2 indicates that, as in 1977 and 1978, more than two-thirds of the direct investment in 1981 must have reflected financial, not real investments. 14/

The large increases in direct investment flows were offset in part by changes in banking flows. The three short-term banking flows given in Table 4-6 are (a) changes in the foreign holding of non-deposit liabilities of Puerto Rican banks, (b) changes in short-term investments by Puerto Rican banks abroad, and (c) changes in foreign 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 four of the next five years. Furthermore, there have been very large increases in investments by Puerto Rican banks in foreign capital markets since 1977. 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 in the years immediately after the enactment of section 936. The foreign (largely U.S.) accumulation of Puerto Rican government obligations diminished substantially in 1976. In part, this was due to smaller total borrowing by the government. However, the creation of section 936 must also have played an important role. Some 936 corporations acquired Puerto Rican government debt. More significant were acquisitions by banks. As noted above, banks were required to invest 20 percent of 936 deposits in government obligations according to rules in force before April 1, 1980, when the requirement

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14/ These data on direct investment flows must be treated with some caution. Direct investment in Puerto Rico is estimated by adding retained earnings of foreign (including U.S.) corporations to the residual from all the other balance of payment flows. Puerto Rico has not undertken a benchmark survey of actual assets of foreign affiliates since 1973.

was raised to 30 percent. One source of capital outflows which became very significant in 1980 was short-term investments abroad by Puerto Rican public corporations. These were quite large in 1978, as well.

The overall picture presented by these balance of payments statistics is that, at least between June 30, 1976 and June 30, 1981, section 936 and the related Puerto Rican regulations did not lead to any substantial growth in the net inflow of capital into Puerto Rico. Section 936 did bring substantial funds back to Puerto Rico, but these appear to have flowed out again through the banking system, switches in the ownership of Puerto Rican public debt, and investments abroad by Puerto Rican public corporations.

2. Overview of the Puerto Rican Capital Market. To what extent does the financial investment of 936 corporations in Puerto Rico contribute to real investment in Puerto Rico and to what extent is it used to finance real investment outside of Puerto Rico? In unconstrained markets, the after-tax rate of return to investment would tend to be equalized among jurisdictions. The purpose of the provisions related to QPSII is to interfere with this equalization of returns by preventing, or at least increasing the costs of, arbitrage between the Puerto Rican and world capital markets.

Arbitrage can be engaged in at several levels, i.e., both by financial institutions and by Puerto Rican borrowers who obtain "low-cost" loans. The costs of arbitrage by financial institutions determine the interest rate they offer on 936 funds relative to the yield on funds in offshore markets. Similarly, the costs of arbitrage by private borrowers set an effective limit on the extent to which the cost of borrowing can fall below the yield on funds in offshore markets in those circumstances where the costs of arbitrage for banks are high enough to create a substantial discount on 936 deposits.

The costs of arbitrage for financial institutions depend on their portfolios. The costs are very low if they have excess eligible Puerto Rican assets, because they are free to accept additional 936 funds without having to find additional Puerto Rican assets. In view of their very low transactions costs, they are then in a position to pay virtually the Eurodollar rate for deposits. If a bank does not have excess eligible assets, however, it cannot engage in arbitrage if it receives additional 936 deposits because it must match 95 percent of the new funds with additional Puerto Rican assets.

At least until the new regulations effective February 1, 1982, the Puerto Rican banking system as a whole has tended to have excess eligible assets. For example, in December 1981 there were eligible assets of $6.2 billion and deposits requiring matching eligible assets of $5.3 billion. Most eligible assets were in local savings banks and smaller commercial banks. For example, 56 percent of the excess eligible assets in December 1981, were in savings banks. Treasurers of 936 corporations were reluctant to make direct deposits in these small institutions because of the risk of default.

This reluctance could be overcome by additional security provided by repos, additional collateral, and guarantees by brokers. Links between the 936 corporations and the smaller banks were usually arranged by brokers. The cost of these investment banking services, including a risk premium if the broker's capital is at risk, set the lower limit for the rate on 936 funds relative to yields on non-936 deposits. Once the spread exceeded these costs, investment bankers in the pre-February 1, 1982 regime were willing to bid for 936 funds because they were then able to offer lower cost funds to the smaller banks than would have been available from non-936 channels.

The February 1, 1982, regulations appear to substantially reduce the opportunities for arbitrage available to both Puerto Rican financial intermediaries and Puerto Rican borrowers. The moving of the base period for computing incremental assets to July 1, 1981, and the choice by the savings banks not to be declared eligible despository institutions, effectively dried up the excess eligible assets in the system. In addition, there is a specific obligation on Puerto Rican borrowers to demonstrate that they have used the proceeds of the loans in their Puerto Rican operations.

These regulations seem to have had a very significant effect on brokers. One indication is that several U.S.-based brokerage firms that had recently opened up offices in Puerto Rico have closed them. The requirement that the proceeds from repos with 936 corporations be invested in eligible assets has apparently caused a cutback in brokers' transactions in 936 funds. In addition, the requirement that 30 percent of the proceeds of repos be invested in relatively low-yield Puerto Rican government debt has reduced the overall return that brokers can offer to 936 depositors. The fact that commercial paper of local Puerto Rican firms tends to be unrated has also hampered brokers' activities. New York Stock Exchange rules make it expensive to carry unrated debt in inventory, and 936 corporations are unwilling to accept the local paper as the underlying asset in repos.

However, this impact of the new regulations on brokers may reflect mainly a short-run adjustment or timing problem. Brokers' activities in the past resulted from the opportunities provided by the excess eligible assets in the smaller banks. As prospective eligible assets are developed by the smaller banks in the future, they will presumably be financed directly with the proceeds from 936 repos. In substance, therefore, there may not be a major change in brokers' role as intermediaries because they will continue to mobilize the eligible assets in the smaller banks, particularly if the eligible assets in savings banks again become available to cover 936 funds.

The apparently dramatic effect of the new regulations on savings banks may also be somewhat misleading. The new July 1, 1981 base period was particularly burdensome to them because of their acquisition of substantial 936 funds in the second half of 1981. That was one reason they chose not to be eligible depository institutions for 936 funds, and instead preferred the status of ultimate eligible recipients of 936 funds from eligible banks and brokers. As ultimate recipients they would not be subject to the restrictions imposed on eligible institutions, such as the requirement that 30 percent of 936 funds be invested in Puerto Rican government debt. They would then hope to use the 936 funds to finance their financial assets. However, this requires that their financial assets be regarded as business inventories for the purpose of satisfying the Puerto Rican rules on the use of 936 funds by ultimate recipients. The Puerto Rican government has not agreed with this interpretation. Whatever the ultimate resolution of this issue, mortgages and other eligible assets generated by savings banks will eventually find their way back to the 936 funds market.

The February 1, 1982 regulations have, at least in the short run, substantially altered the market for 936 funds. The new constraints on banks, brokers, and borrowers and the sterilization of the eligible assets that were excess on July 1, 1981, have reduced the value of 936 deposits and have thereby significantly reduced the interest rate on these deposits relative to offshore financial assets. The longer term effect is somewhat less certain.

In the past, the Puerto Rican financial market has been able to generate more eligible assets than were needed to match both the 936 funds accumulating each year and the initial large inflow in 1976 and thereafter. As long as the "normal" growth of eligible assets, i.e., the increase in eligible assets financed at stateside or Eurodollar interest rates, exceeds the growth in 936 funds seeking investment, any incremental rule will not be effective, no matter how rigorous. It is true that the new regulations have narrowed the range of eligible assets, e.g., through limitations on the eligibility of brokers' loans. However, this has not yet had a visible impact on the amount of eligible assets in the Puerto Rican financial market. Furthermore, the financing of new automobile loans and the refinancing of borrowers' inventory and fixed assets, which are specifically eligible uses of funds, would appear to provide substantial new outlets for 936 funds.

Investment income earned in the Eurodollar market is subject to U.S. tax. Thus, taxes play an important role in the financial investment choice of a 936 corporation. Possessions corporations would not be willing to invest their funds in Puerto Rico unless they could obtain an after-tax return at least equal to the after-tax return in the Eurodollar market. The lowest that the interest rate on 936 funds can be relative to the rate on Eurodollars can therefore be estimated. 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 would remain after Federal income taxes. Based on these assumptions, the 936 rate would have to be at least 60 percent of the Eurodollar return. 15/ For longer term assets, the tollgate tax may be less than 10 percent and the minimum return could therefore be less than 60 percent.

Until the implementation of the February 1, 1982 regulations, the 936 CD rate has generally been substantially greater than 60 percent of the Eurodollar rate. It has usually been in the 70 percent to 95 percent range, and was very close to the top of the range from March through December 1981. In part this reflected the fact that, with the greater development of the Puerto Rican capital market, the costs of arbitrage were reduced. Banks and brokers therefore were able to offer much higher rates than the 60 percent minimum. But as discussed in Section 5 below, the new regulations have had a dramatic impact in reducing the 936 rate to about 60 percent of the Eurodollar level.

15/ Let R be the 936 interest rate and E be the Eurodollar interest rate. Then the 936 corporation is indifferent between the two investments if the after-tax returns are equal, i.e., if $.9R = .54E$ or $R = .6E$.

3. 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 Manhattan, Bank of America which entered in 1978, and Continental Illinois which entered in 1981. Another group are the Puerto Rican banks, the largest of which by far is Banco Popular, with $2.6 billion in assets at the end of 1981. Even so, Banco Popular would only be about 50th 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 Caribbean. There are also foreign-controlled banks which are organized as Puerto Rican subsidiaries and are classified as domestic Puerto Rican banks. These include Banco Central y Economias, Banco de Santander, and Scotiabank de Puerto Rico.

Corporate 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. 16/ This high degree of risk aversion may not be surprising or irrational in view of the Puerto Rican bank failures in the mid-1970s. 17/ Whatever the reason, the conservative financial policy is reflected in the concentration of 936 funds that is evident in column 4 of Table 4-7. The Chase Manhattan and Citibank branches, which have their parents' capital behind them, alone accounted for 45 percent of all 936 deposits and repos in banks in December 1981. Their share of total 936 funds was substantially greater than their 32 percent share of all commercial bank assets in Puerto Rico at the end of 1981. By contrast, the local

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16/ $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.

17/ Banco Credito, the second largest local bank at year-end 1975, was declared insolvent and its assets were distributed to other banks. Banco Economias also became insolvènt 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 4-7

Distribution of 936 Funds, Excess Eligible Assets, and Change in 936 Funds

(Millions of dollars)

Bank	Daily Average - December 1981					Total Excess Eligible Assets, April 1980
	Direct Deposits (1)	Funds Obtained by Repos (2)	Re-deposits Received (3)	Total 936 Funds (4)	Change from April 1980 (5)	(6)
Chase Manhattan	915	0	20	935	+281	6
Citibank	1,289	160	1	1,450	+716	2
Bank of America	341	9	53	403	+93	-32
Continental Illinois	285	1	21	307	+307	n.a.
Total, U.S. banks	2,829	170	95	3,094	+1,396	-24
Banco Popular	347	101	0	449	-3	12
Banco de Ponce	187	21	68	276	+37	26
Scotiabank	35	0	66	101	-3	1
Central	236	72	35	343	197	34
Banco de San Juan	41	7	29	77	42	45
Santander	35	0	113	148	+74	44
Roig	7	20	26	53	+9	16
Comercial de Mayaguez	19	18	0	37	-21	16
Total, Local commercial banks	906	240	337	1,483	+290	184
Bank of Nova Scotia	284	0	0	284	+57	2
Royal Bank	334	0	0	334	+76	30
Total, Canadian banks	618	0	0	618	+133	32
Savings banks	2	534	7	543	+410	486
Total, All Banks	4,354	947	439	5,301*	+2,027	678

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* The overall total does not include redeposits because this would count the same funds twice for the system as a whole.

banks have a much smaller share of 936 funds than of total assets. As noted above, repos are one way in which a 936 corporation can reduce the risk associated with putting funds in the smaller local banks. Repos are therefore an important source of 936 funds for the local banks, particularly the savings banks, which have a large stock of 2(j) assets.

Even though Citibank and Chase Manhattan still account for almost half of total 936 funds in banks, the competition for 936 deposits has substantially increased since 1978. At the end of 1977, the combined Citibank-Chase Manhattan share was almost 60 percent. In 1978, the Bank of America established a branch in Puerto Rico and acquired $403 million in 936 funds by December 1981. In addition, the Banco Popular crossed the $100 in capital threshold in 1978 and bid agressively for deposits in 1979. The Canadian banks have also become 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 in 1980 the Royal Bank obtained approval for the acquisition of the Banco de San Juan. Finally, Continental Illinois entered in early 1981 and acquired $307 million in 936 funds by the end of the year.

The increased ability of the local savings banks and smaller commercial banks to obtain 936 funds was one of the significant developments between the beginning of 1980 and February 1, 1982, the effective date of the new regulatory regime. As shown in Table 4-7, the savings banks tripled their 936 funds between April 1980 and December 1981, and accounted for more than 20 percent of the overall increase in 936 funds over that interval. These funds were obtained almost exclusively with repurchase agreements. Column 5 of Table 4-7 indicates that some of the smaller commercial banks were also successful in attracting substantially more 936 funds in that period.

4. Recent Changes in Commercial Bank Portfolios in Response to the Availability of 936 Funds. The U.S. Treasury Department's 1980 Annual Report on the Operation and Effect of Possessions Corporations contains a review of the changes in commercial bank portfolios between June 30, 1975 and December 31, 1979, which covers the period when the financial assets of possessions corporations flowed into the Puerto Rican banking system from offshore. The Report indicates that the increase in bank loans was relatively modest compared to the large increase in funds made available by 936 corporations. Furthermore, the inflow of 936 deposits accounted for more than 70 percent of the growth in total bank assets over the period. There was a modest increase in other sources of funds, such as regular CDs.

From December 31, 1979 to December 31, 1980, there was a significant change in this pattern. Table 4-8 indicates that from the end of 1979 to the end of 1980, total commercial bank assets increased by $1,582 million, or 15.9 percent. Deposits of 936 corporations increased by $494 million, which is substantially less than the $880 million increase in the previous year, and less than one-third of the increase in total commercial bank liabilities. 18/ There were significant increases in other sources of funds, notably non-936 CDs which include Eurodollar borrowing. The increase in commercial and industrial loans almost exactly matched the increase in 936 deposits. One trend that did continue was a large increase in balances due from other banks, which are largely deposits in the U.S. or Eurodollar money market, although some deposits with the GDB may also be included.

The earlier pattern seems to have been reestablished in calendar year 1981. Deposits by 936 corporations grew by $1,244 million and accounted for more than half of the increase in total assets. Non-936 CDs also increased rapidly, as in 1980, presumably to compensate for the decline in demand and savings deposits. However, commercial and industrial loans increased at only about one-half the 1980 pace. Finally, there was a very large jump in balances due from other banks. In fact, the increase in these balances, largely offshore deposits, exceeded the growth in

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18/ These data, based on consolidated reports to the Puerto Rico Government Development Bank, do not include repos in CDs. Their inclusion would not change the pattern significantly because most of the increase in repos has been in the savings banks.

Table 4-8

Selected Assets and Liabilities of all Commercial Banks in Puerto Rico - year-end 1979 to year-end 1981

(Dollar amounts in millions)

(Percent change from previous year in brackets)

	Dec. 31, 1979	Dec. 31, 1980	Dec. 31, 1981
Total Assets	9,922	11,504 (15.9)	13,791 (19.9)
Balances due from other banks	1,931	2,483 (35.6)	3,885 (56.5)
Total obligations of Commonwealth of Puerto Rico and political subdivisions*	1,039	1,391 (33.9)	1,614 (16.0)
Total loans and discounts	5,454	6,056 (11.0)	6,880 (13.6)
Demand and savings deposits	2,632	2,858 (8.6)	2,749 (-3.8)
Total deposits	8,344	9,663 (15.8)	11,761 (21.7)
936 deposits	2,862	3,356 (17.3)	4,600 (37.1)
Deposits due to other banks	537	815 (51.7)	426 (-47.7)
Regular CDs	1,122	1,675 (49.3)	2,999 (79.0)
Total non-936 deposits	5,482	6,307 (15.0)	7,161 (13.5)
Commercial and industrial loans	2,297	2,762 (20.2)	3,025 (9.5)
Loans to individuals	1,320	1,404 (6.4)	1,476 (5.1)

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* This item includes assets in savings banks.

deposits by 936 corporations. This large increase of balances with other banks is consistent with information on offshore investments by Puerto Rican banks in Table 4-6.

The February 1982 regulations appear to have resulted in a somewhat more rapid growth of commercial loans. Data provided by the Government Development Bank indicate that commercial loans increased by $350 million from February to May 1982, which exceeds the increase in all of 1981.

5. The Interest Rate Differential Between 936 Deposits and Eurodollar Deposits. The analysis of the interest rate differential in the 1980 Annual Report on possessions corporations indicated that the 936 CD rate fell in relation to the Eurodollar or regular CD interest rates whenever the amount of 936 deposits rose more rapidly than eligible assets. This occurred because the costs of arbitrage increase when the amount of eligible assets rises less rapidly than the level of 936 deposits. Conversely, the costs of arbritrage are very low when there is a substantial surplus of eligible assets. For example, the 936 rate almost reached parity with Eurodollar rates in early 1979 because of the very small growth of 936 deposits in the previous year. It then fell throughout 1979 and into early 1980 because of the large increase in 936 deposits compared to the continuing moderate increase in loans.

The movement of the differential since early 1980 has generally been consistent with this pattern. As noted above, 936 CDs in commercial banks increased by $494 million in calendar year 1980, which was just over half the increase in 1979. The modest growth in 936 funds in banks, coupled with somewhat faster growth in loans and eligible assets, contributed to the narrowing differential at the end of 1980 and its virtual elimination in the spring of 1981, both of which are evident in Table 4-9. The growth in eligible assets meant that banks could place new 936 funds in offshore markets and still comply with the regulations. The increased competition for 936 funds noted above probably also played a significant role in keeping 936 interest rates high. The increased competition was in part due to the greater ability of the savings banks and smaller commercial banks to attract funds, which increased the amount of effective eligible assets in the system, i.e., the assets that could be used to bid for deposits.

Table 4-9

Comparison of Interest Rates on 936 and Eurodollar Deposits, Selected Months from January 1980-April 1982*

Month and Year	936 Rate as a Percent of Eurodollar Interest Rate
1980	
January	70
April	58
July	78
September	82
December	82
1981	
January	74
March	87
July	87
December	82
1982	
January	76
February	81
March	59
April	61

* The differential is based on the monthly average rate for 30 day deposits. It is calculated from information provided by Citibank of Puerto Rico, the Puerto Rican Treasury, and from data in World Financial Markets published by Morgan Guaranty Trust.

In calendar year 1981, 936 funds in the banking system increased more rapidly than in 1980, but eligible assets grew at an even faster rate. For purposes of this comparison, it is useful to look at recent information provided by the Puerto Rican Government on all 936 funds (including repos) and incremental eligible assets. These data, in Table 4-10, indicate that total 936 funds in the banking system grew by $1,066 million between December 1980 and December 1981. (This is broadly consistent with the growth of 936 deposits in commercial banks, shown in Table 4-8.) Total eligible assets grew even faster, by $1,426 million, despite the modest growth in the industrial and commercial loan category (shown in Table 4-8). The growth in eligible assets was large enough to absorb the inflow of 936 deposits and enable banks to continue to offer high interest rates on new deposits. As a result, the interest rate on 936 deposits remained close to the rate on Eurodollar deposits in the last 10 months of 1981.

Table 4-9 reveals the dramatic impact that the February 1982 regulations have had on the 936 interest differential. In March and April 1982, the interest paid on 936 deposits was about 60 percent of the rate on Eurodollars, which, as noted earlier, is about as far as it can fall without inducing a shift of funds to the Eurodollar market. When the differential is at this level, the after-tax return on 936 deposits and Eurodollars are approximately equal.

