The Operation and Effect of the Possessions Corporation System of Taxation

Fifth Report

Department of the Treasury
July 1985

THE OPERATION AND EFFECT OF THE POSSESSIONS CORPORATION SYSTEM OF TAXATION

FIFTH REPORT

DEPARTMENT OF THE TREASURY

JULY 1985

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THE SECRETARY OF THE TREASURY
WASHINGTON

JUL 31 1985

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 fifth annual report entitled, The Operation and Effect of the Possessions Corporation System of Taxation. This report covers tax return information for 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 Bob Packwood, Chairman, Committee on Finance.

Sincerely,

James A. Baker III

James A. Baker, III

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

Enclosure

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Enclosure

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Chapter 1

INTRODUCTION AND SUMMARY

This is the fifth report to the U.S. Congress on the possessions corporation system of taxation. Possessions corporations, also known as 936 corporations, are U.S.-chartered companies 1/ which are exempt under section 936 of the Internal Revenue Code 2/ from Federal tax on business income and qualified passive investment income from Puerto Rico and certain other U.S. possessions. Almost all possessions corporations operate in Puerto Rico. This report covers tax return information for possessions corporations filing full year returns for calendar year 1982, or for a fiscal year ending on or before June 30, 1983 (and other economic data available through mid-1984). It does not reflect the amendments to section 936 made by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

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 analyzes their economic impact. Chapter 2 summarizes the U.S. legislation concerning possessions corporations, including the modifications to that legislation in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). TEFRA provided special rules for the allocation to a possessions corporation of income from patents, trademarks, and other intangibles. These amendments reflected Congressional concern that corporations operating in the United States were shifting substantial income from intangibles to their subsidiaries in Puerto Rico in order to increase the tax savings provided under section 936. The TEFRA provisions are effective for taxable years beginning after 1982. Chapter 2 also reviews the relevant Puerto Rican tax legislation.

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. The tax exemptions contributed to a shift in the basis of the economy from agriculture in the 1950s to manufacturing, services, trade, and government in the 1970s. The effect of low wages relative to the United States and exemption from U.S. tariffs also contributed to the sustained high rate of Puerto Rican industrialization and economic growth in the 1948-1972 period. Puerto Rican real gross

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1/ Although Puerto Rico and other U.S. possessions are included in some definitions of the United States, 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").

national product (GNP) grew at an average annual rate of six percent, and real GNP per capita grew by five percent per year. The most buoyant sector of growth was manufacturing, where employment rose from 55,000 in 1950 to 142,000 in 1972.

Since 1972, however, Puerto Rican economic progress has slowed. The economy was badly hurt by the U.S. recessions of 1974-75 and 1981-82. Increases in Puerto Rican wages and cuts in U.S. tariffs have reduced Puerto Rico's ability to compete with foreign locations as a site for U.S. investment. Employment in manufacturing was stagnant in the period 1972-83, despite an expansion of jobs in high-technology industries such as pharmaceuticals and electronics. In constant dollars, private investment in plant and equipment fell in most years after 1973, so that its level in 1983 was about half of its level 10 years earlier. 3/ The Puerto Rican economy was in recession in the two-year period ending in June 1983. With the resumption of growth in the U.S. economy in 1983, Puerto Rican growth has also resumed. The unemployment rate reached an all-time annual high of 23.4 percent in the year ending June 1983, but subsequently declined. It was 21.6 percent in January 1985.

Chapter 4 describes the characteristics, by industry, of possessions corporations. It presents data for tax year 1982 on their assets, income, tax benefits, employment, and payroll. It is estimated that in 1982 there were 447 possessions corporations engaged in manufacturing, and that they earned net income of $4.1 billion and derived tax benefits of $1.7 billion. The average ratio of operating income to operating assets for these companies was more than five times that ratio for all mainland manufacturing companies.

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 section 936 corporations provides an indication of the extent to which this objective has been realized. Based on the sample of corporations for which employment information is available, employment in all possessions corporations in manufacturing industries is estimated at approximately 81,250, which represents 11 percent of total employment in Puerto Rico and 60 percent of all employees in Puerto Rico's manufacturing sector in 1982.

3/ Although private refinery construction represented 30 percent of total private investment in Puerto Rican plant and equipment in the period 1970-72, it had dropped to 4 percent in 1973 and remained at approximately that level during 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).

Possessions corporations' U.S. tax benefits in relation to their employment vary substantially by industry. In 1982, tax benefits per employee averaged $69,200 in the pharmaceutical industry and $3,000-4,000 in the low-technology, labor-intensive industries. Over all manufacturing industries, possessions corporations' tax benefits averaged $20,650 per employee, or 147 percent of the average compensation per employee of $14,070.

Chapter 4 also presents summary data for the period 1974 through 1982. Net income of possessions corporations in the manufacturing sector rose from about $800 million in 1974 to $4 billion in 1982. The percentage of total net income of manufacturing possessions corporations earned by the pharmaceutical industry was 40 to 50 percent through the period 1974-1981 and 54 percent in 1982. The share of net income earned by the electrical and electronics industry varied between 15 percent and 20 percent in most years, except 1981, when it rose to 26 percent; it was 22 percent in 1982.

Possessions corporations held approximately $11 billion in Puerto Rican financial assets as of year-end 1983. Chapter 5 analyzes the impact of these assets on Puerto Rican growth. It first reviews recent regulatory changes by the Puerto Rican government in its continuing effort to channel section 936 financial assets to productive uses in Puerto Rico. The chapter then attempts to evaluate the impact of financial investments by section 936 corporations on interest rates, capital inflows, and real investment in Puerto Rico. The evidence suggests that, while the Puerto Rican government has recently been successful in forcing down the interest rate paid to 936 corporations, the impact of the Qualified Possession Source Investment Income (QPSII) provision on real investment in Puerto Rico has been modest.

Appendix A describes the operation of the possesions corporation system of taxation in American Samoa, Guam, and the Virgin Islands.

Appendix B reports on the assets, income and tax benefits of possessions corporations in Puerto Rico in tax year 1981.

Appendix C discusses the sources and limitations of the data used in the report.

Appendix D contains copies of the tax forms from which the data were obtained.

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, approximately 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 and 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 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. These provisions were adopted primarily to help U.S. corporations compete with foreign firms in the Philippines (a U.S. possession before 1946). Under these provisions, U.S. corporations which met two gross income tests were exempt from tax on all income derived from sources outside the United States. To qualify for the exemption, a U.S. 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 ensure that the 80-50 income tests were met. Under the 1921 Act, dividends paid by a posssessions corporation to a corporate shareholder were fully taxable. In effect, a U.S. corporate shareholder was granted deferral from U.S. tax on the foreign source income of a possessions corporation (from both within and without the possessions) until it was repatriated. 1/

B. Tax Reform Act of 1976. The possessions corporation exemption remained unchanged until the Tax Reform Act of 1976. Many U.S. firms had established plants in Puerto Rico after 1948, when Puerto Rico enacted a program of tax exemption for manufacturing firms. Proponents of continued U.S. tax exemption argued that the possessions corporation system of taxation was needed to 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.

In order to continue to promote Puerto Rico's industrial development, the Tax Reform Act of 1976 left intact the exemption for income derived by U.S. corporations from operations in a possession, and exempted from tax dividends remitted by a possessions corporation to its U.S. parent. But to prevent the avoidance of tax on income invested in foreign countries by possessions corporations, the Tax Reform Act eliminated the exemption for income derived outside of the possessions. The 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:

- Change in the scope of and method of effecting the tax exemption. Before 1976, a possessions corporation was exempt from 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

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1/ Foreign-chartered corporations also benefit from the deferral of U.S. tax on foreign source income until profits are remitted to the United States. However, in the first part of this century U.S. companies 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.

-- QPSII, which is non-business income derived from the possession in which the corporation has its trade or business 2/ and which is attributable to the investment of funds derived from such trade or business.

Instead of actually exempting this income from U.S. taxation, 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.

o Exemption from U.S. tax on dividends remitted by a possessions corporation to its U.S. parent. Prior to 1976, dividends paid by a possessions corporation to its U.S. parent were fully taxable to the U.S. parent, but amounts received upon liquidation of a possessions corporation were exempt from tax. As a consequence, 931 corporations accumulated substantial earnings and invested them in the Eurodollar market in anticipation of a tax-free liquidation. 3/ To accelerate the repatriation of earnings and to remove the tax incentive to liquidate, the Tax Reform Act of 1976 allowed U.S. parent corporations to claim a dividends-received deduction for dividends from an affiliated possessions corporation. If the possessions company is a wholly owned subsidiary (as most are), the deduction equals 100 percent of the dividend and, thus, the dividend is free of any U.S. tax.

o Requirement that a possessions corporation elect the benefits of section 936 for 10 years. Under section 931, as construed by a court decision, 4/ 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 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

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2/ The requirement that QPSII must be derived from the possessipn 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.

3/ Possessions companies were not generally subject to the U.S. accumulated earnings tax.

4/ 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.

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 reasons for 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 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. 5/

C. Treatment of Income from Intangibles under the Tax Equity and Fiscal Responsibility Act of 1982. 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, which had been developed and paid for by an affiliated U.S. corporation and subsequently transferred to the possessions corporation. In many instances, U.S. corporations attempted to increase the income which was exempt from tax under section 931 or 936 by transferring to an affiliated possessions corporation income-producing intangible assets. These corporations construed the law to require no allocation to the U.S. parent of income generated by the intangibles. For example, a pharmaceutical company might develop a patentable drug in its U.S. laboratory and transfer the patent to its wholly owned possessions corporation. The possessions corporation would produce, in whole or in part, the patented drug and would claim the income from the patent as possession source gross income. The view of the Internal Revenue Service, however, was that income generated by the transferred intangibles had to be allocated to the U.S. parent corporations. 6/ This issue has resulted in lengthy litigation. 7/

5/ 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.

6/ For a description of the pre-1982 rules relating to intercorporate transfers of assets and the allocation of income, see pages 14-20 of The Operation and Effect of the Possessions Corporation System of Taxation, Fourth Report, U.S. Treasury Department, February, 1983.

7/ See, for example, Eli Lilly and Co. v. Commissioner, 84 T.C. no. 65 (May 28, 1985).

In the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Congress provided statutory rules for the allocation to a possessions corporation of income from intangibles. The purpose of these provisions was "to lessen the abuse caused by taxpayers claiming tax-free income generated by intangibles developed outside of Puerto Rico." 8/ TEFRA added a new section 936(h) to the Internal Revenue Code providing, as a general rule, that income from intangibles is taxable to the U.S. shareholders of the possessions corporation. TEFRA also provided that a possessions corporation and its affiliates could "elect out" of the general rule under either a "cost sharing" option or a "50/50 profit split" option. These options provide a framework under which a possessions corporation may claim certain income from intangibles developed or purchased by its affiliated corporations. These options apply to the products produced in whole or in part by a possessions corporation (so-called "possession products").

1. Cost Sharing Option. Under the cost sharing option, a possessions corporation is required to make a cost sharing payment equal to a fraction of the current year's research expenditures of the affiliated group in the "product area" in which the possession product falls. 9/ The fraction is equal to the ratio of third party sales of the possession product to third party sales of all products in the product area by the affiliated group. The cost sharing payment is to reduce the amount of deductions otherwise allowable to the appropriate U.S. affiliates.

The quid pro quo for the cost sharing payment is that the possessions corporation is treated as the owner of the manufacturing intangibles (but not marketing intangibles) associated with the possession product. Thus, a determination will have to be made under the cost sharing option as to what portion of the final sales price of the possession product is a return to manufacturing intangibles (and therefore tax-exempt income to the possessions corporation) and what portion is a return to marketing intangibles (and therefore taxable income to its affiliates). The generally applicable regulations under section 482 are to be used for this purpose.

8/ 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.

9/ The "product area" is defined by reference to the 3-digit classification of the Standard Industrial Classification code. Examples of 3-digit codes are drugs, electronic components, and beverages.

2. <u>**50/50 Split of Combined Taxable Income from the Possession Product**</u>. Under the profit split option, 50 percent of the combined taxable income of the possessions corporation and its U.S. affiliates derived from sales of the possession product to foreign affiliates or unrelated persons will be allocated to the possessions corporation, and the remainder will generally be allocated to the U.S. affiliates. This option permits the possessions corporation to obtain part of the return on all intangibles related to the possession product. For purposes of computing the combined taxable income from the product, all direct and indirect expenses relating to the product are taken into account.