6. <u>The Puerto Rico Government and the Mortgage Market as Beneficiaries of 936 Funds</u>

a. <u>Commonwealth of Puerto Rico Obligations</u>. The passage of the Tax Reform Act of 1976 led to a shift in the ownership of Puerto Rican government obligations from foreign to local investors. Banks in Puerto Rico increased their holdings of Puerto Rican government obligations by more than $800 million between June 30, 1975 and December 31, 1980. Possessions corporations have also made some direct purchases of Commonwealth 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 4-11 compares, for the period 1975-1981, net interest costs on Puerto Rican public offerings and on tax-free U.S. municipals (the latter as reported in the <u>Bond Buyer</u> index on the date of each Puerto Rican public

Table 4-10

Change in Total 936 Funds and Eligible

Assets from December 1980 to December 1981

(monthly average in millions)

	December 1980	December 1981	Change
Total 936 funds	3,288	4,354	1,066
Total incremental elibible assets	4,776	6,202	1,426

Source: Puerto Rico Government Development Bank

Table 4-11

Interest Costs on Puerto Rican Bond Issues Sold
1975 - 1981

	Agency	(1) Amount	(2) Date	(3) Net Interest: Cost on P.R. Bonds	(4) Bond Buyer Index	Column 3 Less Column 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	7-18-75	9.42	6.98	2.44
	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
1980	PR Telephone Authority	50,000,000	1-24-80	8.95	7.33	1.62
	Commonwealth of Puerto Rico	300,000,000	5-7-80	9.37	7.96	1.41
	PR Public Buildings	100,000,000	8-07-80	10.31	8.59	1.72
1981	PR Telephone Authority	75,000,000	3-12-81	11.20	10.40	.80
	PR Electricity Authority	75,000,000	6-11-81	11.97	10.59	1.38
	PR Electricity Authority	100,000,000	7-30-81	12.35	11.34	1.01

Source: Government Development Bank for Puerto Rico offering). The table shows that since the enactment of the QPSII provision in 1976, there has been a moderace decline in the differential between net interest costs on Puerto Rican issues and the Bond Buyer index. The differential in the nine issues in 1979-81 was about .60 percentage points lower than in 1975 or 1976. This decline may, however, have been due largely to the widespread perception of Puerto Rico's improved financial management.

The reason for this small effect on interest costs on Puerto Rican bonds is that the QPSII provision in section 936 did not affect the relative desirablity of Puerto Rican publicly issued debt, since it was already exempt from U.S. tax. Puerto Rican debt therefore differs from the case of GNMAs discussed in the following section.

b. GNMAs -- Mortgage-Backed Securities Guaranteed by the U.S. Government. GNMAs 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., the rate of principal repayments.

Section 936 greatly increases the desirability of Puerto Rican source GNMAs from the point of view of 936 corporations because it makes their yield tax-free. Section 936 corporations are willing to take a lower return on Puerto Rican source GNMAs than on taxable U.S. obligations. Puerto Rican GNMAs now sell at a substantially higher price than U.S. GNMAs with same coupon. In June 1981, for example, Puerto Rican GNMAs sold at a four- to five-point premium over recent U.S. GNMAs with the same coupon and maturity. This implies a yield differential of about one percentage point.

This 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 savings 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 in

Puerto Rico than in the United States. According to the Government Development Bank, the interest rate on conventional mortgages in June 1981, varied from 16 to 17 percent, which seems to be close to the range in the United States.

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 1981. In the years immediately following the enactment of section 936, GNMA issues were as high as $250 million per year. In the depressed housing market of recent years, they have amounted to only about $100 million per year.

Chapter 5

CHARACTERISTICS OF POSSESSIONS CORPORATIONS AND REVENUE EFFECT OF SECTION 936

The preceding chapter assessed the impact of the possessions corporation system of taxation on real investment in Puerto Rico. This chapter describes the characteristics, by industry, of possessions corporations, their physical and financial assets, income, tax benefits, employment, and payroll. It also explains the method used in estimating section 936 tax benefits. The tax benefits provided by the possessions corporation system were $1,278 million in fiscal year 1981, and are estimated at $1,373 million in fiscal year 1982. As a result of the amendments to section 936 under the Tax Equity and Fiscal Responsibility Act of 1982 1/, the tax benefits are projected to fall to $1,352 million and $1,074 million in fiscal years 1983 and 1984, respectively. As explained in more detail below, the tax benefits are computed by applying to the qualified possession income of possessions corporations the U.S. tax rate which would have applied in the absence of section 936. 2/

I. Characteristics of Possessions Corporations

A. Assets and Income in 1980. Tables 5-1 and 5-2, based on U.S. income tax returns filed for tax year 1980 by possessions corporations, show year-end balance sheet figures, income statement data, and estimated tax benefits (or tax savings) by industry. The figures are based on all 631 corporations which had filed as 936 corporations for tax year 1980 no later than January 31, 1982. 3/ Tax year 1980

1/ See above, Chapter 2, Section I.D.

2/ This rate takes into account the investment tax credit, accelerated depreciation, and the foreign tax credit for income taxes paid to Puerto Rico.

3/ Between February and June 1982, 60 additional possessions corporations with combined net income of $360 million filed for tax year 1980. Possessions corporations included in Tables 5-1 and 5-2 below account for 90 percent of the income of all 936 corporations which filed for tax year 1980 as of June 1982.

includes accounting periods ending between July 1, 1980, and June 30, 1981. Because most possessions corporations have calendar year accounting periods, tax year 1980 corresponds closely to calendar year 1980.

1. Assets. Only physical and financial assets are directly observable from balance sheets because intangible assets, which are usually the result of R&D and sales promotion activities which have been expensed, are generally carried on the books at a zero basis. Table 5-1 shows that the total assets reported on the balance sheets of possessions corporations were $16.2 billion at year-end 1980. Seventy-five percent of the total assets was held by manufacturing companies, which benefit from total or partial exemption from Puerto Rican taxes. (Non-manufacturing firms generally do not benefit from Puerto Rican tax exemption.) Net plant and equipment of 936 manufacturing firms (shown as "net depreciable assets" on Table 5-1) amounted to $1.5 billion, of which $624 million, or 43 percent, was owned by pharmaceutical corporations. Non-pharmaceutical chemical companies accounted for an additional 16 percent of the total. Other manufacturing industries with substantial amounts of plant and equipment in Puerto Rico were food products, with 9 percent of the total, and electrical and electronic equipment, with 6 percent of the total.

Relative to corporations operating in the United States, possessions corporations have a disproportionately small share of their assets in real fixed assets. Net plant and equipment and land 4/ represented 12.4 percent of all assets held by 936 manufacturing firms. As shown in Table 4-1, the comparable ratio for manufacturing corporations in the United States was 36.6 percent. On an industry basis, 936 companies' percentage of fixed real assets to total assets was generally one-fourth to one-half the percentage for U.S. mainland firms. This difference is only slightly reduced when account is taken of Puerto Rican government-owned land and buildings which are leased to 936 corporations. 5/

4/ The value of land reported by 936 manufacturing corporations, not separately shown in Table 5-1, was $41 million.

5/ As noted in Chapter 4, Section I.D, the Commonwealth government owns land and buildings which it leases to private investors (936 firms and Puerto Rican-chartered firms). Not all of the property, valued at $346.3 million in 1980, is under lease at any given time. Assuming that three-fourths of the government-owned property was under lease to 936 firms in 1980, and treating this property as 936 fixed assets, increases the ratio of 936 fixed assets to total assets from 12.4 percent to 14.6 percent.

Table 5-1

Selected Balance Sheet Information by Industry, 1980

(Dollar amounts in thousands)

	All Industries	Manufacturing Industries							
		Manufacturing Total	Food & Kindred Products	Textile Mill Products	Apparel	Paper	Chemicals		
							Total	Pharmaceuticals	All Other
Number of corporations	631	445	18	9	82	4	86	58	28
Total Assets	16,226,607	12,098,355	892,184	109,162	353,626	9,394	6,554,995	5,611,093	943,901
Cash	2,172,229	1,967,779	270,824	965	33,242	355	1,000,100	978,185	21,914
Accounts receivable	2,833,371	2,361,249	159,323	37,495	141,389	1,262	1,118,295	752,926	365,368
Inventories	1,436,476	1,196,713	141,620	5,063	59,056	2,294	477,516	331,688	145,828
U.S. Government obligations	245,075	236,972	0	0	1,652	0	172,887	172,141	746
State and local obligations	135,289	135,289	0	511	4,316	0	106,037	74,572	31,464
Other current assets	772,481	701,342	42,205	50	3,942	2,334	382,601	361,284	21,316
Mortgage & real estate loans	1,872,775	143,013	0	0	2,733	0	37,250	37,250	0
Other investments	3,517,504	3,248,921	39,687	60,167	73,196	549	2,037,278	1,982,916	54,361
Depreciable Assets	3,565,009	2,271,196	172,246	10,136	34,737	3,394	1,318,162	818,503	499,659
Less: Accumulated depreciation	1,120,218	806,874	45,196	5,752	18,162	1,022	467,369	194,647	272,722
Net depreciable assets	2,444,790	1,464,322	127,050	4,383	16,575	2,371	850,793	623,855	226,937
Other assets	796,069	642,748	111,472	525	17,520	225	372,235	296,270	75,964
Total Liabilities and Stockholders' Equity									
Accounts payable	1,055,596	642,820	68,491	1,088	49,226	1,487	243,016	165,018	77,998
Notes payable in less than 1 year	238,371	118,233	26,409	134	1,463	0	68,537	61,615	6,921
Other current liabilities	2,178,685	289,151	57,837	819	10,423	466	137,503	129,421	8,082
Mortgages more than 1 year	668,597	214,968	24,284	36	2,846	0	141,668	140,554	1,113
Other liabilities	652,802	469,517	4,072	7	4,148	623	414,449	388,724	25,724
Capital stock	1,748,300	990,138	44,761	3,124	15,136	1,302	591,718	362,645	229,072
Retained earnings, total	9,684,250	9,373,527	666,326	103,952	270,382	5,514	4,958,102	4,363,113	594,989
Appropriated	127,766	71,863	0	0	28,357	0	298	298	0
Unappropriated	9,556,483	9,301,663	666,326	103,952	242,024	5,514	4,957,803	4,362,814	594,989

Table 5-1 - continued

	Manufacturing Industries - continued							
	Rubber Products	Leather and Leather Products	Stone, Clay, & Glass Products	Fabricated Metal Products	Machinery, Except Electrical	Electrical and Electronic Equipment	Instruments and Related Products	All Other Manufacturing
Number of corporations	8	13	6	25	12	100	34	48
Total Assets	57,079	77,635	16,447	213,877	169,719	1,932,960	334,310	1,376,962
Cash	1,244	11,965	137	55,090	18,966	463,966	22,032	88,887
Accounts receivable	11,944	26,254	3,356	36,974	29,912	274,976	85,284	434,779
Inventory	7,296	13,847	2,384	38,963	20,323	182,265	32,303	213,776
U.S. Government obligations	0	1,372	0	0	0	25,893	30,716	4,448
State and local obligations	0	9,803	0	0	4,422	8,199	0	2,000
Other current assets	231	1,969	55	12,741	7,686	143,206	9,399	94,918
Mortgage & real estate loans	0	0	0	4,559	1,185	97,284	0	0
Other investments	12,791	9,752	7,441	19,528	74,990	612,683	85,790	215,063
Depreciable assets	26,424	5,959	7,839	57,462	15,950	138,604	53,819	426,457
Less: Accumulated depreciation	4,086	3,414	5,007	16,350	4,582	53,045	14,228	168,655
Net depreciable assets	22,337	2,545	2,832	41,112	11,367	85,559	39,590	257,801
Other assets	1,232	125	239	4,907	864	38,922	29,192	65,285
Total Liabilities and Stockholders' Equity								
Accounts payable	9,142	9,160	976	32,538	5,812	85,561	22,448	113,871
Notes payable in less than 1 year	0	2,322	315	845	0	9,969	7,026	1,208
Other current liabilities	2,555	1,824	565	6,288	2,733	38,382	13,872	15,879
Mortgages more than 1 year	5,000	159	32	3,167	0	3,940	3,852	29,981
Other liabilities	6	437	10	257	8,093	26,604	8,203	2,602
Capital stock	7,497	607	2,795	8,543	4,859	43,188	16,391	250,210
Retained earnings, total	32,877	63,125	11,751	162,235	148,220	1,725,314	262,515	963,208
Appropriated	0	0	1,688	0	0	36,750	3,678	1,090
Unappropriated	32,877	63,125	10,062	162,235	148,220	1,688,564	258,837	962,118

Table 5-1 - continued

	Nonmanufacturing Industries						
	Nonmanu- facturing Total	Construction	Transportation Communications and Utilities	Wholesale Trade	Retail Trade	Finance, Insurance, Real Estate	Services and Industry Not Reported
Number of corporations	186	9	6	27	63	31	50
Total Assets	4,128,251	19,280	818,597	82,151	412,992	2,696,213	99,016
Cash	204,449	3,803	3,095	4,036	35,831	152,398	5,283
Accounts receivable	472,121	7,329	38,543	27,457	53,563	320,738	24,489
Inventory	239,762	447	23,899	18,644	109,490	81,965	5,313
U.S. Government obligations	8,103	0	0	27	0	8,076	0
State and local obligations	0	0	0	0	0	0	0
Other current assets	71,138	1,146	6,832	1,493	15,143	44,293	2,228
Mortgage & real estate loans	1,729,762	0	0	8	0	1,729,724	29
Other investments	268,583	434	7,650	1,756	27,368	226,800	4,573
Depreciable assets	1,293,812	6,450	904,695	32,465	214,923	75,044	60,233
Less: Accumulated depreciation	313,344	2,865	183,420	11,035	88,111	12,360	15,550
Net depreciable assets	980,468	3,584	721,274	21,429	126,812	62,683	44,682
Other assets	153,320	2,534	17,300	7,292	44,782	68,996	12,414
Total Liabilities and Stockholders' Equity							
Accounts payable	412,775	2,815	23,702	20,193	75,437	275,443	15,182
Notes payable in less than 1 year	120,137	286	5,629	2,534	29,556	68,478	13,652
Other current liabilities	1,889,534	2,987	43,008	6,119	55,075	1,773,487	8,856
Mortgages more than 1 year	453,629	9	111,718	670	68,901	267,583	4,745
Other liabilities	183,285	61	40	3,337	4,971	169,741	5,133
Capital stock	758,162	5,946	626,709	18,005	65,882	13,523	28,095
Retained earnings, total	310,722	7,173	7,789	31,290	113,167	127,952	23,349
Appropriated	55,902	362	6,793	0	5,521	42,404	820
Unappropriated	254,8200	6,811	995	31,290	107,645	85,547	22,529

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Table 5-1 shows that total financial assets of 936 manufacturing firms -- cash, net accounts receivables, CDs, and other financial investments 6/, were $9.4 billion. The cash assets category, which may include short-term CDs, was nearly $2 billion, or 34 percent larger than total net plant and equipment. As explained in Chapter 4, the QPSII exemption makes Puerto Rico a very advantageous location for financial investments compared to both the United States and foreign countries. The only limit on the amount of passive financial investments which a possessions corporation can make is that no more than 50 percent of its gross income can come from such investments for the three-year period immediately preceding the close of its taxable year. (This limit is reduced under the Tax Equity and Fiscal Responsibility Act to 45 percent for tax years beginning in 1983, 40 percent for tax years beginning in 1984, and 35 percent thereafter.)

In principle, the distinction between financial investment and physical (or real) investment should not be important. By providing the funds that permit businesses and individuals to purchase plant and equipment, build homes, and hold inventories, financial investments lead to real investments. However, the data presented in Chapter 4 suggest that 936 financial investments in the Puerto Rican capital market have made only a small contribution to the financing of physical investment in Puerto Rico. At least through 1981, the large inflows of 936 funds tended to flow out again through the banking system or to result in shifts in the ownership of Puerto Rican government debt and investment abroad by Puerto Rican government corporations.

2. Retained Earnings. Table 5-1 also shows the incentive for 936 manufacturing companies to retain earnings. At the end of tax year 1980, these companies listed $9.4 billion of retained earnings on their balance sheets. Forty-seven percent of these retained earnings, or $4.4 billion, were held by pharmaceuticals. Slightly less than one-fifth of the retained earnings, or $1.7 billion, were held by the electrical and electronics industry. Retained earnings represented 77 percent of total liabilities and stockholders' equity of 936 manufacturing corporations. The comparable figure for all U.S. manufacturing corporations in 1979 (the latest year in which complete U.S. tax return information is available) was 29.1

6/ See Table 4-4A for the composition of these financial investments.

percent. 7/ The high level of 936 retained earnings is a response to limited opportunities under the Internal Revenue Code for tax-free, financial investment and to Puerto Rico's tollgate tax on repatriated profits. As explained in Chapter 2, the rate of tollgate tax is reduced from 10 percent to 4 or 5 percent if a company operating in Puerto Rico meets certain reinvestment conditions.

3. Total Receipts. Table 5-2 shows that total receipts of 936 manufacturing corporations were \$9.6 billion, of which \$9.1 billion was attributable to business receipts. Most of the remainder, or \$0.4 billion, was attributable to interest on nongovernment securities, such as 936 CDs in Puerto Rican banks. 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 5-2. The amount of such exempt interest income reported by all 936 firms for tax year 1980 was \$25 million.

The pharmaceutical industry accounted for 29 percent of the business receipts of all 936 manufacturing companies. After pharmaceuticals, the manufacturing industries with the greatest business receipts were electrical and electronic equipment, chemicals other than pharmaceuticals, and food products.

7/ Data for all U.S. corporations are from Internal Revenue Service, Source Book, Statistics of Income, 1979: Corporation Income Tax Returns, 1981. 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 the sample of U.S. corporations were distributed among industries, as defined by two digits of the Standard Industrial Classification Code, in the same manner as are the assets of 936 corporations. The U.S. ratio of retained earnings to total liabilities and stockholders' equity was then multiplied by those industry asset figures to obtain an industry-mix-corrected amount of retained earnings. Taking the ratio of this industry-mix-corrected amount to total liabilities and stockholders' equity of U.S. manufacturing firms gives 31.4 as the percentage of retained earnings to total liabilities and stockholders' equity.