Proposed regulations issued by the Treasury Department under section 936(h) 10/ provide rules for the computation of income from the "possession product" in the case that the product is not sold directly to foreign affiliates or unrelated persons, but is a component of, or one stage of processing in, a product sold to unrelated persons.

3. <u>**Eligibility**</u>. To be eligible to use the cost sharing or profit split option to compute income from a possession product, a possessions corporation must have a "significant business presence" with respect to that product in a possession. This requirement is met if the possessions corporation meets one of two tests:

- <u>25% Value added test</u>. The possessions corporation must show that it incurred 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.

- <u>65% labor test</u>. Alternatively, the possessions corporation must show that it incurred, for labor services performed in the possession, at least 65 percent of the total labor costs of the possessions corporation and its affiliates in producing the product or service during the taxable year. 11/

Under the proposed regulations, start-up operations of new 936 corporations and new possession products of existing 936 corporations could meet the "significant business presence" requirement by

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10/ <u>Federal Register</u>, January 10, 1984, pp. 1,227-1,243.

11/ As a variant of this test, the proposed regulations under section 936(h) permit certain Puerto Rican construction costs to be used to meet the business presence requirement.

satisfying a lower threshhold of value-added or labor cost than the percentages referred to above. For such start-up operations, the applicable percentages under the proposed regulations are as follows:

Business Presence Tests for Start-up Operations	Year 1	Year 2	Year 3
Value Added Test	10%	15%	20%
Labor Test	35%	45%	55%

The proposed regulations under section 936(h) would provide a flexible definition of the term "possession product." The term includes any item of property which is the result of a manufacturing process, including components and so-called "end-product forms" (products which are treated as not including certain of their components for purposes of the business presence test and the computation of income from the possession product). This flexible definition would permit a possessions corporation to satisfy the significant business presence test with respect to some possession product, and then to compute its income under the cost-sharing option or profit-split option with respect to that same product.

D. **Passive Income Limitation under TEFRA.** In addition to the new guidelines on income from intangibles, TEFRA 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 years 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 or for such part of such period as may be applicable. The greater level of required active business income will mean that proportionately less passive investment income can be earned by a corporation still wishing to qualify for effective tax exemption under section 936.

II. Puerto Rican Tax Provisions

Since 1948, Puerto Rico generally has provided its own tax incentives for manufacturing and other specified business activities. 12/ Puerto Rico currently grants partial exemptions from income tax and other taxes to approved businesses for specified periods of time (generally 10 to 25 years). Possessions corporations in the manufacturing sector in Puerto Rico normally hold an exemption contract from the Puerto Rican government. In 1983 such corporations paid, on average, an estimated 5 percent of their income in taxes to Puerto Rico.

12/ Pages 23-25 of the Fourth Report summarize the history of the Puerto Rican Industrial Incentives 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.

A. Taxation of Non-Exempt Corporations. 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 Puerto Rican 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 residents and Puerto Rican 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.

In addition to its income tax, Puerto Rico imposes a "tollgate tax" on dividends paid out of Puerto Rican source earnings and profits to a U.S. or foreign parent corporation. If the parent corporation is not engaged in a trade or business in Puerto Rico, the dividend is subject to a 25 percent tollgate tax withheld at source. However, the rate of tollgate tax is 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 the parent corporation.

B. Taxation Under an Old Exemption Grant. In general, a firm which has a tax exemption grant under the 1963 Industrial Incentive Act is 100 percent exempt from tax on business income and on investment income from certain designated assets 13/. This tax-exempt

13/ The assets which give rise to tax-exempt passive 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 the Puerto 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. 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 5, below.

income is called Industrial Development Income. The firm is also 100 percent exempt from property and gross receipts taxes. The tax exemption grant lasts from 10 to 30 years, depending on the location of the plant.

Dividends paid out of Industrial Development Income to a U.S. parent corporation are subject to the 10 percent tollgate tax. However, the rate is reduced to 7 percent where the tax-exempt firm retains a certain percentage of its annual earnings in Puerto Rico for a specified period of time. On liquidation, a firm with an old tax exemption grant may distribute all accumulated earnings free of the tollgate tax.

C. __Taxation Under an Old Exemption Grant "Converted" to the 1978 Industrial Incentives Act.__ The 1978 Industrial Incentives Act does not affect the terms of tax exemption grants which were issued before June 1978, but it provides opportunities to firms operating under old tax exemption grants to convert to partial tax exemption under the new Act. The election to convert had to be made by December 31, 1979, and two optional conversion plans were available:

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

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

After the period of original exemption has expired, the firm electing this option is automatically entitled to operate partially exempt from taxation for ten more years. During the first five of those ten years, 50 percent of income will be exempt. During the second five years, between 35 percent and 50 percent will be exempt, depending on the location of the plant.

__Option Two.__ A company with six or more years remaining on its current tax exemption may make an alternative election. It may exclude 90 percent of its income from taxation, and may credit two-thirds of the corporate income taxes actually paid against the tollgate tax on dividends paid from current earnings. A company that elects this 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, dividends paid by converted firms out of pre-1978 earnings may benefit from a reduced tollgate tax rate. On liquidation, pre-1978 earnings of "converted" firms are exempt from tollgate tax.

D. <u>Taxation Under a New Exemption Grant</u>. 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 14/	
		Minimum	Maximum
1-5	90%	2.20%	4.50%
6-10	75	5.50	11.25
11-15	65	8.75	15.75
16-20	55	9.90	20.25
21-25	50	11.00	22.50

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

The actual effective tax rates will be somewhat lower than those shown because of two additional incentives provided by the 1978 Act to encourage labor-intensive operations and assist small firms. All grants issued under the new Act allow the firm an added deduction of 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.

14/ 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.

If a firm with a partial exemption grant 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 Puerto Rican income tax. The intent of the tax exemption for 2(j) earnings is to induce 936 corporations to reinvest their business profits in Puerto Rico. However, the main incentive to a firm to retain its profits 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, instead of 10 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 island with a population of almost 3.3 million and few natural resources. Its economy is closely integrated with the U.S. economy. 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. During the year ending June 30, 1982, approximately 84 percent of Puerto Rico's exports were to the United States. In recent years about 90 percent of gross fixed investment in Puerto Rico has been derived from U.S. sources. Federal statutes other than domestic tax laws generally apply to Puerto Rico, some (such as minimum wage legislation) with large economic impacts. With a few important exceptions, Federal grant-in-aid programs and income maintenance programs apply to Puerto Rico. Residents participate fully in the Social Security and Unemployment Insurance programs. However, Puerto Rico administers nutritional assistance (such as Food Stamps) under a block grant instead of an entitlement program, and Federal payments to Puerto Rican residents for Medicaid and Aid to Families with Dependent Children are subject to a cap.