Table 5-2

Selected Income Statement Information and Tax Benefits by Industry, 1980

(Dollar amounts in thousands)

	All Industries	Manufacturing Industries							
		Total	Food & Kindred Products	Textile Mill Products	Apparel	Paper	Chemicals		
							Total	Pharmaceuticals	All Other
Number of corporations	631	445	18	9	82	4	86	58	28
Total receipts	11,575,860	9,573,482	825,515	49,652	434,426	17,210	3,757,136	2,882,484	874,652
Business receipts	10,798,879	9,074,605	789,008	46,688	420,891	17,129	3,489,801	2,625,111	864,690
Nongovernment interest	590,105	413,381	25,205	2,893	7,468	6	229,752	220,432	9,410
Other receipts	186,875	85,494	11,301	70	6,066	74	37,582	37,030	552
Total deductions	8,431,990	6,607,958	644,506	36,355	351,620	15,975	2,149,724	1,449,325	700,398
Cost of sales	6,422,525	5,347,310	543,463	29,860	323,302	15,101	1,424,757	823,196	601,560
Depreciation	190,338	111,835	7,412	683	1,919	186	62,782	43,305	19,476
All other deductions	1,819,125	1,148,812	93,631	5,811	26,398	686	662,185	582,823	79,361
Estimated net income per return	3,143,872	2,965,523	181,008	13,297	82,806	1,235	1,607,412	1,433,158	174,253
Estimated net income per books	2,794,924	2,692,332	187,960	12,797	76,608	1,050	1,432,578	1,274,596	157,982
Reduction in U.S. tax liability	1,244,536	1,244,536	69,372	5,602	36,865	524	663,827	590,708	73,118
Distributions	1,284,500	1,215,380	160,319	86	5,981	150	798,753	758,468	40,284

Table 5-2 - continued

	Manufacturing Industries - continued							
	Rubber Products	Leather and Leather Products	Stone, Clay and Glass Products	Fabricated Metal Products	Machinery, Except Electrical	Electrical and Electronic Equipment	Instruments and Related Products	All Other Manufacturing
Number of corporations	8	13	6	25	12	100	34	48
Total receipts	49,221	103,406	17,735	171,705	143,602	1,370,682	263,662	2,369,524
Business receipts	46,389	101,560	16,482	165,414	137,000	1,273,810	253,232	2,317,197
Nongovernment interest	1,054	1,090	27	5,422	5,833	88,305	9,893	36,426
Other receipts	1,777	755	1,226	868	768	8,566	536	15,899
Total deductions	31,136	93,005	13,978	133,160	102,109	853,763	152,867	2,029,756
Cost of sales	25,682	83,505	10,857	112,821	88,399	725,840	115,379	1,848,339
Depreciation	1,202	346	668	3,686	1,429	11,082	4,316	16,119
All other deductions	4,251	9,153	2,452	16,652	12,280	116,840	33,171	165,297
Estimated net income per return	18,085	10,401	3,757	38,544	41,493	516,918	110,794	339,767
Estimated net income per books	18,011	10,493	3,025	37,364	42,079	507,358	96,038	266,965
Reduction in U.S. tax liability	7,993	4,851	1,583	17,674	18,025	229,528	48,054	140,633
Distributions	1,748	760	90	1,472	10,983	44,233	36,519	154,280

Table 5-2 - continued

	Non-Manu-facturing	Construction	Transportation Communications and Utilities	Wholesale Trade	Retail Trade	Finance, Insurance, Real Estate	Services and Industry Not Reported
		Nonmanufacturing Industries					
Number of corporations	186	9	6	27	63	31	50
Total Receipts	2,002,378	75,147	253,117	216,084	1,115,486	224,345	118,196
Business receipts	1,724,274	74,132	251,272	213,819	1,055,964	21,416	107,668
Nongovernment interest	176,723	23	585	693	2,118	172,851	453
Other receipts	101,380	991	1,260	1,571	57,404	30,078	10,074
Total Deductions	1,824,031	40,734	198,672	186,523	1,068,898	220,821	108,379
Cost of sales	1,075,214	25,615	94,712	139,383	743,899	147	71,456
Depreciation	78,503	582	56,145	1,274	13,260	3,232	4,007
All other deductions	670,313	14,537	47,815	45,865	311,737	217,440	32,915
Estimated net income per return	178,349	34,415	54,444	29,560	46,587	3,523	9,816
Estimated net income per books	102,592	565	54,126	27,292	12,255	1,298	7,054
Reduction in U.S. tax liability	0	0	0	0	0	0	0
Distributions	69,120	825	53,79	14,115	6	226	156

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4. Net Income per Tax Return. Net income per return (total receipts minus total deductions on Table 5-2, or taxable income on the U.S. corporation income tax return) amounted to almost $3.0 billion for all 936 manufacturing corporations. The industry with the greatest amount of net income was pharmaceuticals, with 48 percent of the total. The electrical and electronic equipment industry accounted for 17 percent of the combined net income of 936 manufacturing firms, and food products and chemicals other than pharmaceuticals each accounted for 6 percent of the total.

5. Reduction in U.S. Tax Liability. Table 5-2 shows that U.S. tax liabilities were reduced by $1,245 million in tax year 1980 by the possessions corporation system. The reduction in Federal tax liabilities under section 936 was estimated by applying to possessions corporations in manufacturing the same U.S. tax rules which applied to corporations operating within the United States in 1980, and then subtracting income and tollgate taxes paid by 936 corporations to Puerto Rico. Possessions corporations in non-manufacturing industries were assumed to pay an effective rate of income tax to Puerto Rico at least equal to the U.S. rate, and thus they did not give rise to any Federal revenue loss. The pharmaceutical industry accounted for 47 percent of the total Federal tax savings provided under section 936. Eighteen percent of the tax savings was attributable to the electrical and electronic equipment industry.

6. Distributions. The final line in Table 5-2 shows that 936 manufacturing corporations reported $1,215 million of distributions, which was 41 percent of their net income in tax year 1980. This represented an increase over the 1979 level of distributions, which was $899 million, or one-third of net income. Fifty-five percent of total distributions by manufacturing corporations in these two years was attributable to the pharmaceutical industry.

B. Payroll and Employment in 1980. In enacting section 936 in 1976, Congress sought to assist Puerto Rico in obtaining employment-producing investments. Matching 936 corporations' U.S. income tax returns with payroll and employment data from the companies' Federal unemployment insurance tax returns provides one indication of the extent to which this objective has been attained. Table 5-3 presents, by industry, 936 tax benefits per employee and as a percent of labor compensation. The actual tax benefits received by a possessions corporation depend, of course, on

Table 5-3

Tax Benefits, Employment, and Compensation of Employees by Industry, 1980

	Number of Corporations	Qualified Possession Net Income ($000) 1/	Tax Benefits: Amount ($000)	Tax Benefits: Percent of Total	Employees: Number	Employees: Percent of Total	Compensation of Employees 2/: Amount ($000)	Compensation of Employees 2/: Percent of Total	Tax Benefits per Employee ($)	Average Employee Compensation ($)	Tax Benefits as a Percent of Compensation of Employees
All Manufacturing Industries	282	2,234,383	961,693	100.0	54,202	100.0	645,948	100.0	17,186 3/	11,915 3/	144.2 3/
Food and kindred products	10	85,983	33,174	3.4	5,355	9.9	57,794	8.9	6,194	10,792	57.4
Textile mill products	6	5,594	2,687	*	507	.9	4,832	.7	5,299	9,530	55.6
Apparel	52	70,906	32,809	3.4	11,361	21.0	97,084	15.0	2,887	8,545	33.8
Men's and boys'	14	29,233	13,346	1.4	3,952	7.3	34,667	5.4	3,377	8,772	38.5
Women's and children's	32	37,635	17,707	1.8	6,433	11.9	54,410	8.4	2,752	8,457	32.5
Hats, caps, etc.	3	2,212	939	*	439	.8	3,447	.5	2,138	7,851	27.2
All other	3	1,828	817	*	537	1.0	4,560	.7	1,521	8,491	17.9
Chemicals	52	1,234,178	523,260	54.4	10,347	19.1	174,172	27.0	50,571	16,833	300.4
Industrial chemicals, plastics	7	105,705	44,471	4.6	1,863	3.4	42,780	6.6	23,870	22,962	104.0
Pharmaceuticals	34	1,092,059	462,664	48.1	7,876	14.5	123,217	19.1	58,743	15,644	375.5
Soaps, cleaners, etc.	4	31,300	13,828	1.4	413	.8	5,062	.8	33,481	12,256	273.2
All other	7	5,114	2,297	*	195	*	3,113	.5	11,779	15,964	73.8
Rubber and plastics	6	15,376	6,830	.7	528	1.0	6,410	1.0	12,935	12,140	106.6
Leather	8	10,957	4,777	.5	2,412	4.5	21,402	3.3	1,980	8,873	22.3
Footwear	5	8,189	3,674	*	2,154	4.0	19,136	3.0	1,705	8,883	19.2
All other	3	2,408	1,103	*	258	.5	2,266	*	4,275	8,782	48.7
Stone, clay, and glass	3	1,580	621	*	79	.1	1,786	*	7,860	22,607	34.8
Fabricated metal products	17	27,033	12,584	1.3	1,335	2.5	18,295	2.8	9,426	13,704	68.8
Metal cans and containers	5	6,040	2,800	*	579	1.1	9,076	1.4	4,835	15,675	30.9
Cutlery, hand tools, screws, bolts	3	9,270	4,236	*	251	.5	2,382	.4	16,876	9,490	177.8
All other	9	11,723	5,548	.6	505	.9	6,837	1.1	10,986	13,538	81.1
Machinery, except electrical	5	29,998	13,207	1.4	785	1.4	9,809	1.5	16,824	12,495	134.6
Electrical and electronic equipment	74	411,569	185,959	19.3	12,712	23.5	142,844	22.1	14,628	11,236	130.2
Radio, TV, communication	7	58,245	26,112	2.7	1,893	3.5	19,844	3.1	13,793	10,482	131.6
Electronic components	19	69,438	31,086	3.2	3,012	5.6	31,108	4.8	10,320	10,328	99.9
All other	48	283,886	128,761	13.4	7,807	14.4	91,892	14.2	16,493	11,770	140.1
Transportation equipment	5	13,568	6,116	.6	761	1.4	8,423	1.3	8,036	11,068	72.6
Instruments and related products	23	77,246	33,376	3.5	2,759	5.1	31,263	4.8	12,097	11,331	106.8
Scientific instruments	6	6,109	3,153	*	158	.3	1,718	*	19.955	10,873	183.5
All other	17	71,137	30,223	3.1	2,601	4.8	29,545	4.6	11,619	11,359	102.3
All other manufacturing 4/	21	250,755	106,293	11.1	5,261	9.7	71,834	11.1	20,203	13,654	148.0

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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 1.232 times payroll. The 23.2 percent reflects the employer-paid portion of Social Security, unemployment insurance, and other non-payroll costs. The 23.2 percent is the average for all U.S. manufacturing industries in 1980. Source: Unpublished estimates of the U.S. Department of Commerce.

3/ Compensation of employees and number of employees used to compute these amounts were weighted, by industry, by using the ratio of income in Table 5-2 and income in this Table. The unweighted figures are the following: tax benefits per employee, $17,742; tax benefits as a percent of compensation, 148.9%; average employee compensation, $11,917.

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

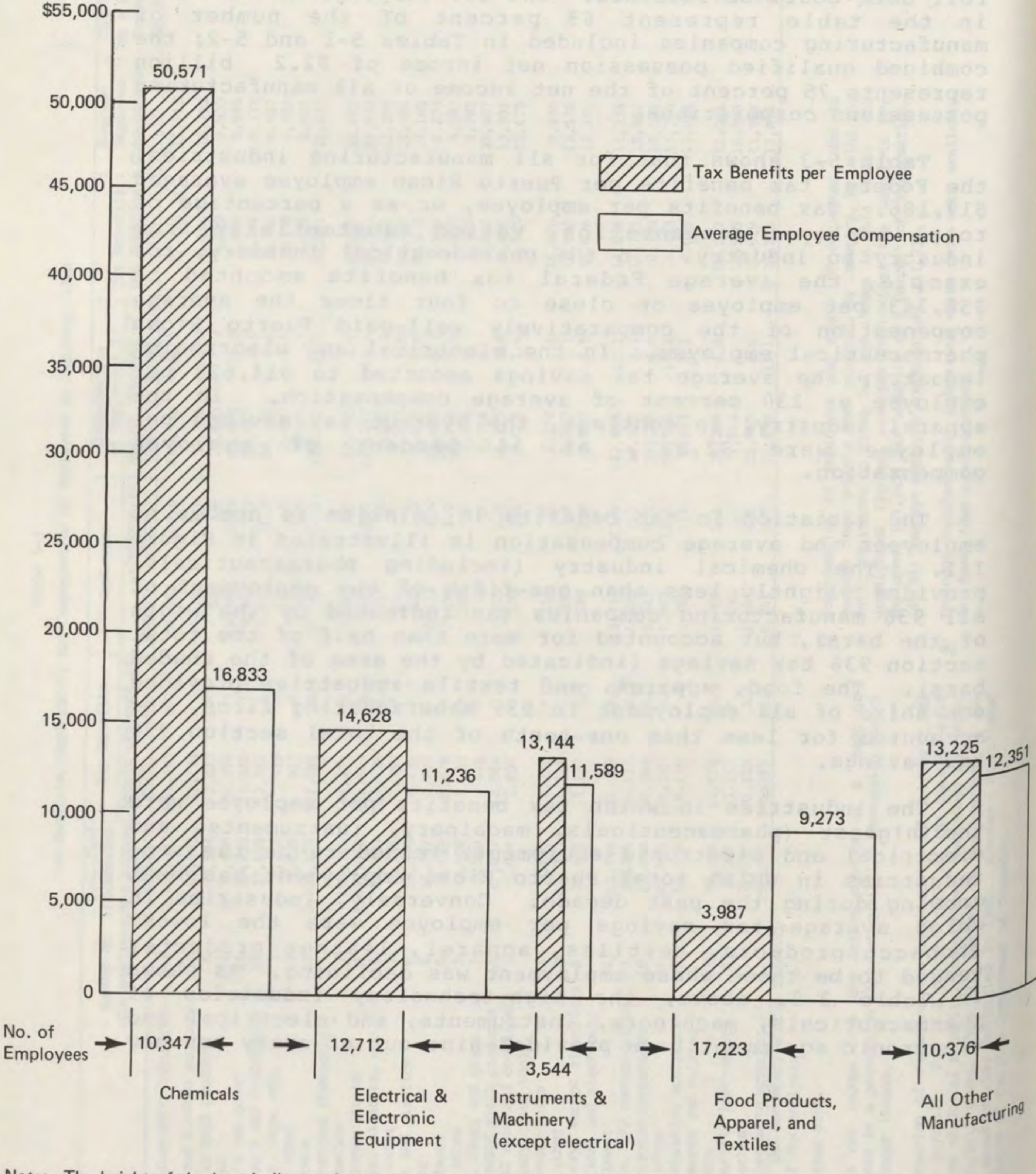
the amount of income which it earns, not on the number of workers it employs. Table 5-3 is based on all 936 firms in the manufacturing sector for which 1980 employment and payroll data could be obtained. The 282 corporations included in the table represent 63 percent of the number of manufacturing companies included in Tables 5-1 and 5-2; the combined qualified possession net income of $2.2 billion represents 75 percent of the net income of all manufacturing possessions corporations.

Table 5-3 shows that for all manufacturing industries, the Federal tax benefits per Puerto Rican employee averaged $17,186. Tax benefits per employee, or as a percentage of total employee compensation, varied substantially from industry to industry. In the pharmaceutical industry, for example, the average Federal tax benefits amounted to $58,743 per employee or close to four times the average compensation of the comparatively well-paid Puerto Rican pharmaceutical employee. In the electrical and electronics industry, the average tax savings amounted to $14,628 per employee or 130 percent of average compensation. In the apparel industry, in contrast, the average tax savings per employee were $2,887, or 34 percent of employee compensation.

The variation in tax benefits in relation to number of employees and average compensation is illustrated in Figure III. The chemical industry (including pharmaceuticals) provided slightly less than one-fifth of the employment of all 936 manufacturing companies (as indicated by the width of the bars), but accounted for more than half of the total section 936 tax savings (indicated by the area of the shaded bars). The food, apparel, and textile industries provided one-third of all employment in 936 manufacturing firms, and accounted for less than one-tenth of the total section 936 tax savings.

The industries in which tax benefits per employee were the highest (pharmaceuticals, machinery, instruments, and electrical and electronic equipment) tended to be the same industries in which total Puerto Rican employment has been growing during the past decade. Conversely, industries in which average tax savings per employee were the lowest (tobacco products, textiles, apparel, leather products) tended to be those whose employment was declining. As shown in Table 3-8, above, the high-technology industries of pharmaceuticals, machinery, instruments, and electrical and electronic equipment have provided nine out of every ten new

FIGURE III
Tax Benefits Per Employee and Average Employee Compensation, Selected Manufacturing Industry Groups, 1980



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

jobs in those Puerto Rican manufacturing industries which have experienced an increase in employment since 1968. In 1980, these industries accounted for 36 percent of total employment in Puerto Rico's manufacturing sector.

Table 5-3A is based on the same 282 possessions corporations shown in Table 5-3, but ranked according to the Federal tax benefits per employee. At the top of the ranking are 10 companies for which the U.S. tax benefits represented more than $100,000 per employee in Puerto Rico. At the low end are the companies which incurred losses and thus derived no immediate tax benefit from section 936. The top 10 possessions corporations accounted for 24.5 percent of the tax benefits but provided only 2.6 percent of the employment of the 282 manufacturing companies. The top 32 possessions corporations, those for which tax savings per employee equalled or exceeded $50,000 in 1980, collectively accounted for 48.2 percent of the total tax benefits and 8.2 percent of total employment.

C. Summary Data for 1973-1980. Table 5-4 presents data for the period 1973-1980 on the number of possessions corporations, their net income, estimated tax benefits, and tax benefits in relation to payroll and employment. The table reveals a number of trends:

- After declining from 399 to 374 between 1974 and 1978, the number of possessions corporations in manufacturing increased to 445 firms by 1980. One-fourth of the new firms were in the electrical and electronics industry.

- Net income of manufacturing possessions corporations rose from $813 million in 1974, to almost $3 billion in 1980. In real terms, this represented an increase of 141 percent. The percentage of the total net income earned by the pharmaceutical industry stood at approximately 50 percent throughout this period, while the share of the electrical and electronics industry varied between 15 percent and 20 percent.

- As the net income of possessions corporations has grown, the tax benefits of possessions corporations have increased roughly in proportion, from $397 million in tax year 1974, to $1,245 million in tax year 1980.

Table 5-3A

Tax Benefits, Employment, and Compensation of Employees by Size of Tax Benefits Per Employee, 1980

	Number of Returns	Qualified Possession Net Income ($000) 1/	Tax Benefits		Employees		Total Compensation of Employees 2/		Tax Benefits per Employee ($)	Average Employee Compensation ($)	Tax Benefits as a Percent of Compensation of Employees
			Amount ($000)	Percent of Total	Number	Percent of Total	Amount ($000)	Percent of Total			
All Manufacturing Corporations	282	2,234,383	961,693	100.0	54,202	100.0	645,948	100.0	17,186 3/	11,915 3/	144.2 3/
$100,000 or more	10	553,228	235,411	24.5	1,399	2.6	28,151	4.4	168,270	20,122	836.2
$ 50,000 under $100,000	22	518,967	227,853	23.7	3,061	5.6	47,995	7.4	74,437	15,679	474.7
$ 10,000 under $ 50,000	96	863,061	370,892	38.6	16,798	31.0	241,154	37.3	22,079	14,356	153.8
$ 5,000 under $ 10,000	40	152,758	64,670	6.7	9,014	16.6	100,983	15.6	7,174	11,202	64.0
$ 1,000 under $ 5,000	78	147,600	61,848	6.4	19,687	36.3	186,452	28.9	3,141	9,470	33.2
$ 500 under $ 1,000	10	1,125	445	*	626	1.2	7,020	1.1	710	11,214	6.3
$ 1 under $ 500	10	1,385	574	*	1,633	3.0	14,167	2.2	352	8,675	4.1
No tax benefits	16	-3,726	0	0	1,984	3.7	20,026	3.1	0	10,093	0

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* Less than 0.1 percent.

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 1.232 times payroll. The 23.2 percent reflects the employer-paid portion of social security, unemployment insurance, and other non-payroll costs. The 23.2 percent is the average for all U.S. manufacturing industries in 1980.

3/ Compensation of employees and number of employees used to compute these amounts were weighted, by industry, by using the ratio of income in Table 5-2 to income in Table 5-3.

Table 5-4

Summary Data on Possessions Corporations, 1973-1980

	1974	1975	1976	1977	1978	1979	1980 P/
Number of corporations, all industries	596	595	528	519	637	672	631
Manufacturing industries	399	394	395	385	460	502	445
Pharmaceuticals	44	47	52	53	58	65	58
Electrical and electronic equipment	76	76	81	80	90	112	100
All other manufacturing	279	271	262	252	312	325	287
Nonmanufacturing industries	197	201	133	134	177	170	186
Net income, all industries ($000)	852,058	1,108,881	1,627,213	1,800,313	2,484,572	3,088,304	3,152,766
Manufacturing industries	813,057	1,055,060	1,551,677	1,714,321	2,361,446	2,798,156	2,965,523
Pharmaceuticals	405,355	547,060	779,954	876,576	1,053,252	1,325,309	1,433,158
Electrical and electronic equipment	167,389	195,593	323,249	231,475	417,629	543,195	516,918
All other manufacturing	240,313	312,407	448,474	606,270	890,565	929,652	1,015,447
Nonmanufacturing industries	39,002	54,059	75,536	85,992	123,126	290,148	187,243
Estimated tax benefits ($000) 1/							
Manufacturing industries	397,021	478,367	698,839	771,444	998,120	1,167,529	1,244,535
Pharmaceuticals	181,508	245,486	350,941	394,459	438,695	552,020	590,708
Electrical and electronic equipment	75,231	89,106	145,575	104,164	184,501	219,771	229,528
All other manufacturing	140,282	143,819	202,322	272,821	374,924	395,738	424,299
Tax benefits per employee ($)							
Manufacturing industries 2/	6,310	8,512	11,454	11,217	14,250	15,690	17,186
Pharmaceuticals	38,129	39,031	47,166	39,337	48,669	51,417	58,743
Electrical and electronic equipment	6,237	9,488	10,816	11,315	11,988	15,439	14,628
All other manufacturing	3,479	3,987	5,300	4,432	9,639	8,415	9,314
Tax benefits as a percent of compensation of employees							
Manufacturing industries 2/	91.7	116.1	143.3	135.9	133.2	135.4	144.2
Pharmaceuticals	425.5	389.1	428.1	327.5	357.3	343.8	375.5
Electrical and electronic equipment	93.5	126.0	129.2	126.6	122.6	138.9	130.2
All other manufacturing	52.7	55.8	72.3	62.2	94.6	77.7	82.4

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P/ Preliminary. As noted on page 101, figures for 1980 are based on corporations which filed as possessions corporations for tax year 1980 no later than January 31, 1982, that is, within 7 months of the end of the tax year. Figures for years prior to 1980 have been revised to include corporations which filed as possessions corporation within 12 months of the end of of the tax year.

1/ The estimated tax benefits shown here differ from the corresponding years shown in Table 5-5 because that table is based on calendar and Federal fiscal years, whereas the data above are based on the taxable years of possessions corporations, as explained in pages 101-102.

2/ These figures are weighted averages based on only those returns for which employment and compensation of employees were available. See Table 5-3 for details.

- U.S. tax savings under the possessions corporation provisions in relation to the number of employees in 936 companies rose from $6,310 per employee in 1974, to $17,186 per employee in 1980. This increase reflects the fact that the tax-exempt income of possessions corporations grew more than twice as fast as employment in this period.

- While tax benefits per employee have increased rapidly, compensation per employee in 936 companies has also increased (from $6,973 in 1974 to $11,915 in 1980). Total U.S. tax benefits under the possessions corporation provisions have stood at about 138 percent of 936 employee compensation since 1976.

II. Estimates of Linkages

The preceding sections related the tax benefits of the possessions corporation system of taxation to the employment and payroll of 936 companies. In addition to creating jobs directly, the industry development encouraged by 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 linkages." Manufacturing also gives rise to "backward (supplier) linkages." Production requires raw materials, intermediate goods, and services, a portion of which are supplied by the local economy; and investment in plant in Puerto Rico creates jobs in the construction industry.

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 1977. Table 5-5 shows the percentages of manufacturing industries' shipments in 1977 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, 33.4 percent of direct shipments went to Puerto Rico, 59.2 percent to buyers (including parent companies) in the United States, and 7.4 percent to foreign purchasers. If indirect shipments outside of Puerto Rico (i.e., goods sold to other Puerto Rican manufacturers who, in turn, sold them to the United States or foreign countries) could be estimated separately, Puerto Rico's sales to the U.S. and foreign markets would appear larger than Table 5-5 indicates.

Table 5-5 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 chemical industry and electrical and electronic equipment industry sold 9.2 percent and 7.3 percent respectively, of their total production to Puerto Rican buyers. These two industries, together with the consumer good industries, apparel and food products, account for two-thirds of the business receipts of all 936 manufacturing firms. The evidence of Table 5-5 would therefore suggest that possessioins corporations are not generally an important stimulant to the development of "downstream" industries.

B. Backward Linkages

Backward linkages refer to the generation of income and employment in "upstream" (supplier) industries as a result of an industry's purchases of local goods and services. The 1978 Annual Report on possessions corporations estimated that in most Puerto Rican manufacturing industries, one-third to one-half of all materials were purchased from Puerto Rican sources. The usefulness of this data is limited, however, because it is based on import coefficients for 1963 and because it does not distinguish between purchases of materials from 936 manufacturing companies (whose investment and employment are included in Tables 5-1 to 5-3 as direct benefits to Puerto Rico) and all other companies.

The Puerto Rican government views the electronics industry as the centerpiece for a growing locally-owned electronics and metal products industry. There is evidence

Table 5-5

Destination of Shipments by Puerto Rican
Manufacturing Industries, 1977
(Percentage of total)

Industry Group	Puerto Rico	United States 1/	Foreign Countries
All Manufacturing Industries	33.4	59.2	7.4
Food and kindred products	55.1	39.2	5.8
Tobacco products	45.3	54.7	*
Textile mill products	27.8	72.2	*
Apparel	18.6	76.3	*
Lumber and wood products	100.0	-	-
Furniture and fixtures	87.1	12.2	*
Paper and allied products	87.6	4.0	8.2
Printing and publishing	53.8	44.4	1.7
Chemicals	9.2	74.2	16.6
Drugs	1.6	71.2	27.2
Petroleum refining	68.9	28.7	2.4
Rubber products	20.0	79.8	.5
Leather and leather products	2.5	97.2	.1
Stone, clay and glass products	83.8	15.3	.8
Primary metal industries	49.1	34.0	16.9
Fabricated metal products	76.5	20.9	2.5
Machinery except electrical	27.8	71.7	.5
Electrical and electronic equipment	7.3	84.8	.8
Transportation equipment	9.1	84.6	6.2
Instruments and related products	.4	95.4	4.1
Miscellaneous manufacturing industries	3.4	95.2	1.1

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Source: U.S. Department of Commerce, 1977 Economic Censuses of Outlying Areas, Manufactures, Puerto Rico, November 1980, Chapter 2, Table 3.

1/ Figures for shipments to the United States represent direct exports by Puerto Rican manufacturing establishments to the United States and the U.S. Virgin Islands.

* Less than 0.05 percent.

that some locally owned firms are currently supplying materials to 936 electronics firms. In addition, a substantial service sector in Puerto Rico provides banking, transportation, and utilities to 936 manufacturing firms. Employment in these "supplier" industries is not included in employment figures reported in Table 5-3, above.

III. Revenue Impact of Section 936

A. Projections and Estimating Procedure

Table 5-6 presents the estimated U.S. tax benefits provided by the possessions corporation system on the basis of fiscal and calendar years 1973-1980, and projected tax benefits for 1981-1988. Adjusting the income of possessions corporations to a fiscal year basis requires apportioning the income reported on all possessions corporatons' returns filed for tax years which overlap the fiscal year. This results in an estimate of $1,195 million in tax benefits under section 936 for fiscal year 1980.

For accounting periods beginning after December 31, 1982, possessions corporations are subject to the provisions of TEFRA. As explained in Chapter 2, TEFRA provides that only certain income from intangibles developed by a U.S. corporation may be allocated to an affiliated possessions corporation. The remainder of the income from such intangibles must be allocated to the U.S. parent and be subject to U.S. tax. It is estimated that the intangibles income provision in TEFRA will reduce the tax benefits under section 936 by about 30 percent in 1984 and subsequent years (see column (3)). The estimated revenue effect of TEFRA is based on the assumption that, absent TEFRA, some U.S. mainland corporations would continue to transfer to 936 subsidiaries title to patents, trademarks, and other intangibles and to claim the benefits of tax exemption on the income attributable to such intangibles.

In addition to providing rules relating to income from intangibles, TEFRA reduces the amount of passive investment income which a corporation can receive if it wishes to qualify for the possessions tax credit. Under current law, a possessions corporation may receive up to 50 percent of its gross income in passive investment income. This will be reduced to 45 percent for tax years beginning in 1983, 40 percent for tax years beginning in 1984, and 35 percent thereafter. These reductions will affect only those corporations which currently earn passive income in amounts

Table 5-6

Federal Revenue Cost Estimates and Projections, Possessions Corporation Provisions, 1973-1988

(millions of dollars)

Year	Fiscal Year Receipts Forgone				Reduction in Calendar Year Tax Liability 2/
		TEFRA Cost Reductions			
	Pre-TEFRA 1/	Intangibles Income Provisions	Passive Income Limitation	Post-TEFRA	
1973	254				269
1974	325				393
1975	429				473
1976	572				692
1977	724				763
1978	864				988
1979	1,121				1,156
1980	1,195				1,233
1981	1,278				1,323
1982	1,373				1,424
1983	1,479	112	15	1,352	1,165
1984	1,566	471	21	1,074	1,091
1985	1,666	501	30	1,135	1,177
1986	1,825	549	37	1,239	1,300
1987	2,026	610	43	1,373	1,446
1988	2,251	678	50	1,523	1,601

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1/ Estimates for 1973 through 1975 are based on the original possessions corporation provisions enacted in the Revenue Act of 1921. Estimates for 1976 and all subsequent years are based on the section 936 provisions of the Tax Reform Act of 1976.

2/ Estimates for 1973 through 1982 are computed on the same basis as described in footnote 1. Estimates for 1983 and subsequent years are based on the amendments to section 936 in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

Source: The 1973 through 1975 figures are based on book income data taken primarily from 936 election forms filed for 1976 (Form 5712). The 1976 and 1977 estimates are based on net income data taken primarily from Federal income tax forms (Form 1120). The figures for 1978-1980 are based on qualified possession taxable income taken from possessions credit computation forms (Form 5735). Figures for 1981 and subsequent years are projections which reflect an assumed 10 percent annual growth in qualified possession taxable income.

close to the current limit. Because the passive investment income earned by most possessions corporations is well below 50 percent of their gross income (the passive income of all 936 manufacturing companies represented approximately 15 percent of their combined gross income in 1980 8/), the revenue effect of the new passive income limitation under TEFRA is expected to be relatively small. Column (4) of the table shows that the new passive income limitation is projected to reduce section 936 tax benefits by $15 million in fiscal year 1983, and by $50 million in 1988.

In past Annual Reports on possessions corporations, the U.S. tax benefits under section 936 were estimated by applying the average effective U.S. corporate tax rate to the qualified possession income of 936 corporations (except those in nonmanu- facturing industries) 9/ and then

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8/ A rough measure of income from financial assets in 1980 may be obtained by summing the nongovernment interest ($413.4 million) and the government interest ($25 million) reported by possessions manufacturing corporations in tax year 1980. The total of $438 million in gross interest income represented 14.8 percent of the net income of 936 manufacturing corporations. This estimate does not take into account the overhead or other expenses of earning financial income, nor does it take into account non-interest income on financial investments. The proportion of financial income in total 936 income is estimated to rise after 1980 because of the rise in interest rates and the reinvestment of interest income.

9/ It is assumed that 936 companies in nonmanufacturing industries do not qualify for a Puerto Rican tax exemption grant and that the taxes which they pay 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 income of 936 firms in these industries was negligible in 1980. Moreover, a sample of the 1978 Puerto Rican tax returns filed by 936 firms in all nonmanufacturing industries suggests that the average effective Puerto Rican tax rate for such companies was roughly 40 percent.

subtracting income and tollgate taxes paid to Puerto Rico. The Treasury used 40 percent as the effective U.S. tax rate for years through 1978, and 38 percent as the effective U.S. tax rate for later years. These figures were based on the average effective tax rate paid by U.S. corporations. 10/ Use of the average effective U.S. tax rate to estimate the tax benefits of the possessions corporation system implicitly assumes that the amount of 936 assets which, in the absence of the possessions corporation provisions, would have been eligible for accelerated depreciation and the investment tax credit, bears the same relationship to 936 income as eligible U.S. assets bear to the income of U.S. corporations as a whole. Since 936 corporations have only one-eighth as much property, plant, and equipment in relation to their income as do corporations operating in the United States, such an assumption results in an underestimate of the revenue impact of section 936. 11/

Accordingly, this Report does not apply the average U.S. effective tax rate to the qualified income of possession corporations. Instead, it estimates the 936 tax benefits by (1) subtracting from the qualified income of possession corporations the additional depreciation deductions which these corporations would have enjoyed had they been eligible for the accelerated cost recovery system, and (2) applying the U.S. statutory tax rate to the adjusted qualified income. The revenue estimate which is thereby obtained is then reduced by the amount of the investment tax credit which would have been available had the corporations been operating in the United States, and by the tollgate and income taxes paid to Puerto Rico. 12/

The $1,245 million estimated revenue impact of section 936 in tax year 1980 (shown in Table 5-2) is less than the 936 credits claimed by manufacturing firms in that period

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10/ See Department of the Treasury, Effective Income Tax Rates Paid by U.S. Corporations in 1972, May 1978.

11/ At the end of tax year 1980, possessions corporations' net property, plant, and equipment was equal to 51 percent of their net income per return. For U.S. mainland corporations, net property, plant and equipment was equal to 419 percent of their before-tax income. See Tables 5-1 and 5-2 and Federal Trade Commission, Quarterly Financial Report, First Quarter 1981, 1982.

12/ In 1980, Puerto Rican tollgate and income taxes on possessions corporations in manufacturing were approximately 3.5 percent of their qualified possession source net income. See Chapter 6.

($1,404 million), because the credit is based on tax liability computed without regard to accelerated depreciation, the investment tax credit, and the foreign tax credit.

Whether the elimination of the possessions corporation exemption would result in a gain to the U.S. Treasury of the tax benefits provided under section 936 depends on the tax-saving alternatives available to possessions corporations and on the induced effect on the aggregate level of investment by U.S. persons. This is the subject of the remainder of this chapter.

B. Alternative Tax-saving Routes

1. Physical Assets. As explained in Chapter 4, the tax-saving alternatives to investment through a 936 firm differ significantly for physical assets, financial assets, and intangible assets. Table 5-7 shows for selected manufacturing industries the effective U.S. tax rates on income from new plant and equipment under law in effect in the period 1979-81, during 1981-82, and after 1982. The accelerated cost recovery schedule and the safe harbor leasing rules enacted in ERTA reduced the effective tax rate on plant and equipment in the industries shown by roughly one-half. TEFRA retained ERTA's cost recovery schedule applicable to depreciable property placed in service in 1981 or 1982, but tightened the leasing provisions and reduced the basis of depreciable property by one-half of the amount of the investment tax credit. The effect of TEFRA will be to increase the U.S. effective tax rate for years after 1982 by 6-10 percentage points in the industries shown.

To obtain the benefit of 100 percent U.S. tax exemption on current income from physical assets, a possessions corporation could elect to remain in Puerto Rico as a Puerto Rican-chartered corporation, or it could move to a foreign country. The United States generally does not tax the current foreign earnings of a corporation chartered outside the United States until the earnings are repatriated. Moreover, Federal income tax can be avoided altogether where a U.S. parent corporation has excess foreign tax credits that can be used to offset the Federal tax on dividends from a foreign affiliate.

If a possessions corporation derives most of its income from investment in physical assets, then it might elect to reincorporate in Puerto Rico or in a foreign country if section 936 were repealed. With respect to firms that took

Table 5-7

Effective U.S. Tax Rates on New Depreciable Assets, Selected Industries

Industry	1979-1981 Law	1981-82 Law (ERTA)	Post-1982 Law (TEFRA)
Food	43.5	20.4	26.7
Apparel	40.6	23.1	28.9
Chemicals	28.6	8.5	17.7
Fabricated metals	47.3	24.7	32.2
Machinery and instruments	38.2	18.6	25.7
Electrical and electronic equipment	31.9	15.8	25.7

Note: Effective tax rates are based on investment patterns by corporations in the United States, and assume a 4 percent real after-tax rate of return and 6 percent inflation. The source of these figures is unpublished statistics based on the Treasury Department depreciation tax model.

this course, the repeal of the possessions corporation credit would not result in a large gain to the U.S. Treasury of the tax benefits provided under section 936. Those possessions corporations with the largest percentage of their income attributable to physical assets are in the low-technology industries. In 1980, the combined income of possessions companies in low-technology industries represented only 11.2 percent of the income of all 936 manufacturing corporations. 13/

2. Financial Assets. For income from financial assets, there are very few tax-saving alternatives to section 936. If a U.S. corporation invests through a foreign corporation, the return on financial investments will generally avoid U.S. tax only if the income is less than 10 percent of the foreign subsidiary's gross income. In the absence of the QPSII provision of section 936, the assets currently placed in the Puerto Rican capital market could be redirected into other assets, including taxable financial assets and physical assets in the U.S. and abroad; the funds could also be used to pay higher dividends to U.S. individual shareholders. It may therefore be reasonable to assume that a substantial part of the income from these currently tax-exempt assets would become taxable by the United States. 14/ Income from financial assets represented approximately 15 percent of total 936 income in 1980, and will rise somewhat in later years. 15/

3. Intangible Assets. Income from intangible assets generally means income derived from patents, know-how, trademarks, brand names, access to established marketing and distribution channels, and goodwill with customers. In many cases, U.S. parent corporations have

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13/ See Tables 4-2 and 5-2. If those possessions corporations in the "all other manufacturing" category in Table 5-2 are counted as firms in low-technology industries, then the percentage which these industries represent in the income of all 936 manufacturing firms rises from 11.2 percent to 22.7 percent.

14/ Although a U.S. corporation can offset dividends received from a wholly owned U.S. subsidiary (including a 936 subsidiary) with a 100 percent dividends-received deduction, which frees the dividend from Federal tax, dividends paid by a U.S. corporation to individual shareholders are taxable to the individuals at the time they are received.

15/ See footnote 8 above.

transferred (tax-free) to affiliated 936 corporations the U.S. rights to certain intangibles, and the 936 affiliates have claimed as part of their income the gross return attributable to the intangibles. In the absence of section 936, taxpayers could not claim the benefits of tax exemption for this return. If a possessions corporation reincorporated in Puerto Rico or a foreign country, the transfer of the U.S. rights to intangibles from the possessions company to the foreign-organized company would generally be subject to Federal tax on the gain (i.e., the fair market value of the intangible less the adjusted basis in the hands of the transferor, which would normally be zero).

Although it is difficult to measure precisely the amount of 936 income which is attributable to intangibles, Table 4-3 implies that in 1980, roughly 50 percent of the income of 936 manufacturing corporations may be a return on intangibles. 16/ The income derived by 936 firms from

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16/ In the absence of "shifting" of items of income or expense between related corporations in order to reflect greater amounts of income in one of the corporations, it would be expected that the average before-tax return to U.S.-owned operating assets in Puerto Rico would be less than the return on such assets in the U.S., since the Puerto Rican income is not taxable, while the U.S. income is. In fact, Table 4-2 shows that for high-technology industries (which account for about 80 percent of the income of 936 manufacturing firms), 936 income-to-asset ratios are, on average, 4.8 times greater than comparable U.S. profit margins. When 936 margins are adjusted for Puerto Rican-U.S. wage differentials, 936 margins in high-technology industries still remain about 4 times larger than U.S. profit margins. The unexpectedly high 936 pre-tax profit margins would suggest that the 936 margins include a large return to intangible assets developed in the United States or to management or other services provided by the U.S. parent at little or no charge to the 936 subsidiary. The difference in rates of return implies that income from activities performed by the U.S. parent corporations, including R&D and marketing, constitutes at least three-fourths (i.e., 1 - 1/4 = 3/4) of the operating income of 936 high-technology firms, or about 50 percent of the total income of all 936 manufacturing firms in 1980 (i.e., .75 X .85 (operating income as a share of all 936 income) X .80 (income of high-technology firms as a share of all 936 income)).

intangibles is earned predominantly on sales to the U.S. market. 17/ If section 936 were eliminated, the income earned on U.S. rights to intangibles would become taxable by the United States.

In the long run, however, there may be other adjustments by U.S. parent companies which may substantially reduce the revenue pick-up from repealing section 936. For example, U.S. high-technology companies, which have been enjoying a much higher after-tax return because of 936 benefits, would tend both to reduce their total R&D effort and to shift some of their R&D from the United States to foreign locations. If U.S. firms reduced their total R&D effort or shifted some of their R&D from the United States to foreign locations, the effect of the repeal of section 936 would be to reduce the income of high-technology U.S. firms. If such an effect occurred by 1986, then the estimated $1.2 billion revenue impact of section 936 for the year would overestimate the gain to the U.S. Treasury from the repeal of section 936.

17/ The United States is the principal market for high-technology products, as well as for apparel, made in Puerto Rico. For example, in 1977, 84 percent of the pharmaceutical preparations made in Puerto Rico were shipped to the U.S.; 85 percent of the output of the Puerto Rican electrical and electronics industry was shipped to the U.S.; 95 percent of the scientific instruments made in Puerto Rico were shipped to the U.S.; 75 percent of Puerto Rican apparel shipments were to the U.S. (U.S. Department of Commerce, 1977 Economic Census of Outlying Areas, Manufactures, Puerto Rico, 1980.)