The ties between Puerto Rico and the United States have helped shape the push for Puerto Rican economic 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. Employment in manufacturing grew from 55,000 in 1950 to 142,000 in 1972. Gross National Product and GNP per capita also grew rapidly. In the period 1973-1983, however, Puerto Rican economic progress slowed. Total employment and employment in the manufacturing sector were stagnant. Real GNP per capita has changed little since 1974. Private investment in plant and equipment as a percentage of GNP fell steadily from 10.3 percent of GNP in 1973, to 4.6 percent in 1983.

In part, the decline in Puerto Rico's economic performance is traceable to the U.S. recessions of 1974-75 and 1981-82. Puerto Rican growth has also been reduced by the erosion of the U.S.-Puerto Rican wage differential, U.S. tariff and tax cuts, and structural changes in the world economy.

I. Growth Since 1948 1/

Puerto Rico's economic growth in the period from 1948 through 1973 has often been referred to as an "economic miracle." Figure 3-1 and Table 3-1 show total and per capita GNP for Puerto Rico during the 1947-1983 period. According to this information, Puerto Rican GNP (expressed in 1972 dollars) increased at an average annual rate of 5.3 percent in the 1950s and 7.0 percent in the 1960s, compared to U.S. average annual growth in this period of 3.7 percent. Puerto Rico's remarkable growth was accompanied by the transformation of the agricultural economy of the 1940s to an economy based primarily on services and manufacturing. Manufacturing net income surpassed agricultural net income in 1955, while manufacturing employment surpassed agricultural employment in 1966. Real GNP per capita, which reflects substantial emigration from Puerto Rico, rose at an average annual rate of 4.7 percent in the 1950s and 5.5 percent in the 1960s, compared to 2.2 percent in the 1950-70 period in the United States.

Total employment in Puerto Rico grew much less quickly than GNP, and more slowly than U.S. employment. Total employment grew by 15 percent in Puerto Rico between 1950 and 1970, compared to a 35 percent increase in civilan employment in the United States. Emigration was substantial during that period. Presumably in response to cheaper air fares and better opportunities for employment on the mainland, emigration averaged nearly 50,000 persons per year between 1950 and 1960 and 20,000 per year in the following decade. (See Table 3-2). Since 1970, emigration patterns have fluctuated. The average net outflow was approximately 13,000 persons per year in the four-year period 1978-81, but increased in 1982 and 1983 to an average rate of 35,000 per year.

Table 3-3 shows the change in the sectoral distribution of employment in Puerto Rico from 1950 to 1983. The replacement of employment in home needlework and agriculture by employment in manufacturing and government was the most fundamental change of the 1950s and 1960s. Employment in manufacturing grew at an average annual rate of 3.9 percent and 5 percent, respectively, in the late 1950s and 1960s. Employment in government grew almost as rapidly through the 1950s and 1960s, and employment in construction and other services increased strongly in the 1960s. Total nongovernment employment declined in the 1950s but increased in the 1960s.

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

FIGURE 3-1

Total and Per Capita Gross National Product of Puerto Rico, 1947-1983 (Constant 1972 Dollars)