Chapter 6

IMPACT OF CHANGING FROM SECTION 931 TO SECTION 936 AND OF CHANGES IN THE PUERTO RICAN TOLLGATE TAX AND INDUSTRIAL INCENTIVES PROGRAM

As explained in Chapter 2, the possessions corporation system was modified in the period 1976-1978 by the 1976 Tax Reform Act, the new Puerto Rican tollgate tax rules, and the 1978 Industrial Incentives 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. The principal effect of these changes was to induce possessions corporations to bring back to Puerto Rico the large pool of funds that had been invested abroad (as explained in Section III of Chapter 4) and to increase 936 dividend repatriations and Puerto Rican tax revenues (described below).

I. Dividend Repatriation

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

There has been a clear response in the repatriation of earnings. Before 1977, possessions corporations paid virtually no dividends to their U.S. parents. In tax years 1978 to 1980, however, possessions corporations in manufacturing distributed dividends of $885 million, $905 million, and $1,215 million, respectively. The 1980 dividends represented 13 percent of the companies' $9.4 billion in retained earnings, and 41 percent of current earnings.

Thus, while possessions corporations have repatriated substantial dividends since 1976, they continue to accumulate more than half of their current earnings in the possessions corporation. QPSII is effectively exempt from Federal and Puerto Rican tax, whereas income on comparable investments made by the U.S. parent is not. Both U.S. and Puerto Rican law, moreover, exempt 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. 1/

II. Impact on Federal and Puerto Rican Tax Revenues

If the changes in U.S. and Puerto Rican law between 1976 and 1978 made the possessions corporation system more attractive to U.S. firms and thereby resulted in the shifting of some U.S. investment to Puerto Rico, the Federal revenue loss under the possessions corporation exemption would have increased. If, on balance, the changes in the law reduced the after-tax return to investment in Puerto Rico and led to a shifting of U.S. investment away from Puerto Rico, the U.S. revenue loss would have decreased. In addition, any income and tollgate taxes paid to Puerto Rico under the new Puerto Rican laws reduce the tax benefits received by possessions corporations.

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 1976. 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 QPSII, 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 6-1 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. There were 19 additional elections under section 936 in the year ending June 1981, and 38 new elections in the year ending June 1982. Most of the new electors were in manufacturing industries. Over the two-year period ending June 1982, eleven of the new electors were in the electrical

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1/ As explained in Chapter 2, 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 6-1

Elections under Section 936

Industry	Total as of June 1980*	New Elections	Total as of June 1982
All Industries	750	57	807
All Manufacturing Industries	575	44	619
Apparel	124	5	129
Chemicals	100	8	108
Fabricated metal products	37	4	41
Electrical and electronic equipment	115	11	126
All other manufacturing	199	16	215
Non-manufacturing Industries	175	13	188

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* To alleviate hardship caused by the filing deadline set by temporary section 936 regulations, the final regulations allowed a corporation which had made its election before April 9, 1980, to revoke that election for the first taxable year to which the election applied. 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.

and electronic equipment industry, 8 electors were chemical firms, and 5 electors were apparel firms. These electors 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 of firms electing possessions corporation status was higher or lower than it would have been under section 931.

For some firms, the 1978 Puerto Rican Industrial Incentives 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 which elected to convert to a new, partially taxable status before December 31, 1979, received a guarantee of an automatic 10-year extension of the grant, 2/ 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 on 90 percent of their income.

The main result of the complex changes made in Puerto Rican law, both the tollgate tax and the new Industrial Incentives Act, was to impose additional taxes on possessions corporations. Total tax revenues generated by the new Puerto Rican tax provisions are estimated to be $111 million in Puerto Rico's fiscal year 1980, and $106 million in fiscal year 1981. 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.

Collections under the tollgate tax amounted to $65.0 million in the year ending June 30, 1979, $81 million in fiscal year 1980, and $56 million in fiscal year 1981. These tollgate taxes represented an effective tax rate of about 8 percent on repatriated dividends in calendar year 1979, and 6 percent in calendar year 1980. The drop in the effective tollgate tax reflects in part the pre-payment of tollgate taxes by a number of 936 firms in 1979. It also reflects the fact that income taxes can offset two-thirds of

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2/ As explained in Chapter 2 above, the 10-year automatic extension provides 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.

tollgate taxes owed by a firm which has converted its 100 percent tax exemption grant to a grant of partial tax exemption under the Puerto Rican Industrial Incentives Act of 1978.

In addition to tollgate tax collections, Puerto Rico receives income tax revenues from companies operating under the new Industrial Incentives Act, which provides for only a partial exemption from income tax for new or "converted" firms. Total income taxes paid by all firms with partial tax exemption grants are estimated to be $30 million in the year ending June 1980, and $50 million in the year ending June 1981.

Combining the above estimates of Puerto Rican tax collections from the tollgate tax and income tax, it appears that in calendar year 1980, they amounted to approximately 3.5 percent of the net income of all manufacturing possessions corporations in that year. Because new tax exemption grants issued under the Industrial Incentives Act of 1978 provide that the rate of exemption decreases after the first five years of the grant's duration, the Puerto Rican effective tax rate will rise somewhat after 1983. Accordingly, the projected Federal tax benefits under the possessions corporation system, shown in Table 5-5 above, have been reduced to reflect tax payments to Puerto Rico of 3.5 percent of pre-tax income in calendar years 1981 through 1983, and 5 percent of pre-tax income for the period 1984 through 1987.

Appendix A

Operation of the Possessions Corporation System of Taxation in American Samoa, Guam, 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) 1/, and other smaller U.S. territories. 2/ It does not include the Virgin Islands. U.S. corporations operating in American Samoa or Guam qualify for special tax treatment under section 936 in the same manner as U.S. corporations operating in Puerto Rico. Moreover, American Samoa and Guam, like Puerto Rico, provide exemptions from, or rebates of, their local possession income tax to complement the exemption from Federal tax under section 936.

The first part of this Appendix describes the income tax laws of American Samoa and Guam and the characteristics of possessions corporations operating in these islands. It is estimated that possessions corporations operating in Guam were subject to an effective Guam income tax rate of 10 percent; possessions corporations operating in American Samoa or the Canal Zone were generally subject to no possession income tax. The reduction in U.S. Federal tax provided under section 936 to all possessions corporations operating outside of Puerto Rico was approximately $2.4 million in tax year 1980. The $2.4 million in Federal tax benefits is estimated by computing the U.S. tax liability which these corporations would have owed in the absence of section 936, and then subtracting the estimated income taxes paid or accrued to the host possession.

The second part of the Appendix describes the tax treatment accorded to corporations operating in the Virgin Islands. Under the Revised Organic Act of 1954, section 28(a) 3/, all "inhabitants" of the Virgin Islands satisfy

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1/ Pursuant to the Panama Canal Treaties of 1977, the United States ceased to have jurisdiction over the Panama Canal Zone on October 1, 1979.

2/ Other territories to which section 936 benefits apply are the Northern Mariana Islands and Wake and Midway Islands.

3/ 48 U.S.C. 1642.

their liability for U.S. tax by paying tax on their worldwide income to the Virgin Islands. The Virgin Islands is required by the Naval Appropriations Act of 1922 4/ to administer the U.S. income tax laws as the Virgin Islands territorial income tax, but may rebate the tax which it collects on Virgin Islands source income earned by U.S. or V.I.-chartered corporations operating primarily in the Virgin Islands. In 1980, the amount of income tax subject to a rebate under the Virgin Islands tax-incentive program is estimated at $40.6 million, of which $37.5 million is attributable to Virgin Islands subsidiaries of U.S. corporations.

I. American Samoa, Guam, and the Panama Canal Zone

A. Federal and Possession Taxation

American Samoa and Guam, like Puerto Rico, constitute income tax jurisdictions separate 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.

In 1963, the legislature of American Samoa adopted the "Samoan Income Tax Act," which provides that:

> The income tax and the income tax rules in force in the United States of America and those which may hereafter be enacted or adopted, where not clearly inapplicable or incompatible with the intent of this section, are adopted by American Samoa, and shall be deemed to impose a separate territorial income tax, payable to the government.

American Samoa generally applies the U.S. Internal Revenue Code as the American Samoan Income Tax by substituting "American Samoa" for "United States," where appropriate in order to give the income tax law proper effect in American Samoa.

The legislature of American Samoa has from time to time amended the locally applicable U.S. income tax laws. American Samoa also provides exemptions from tax on American Samoan source income to businesses whose investments are deemed to promote Samoan economic development. In order to qualify for tax exemption, a corporation, partnership, or sole proprietorship must employ a work force at least 75 percent of which consists of American Samoan residents. For purposes of the 75 percent work force rule, a resident means any person who has continuously resided in American Samoa

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4/ 48 U.S.C. 1397.

for at least five years. Tax exemption grants generally last 10 years and are subject to renewal. However, the period of tax exemption may be made to terminate early if the cumulative amount of all taxes forgiven under the grant equals 200 percent of the business's total investment in American Samoa.

Guam, unlike American Samoa and Puerto Rico, does not have the authority to adopt its own income tax system, and the income tax system which Congress provided for it is closely integrated with the income tax jurisdiction of the United States. The Organic Act of 1950 5/ requires that Guam administer the income tax laws in force in the United States as the Guam territorial income tax, the so-called Guam "mirror" tax. The U.S. Internal Revenue Code is generally applied as the Guam territorial income tax by substituting "Guam" for "United States," where appropriate in order to give the income tax law proper effect in Guam. Section 935 of Internal Revenue Code provides that individuals who are residents of Guam but derive income from the United States file a single income tax return with Guam; individuals who are residents of the United States but derive income from Guam file a single return with the United States. In addition, Code section 881(b) provides that interest, dividends, and other passive investment income received from U.S. sources by corporations chartered in Guam is exempt from the U.S. tax withheld at source on such gross amounts. Similarly, passive investment income received from Guam sources by corporations chartered in the United States is exempt from the Guam tax withheld at source on such gross amounts.

No Federal provision explicitly limits the authority of Guam to provide income tax relief through rebates. Under the tax-incentive program of Guam, the Guam Economic Development Authority provides 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 needed facilities). The rebate is allowed for up to 20 years.

Most possessions corporations operating in Guam in 1980 were entitled to a rebate of 75 percent of Guam income taxes. Given the effective exemption from U.S. tax under section 936, these corporations paid an over-all effective tax rate of about 10 percent on income from the active

5/ 48 U.S.C. 1421i.

conduct of a trade or business in Guam and on QPSII (i.e., Guam source income derived from the reinvestment of income from the Guam trade or business). Many of these 936 corporations enjoyed, in addition, exemption from the Guam real property tax. Dividends paid by certain tax-exempt corporations to individual shareholders were also eligible for a rebate of 75 percent of the Guam shareholder level income tax.

The Panama Canal Zone, which ceased to be a possession for purposes of section 936 on October 1, 1979, imposed no local territorial income tax. Before October 1979, a Federal agency (the Panama Canal Company) administered the Canal Zone and financed agency 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 Operating Outside of Puerto Rico

Table A-1 shows that in tax year 1980, there were 13 active 936 corporations operating in possessions other than Puerto Rico. Three of these corporations claimed the section 936 credit for operations in the Panama Canal Zone, even though the Canal Zone ceased to be eligible for the benefits of section 936 as of October 1, 1979.

The qualified possession net income of the 13 corporations shown in Table A-1 was $6.4 million, of which 42 percent was attributable to possessions corporations operating in Guam. These 13 corporations claimed tax savings of $2.4 million under section 936.

The comparable data for tax year 1979 are a total of 11 possessions corporations operating outside of Puerto Rico, with qualified income of $2.1 million and tax savings under section 936 of $0.9 million.

II. Virgin Islands

A. Taxation of Corporations Operating in the Virgin Islands

The Virgin Islands is 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.

Table A-1

Possessions Corporations Outside of Puerto Rico - Income and Estimated Tax Benefits, 1980

Possession	Number of 936 Corporations	Qualified Possession Net Income ($000)	Estimated Tax Benefits ($000)
Guam	5	2,650	835
Panama Canal Zone	3	176	74
Other U.S. possessions, except Puerto Rico	5	3,557	1,494
Total	13	6,383	2,403

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The Naval Appropriations Act of 1922 requires the Virgin Islands to administer the income tax laws in force in the United States as the Virgin Islands territorial income tax, the so-called Virgin Islands "mirror" tax. In 1954, Congress enacted section 28(a) of the Revised Organic Act in order to allocate taxing responsiblities with respect to persons who were "inhabitants" of the Virgin Islands and to transfer additional revenues to the Virgin Islands. Section 28(a) provides that:

> [inhabitants of the Virgin Islands] shall satisfy their income tax obligations under the taxing laws of the United States by paying their tax on income from all sources both within and without the Virgin Islands into the Treasury of the Virgin Islands.

In other words, Virgin Islands "inhabitants" are subject to Virgin Islands tax on their worldwide income and generally pay no tax to the United States, even on U.S. source income. "Inhabitants" of the Virgin Islands include U.S. citizens who are resident in the Virgin Islands as of the last day of their taxable year, corporations chartered in the Virgin Islands, and certain U.S. corporations which operate primarily in the Virgin Islands.

Section 934(a), added to the Internal Revenue Code in 1960, prohibits the Virgin Islands from granting relief, directly or indirectly, from Virgin Islands income tax. However, an exception is made under section 934(b) with respect to non-U.S. source income of U.S. or Virgin Islands corporations that have derived at least 80 percent of their gross income from Virgin Islands sources and at least 50 percent of their gross income from the active conduct of a trade or business in the Virgin Islands during the three-year period preceding the close of the taxable year (or applicable part of such period). The Tax Equity and Fiscal Responsibility Act of 1982 increases the 50-percent active trade or business test to 65 percent for taxable years beginning after December 31, 1984. The provision is phased in so that the required percentage of active trade of business income rises to 55 percent for taxable years beginning in 1983, and to 60 percent for taxable years beginning in 1984.

The Virgin Islands has established an industrial incentive program which provides tax rebates for corporations which meet the gross income tests of section 934(b) and certain further criteria. The principal requirements are that the corporation:

(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 the hiring of any nonresident workers; 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 Virgin Islands 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 or 90 percent of 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. Rebates of income tax do not, however, apply to corporate tax on interest income, capital gains, and certain types of rental income. Any particular package of benefits is negotiated between the applicant and the Virgin Islands 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 business operations. 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 plants in certain economically depressed areas. Moreover, any beneficiary under the Industrial Development Program may be granted a renewal of those benefits subject to 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(b) and the Industrial Development Program for a rebate of 75 percent of income taxes, pays an average effective corporate income tax rate in the Virgin Islands of approximately 10 percent.

B. Taxation of Dividends Received from Corporations Operating in the Virgin Islands

U.S. law generally imposes a 30 percent tax on the gross amount of dividends, interest, and certain other passive investment income paid by U.S. persons to nonresident aliens and foreign corporations when that income is not effectively connected with the conduct of a U.S. trade or business by the foreign person. This 30 percent tax is often reduced or eliminated by income tax treaties, but the Virgin Islands is not a party to U.S. income tax treaties. The Government of the Virgin Islands and the U.S. Internal Revenue Service take the position that the mirror system imposes a similar 30 percent tax withheld at source on the gross amount of passive investment income paid from Virgin Islands sources to non-Virgin Islands persons, including U.S. persons. 5/ A U.S. recipient of passive investment income from the Virgin Islands can take a foreign tax credit for any such tax against its U.S. tax liability, but the amount of the credit is limited to the U.S. tax liability on foreign source net income. Therefore, the 30 percent tax on V.I. source gross passive investment income frequently results in such income being taxed at a higher rate than similar income earned by U.S. persons in the United States or foreign treaty countries. The Virgin Islands cannot rebate this tax under section 934(b) since the tax is upon the U.S. recipient and not upon the corporations operating in the Virgin Islands.

5/ The U.S. Court of Appeals for the Third Circuit cast doubt on this interpretation of the mirror system. Vitco v. Government of the Virgin Islands, 560 F. 2nd 180 (3rd Cir. 1977), cert. denied, 435 U.S. 180 (1978). However, the Report of the Committee on Ways and Means on H.R. 7093 (Public Law 97-455), an Act to reduce the rate of the Virgin Islands tax from 30 percent to 10 percent on payments to U.S. persons, states that, "The bill makes clear the Virgin Islands right both to impose the tax and to collect it by requiring withholding." H.R. Rep No. 833, 97th Congress 2nd Sess. 4 (1982).

To remove this disincentive to investment by U.S. persons in the Virgin Islands, Congress in December 1982 passed legislation adding a new section 934A to the Internal Revenue Code. This section reduces from 30 percent to 10 percent the rate of Virgin Islands tax imposed on payments of Virgin Islands source passive investment income to U.S. corporations, citizens and resident aliens. 6/ The Act allows the Virgin Islands, at its discretion, to use rebates to further reduce or eliminate this 10 percent rate. However, the Act continues the 30 percent rate for dividends paid to U.S. persons out of earnings and profits accumulated during taxable years beginning before January 12, 1983. The Act treats dividends as first coming out of earnings and profits accumulated during taxable years beginning before January 12, 1983, so that the 10 percent tax rate on dividends received by U.S. persons will apply only after a corporation operating in the Virgin Islands has distributed all pre-1983 earnings and profits.

Dividends received from a U.S. subsidiary operating in the Virgin Islands are eligible for the dividends-received deduction under section 243 of the Code. However, the United States does not allow a U.S. parent to take a dividends-received deduction for dividends paid by a subsidiary incorporated in the Virgin Islands. 7/ Thus,

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6/ Public Law 97-455, section 1 (1983).

7/ This follows from the treatment of Virgin Islands-chartered 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 50 percent or more of the foreign corporation's income has been derived, for the 36 months (or lesser period that the corporation has been in existence) ending with the close of the taxable year in which the dividends are paid, from a U.S. trade or business, and in that case, only to the extent of the corporation's U.S. effectively connected income. A corporation which met the so-called "80-50 gross income tests" required to be eligible for V.I. relief tax relief would not qualify for the deduction even with respect to dividends attributable to U.S. source income (Code section 245(a)).

even though the profits of a 934(b) Virgin Islands subsidiary may be 75 percent or 90 percent tax-free in the Virgin Islands, the profits will be subject to the normal U.S. corporate rate of income tax once they are repatriated.

In 1980, the Internal Revenue Service ruled that a U.S.-chartered corporation which satisified the 80-50 gross income tests under section 934(b), conducted all significant business operations in the Virgin Islands, held all shareholder meetings in the Virgin Islands, and all of whose officers where Virgin Islands residents, constituted an "inhabitant" of the Virgin Islands. 8/ The ruling does not make clear whether all these conditions must be satisfied to constitute an "inhabitant" of the Virgin Islands, and most U.S. investors in the Virgin Islands continue to operate through Virgin Islands-chartered corporations. Thus, their income from the Virgin Islands becomes subject to U.S. tax at the time it is repatriated in the form of dividends, and a foreign tax credit is allowed (subject to the general foreign tax credit limitation) for taxes paid to the Virgin Islands.

C. Allocation of Income Attributable to Intangibles

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) provides rules for the allocation of income from intangibles between a U.S. parent corporation and an affiliated U.S. 934(b) corporation to conform the tax benefits available to such corporations with those available to possessions corporations. As explained in Chapter 2 above, these rules permit a 936 corporation or a U.S. 934(b) corporation to compute its business income with respect to a product or type of service under the R&D cost-sharing method or the 50/50 profit split method. To qualify for either of these income allocation methods, the 936 or 934(b) corporation must meet a significant business presence test in a possession with respect to the product or service. These provisions are generally effective for taxable years beginning after December 31, 1982.

D. Characteristics of Corporations, Partnerships, and Sole Proprietorships Eligible for Virgin Islands Tax Rebates

Tables A-2 to A-4 present data on assets, income, tax rebates, and employment for corporations and other entities

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8/ Revenue Ruling 80-40, 1980-2 C.B. 175.

which qualified in 1980 for income tax rebates under Code section 934(b) and the Virgin Islands Industrial Incentive Program (hereinafter referred to as 934(b) entities). The tables cover accounting periods ending in calendar year 1980, and are based on income tax returns filed with the Virgin Islands. Tables A-2 and A-3 are based on the 48 active 934(b) entities for which both balance sheet and income statement data are available. It is estimated that these 48 corporations accounted for over 95 percent of the assets and income of the active 934(b) entities in 1980, and 90 percent of the total number of active 934(b) entities.

1. Assets, Income, and Income Tax Benefits by Type of Entity

Table A-2 presents data on the assets, income, and income tax benefits of 934(b) entities by type of entity. Of the 48 active 934(b) entities for which data are available, 15 were Virgin Islands-chartered subsidiaries of U.S. corporations, and 26 were Virgin Islands corporations with no parent, partnerships, or sole proprietorships. The remaining seven 934(b) corporations were either foreign-controlled V.I. corporations or U.S.-chartered corporations.

The 48 entities had assets of $1,965 million. Ninety-five percent of these assets, or $1,860 million, were held by Virgin Islands subsidiaries of U.S. corporations. Locally controlled Virgin Islands corporations, partnerships, and sole proprietorships accounted for an additional $41 million, or 2 percent, of the total assets of 934(b) entities; and the remainder, or 3 percent, was owned by foreign controlled or U.S.-chartered companies.

Net plant and equipment of 934(b) entities (shown in Table A-2 as net depreciable assets) were $435 million, or 22.1 percent of total assets. The share of net depreciable assets in total assets was almost twice as large in 934(b) entities as in 936 manufacturing corporations. The comparable figure for 936 manufacturing corporations was 12.1 percent, as shown in Table 5-1, above.

Ninety-six percent of the net plant and equipment of 934(b) entities belonged to Virgin Islands subsidiaries of U.S. companies. Virgin Islands subsidiaries of U.S. companies also accounted for most (approximately 99 percent) of the $5.1 billion in 934(b) total receipts.

Table A-2

934(b) Corporations in the Virgin Islands - Selected Balance Sheet and Income Statement Items and Tax Benefits by Type of Corporation, 1980

(Dollar amounts in thousands)

	All Entities	V.I. Corporations with a U.S. Parent	V.I. Corporations with No Parent, V.I. Partnerships & Sole Proprietorships	V.I. Corporations with a Foreign Parent & U.S. Corporations
Number of corporations	48	15	26	7
Total assets	1,964,908	1,859,600	41,421	63,887
Inventories	629,903	615,924	10,585	3,394
Depreciable assets	813,579	786,963	20,355	6,261
Accumulated depreciation	378,818	370,057	7,048	1,713
Net depreciable assets	434,735	416,898	13,291	4,546
Total receipts	5,106,356	5,038,136	44,888	23,332
Business receipts	5,081,955	5,017,670	41,669	22,616
All other receipts	24,401	20,466	3,219	716
Total deductions	4,984,462	4,920,909	44,244	19,309
Cost of sales and operations	4,734,643	4,694,636	26,410	13,597
All other deductions	249,819	226,273	17,834	5,712
Taxable income	114,668	115,707	-3,820	2,781
Virgin Islands income tax subsidy	40,590	37,543	1,336	1,711

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Business reciepts provided 99.5 percent of the gross receipts of 934(b) entities. Information on nongovernment interest and other investment income of 934(b) corporations is not available, but the high share of business receipts in total receipts suggests that passive investment income represents a relatively insignificant share of the income of 934(b) entities. As noted above, the Virgin Islands Industrial Development Program, unlike the Puerto Rican Industrial Incentive Acts, does not provide relief from tax on interest and certain other kinds of passive investment income.

Taxable income equals the difference between total receipts and total (current) deductions, less net operating loss carryovers and certain special deductions for dividends received. The combined taxable income of the 48 entities shown in the table amounted to $115 million. Virgin Islands subsidiaries of U.S. corporations reported income of almost $116 million, foreign-controlled V.I. firms and U.S.-chartered firms had income of almost $3 million, and locally-controlled V.I. entities had combined net losses of $4 million.

Virgin Islands income tax rebates due, which represented in most cases 75 or 90 percent of income taxes paid, were estimated to be about $41 million. U.S.-controlled Virgin Islands firms accrued somewhat less than $38 million in tax rebates for 1980, while Virgin Islands entities with no parent accrued approximately $1 million in tax rebates.

2. Assets, Income, and Tax Rebates by Industry

Table A-3 covers the same entities as Table A-2, but presents the asset, income, and tax benefit data by industry.

Four corporations in the petroleum refining, alumina processing, and concrete products industries accounted for 78 percent of all net plant and equipment and 93 percent of the combined net income of 934(b) entities. These 4 corporations accrued tax rebates of slightly less than $36 million, or 88 percent of the Virgin Islands income tax rebates for all industries.

Other 934(b) firms with substantial plant and equipment were hotels, with almost $25 million in net depreciable assets. Most of the fourteen 934(b) hotels reported losses for tax purposes. As a result, this industry accrued less than $0.5 million in income tax rebates in 1980.

Table A-3

934(b) Corporations in the Virgin Islands - Selected Balance Sheet and Income Statement Items and Tax Benefits by Industry, 1980

(Dollar amounts in thousands)

	All Industries	Chemicals	Watches	Petroleum Refining, Alumina Processing, & Concrete	Other Manufacturing	Hotels	Other Services
Number of Corporations	48	5	14	4	6	13	6
Total Assets	1,964,908	10,687	26,221	1,766,459	63,574	30,984	66,983
Inventories	629,903	1,818	5,516	611,321	3,838	365	7,045
Depreciable assets	813,579	3,028	3,752	669,546	4,990	33,774	98,489
Accumulated depreciation	378,818	863	1,832	332,369	1,542	9,201	33,011
Net depreciable assets	434,735	2,160	1,914	337,175	3,446	24,565	65,475
Total Receipts	5,106,356	15,961	33,671	4,972,950	17,705	26,925	39,144
Business receipts	5,081,955	15,816	33,672	4,953,644	17,642	24,275	36,906
All other receipts	24,401	145	-1	19,306	63	2,650	2,238
Total Deductions	4,984,462	13,899	32,517	4,866,739	12,240	25,875	33,192
Cost of sales and operations	4,734,643	11,435	28,889	4,679,738	8,897	5,003	681
All other deductions	249,819	2,464	3,628	187,001	3,343	20,872	32,511
Taxable income	114,668	2,062	-364	106,173	5,460	-252	1,553
V.I. income tax subsidy	40,590	749	773	35,627	2,125	490	825

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The manufacturing category with the largest number of 934(b) firms in 1980 was watches. The 14 Virgin Islands watch manufacturers reported $2 million in net plant and equipment, earned almost $34 million in business receipts, and accrued $0.8 million in income tax rebates. The industry as a whole reported losses for tax purposes of $0.4 million.

3. Employment

To obtain a more complete picture of the operations of 934(b) entities, the Virgin Islands Finance Department matched employment and payroll information with tax return information for these entities. The employment and payroll information was obtained from Form W-3, "Transmittal of Income and Tax Statements," used by employers to transmit to the Virgin Islands Finance Department statements of compensation and withheld tax for employees in the Virgin Islands. The 37 entities for which such information was available accounted for 80 percent of the income of the entities covered in Tables A-2 and A-3. These entities had a total of 5,402 full-and part-time employees in calendar year 1980.

Table A-4 ranks the 37 entities according to the size of the Virgin Islands income tax bnefits per employee. At the top of the ranking were four companies for which the Virgin Islands tax benefits represented, on average, $19,533 per employee; at the low end were 18 entities which incurred losses and thus derived no immediate tax benefits under section 934(b). The top four corporations in terms of tax benefits per employee accounted for 94 percent of the total income tax benefits, 29 percent of the total employment, and 59 percent of total compensation of firms covered in Table A-4. The average compensation of all full- and part-time employees in these firms was $24,569, several times higher than average compensation in most other 934(b) firms. The bottom 24 entities, receiving tax benefits per employee of less than $500, accounted for 1.6 percent of the total income tax benefits, 62 percent of the total employment, and 36 percent of the total comensation. Average employee compensation of all full- and part-time workers employees in these 24 firms was $7,131.

Table A-4

934(b) Corporations in the Virgin Islands - Tax Benefits, Employment, and Compensation of Employees by Size of Tax Benefits per Employee, 1980

Size of tax benefits per employee	Number of corporations	Taxable income ($000)	Tax benefits		Employees		Compensation of employees 1/		Tax benefits per employee ($)	Average employee compensation 2/ ($)	Tax benefits as a percent of compensation of employees
			Amount ($000)	Percent of total	Number	Percent of total	Amount ($000)	Percent of total			
All entities	37	92,243	32,835	100.0	5,402	100.0	65,913	100.0	6,078	12,201	49.8
$10,000 or more	4	96,465	30,922	94.2	1,583	29.3	38,893	59.0	19,533	24,569	79.5
$5,000 under $10,000	3	1,970	770	2.3	120	2.2	1,139	1.7	6,416	9,491	67.6
$1,000 under $5,000	3	1,047	534	1.6	262	4.9	1,418	2.2	2,038	5,412	37.7
$ 500 under $1,000	3	276	78	.2	94	1.7	625	.9	712	6,648	10.7
$ 1 under $500	6	3,888	542	1.6	1,821	33.7	14,338	21.8	298	7,875	3.8
Entities with losses	18	-11,403	0	0	1,522	28.2	9,500	14.4	0	6,241	0

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1/ Compensation of employees is computed by multiplying 1.232 times payroll. The 23.2 percent reflects the employer-paid portion of Social Security, unemployment insurance, and other non-payroll costs. The 23.2 percent is the average for all U.S. manufacturing industries in 1980. Source: unpublished estimates of U.S. Department of Commerce.

2/ Total compensation divided by total number of employees in calendar year 1980. Because part-year and part-time employees are included in the total number of employees, the average employee compensation is not comparable to that reported in Tables 5-3, 5-4, B-3, and B-4, which are based on the number of full-time equivalent employees during the year. See Appendix C.

Appendix B

Possessions Corporations in Tax Year 1979

This appendix presents data on the assets, income, tax benefits, and employment of possessions corporations in tax year 1979, which includes accounting periods ending between July 1, 1979, and June 30, 1980. Tax year 1979 corresponds closely to the calendar year because most possessions corporations have calendar year accounting periods. Tables B-1 through B-3 are similar to Tables 5-1 through 5-3, above, covering tax year 1980.

I. Assets and Income in 1979

Tables B-1 and B-2 are based on the 546 possessions corporations which filed a corporate income tax return for tax year 1979 no later than February 1981. Between February and June 1981, 126 additional possessions corporations with comibined net income of $253 filed. Possessions corporations included in Tables B-1 and B-2 account for 92 percent of the income of all possessions corporations which had filed for tax year 1979 as of June 1981.

A. Assets. Table B-1 shows that the total assets of possessions corporations were $13.4 billion at year-end 1979, with 77 percent of the assets held by manufacturing companies. Net plant and equipment of these manufacturing firms amounted to $1.3 billion. The pharmaceutical industry accounted for $529 million, or 40 percent, of the net plant and equipment of 936 manufacturing firms. Other industries with substantial manufacturing plant and equipment were chemicals other than pharmaceuticals, with 18 percent of the total, and food products, with 11 percent. Electrical and electronic equipment accounted for 8 percent of the total plant and equipment of 936 manufacturing firms.

Fixed assets of 936 manufacturing firms included, in addition to the $1.3 billion of net plant and equipment, $62 million of land (not shown separately on Table B-1). The

Table B-1

Selected Balance Sheet Information by Industry, 1979

(Dollar amounts in thousands)

	All Industries	Manufacturing Industries							
		Manufacturing Total	Food & Kindred Products	Textile Mill Products	Apparel	Paper	Chemicals		
							Total	Pharmaceuticals	All Other
Number of corporations	546	417	21	9	71	5	78	57	21
Total assets	13,399,880	10,292,296	820,026	26,076	265,514	17,848	5,666,788	4,849,604	817,183
Cash	1,776,005	1,608,211	283,387	1,146	29,616	142	798,395	773,312	25,082
Accounts receivable	2,286,321	1,900,405	154,158	3,806	103,842	3,505	976,606	677,743	298,862
Inventories	1,159,504	1,047,991	121,602	3,383	41,575	3,735	428,492	303,983	124,509
U.S. Government obligations	231,642	225,618	0	0	2,948	0	189,328	171,262	18,065
State and local obligations	144,385	143,147	9	0	3,384	0	111,262	82,025	29,237
Other current assets	646,636	575,588	29,216	636	7,899	2,084	341,769	334,870	6,899
Mortgage & real estate loans	1,436,278	98,258	0	0	2,884	0	7,282	7,200	82
Other investments	2,973,983	2,847,540	78,929	13,764	38,432	5,437	1,703,564	1,688,740	14,823
Depreciable assets	3,024,691	2,002,836	198,301	5,580	27,109	3,561	1,178,601	682,347	496,254
Less: Accumulated depreciation	909,559	695,938	58,410	2,299	12,020	826	411,654	153,578	258,075
Net depreciable assets	2,115,132	1,306,898	139,891	3,280	15,089	2,734	766,947	528,768	238,178
Other assets	603,284	536,883	11,079	57	18,842	209	343,140	281,696	61,444
Total liabilities and stockholders' Equity									
Accounts payable	841,236	581,967	61,556	748	46,592	3,226	215,965	119,284	96,681
Notes payable in less than 1 year	248,247	175,205	52,472	2,121	2,056	0	60,681	53,385	7,295
Other current liabilities	1,551,326	240,345	52,477	457	7,095	216	73,631	68,647	4,984
Mortgages more than 1 year	543,996	209,188	2,356	250	4,850	0	160,204	154,125	6,078
Other liabilities	180,900	87,936	10,515	22	1,716	499	26,584	9,969	16,615
Capital stock	1,552,718	894,125	60,494	1,339	12,692	1,552	582,506	358,301	224,204
Retained earnings, total	8,456,591	8,102,213	578,840	21,135	189,510	12,353	4,547,215	4,085,891	461,323
Appropriated	112,937	69,763	36,986	0	4,538	0	6,592	5,342	1,250
Unappropriated	8,343,654	8,032,450	541,854	21,135	184,972	12,353	4,540,622	4,080,549	460,073

Table B-1 - 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*	All Other Manufacturing
Number of corporations	9	12	6	24	14	99	31	39
Total assets	31,550	71,039	66,626	232,257	198,043	1,772,371	407,128	722,030
Cash	3,278	7,671	28,948	70,268	9,789	292,845	24,562	58,419
Accounts receivable	4,319	25,205	22,747	31,330	50,916	293,482	77,837	155,196
Inventory	5,997	13,962	6,887	35,169	39,649	185,158	28,529	134,377
U.S. Government obligations	0	1,750	0	10,535	0	31,590	0	0
State and local obligations	0	10,207	0	248	6,500	11,533	0	0
Other current assets	306	1,726	399	10,535	18,317	67,370	2,863	92,543
Mortgage & real estate loans	0	0	0	0	0	88,091	0	0
Other investments	8	8,288	548	27,364	61,113	666,840	187,183	56,065
Depreciable assets	17,903	4,292	13,513	62,404	14,486	197,055	66,946	213,780
Less: Accumulated depreciation	2,632	2,751	6,542	16,201	3,651	86,245	12,091	80,733
Net depreciable assets	15,270	1,541	6,970	46,202	10,835	110,810	54,855	133,047
Other assets	2,368	686	123	11,137	920	24,647	31,296	92,380
Total liabilities and stockholders' Equity								
Accounts payable	3,279	6,499	501	37,434	15,191	92,693	17,676	80,705
Notes payable in less than 1 year	1,440	201	343	40,116	25	8,421	6,932	391
Other current liabilities	2,278	1,556	1,226	11,741	24,327	41,948	8,391	15,095
Mortgages more than 1 year	6,693	0	792	691	5,565	9,194	15,117	4,971
Other liabilities	1,668	120	21	10,747	2,887	19,986	1,769	11,396
Capital stock	6,249	1,453	1,632	8,388	4,850	78,051	19,873	115,040
Retained earnings, total	9,940	61,208	62,107	123,136	145,196	1,522,074	337,366	494,430
Appropriated	0	1,374	0	14,272	0	59	119	5,821
Unappropriated	9,940	59,834	62,107	108,864	145,196	1,522,015	337,247	488,608

* Includes photographic goods and watches

Table B-1 - continued

	Nonmanufacturing	Nonmanufacturing Industries					
		Construction	Transportation Communications and Utilities	Wholesale Trade	Retail Trade	Finance, Insurance, Real Estate	Services and Industry Not Reported
Number of corporations	129	8	6	22	37	27	28
<u>Total Assets</u>	3,107,584	16,005	698,562	256,721	197,244	1,858,965	76,077
Cash	167,793	3,708	3,390	93,425	13,852	50,380	2,774
Accounts receivable	385,915	5,596	33,640	84,920	10,596	226,805	21,804
Inventory	111,512	2,028	9,609	44,992	49,712	446	4,193
U.S. Government obligations	6,024	0	0	0	708	4,914	401
State and local obligations	1,238	0	0	0	0	0	1,238
Other current assets	71,047	2,135	1,421	18,489	7,074	40,561	1,284
Mortgage & real estate loans	0	23	0	0	0	1,338,019	0
Other investments	126,442	20	5	392	11,402	112,785	1,836
Depreciable assets	1,021,854	4,437	792,977	18,536	98,711	63,120	43,370
Less: Accumulated depreciation	213,621	2,037	148,630	7,332	36,468	8,583	10,445
Net depreciable assets	808,233	2,400	644,346	11,203	62,242	54,536	32,924
Other assets	66,400	115	6,147	3,297	16,700	30,514	9,617
<u>Total liabilities and stockholders' Equity</u>							
Accounts payable	259,268	3,899	23,996	20,371	38,371	160,219	12,307
Notes payable in less than 1 year	73,041	772	2,570	1,162	17,506	48,581	2,448
Other current liabilities	1,310,981	1,807	23,684	27,963	11,478	1,242,660	3,287
Mortgages more than 1 year	334,807	1	9,634	6,305	2,948	218,949	6,468
Other liabilities	92,963	502	3	409	2,885	87,294	1,868
Capital stock	658,593	162	547,588	29,142	33,259	28,142	20,296
Retained earnings, total	354,378	8,860	2,084	171,367	67,245	73,117	29,400
Appropriated	43,173	54	15	0	0	41,980	1,123
Unappropriated	311,204	8,805	2,069	171,367	67,245	31,136	28,277

Office of the Secretary
Office of Tax Analysis

combined fixed assets represented 13.3 percent of total assets held by 936 manufacturing firms. The comparable ratio of fixed to total assets for manufacturing corporations in the United States was 35.5. percent. 1/

B. Retained Earnings. At the end of tax year 1979, possessions companies reported $8.5 billion of retained earnings on their balance sheets, with 96 percent of these held by manufacturing companies. Nearly half, or $4.1 billion, was reported by pharmaceuticals. The electrical and electronics industries held $1.5 billion in retained earnings. Retained earnings represented 79 percent of total liabilities and stockholders' equity of all 936 manufacturing corporations. The comparable figure for all U.S. manufacturing corporations in 1979 was 29 percent. 2/

C. Total Receipts. The total receipts of 936 manufacturing corporations were $7.7 billion in 1979, as shown in Table B-2. Ninety-five percent of total receipts was attributable to business receipts, and the remainder was attributable primarily to interest, including QPSII. 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 5-2. The amount of such excluded interest income reported by possessions corporations was $16 million.

The pharmaceutical industry accounted for 32 percent of the business receipts of all 936 manufacturing firms. After pharmaceuticals, the industries with the greatest business receipts were electrical and electronic equipment, food products, and chemicals other than pharmaceuticals.

1/ Data for all U.S. corporations are from Federal Trade Commission, Quarterly Financial Report, Fourth Quarter, 1980, 1981.

2/ Data for all U.S. corporation are from Internal Revenue Service, Source Book, Statistics of Income, 1979: Corporation Income Tax Returns, 1982.