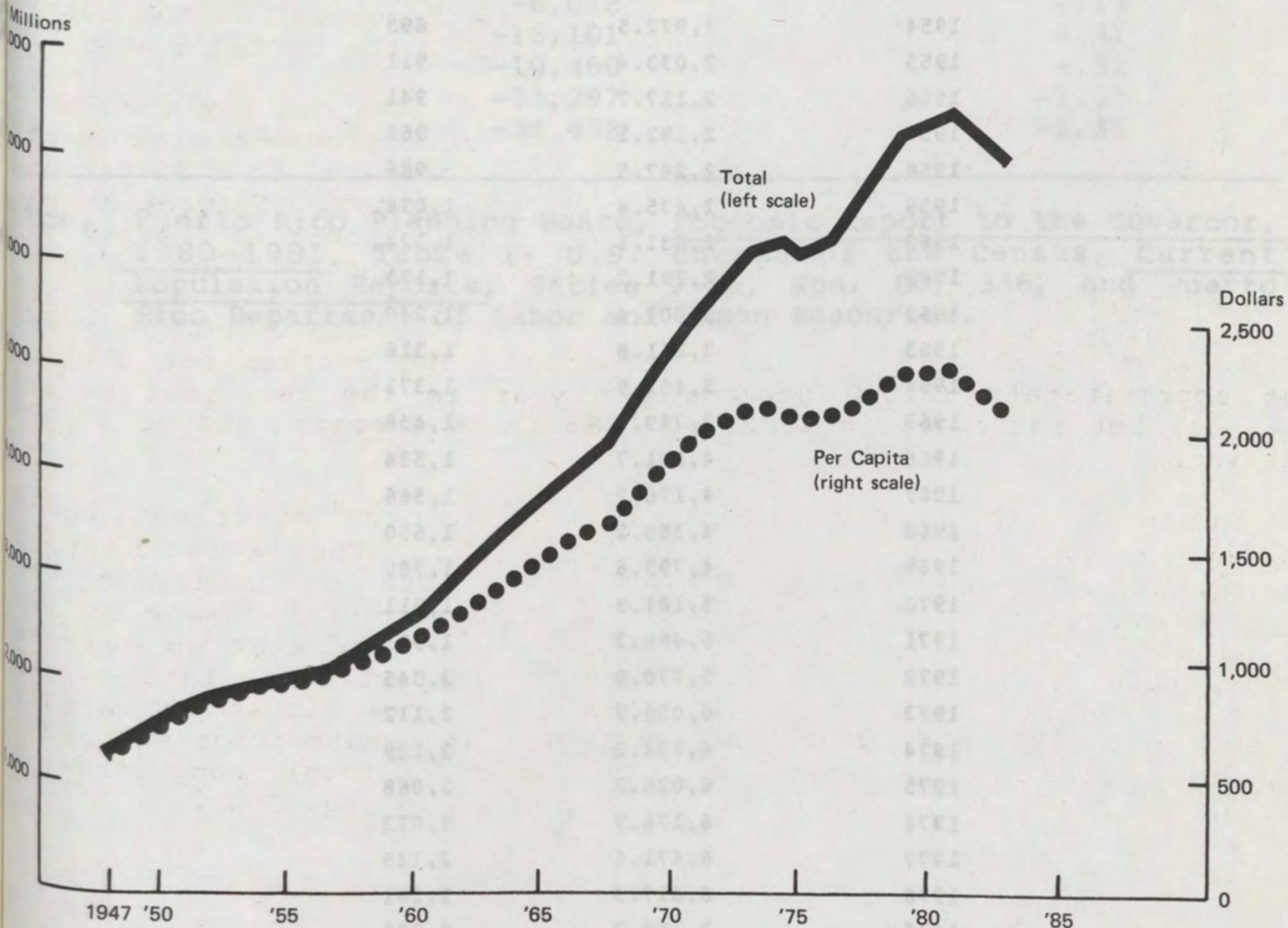

Table 3-1

Total and Per Capita Gross National Product of Puerto Rico, 1947-1983

Fiscal Year	GNP (millions)	GNP per capita 1/
	(constant 1972 dollars)	
1947	1,260.0	586
1948	1,307.9	601
1949	1,462.0	667
1950	1,569.4	711
1951	1,652.1	742
1952	1,814.4	813
1953	1,931.2	871
1954	1,972.5	893
1955	2,033.4	911
1956	2,117.7	941
1957	2,182.1	968
1958	2,247.5	986
1959	2,435.4	1,054
1960	2,631.1	1,124
1961	2,791.2	1,173
1962	3,007.4	1,240
1963	3,251.8	1,316
1964	3,462.9	1,373
1965	3,749.2	1,458
1966	4,001.7	1,534
1967	4,178.2	1,586
1968	4,385.2	1,650
1969	4,793.6	1,780
1970	5,181.9	1,911
1971	5,488.2	1,995
1972	5,770.9	2,045
1973	6,059.7	2,112
1974	6,134.2	2,129
1975	6,026.3	2,068
1976	6,176.7	2,073
1977	6,471.6	2,125
1978	6,817.9	2,201
1979	7,188.7	2,289
1980	7,281.0	2,287
1981	7,370.8	2,284
1982	7,103.8	2,182
1983	6,950.9	2,129

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1/ Based on average of population estimates at the beginning and end of the fiscal year.

Source: Puerto Rico Planning Board, Economic Report to the Governor, 1980-1981, Table 1.

Table 3-2

Net Migration of Residents of Puerto Rico

Fiscal Year	Net Migration of Residents of Puerto Rico	Annual Rate per mid-period population
950-1960	-493,000	-2.19%
960-1970	-201,000	-.79
970-1977	-43,640	-.22
978	-20,282	-.65
979	-6,078	-.19
980	-16,101	-.51
981	-10,460	-.32
982	-33,297	-1.02
983	-44,433	-1.36

urce: 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 Department of Labor and Human Resources.

Table 3-3

Puerto Rican Unemployment Rate and Distribution of Employment in Selected Years, 1950 - 1983
(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	11.2	699	111	588	61	132	*	81	134	15	47	117
1972	11.9	738	131	607	58	142	*	80	135	16	49	126
1973	11.7	745	141	604	49	139	*	78	144	18	49	125
1974	12.2	744	140	604	52	141	*	77	141	17	51	123
1975	15.3	699	143	556	47	130	*	65	134	17	49	114
1976	19.2	678	149	529	44	126	*	50	132	17	44	114
1977	20.0	691	157	534	40	135	*	40	136	18	46	119
1978	18.7	722	167	555	36	145	*	41	139	19	46	128
1979	17.5	735	173	562	36	146	*	44	141	19	46	130
1980	17.0	753	184	569	40	143	*	44	138	21	47	135
1981	17.9	759	185	574	38	141	*	44	142	23	49	137
1982	21.7	719	171	548	35	134	*	36	141	21	48	132
1983	23.4	703	170	533	37	131	*	30	136	22	45	132
Average annual growth rate												
1950-1960		-0.9%	3.3%	-1.3%	-5.3%	3.9%	-15.0%	5.2%	0.8%	7.2%	3.4%	-0.3%
1960-1970		2.4	5.5	1.9	-5.8	5.0	—	5.4	2.8	8.0	1.4	4.5
1970-1980		0.9	5.7	-0.2	-5.2	0.8	—	-5.3	0.8	4.9	0.4	1.5
1980-1983		-2.2	-2.6	-2.2	-2.6	-2.9	—	-12.0	-0.5	1.6	-1.4	-0.7

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1/ Includes only public administration.

* Less than 2,000

n.a. - not available

Sources: Puerto Rico Planning Board, Economic Report to the Governor, 1982-1983, 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.

Note: Figures for 1971 through 1981 were revised in the Economic Report to the Governor, 1982-1983.

A number of factors contributed to the growth of Puerto Rican employment during the 1960s. Exemptions from local taxes played a key role in inducing U.S. firms to locate plants in Puerto Rico. As explained in the Fourth Report, Puerto Rican labor was low-cost relative to mainland levels and contributed to Puerto Rico's attraction as a site for investment. 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.

Growth in government employment continued to be strong in the 1970s, from 1970 through 1981, declining only in the recession of 1982 and 1983. However, manufacturing employment was virtually stagnant in the period 1970-1983 and total non-government employment declined throughout most of the decade 1973-1983. In the period 1974-75 and again in the 1980s, the Puerto Rican economy was adversely affected by the U.S. recession and high U.S. interest rates. The Puerto Rican petrochemical industry suffered from the sharp increase in the price of foreign oil in 1973-74. The traditional Puerto Rican manufacturing industries, such as apparel, shoes, and textiles, faced increased competition from low-wage foreign countries. The Puerto Rican economy experienced a recession in 1974-76, and then grew by an average annual rate of 4.2 percent between 1976 and 1981. Real GNP fell 3.6 percent in the year ending June 1982 and 2.2 percent in the year ending June 1983, reflecting the U.S. recession and a reduction (in real terms) of Federal payments to Puerto Rico.

The unemployment rate, shown in column 1 of Table 3-3, has generally been very high by U.S. standards. Unemployment declined through the 1960s to just under 11 percent, but then rose steadily in the period 1970-77, when it peaked at 20 percent. With the U.S. recession and the elimination in U.S. fiscal year 1981 of 21,173 Puerto Rican public service jobs financed through the Federal Comprehensive Employment and Training Program (CETA), the unemployment rate increased again, from 17.0 percent in 1980 to 23.4 percent in 1983. The unemployment rate might have been even higher had it not been for a decline in the adult labor force. Labor force participation as a percentage of adult population fell from 44.5 percent in the early 1970s to 41.0 percent in 1983. The unemployment rate reached an all-time annual high of 23.4 percent in the year ending June 1983. By May 1984, it had dropped to 20.5 percent. Unemployment was at 21.6 percent in January 1985.

High levels of unemployment and low labor force participation rates explain most of the poverty in Puerto Rico. It is estimated that one-half of Puerto Rican families lived below the Federal poverty level in 1983.

Federal payments to Puerto Rico are an important component of personal income. As shown in Table 3-4, Federal payments include grants to the Puerto Rican government, Federal taxes earmarked for Puerto Rico, and net transfer payments to individuals, less social security taxes and other contributions by Puerto Rico. Net Federal payments in current dollars were $286 million in 1968, and $3,320

Table 3-4

Net Federal Payments to Puerto Rico
Selected Fiscal Years 1968-1983 1/

(millions of dollars)

	1968	1981	1982	1983
Federal grants to Puerto Rican Commonwealth and municipal governments, total	129	1,893	1,778	1,722
Food and nutrition assistance 2/	5	993	1,016	946
Education programs	--	97	92	74
Public assistance 3/	31	103	118	124
Community development block grants	15	115	94	95
Low-rent public housing	11	96	86	118
Employment and training programs	8	220	90	82
All other grants	59	269	283	283
Federal taxes transferred to Commonwealth government, total	93	319	290	389
Alcoholic beverage and tobacco excise taxes	66	236	239	326
Customs duties	27	83	51	62
Net Federal transfer payments to individuals, total 4/	64	846	1,144	1,209
Old age, survivors, and disability insurance	1	502	648	712
Veterans benefits	59	231	274	280
Excess of withdrawals over deposits in Unemployment Trust Fund	-3	-27	38	5
All other payments	7	140	184	212
TOTAL	286	3,058	3,212	3,320

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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/ Effective July 1, 1982, the food stamp program in Puerto Rico was terminated and replaced by a nutritional assistance grant program. In order to make the yearly figures comparable, all food stamp payments to individuals prior to July 1, 1982 are included within the category of block grants for food and nutrition assistance.

3/ Includes Medicaid, child support enforcement, maintenance assistance (AFDC), and low-income home energy assistance.

4/ 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.

Sources: U.S. Department of Commerce, Bureau of the Census, Federal Expenditures by State, FY 1982, FY 1983; U.S. Department of the Treasury, Federal Aid to States, FY 1981, FY 1982; 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).

million in 1983. As a percentage of income from productive activity (Puerto Rican GNP), net Federal payments rose from 7.7 percent in 1968 to 23.6 percent in 1983. The current-dollar amount of net Federal payments continued to increase somewhat between 1981 and 1983, but in real (inflation-corrected) terms they declined by 2 percent. The decline reflects principally the termination of the public service jobs programs and to a lesser extent, the statutory ceiling imposed on Federal nutritional assistance to Puerto Rico.

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 made substantial headway in the period 1947-1973, and real GNP per capita rose from $586 to $2,112 (in constant dollars). 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/

Components of fixed investment in Puerto Rico are illustrated in Figure 3-2 and Table 3-5 for the years 1960-1983. 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 market considerations. 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 for almost one-third of total private investment in plant and equipment between 1970 and 1972, but represented less than 4 percent of the total in 1973 and most later years.

It is clear from Figure 3-2 and Table 3-5 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 have continued to decline in most years since the recession. For example, annual private investment in machinery and equipment, which exceeded $400 million (in 1972 dollars) in the early 1970s, dropped to about $300 million during the 1974-76 recession and continued to decline in every year between 1978 and 1982. It rose slightly in 1983 to a level equal to 60 percent of the average in the early 1970s. Similarly, housing construction, which rose almost continuously until 1972 to a peak of $472 billion, declined sharply in nearly every year after that.

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.

FIGURE 3-2

Components of Real Investment in Puerto Rico, 1960-1983 (Constant 1972 Dollars)