Table B-2

Selected Income Statement Information and Tax Benefits by Industry, 1979

(Dollar amounts in thousands)

	All Industries	Manufacturing Industries: Total	Food & Kindred Products	Textile Mill Products	Apparel	Paper	Chemicals: Total	Chemicals: Pharmaceuticals	Chemicals: All Other
Number of corporations	546	417	21	9	71	5	78	57	21
Total receipts	9,460,735	7,705,773	763,073	24,688	322,925	21,045	3,181,225	2,458,076	723,148
Business receipts	8,692,928	7,340,627	738,076	24,338	317,104	20,641	2,978,228	2,260,133	718,094
Nongovernment interest	442,518	309,633	21,339	241	4,098	348	174,681	170,629	4,051
Other receipts	325,287	55,512	3,657	108	1,722	55	28,315	27,312	1,002
Total deductions	6,624,984	5,123,218	575,759	19,760	270,293	16,712	1,845,647	1,220,676	624,970
Cost of sales	5,073,872	4,019,634	443,148	17,582	244,746	14,866	1,282,576	723,101	559,475
Depreciation	182,726	127,116	9,566	509	1,751	257	78,976	42,399	36,577
All other deductions	1,368,384	976,468	123,044	1,669	23,796	1,588	484,094	455,176	28,918
Estimated net income per return	2,835,742	2,582,554	187,313	4,927	52,631	4,333	1,335,577	1,237,399	98,178
Estimated net income per books	2,750,311	2,512,609	180,908	4,785	46,363	4,302	1,328,295	1,234,985	93,309
Reduction in U.S. tax liability	1,040,280	1,040,280	76,329	2,036	20,988	1,783	535,056	494,416	40,639
Distributions	899,072	827,276	59,090	2,553	12,212	0	420,255	371,400	48,855

Table B-2 - continued

	Manufacturing Industries - continued							
	Rubber Products	Leather and Leather Products	Stone, Clay and Glass Products	Fabricated Metal Products	Machinery, Except Electrical	Electrical and Electronic Equipment	Scientific Instruments*	All Other Manufacturing
Number of corporations	9	12	6	24	14	99	31	39
Total receipts	26,034	95,239	80,209	165,034	214,337	1,263,639	349,288	1,202,973
Business receipts	25,654	93,613	77,707	159,117	207,966	1,185,162	331,886	1,185,071
Nongovernment interest	356	832	2,214	5,939	4,947	70,231	10,120	14,282
Other receipts	22	794	287	-21	1,424	8,244	7,281	3,619
Total deductions	16,640	81,010	61,114	124,420	155,114	737,515	210,235	1,011,021
Cost of sales	12,411	73,327	54,381	112,204	127,250	634,660	126,764	877,510
Depreciation	834	271	1,051	3,369	1,266	15,911	2,968	10,452
All other deductions	3,394	7,411	5,681	8,845	26,597	86,943	80,501	123,058
Estimated net income per return	9,393	14,228	19,094	40,614	59,222	526,123	139,053	191,952
Estimated net income per books	7,304	14,178	17,937	40,272	59,092	524,271	97,890	188,919
Reduction in U.S. tax liability	3,861	5,836	7,747	16,728	24,105	213,009	56,261	76,536
Distributions	1,036	7,791	3,765	795	6,070	240,069	50,827	23,807

* Includes photographic goods and watches.

Table B-2 - continued

	Non-Manufacturing	Nonmanufacturing Industries					
		Construction	Transportation Communications and Utilities	Wholesale Trade	Retail Trade	Finance, Insurance, Real Estate	Services and Industry Not Reported
Number of corporations	129	8	6	22	37	27	28
Total Receipts	1,754,961	29,894	219,997	818,462	426,273	172,001	84,392
Business receipts	1,352,301	29,399	12,149	816,279	391,126	23,769	75,636
Nongovernment interest	132,884	359	874	811	13,056	117,533	249
Other receipts	269,775	135	206,973	1,371	22,090	30,698	8,506
Total Deductions	1,501,765	29,128	147,266	683,008	397,911	168,245	74,177
Cost of sales	1,054,238	26,434	75,195	648,113	247,632	14,343	40,722
Depreciation	55,610	342	43,189	861	5,957	2,926	2,261
All other deductions	391,916	2,351	28,881	34,033	144,321	150,976	31,193
Estimated net income per return	253,187	765	72,731	135,453	28,353	3,755	10,214
Estimated net income per books	237,702	346	72,517	137,030	10,681	6,743	8,470
Reduction in U.S. tax liability	0	0	0	0	0	0	0
Distributions	71,795	3	70,282	221	0	0	1,288

Office of the Secretary
Office of Tax Analysis

D. Net Income per Tax Return. Net income per return (total receipts minus total deductions on Table B-2) amounted to $2.8 billion for all possessions corporations. Over 90 percent of the net income was attributable to manufacturing firms. The industries with the greatest amount of net income were pharmaceuticals, with 48 percent of the total income of manufacturing possessions corporations, and electrical and electronic equipment, which accounted for 20 percent of the total net income.

E. Reduction in U.S. Tax Liability. Table B-2 shows that U.S. tax liabilities were reduced by $1,040 million in tax year 1979 by the possessions corporation system. The pharmaceutical industry obtained tax benefits of $494 million, and the electrical and electronic equipment industry obtained tax benefits of $213 million.

F. Distributions. The final line in Table B-2 shows that 936 corporations reported $899 million of distributions, which was one-third of their net income in tax year 1979. Forty-five percent of total distributions by manufacturing corporations in these two years was attributable to the pharmaceutical industry.

II. Payroll and Employment in 1979

Table B-3 provides an industry-by-industry comparison of 936 tax benefits per employee and as a percent of industry compensation. Table B-3 is based on all 936 firms in the manufacturing sector for which 1979 employment and payroll data could be obtained from the companies' Federal unemployment insurance tax returns. The 287 corporations included in the table represent two-thirds of the number, and 75 percent of the net income, of the manufacturing corporations included in Tables B-1 and B-2.

Table B-3 shows that for all manufacturing industries, the Federal tax benefits per Puerto Rican employee averaged $15,690. Tax benefits per employee, or as a percentage of total employee compensation, varied substantially from industry to industry. In the pharmaceutical industry, the

Table B-3

Tax Benefits, Employment, and Compensation of Employees by Industry, 1979

	Number of Corporations	Qualified Possession Net Income ($000) 1/	Tax Benefits Amount ($000)	Tax Benefits Percent of Total	Employees Number	Employees Percent of Total	Compensation of Employees 2/ Amount ($000)	Compensation of Employees 2/ Percent of Total	Tax Benefits per Employee ($)	Average Employee Compensation ($)	Tax Benefits as a Percent of Compensation of Employees
All Manufacturing Industries	287	1,937,166	891,411	100.0	48,683	100.0	551,469	100	15,690 3/	11,587 3/	135.4 3/
Food and kindred products	13	90,542	41,646	4.7	4,443	9.1	55,335	10.0	9,373	12,454	75.3
Textile mill products	6	1,395	697	*	255	.5	2,173	*	2,733	8,521	32.1
Apparel	54	44,798	20,834	2.3	9,493	19.5	76,830	13.9	2,194	8,093	27.1
Men's and boy's	8	10,183	4,683	.5	1,914	3.9	16,180	2.9	2,446	8,453	28.9
Women's and children's	25	22,396	10,464	1.2	4,171	8.6	32,588	5.9	2,508	7,812	32.1
Hats, caps, etc.	11	2,574	1,212	*	1,180	2.4	9,412	1.7	1,027	7,976	12.9
All other	10	9,647	4,475	.5	2,228	4.6	18,650	3.4	2,008	8,370	24.0
Paper	3	3,337	1,535	*	79	*	938	*	19,430	11,873	163.6
Chemicals	55	1,055,439	485,485	54.5	9,955	20.4	145,661	26.4	48,767	14,631	333.3
Industrial chemicals, plastics	7	33,916	15,599	1.7	510	1.0	6,304	1.1	30,586	12,360	247.4
Pharmaceuticals	41	1,002,553	461,161	51.7	8,969	18.4	134,130	24.3	51,417	14,954	343.8
Soaps, cleaners, etc.	3	15,151	6,969	.8	411	.8	4,442	.8	16,956	10,807	156.9
All other	4	3,819	1,756	*	65	*	785	*	27,015	12,076	223.7
Rubber and plastics	4	3,540	1,627	*	287	.6	2,571	.5	5,668	8,958	63.3
Leather	10	9,724	4,547	.5	1,830	3.8	14,648	2.7	2,484	8,004	31.0
Footwear	6	5,980	2,826	*	1,354	2.8	10,744	1.9	2,087	7,935	26.3
All other	4	3,744	1,721	*	476	1.0	3,904	.7	3,615	8,201	44.1
Stone, clay, and glass	6	18,819	8,654	1.0	478	1.0	5,608	1.0	18,104	11,732	154.3
Fabricated metal products	17	29,399	13,519	1.5	1,473	3.0	16,651	3.0	9,177	11,304	81.2
Metal cans and containers	6	17,625	8,105	.9	624	1.3	7,303	1.3	12,988	11,703	111.0
Cutlery, hand tools, screws, bolts	3	5,655	2,601	*	259	.5	3,054	.6	10,042	11,791	85.2
All other	5	2,816	1,295	*	394	.8	3,587	.7	3,286	9,104	36.1
Machinery, except electrical	7	27,247	12,531	1.4	642	1.3	6,832	1.2	19,518	10,641	183.4
Office, computing, and accounting	3	17,933	8,249	.9	344	.7	3,651	.7	23,979	10,613	225.9
All other	4	9,314	4,282	.5	298	.6	3,181	.6	14,369	10,674	134.6
Electrical and electronic equipment	70	417,367	191,992	21.5	12,435	25.5	138,210	25.1	15,439	11,114	138.9
Radio, TV, communication	6	57,351	26,379	3.0	1,343	2.8	13,821	2.5	19,641	10,291	190.9
Electronic components	16	72,287	33,274	3.7	2,440	5.0	24,699	4.5	13,636	10,122	134.7
All other	48	287,729	132,339	14.8	8,652	17.8	99,690	18.1	15,295	11,522	132.8
Instruments, photographic goods and watches	21	109,618	50,417	5.7	3,130	6.4	35,793	6.5	16,107	11,435	140.9
Scientific instruments	6	8,814	4,053	.5	425	.9	3,996	.7	9,536	9,402	101.4
Optical, medical, ophthalmic	15	100,804	46,364	5.2	2,705	5.6	31,797	5.8	17,140	11,754	145.8
All other manufacturing 4/	21	125,941	57,927	6.5	4,183	8.6	50,219	9.1	13,848	12,005	115.3

Office of the Secretary
Office of Tax Analysis

* 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 1.225 times payroll. The 22.5 percent reflects the employer-paid portion of social security, unemployment insurance, and other non-payroll costs. The 22.5 percent is the average for all U.S. manufacturing industries in 1979; see the U.S. Department of Commerce, Survey of Current Business, December 1980, Tables 6.5 and 6.6.

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

average Federal tax benefits amounted to $51,417 per employee, or more than triple the average compensation of the comparatively well-paid Puerto Rican pharmaceutical employee. In the electrical and electronics industry, the average tax benefits amounted to $15,439 per employee, or 139 percent of average compensation. The industry where average tax benefits per employee were lowest was apparel, with $2,194 in tax benefits per employee, or 27 percent of employee compensation.

Appendix C

Sources and Limitations of the Data

Throughout, unless otherwise noted, 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 tax year 1980 contain data for corporations with accounting periods ending on or after July 1, 1980 and on or before June 30, 1981.

Data for 1980 and data in the appendix tables for 1979 include corporations which filed as possessions corporations within seven months of the end of the tax year. All other figures for years prior to 1980 (e.g., in Tables 5-4 and 5-6) have been revised to include corporations which filed as possessions corporations within 12 months of the end of the tax year.

Income statement and balance sheet data for 1977-1980, 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 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 estimates of total tax benefits, which are based on the income of profitable firms only.

An additional source of income and tax data for 1973-1975 was income tax returns (Forms 480.20) filed with the Puerto Rican government.

The employment and payroll data for all years were 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 were associated with income data for the accounting period most nearly corresponding to the calendar year. For example, the calendar year 1980 Form 940 data were associated with taxable years ending between July 1, 1980 and June 30, 1981.

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 in the 1970s 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 over-estimate employment for a company with relatively high wages and part-time employees or a high labor turnover rate. However, secondary data from Form 940 and other sources suggest that the method used here provides reasonably accurate estimates of full-time equivalent employment.

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 for all U.S. manufacturing industries. The value of this factor for 1980 and 1979 is noted in the footnotes to Tables 5-3 and B-3. 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.

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

Tax Forms from Which Data Included in This Report Were Obtained

Form **5712**
(Rev. February 1980)
Department of the Treasury
Internal Revenue Service

Election to be Treated as a Possessions Corporation Under Section 936

(Do NOT Attach to Your Tax Return—File Separately)

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")

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 on or before the later of the following dates:

(a) the due date (including extensions) of the first return to which the election is to apply, or

(b) April 8, 1980.

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 Allowed 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 posssession source investment income	All other gross income		
	From sources within U.S. possessions (f)	From all other sources without the U.S. (g)	From sources within the U.S. (h)	(i)	From sources within U.S. possessions (j)	From all other sources without the U.S. (k)	From sources within the U.S. (l)
Totals							

1 Total gross income in applicable period (add totals of columns (f) through (l)) . . . .
2 Gross income in applicable period from sources within U.S. possessions (add totals of columns (f), (i), and (j)) .
3 Line 2 divided by line 1 (if less than 80%, do not complete Part II) . . . .
4 Gross income 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 **1120**
Department of the Treasury
Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 1980 or other tax year beginning ...., 1980, ending ...., 19.......

1980

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 Specific Instructions)
E. Date incorporated
F. Total assets (see Specific Instructions) $

Gross Income

1	(a) Gross receipts or sales $.................. (b) Less returns and allowances $.................. Balance ▶	1(c)	
2	Cost of goods sold (Schedule A) and/or operations (attach schedule)	2	
3	Gross profit (subtract line 2 from line 1(c))	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(a), 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 WIN and jobs credit(s) .... 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)	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 1979 allowed as a credit		
	(b) 1980 estimated tax payments		
	(c) Less refund of 1980 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) Federal tax on special fuels and oils (attach Form 4136 or 4136–T)	32	
33	TAX DUE (subtract line 32 from line 31). See instruction C3 for depositary method of payment. (Check ▶ ☐ if Form 2220 is attached. See instruction D.) ▶ $..................	33	
34	OVERPAYMENT (subtract line 31 from line 32)	34	
35	Enter amount of line 34 you want: Credited to 1981 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 Use Only

Preparer's signature and date ▶ | Check if self-employed ▶ ☐ | Preparer's social security no.

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

Schedule A Cost of Goods Sold (See Instructions for Schedule A)

1 Inventory at beginning of year	
2 Merchandise bought for manufacture or sale	
3 Salaries and wages	
4 Other costs (attach schedule)	
5 Total—Add lines 1 through 4	
6 Inventory at end of year	
7 Cost of goods sold—Subtract line 6 from line 5. Enter here and on line 2, page 1	

8 (a) Check all methods used for valuing closing inventory: *(i)* ☐ Cost *(ii)* ☐ Lower of cost or market as described in Regulations section 1.471-4 (see instructions) *(iii)* ☐ Writedown of "subnormal" goods as described in Regulations section 1.471-2(c) (see instructions)

(b) Did you use any other method of inventory valuation not described above? ☐ Yes ☐ No
If "Yes," specify method used and attach explanation ▶

(c) Check if this is the first year LIFO inventory method was adopted and used. (If checked, attach Form 970.) ☐

(d) If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO

(e) 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

(f) 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 instructions for Schedule C)

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 Includible 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 dividends—Add lines 1 through 10. Enter here and on line 4, page 1	

Schedule E Compensation of Officers (See instruction for line 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 for line 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
1975						
1976						
1977						
1978						
1979						
1980						

Schedule I Special Deductions (See instructions for Schedule I)

1 (a) 85% of Schedule C, line 1	
(b) 59.13% of Schedule C, line 2	
(c) 85% of Schedule C, line 3	
(d) 100% of Schedule C, line 4	
2 Total—Add lines 1(a) through 1(d). See instructions for limitation	
3 100% of Schedule C, line 8	
4 Deduction for dividends paid on certain preferred stock of public utilities (see instructions)	
5 Total special deductions— Add lines 2 through 4. Enter here and on line 29(b), page 1	

Schedule J Tax Computation (See instructions for Schedule J on pages 6 and 7)

1 Taxable income (line 30, page 1) . . . .

2 (a) Are you a member of a controlled group? . . . . ☐ Yes ☐ No

(b) If "Yes," see instructions and enter your portion of the $25,000 amount in each taxable income bracket:

(i) $.................. (ii) $.................. (iii) $.................. (iv) $..................

3 Income tax (see instructions to figure the tax; enter this tax or alternative tax from Schedule D, whichever is less). Check if from Schedule D ▶ ☐ . . . .

4 (a) Foreign tax credit (attach Form 1118) . . . .

(b) Investment credit (attach Form 3468) . . . .

(c) Work incentive (WIN) credit (attach Form 4874) . . . .

(d) Jobs credit (attach Form 5884) . . . .

5 Total—Add lines 4(a) through 4(d) . . . .

6 Subtract line 5 from line 3 . . . .

7 Personal holding company tax (attach Schedule PH (Form 1120)) . . . .

8 Tax from recomputing prior-year investment credit (attach Form 4255) . . . .

9 Minimum tax on tax preference items (see instructions—attach Form 4626) . . . .

10 Total tax—Add lines 6 through 9. Enter here and on line 31, page 1 . . . .

Schedule K Record of Federal Tax Deposit Forms 503

(List deposits in order of date made—See instruction C3)

Date of deposit	Amount	Date of deposit	Amount	Date of deposit	Amount

Additional Information (See page 7 of instructions)

Yes | No

G (1) Did you claim a deduction for expenses connected with:

(a) Entertainment facility (boat, resort, ranch, etc.)? . . .

(b) Living accommodations (except employees on business)? .

(c) Employees attending conventions or meetings outside the U.S. or its possessions? . . . .

(d) Employees' families at conventions or meetings? . . .

If "Yes," were any of these conventions or meetings outside the United States or its possessions? . . . .

(e) Employee or family vacations not reported on Form W-2? .

(2) Enter total amount claimed on Form 1120 for entertainment, entertainment facilities, gifts, travel, and conventions that requires substantiation under section 274(d). (See instructions.) ▶..................

H (1) Did you at the end of the tax year own, directly or indirectly, 50% or more of the voting stock of a domestic corporation? (For rules of attribution, see section 267(c).) . . .

If "Yes," attach a schedule showing: (a) name, address, and identifying number; (b) percentage owned; (c) taxable income or (loss) (e.g., if a Form 1120: from Form 1120, line 28, page 1) of such corporation for the tax year ending with or within your tax year; (d) highest amount owed by you to such corporation during the year; and (e) highest amount owed to you by such corporation during the year.

(2) Did any individual, partnership, corporation, estate or trust at the end of the tax year own, directly or indirectly, 50% or more of your voting stock? (For rules of attribution, see section 267(c).) If "Yes," complete (a) through (e) . . .

(a) Attach a schedule showing name, address, and identifying number; (b) Enter percentage owned ▶..................

(c) Was the owner of such voting stock a person other than a U.S. person? (See instructions.) . . . .

If "Yes," enter owner's country ▶..................

(d) Enter highest amount owed by you to such owner during the year ▶..................

(e) Enter highest amount owed to you by such owner during the year ▶..................

(Note: For purposes of H(1) and H(2), "highest amount owed" includes loans and accounts receivable/payable.)

Yes | No

I Did you ever declare a stock dividend? . . . .

J Taxable income or (loss) from Form 1120, line 28, page 1, for your tax year beginning in: 1977.................., 1978 ...., 1979 ....

K If you were a member of a controlled group subject to the provisions of section 1561, check the type of relationship:

(1) ☐ parent-subsidiary (2) ☐ brother-sister

(3) ☐ combination of (1) and (2) (See section 1563.)

L Refer to page 8 of instructions and state the principal:

Business activity..................

Product or service..................

M Did you file all required Forms 1087, 1096, and 1099? . . . .