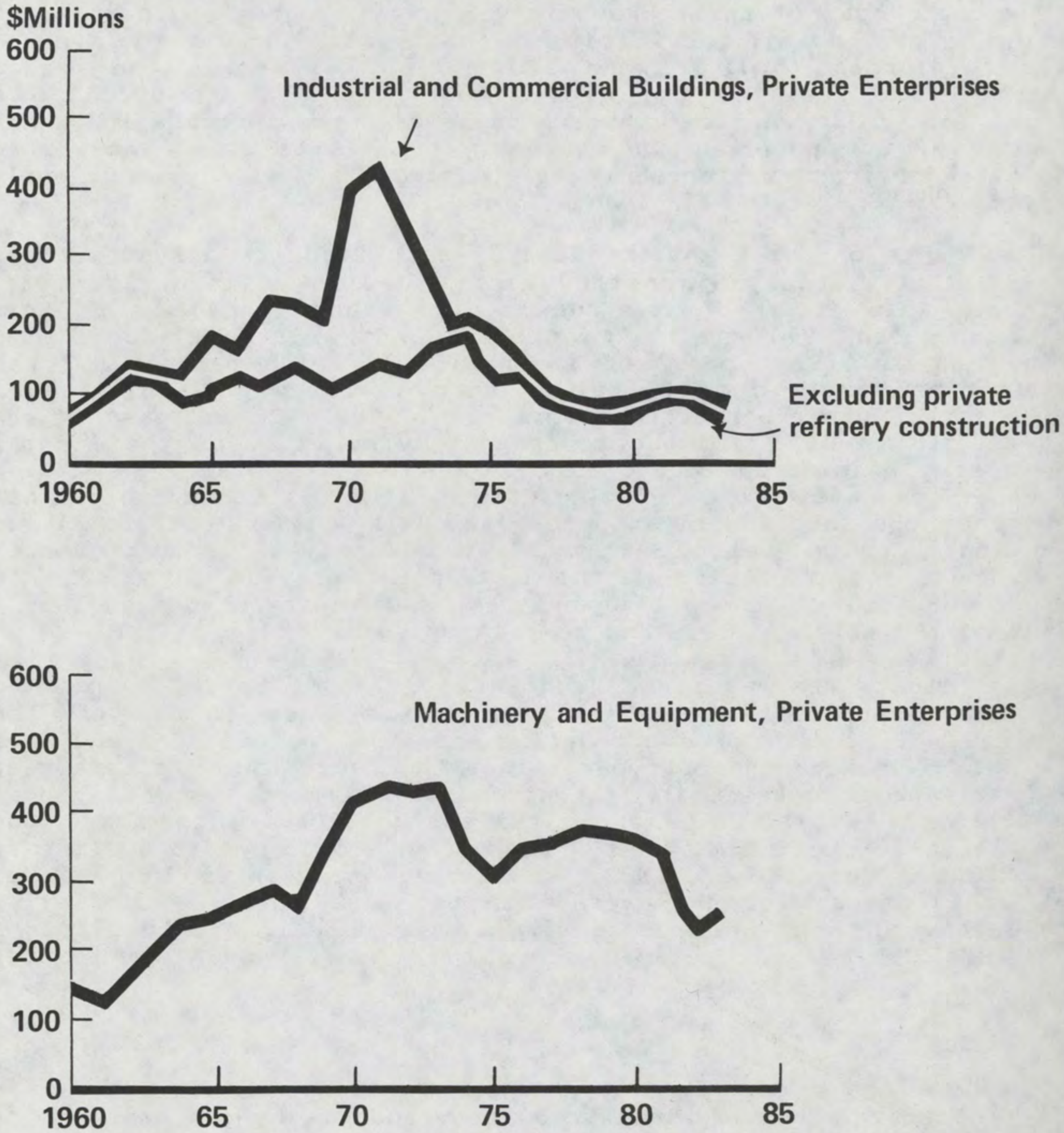

FIGURE 3-2, Continued

Components of Real Investment in Puerto Rico, 1960-1983 (Constant 1972 Dollars)

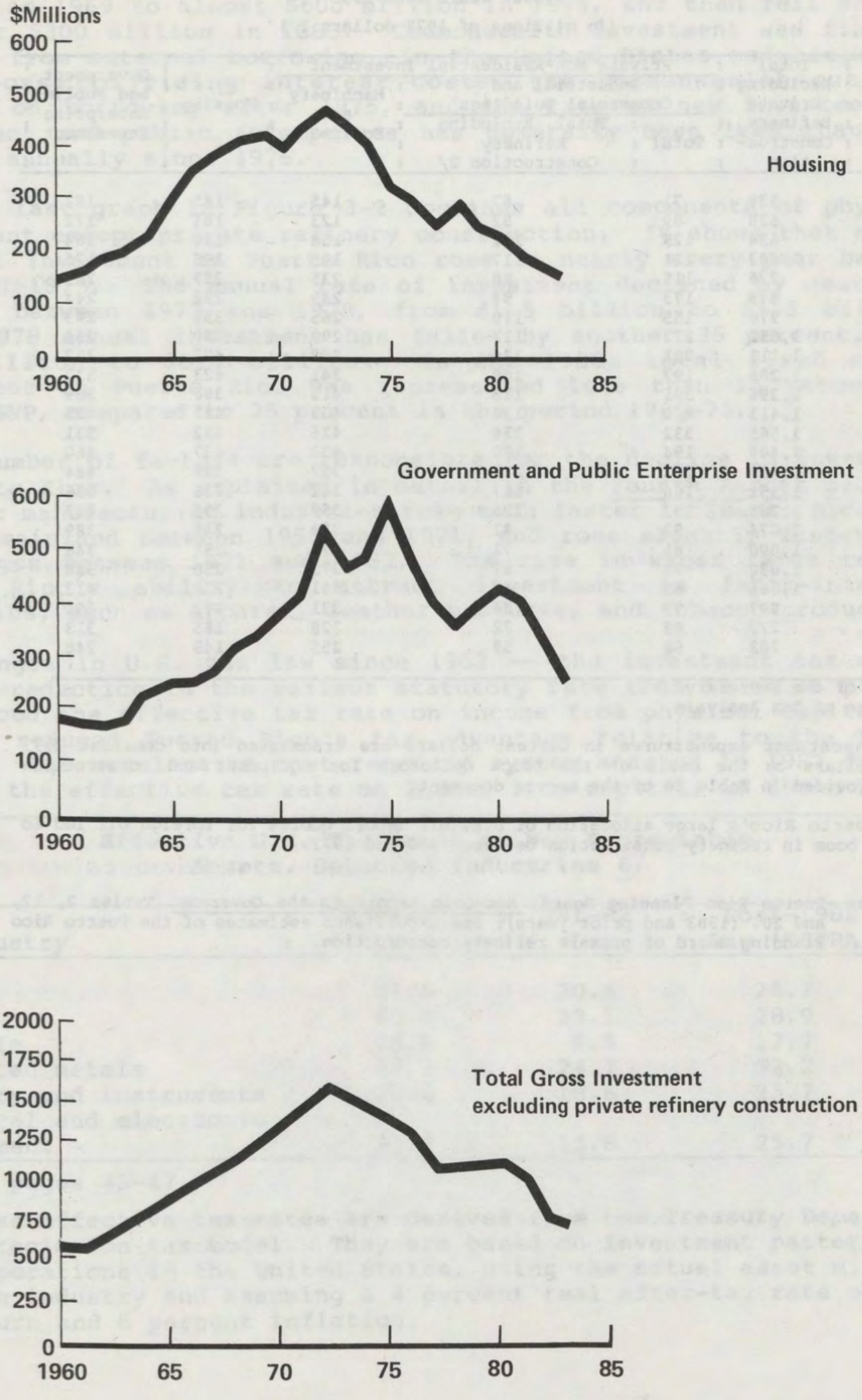

Table 3-5

Components of Real Fixed Investment in Puerto Rico
Fiscal Years 1960-1983

(in millions of 1972 dollars 1/)