N Were you a U.S. shareholder of any controlled foreign corporation? (See sections 951 and 957.) If "Yes," attach Form 3646 for each such corporation . . . .

O At any time during the tax year, did you have an interest in or a signature or other authority over a bank account, securities account, or other financial account in a foreign country (see instructions)? . . . .

P Were you the grantor of, or transferor to, a foreign trust which existed during the current tax year, whether or not you have any beneficial interest in it? . . . .

If "Yes," you may have to file Forms 3520, 3520-A or 926.

Q During this tax year, did you pay dividends (other than stock dividends and distributions in exchange for stock) in excess of your current and accumulated earnings and profits? (See sections 301 and 316.) . . . .

If "Yes," file Form 5452. If this is a consolidated return, answer here for parent corporation and on Form 851, Affiliations Schedule, for each subsidiary.

R During this tax year was any part of your tax accounting records maintained on a computerized system? . . . .

S (1) Did you elect to claim amortization (under section 191) or depreciation (under section 167(o)) for a rehabilitated certified historic structure (see instructions for line 20)? . . .

(2) Amortizable basis (see instructions for line 20):

Schedule L Balance Sheets

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

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

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

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

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

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

Employer's Annual Federal Unemployment Tax Return

1980

T	
FF	
FD	
FP	
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T	

If incorrect, make any necessary change.

Name (as distinguished from trade name)
Trade name, if any
Address and ZIP code

Calendar Year
1980
Employer identification number

A Did you pay all required contributions to your State unemployment fund by the due date of Form 940? . . . . . . ☐ Yes ☐ No
If you check the "Yes" box, enter amount of contributions timely paid to your State unemployment fund . . . ▶ $
B Are you required to pay contributions to only one State? . . . . . . ☐ Yes ☐ No
If you checked the "Yes" box, (1) Enter the name of the State where you are required to pay contributions . . . ▶
(2) Enter your State reporting number as shown on State unemployment tax return . . . ▶

Part I Computation of Taxable Wages and Credit Reduction (To Be Completed by All Taxpayers)

1 Total payments (including exempt payments) during the calendar year for services of employees . . . . .

	Amount paid
2 Exempt payments. (Explain each exemption shown, attaching additional sheets if necessary) ▶	
3 Payments for services in excess of $6,000. Enter only the excess over the first $6,000 paid to individual employees exclusive of exempt amounts entered on line 2. Do not use State wage limitation . . .	

4 Total exempt payments (add lines 2 and 3) . . . . .
5 **Total taxable wages** (subtract line 4 from line 1). (If any portion is exempt from State contributions, see instructions) . . ▶
6 State wages included on line 5, Part I

(a) CT ____ × .007 ____	(d) IL ____ × .003 ____	(h) PR ____ × .003 ____
(b) DE ____ × .006 ____	(e) ME ____ × .003 ____	(i) RI ____ × .006 ____
(c) DC ____ × .006 ____	(f) NJ ____ × .003 ____	(j) VT ____ × .006 ____
	(g) PA ____ × .006 ____	(k) VI ____ × .003 ____

7 Add lines 6(a) through 6(k). (Enter total on line 2, Part II or line 4, Part III, as appropriate) . . . . . . ▶

Part II Tax Due or Refund (Complete if You Checked the "Yes" boxes in Both Items A and B Above)

1 FUTA tax. Multiply the wages on line 5, Part I, by .007 and enter here . . . . .
2 Credit reduction. Enter amount from line 7, Part I . . . . .
3 Total FUTA tax (add lines 1 and 2) . . . . .
4 Less: Total FUTA tax deposited from line 5, Part IV . . . . .
5 Balance due (subtract line 4 from line 3—if over $100, see Part IV instructions). Pay to IRS . . . . . ▶
6 Overpayment (subtract line 3 from line 4) . . . . . ▶

Part III Tax Due or Refund (Complete if You Checked the "No" Box in Either Item A or Item B Above)

1 Gross FUTA tax. Multiply the wages on line 5, Part I, by .034 . . . . .
2 Maximum credit. Multiply the wages on line 5, Part I, by .027 . . . . .
3 Enter the smaller of the amount on line 11, Part V, or line 2, Part III . . . . .
4 Credit reductions. Enter amount from line 7, Part I . . . . .
5 Credit allowable (subtract line 4 from line 3) . . . . .
6 Net FUTA tax (subtract line 5 from line 1) . . . . .
7 Less: Total FUTA tax deposited from line 5, Part IV . . . . .
8 Balance due (subtract line 7 from line 6—if over $100, see Part IV instructions). Pay to IRS . . . . . ▶
9 Overpayment (subtract line 6 from line 7) . . . . . ▶

Part IV Record of Federal Tax Deposits for Unemployment Tax (Form 508) (Do not include contributions paid to State)

	a. Quarter	b. Liability for quarter	c. Date of deposit	d. Amount of deposit
1	First			
2	Second			
3	Third			
4	Fourth			

5 **Total FUTA tax deposited** (add column d, lines 1 through 4) . . . . . . ▶

If you will not have to file returns in the future, write "Final" here (see general instruction "Who Must File") . . ▶

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 payments to employees.

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

Part V **Computation of Tentative Credit (Complete if You Checked the "No" Box in Either Question A or B on Page 1—See Instructions)**

Name of State 1	State reporting number(s) as shown on employer's State contribution returns 2	Taxable payroll (as defined in State act) 3	State experience rate period 4 From—	To—	State experience rate 5	Contributions if rate had 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
10 Totals . . . . . . ▶									

11 Total tentative credit (add line 10, columns 8 and 9—see instructions for limitations) . . . . ▶

1. Household Employers: You do not have to file this form unless you paid cash wages of $1,000 or more for household work in any calendar quarter in 1979 or 1980.

2. Household and Other Employers Who File Form 940: If your total Federal unemployment (FUTA) tax for 1980 is not more than $100, you do not have to deposit the tax. If you do not have to deposit FUTA tax and you:

(a) made all required payments to your State unemployment fund,

(b) are required to make payments to the unemployment fund of only one State, and

(c) paid wages subject to Federal unemployment tax that are also subject to State unemployment tax,

complete Parts I and II. Otherwise, complete Parts I, III, and V.

3. Employers Who Are Required to Deposit FUTA Tax: If you meet tests (a), (b), and (c) above, complete Parts I, II, and IV. Otherwise, complete Parts I, III, IV, and V.

General Instructions

Purpose of Form 940.—Use it for the annual reporting of tax under FUTA. **This tax is paid only by the employer.** The gross tax rate is 3.4% (.034) on the first $6,000 of wages paid to each employee during 1980.

Who Must File.—In general, every employer who during 1979 or 1980 (a) paid wages of $1,500 or more in any calendar quarter or (b) at any time had one or more employees for some part of a day in any 20 different weeks must file. Count all regular, temporary, and part-time employees. A partnership should not count its partners. If there is a change in ownership or other transfer of business during the year, each employer who meets tests (a) or (b) above must file. But neither should report wages paid by the other. Organizations described in Code section 501(c)(3) do not have to file.

As an agricultural or household employer, you must file Form 940 if any of the following apply to you:

(1) You paid cash wages of $20,000 or more to farmworkers during any calendar quarter in 1979 or 1980.

(2) You employed 10 or more farmworkers during some part of a day (whether or not at the same time) for at least one day during any 20 different weeks in 1979 or 1980. Count aliens admitted to the U.S. on a temporary basis to perform farmwork in 1980 (after 1980, in the current or preceding year) to determine if you meet either of the above tests. However, wages paid to these aliens are not subject to FUTA tax until 1982.

(3) You paid cash wages of $1,000 or more in any calendar quarter in 1979 or 1980 for household work in a private home, local college club, or a local chapter of a college fraternity or sorority. **Note:** See Form 942 for a definition of household work in a private home.

If you receive a form and are not liable for Federal unemployment tax for 1980, write "Not Liable" across the front and return it to IRS. If you will not have to file returns after this, write "Final" on the line above the signature line.

Once you have filed a Form 940, we will send you an addressed form near the end of the year. If you do not receive it, ask for one from an IRS office in time to file.

Due Date.—Form 940 for 1980 is due by February 2, 1981. However, if you made timely deposits in full payment of the tax due, your due date is February 10, 1981.

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
Delaware, District of Columbia 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 IRS 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.

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

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

There are also penalties for willful failure to pay tax, keep records, 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 amounts you pay into a certified State (including Puerto Rico and the U.S. Virgin Islands) unemployment fund by the due date of Form 940.

"Contributions" are payments that State law requires you to make to an unemployment fund because you are an employer. These payments are "contributions" only to the extent that they are not deducted or deductible from the employees' pay.

You may take credit against the tax whether or not you paid amounts for "employment." You may not take credit for voluntary payments or for penalties or interest payments to a State.

Credit for payments you make after the due date (or extended due date) for filing Form 940 may not be more than 90% of the amount that would have been allowable if you had paid the amounts by the due date.

If you have been granted an experience rate lower than 2.7% (.027) by a State for the whole or part of the year, you are entitled to an additional credit. This credit is equal to the difference between actual payments and the amount you would have been required to pay at 2.7%.

The total credit allowable may not be more than 2.7% of taxable wages.

Special Credit for Successor Employers.—If you are claiming special credit as a successor employer, see Code section 3302(e) for the conditions that you must meet, or contact an IRS office.

Specific Instructions

All filers must complete Questions A, B, and Part I.

Use Part II if you pay contributions to only one State unemployment fund, you made all State payments by the due date of Form 940, and all of the FUTA wages are subject to the State's unemployment fund taxes. Otherwise, complete Parts III and V.

Complete Part IV if your total tax for the year is more than $100.

Part I.—Computation of Taxable Wages and Credit Reduction

Line 1—Total payments.—Enter the total payments you made to employees during the calendar year, even if they are 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. Enter the amount before any deductions.

How the payments are made is not important in determining if they are wages. Thus, you may pay wages for piecework or

(Instructions continued on page 4.)

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

Employer's Annual Federal Unemployment Tax Return

1980

Calendar Year 1980

Employer identification number

YOUR COPY

A Did you pay all required contributions to your State unemployment fund by the due date of Form 940? ☐ Yes ☐ No

If you check the "Yes" box, enter amount of contributions timely paid to your State unemployment fund ▶ $

B Are you required to pay contributions to only one State? ☐ Yes ☐ No

If you checked the "Yes" box, (1) Enter the name of the State where you are required to pay contributions ▶

(2) Enter your State reporting number as shown on State unemployment tax return ▶

Part I Computation of Taxable Wages and Credit Reduction (To Be Completed by All Taxpayers)

1 Total payments (including exempt payments) during the calendar year for services of employees

2 Exempt payments. (Explain each exemption shown, attaching additional sheets if necessary) ▶ — Amount paid

3 Payments for services in excess of $6,000. Enter only the excess over the first $6,000 paid to individual employees exclusive of exempt amounts entered on line 2. Do not use State wage limitation

4 Total exempt payments (add lines 2 and 3)

5 Total taxable wages (subtract line 4 from line 1). (If any portion is exempt from State contributions, see instructions) ▶

6 State wages included on line 5, Part I

(a) CT ____ × .007 ____	(d) IL ____ × .003 ____	(h) PR ____ × .003 ____
(b) DE ____ × .006 ____	(e) ME ____ × .003 ____	(i) RI ____ × .006 ____
(c) DC ____ × .006 ____	(f) NJ ____ × .003 ____	(j) VT ____ × .006 ____
	(g) PA ____ × .006 ____	(k) VI ____ × .003 ____

7 Add lines 6(a) through 6(k). (Enter total on line 2, Part II or line 4, Part III, as appropriate) ▶

Part II Tax Due or Refund (Complete if You Checked the "Yes" boxes in Both Items A and B Above)

1 FUTA tax. Multiply the wages on line 5, Part I, by .007 and enter here

2 Credit reduction. Enter amount from line 7, Part I

3 Total FUTA tax (add lines 1 and 2)

4 Less: Total FUTA tax deposited from line 5, Part IV

5 Balance due (subtract line 4 from line 3—if over $100, see Part IV instructions). Pay to IRS ▶

6 Overpayment (subtract line 3 from line 4) ▶

Part III Tax Due or Refund (Complete if You Checked the "No" Box in Either Item A or Item B Above)

1 Gross FUTA tax. Multiply the wages on line 5, Part I, by .034

2 Maximum credit. Multiply the wages on line 5, Part I, by .027

3 Enter the smaller of the amount on line 11, Part V, or line 2, Part III

4 Credit reductions. Enter amount from line 7, Part I

5 Credit allowable (subtract line 4 from line 3)

6 Net FUTA tax (subtract line 5 from line 1)

7 Less: Total FUTA tax deposited from line 5, Part IV

8 Balance due (subtract line 7 from line 6—if over $100, see Part IV instructions). Pay to IRS ▶

9 Overpayment (subtract line 6 from line 7) ▶

Part IV Record of Federal Tax Deposits for Unemployment Tax (Form 508) (Do not include contributions paid to State)

	a. Quarter	b. Liability for quarter	c. Date of deposit	d. Amount of deposit
1	First			
2	Second			
3	Third			
4	Fourth			

5 Total FUTA tax deposited (add column d, lines 1 through 4) ▶

If you will not have to file returns in the future, write "Final" here (see general instruction "Who Must File") ▶

Keep This Copy for Your Records

You must keep 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 later. These copies must be available for inspection by the Internal Revenue Service.

For More Information

See **Publication 15**, Circular E, Employer's Tax Guide, and **Publication 539**, Withholding Taxes and Reporting Requirements, for more detailed information. Household employers should see **Publication 503**, Child and Disabled Dependent Care.

Part V **Computation of Tentative Credit (Complete if You Checked the "No" Box in Either Question A or B on Page 1—See Instructions)**

Name of State 1	State reporting number(s) as shown on employer's State contribution returns 2	Taxable payroll (as defined in State act) 3	State experience rate period 4 From—	To—	State experience rate 5	Contributions if rate had 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
10 Totals . . . . . . ▶									
11 Total tentative credit (add line 10, columns 8 and 9—see instructions for limitations) . . . . ▶									

as a percentage of profits, and you may pay wages hourly, daily, weekly, monthly, or yearly. You may pay wages in cash or some other way, such as goods, lodging, food, or clothing. For items other than cash, use the fair market value at the time of payment.

Line 2—Exempt payments.—"Wages" and "employment" as defined for FUTA purposes do not include every payment and every kind of service an employee may perform. In general, payments excluded from wages and payments for services excepted from employment are not subject to tax. You may deduct these payments from total payments only if you explain them on line 2.

Enter such items as the following:

(1) Agricultural labor if you (a) paid cash wages of less than $20,000 for such labor for each calendar quarter in 1979 and 1980 AND did not employ 10 or more farmworkers during any part of a day during any 20 different weeks in 1979 or 1980, OR (b) paid wages to aliens admitted to the United States on a temporary basis to perform farmwork before 1982.

(2) Benefit payments for sickness or injury under a worker's compensation law, insurance plan, and certain employer plans.

(3) Household service if you paid cash wages of less than $1,000 in each calendar quarter in 1979 and 1980.

(4) Certain family employment.

(5) Certain fishing activities.

(6) Non-cash payments for farm work or household services in a private home that are included on line 1. Only cash wages to these workers are taxable.

(7) Any other exempt payments or services.

For more detailed information, see Circular E, Employer's Tax Guide (Rev. 11–78).

Line 3.—Enter the total of the amounts you paid each employee in excess of $6,000. For example, if you have 10 employees whom you paid $8,000 each during the year, enter $80,000 on line 1 and $20,000 on line 3. The $6,000 wage limitation is for FUTA purposes only. Do not use the State wage limitation for this entry.

Line 5—Total taxable wages.—If any part of these wages is exempt from State unemployment taxes, you must fill out Parts III and V, even if you checked questions A and B "Yes."

Line 6.—Enter any FUTA wages subject to the unemployment compensation laws of Connecticut, Delaware, District of Columbia, Illinois, Maine, New Jersey, Pennsylvania, Puerto Rico, Rhode Island, Vermont, or Virgin Islands. (If in doubt, ask your local IRS office.) Multiply the wages by the appropriate rate. This adjustment is required by Internal Revenue Code section 3302(c)(2).

If no wages are subject, enter "none" on line 7.

Part II.—Tax Due or Refund

Use this part if you made payments to only one State by the due date of Form 940, and all your wages shown on line 5 of Part I are subject to the State's unemployment fund taxes. The tax rate of .007 gives you credit for your payments to your State's unemployment fund.

Part III.—Tax Due or Refund

Use this part if you do not qualify for Part II.

Line 3.—Enter the smaller of (1) line 11, Part V—Total tentative credit, or (2) line 2, Part III—2.7% of taxable FUTA wages. This is the maximum credit allowable for your payments to the State unemployment fund.

Line 4.—Enter the amount from line 7, Part I. Subtract this amount from line 3, Part III. The result on line 5 is your net allowable credit for payments to the State unemployment fund.

Part IV.—Record of Federal Tax Deposits

Complete this part if your total tax (line 3, Part II or line 6, Part III) is over $100. To figure your FUTA tax liability for each of the first 3 quarters of a year, multiply by .007 that part of the first $6,000 of each employee's annual wages you paid during the quarter. Enter this amount in column b, Liability for quarter.

The total of column b must equal your total tax. Otherwise, you may be assessed a failure to deposit penalty computed on your average liability. In columns c and d, be sure to enter the date and the amount of the deposit you made for each quarter.

If the amount subject to deposit (plus any undeposited amount of $100 or less for any earlier quarter) is more than $100, deposit it by the last day of the first month following the close of the quarter.

Your liability for the 4th quarter is the total tax (line 3, Part II or line 6, Part III) minus amounts deposited for the year. If this is over $100, deposit the entire amount by January 31. If it is $100 or less, you can either make a deposit or pay it with your Form 940 by January 31.

If you deposited the proper amounts, following these rules, the balance due with Form 940 will never be more than $100.

Deposit Federal unemployment tax in an authorized financial institution or the Federal Reserve Bank for your area according to the instructions on the back of a preinscribed Federal Tax Deposit (FTD) Form 508 which must accompany each deposit.

Preinscribed FTD Forms 508 are mailed to you around the end of March for your use throughout the year. The number of cards you receive is based on your history of payments during the previous two years. If you do not receive a supply of cards or need more than the number sent to you, you can order cards by telephoning the toll-free IRS number for your area or by writing the Service Center where you file Form 940. Your request should show your name, address, employer identification number, the kind of tax (FUTA), the tax period ending date (December 31), and the number of cards you need.

Part V.—Computation of Tentative Credit

Complete this schedule if: (1) You made payments to the unemployment fund of more than one State; (2) You did not make your State payments by the due date of Form 940; or (3) Any wages subject to Federal unemployment tax were exempted from State unemployment taxes. If you have a State experience rate lower than 2.7% for all or part of the year, use columns 1 through 9. If you have no experience rate, use columns 1, 2, 3, and 9 only. If you have a rate of 2.7% or higher, use columns 1, 2, 3, 4, 5, and 9 only. If you have an experience rate on part of your payroll, show separately in columns 1, 2, 3, and 9 the part that the rate does not apply to. If you were granted an experience rate for only part of the year or the rate was changed during the year, enter in the appropriate columns the period each separate rate applied to, your payroll rate, 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) that you were required to pay contributions to.

Column 2.—Enter the State reporting number that was assigned to you when you registered as an employer with your State.

Column 3.—Enter the taxable payroll that you must pay taxes on to the unemployment fund of the State in column 1. If your experience rate is zero, enter the amount of wages that you would have had to pay on if the rate had not been granted.

Columns 4 and 5.—Your State experience rate is the rate at which the State taxes your payroll for State unemployment purposes. This rate may be adjusted from time to time based on your "experience" with the State fund, that is, based on the number and length of claims for unemployment compensation by your former employees against the fund. If you do not know your rate, contact your State employment security agency.

Column 8.—Subtract the amount in column 7 from column 6. If zero or less, enter "0."

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

Line 11.—Add the total of line 10, columns 8 and 9. The allowable credit for State contributions you make after the due date (or extended due date) for filing Form 940 may not be more than 90% of the credit that would have been allowed if you had paid the State contributions by the due date.

Department of the Treasury
Washington, D.C. 20220

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