Year	Total Excluding Private Refinery Construction	Private Non-Residential Investment			Housing	Government and Public Enterprise Investment
		Industrial and Commercial Buildings: Total	Industrial and Commercial Buildings: Total, Excluding Refinery Construction 2/	Machinery and Equipment		
1960	539	71	67	145	145	182
1961	538	89	82	123	161	172
1962	634	129	122	158	190	164
1963	683	121	117	195	195	176
1964	776	115	89	235	227	225
1965	879	173	94	249	292	244
1966	978	155	119	265	351	243
1967	1,051	222	117	290	380	264
1968	1,111	221	134	263	407	307
1969	1,205	197	108	341	423	332
1970	1,296	391	118	413	396	369
1971	1,413	422	134	433	441	405
1972	1,565	332	136	426	472	531
1973	1,499	194	170	432	437	460
1974	1,420	203	181	357	398	484
1975	1,352	186	117	312	336	586
1976	1,263	152	125	360	295	483
1977	1,074	93	81	354	249	389
1978	1,090	81	71	379	291	348
1979	1,080	77	67	375	250	388
1980	1,066	85	64	361	228	413
1981	997	97	84	331	192	390
1982	777	82	72	228	165	313
1983	703	68	59	255	149	240

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1/ Investment expenditures in current dollars are translated into constant 1972 dollars on the basis of the price deflators for equipment and construction 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.

Sources: Puerto Rico Planning Board, Economic Report to the Governor, Tables 2, 12, and 20, (1983 and prior years); and unpublished estimates of the Puerto Rico Planning Board of private refinery construction.

Figure 3-2 also shows the expansion of Puerto Rican government investment since 1960. Total investment by the Puerto Rican government plus investment by public enterprises rose from about $300 million in 1969 to almost $600 million in 1975, and then fell sharply to under $300 million in 1983. Commonwealth investment was financed largely from external borrowing, in the United States and elsewhere. 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 annually since 1976.

The last graph in Figure 3-2 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 nearly 30 percent between 1973 and 1978, from $1.5 billion to $1.1 billion. Since 1978 annual investment has fallen by another 35 percent, from $1.1 billion to $0.7 billion. In the 1980s total fixed annual investment in Puerto Rico has represented less than 15 percent of annual GNP, compared to 25 percent in the period 1966-73.

A number of factors are responsible for the decline in investment in Puerto Rico. As explained in detail in the Fourth Report 5/, wage rates in manufacturing industries rose much faster in Puerto Rico than on the mainland between 1955 and 1971, and rose slightly faster than U.S. wages between 1971 and 1982. The rise in wages rates reduced Puerto Rico's ability to attract investment in labor-intensive industries, such as apparel, leather products, and tobacco products.

Changes in U.S. tax law since 1962 -- the investment tax credit and the reduction in the maximum statutory rate from 52 to 46 percent -- reduced the effective tax rate on income from physical capital and thereby reduced Puerto Rico's tax advantage relative to the United States. The accelerated cost recovery system enacted in 1982 further reduced the effective tax rate on income from capital, as shown below:

Effective U.S. Tax Rates on New Depreciable Assets, Selected Industries 6/

Industry	1979-1981 Law	1981-82 Law	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

5/ See pages 43-47.

6/ These effective tax rates are derived from the Treasury Department depreciation tax model. They are based on investment patterns by corporations in the United States, using the actual asset mix in each industry and assuming a 4 percent real after-tax rate of return and 6 percent inflation.

By reducing the basis of depreciable property by a portion of the investment tax credit and by tightening certain leasing provisions, TEFRA offset roughly one-third of the 1982 tax cut on income from physical capital.

The changes in Puerto Rican wage rates and U.S. tax law reduced Puerto Rico's locational advantages relative to the United States as a site for plant and equipment. Changes in the U.S. tariff structure in the 1960s reduced the locational advantage of Puerto Rico relative to foreign countries, as the price advantage which Puerto Rican products could enjoy in the U.S. market relative to foreign products was cut. 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. investors also started manufacturing in low-wage countries and exporting back to the United States. U.S. investors who established foreign manufacturing subsidiaries could obtain the benefit of 100 percent U.S. tax exemption on current income from physical assets, since the United States generally does not tax such income until it is repatriated to the United States. 7/

Changes in Puerto Rico's relative comparative advantages are reflected in the basic change in the manufacturing sector since 1970. Puerto Rican business expansion has been concentrated in four high-technology industries, chemicals (including pharmaceuticals), scientific instruments, electrical and electronic equipment, and machinery. These U.S. industries are among the leaders in investment in research and development (R&D) spending. 8/ Under current law, when a possessions corporation produces, in whole or in part, a product in Puerto Rico, the return on the R&D and other intangible property associated with the product enjoys unique tax advantages under U.S. law.

Table 3-6 presents the industry composition of Puerto Rican manufacturing income. Between 1960 and 1970, the composition of the manufacturing sector changed little, except that the food industry declined as a percent of the total and chemicals, increased sharply as a percent of the total. Between 1970 and 1983, however, the

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7/ This exemption is also available for subsidiaries incorporated in the U.S. possessions.

8/ In 1980, electrical and electronic equipment took first place among 16 manufacturing industry categories in the dollar amount of spending on R&D in the United States, with estimated total spending of $8.9 billion. As a percentage of spending on plant and equipment, R&D spending was 103% in instruments, 92% in electrical and electronic equipment, 50% in non-electrical machinery, and 37% in chemicals. Figures are based on actual 1980 spending, and are from Annual McGraw-Hill Survey of Business' Plans for Research and Development Expenditures, 1981-84.

Table 3-6

Net Income Originating in Puerto Rican Manufacturing
Fiscal Years 1960, 1970, 1980, and 1983

(dollars in millions)

	1960		1970		1980		1983p	
	Amount of Net Income	Percent of Total	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%	4,808.7	100.0%	5,764.6	100.0%
Food and kindred products	66.7	23.1	161.3	16.8	548.5	11.4	670.0	11.6
Tobacco products	10.4	3.6	36.4	3.8	46.3	1.0	58.0	1.0
Textile mill products	13.9	4.8	41.1	4.3	39.6	0.7	27.0	0.5
Apparel	50.7	17.6	172.0	18.0	360.7	7.5	343.9	6.0
Furniture and wood prodcts	8.8	3.0	26.2	2.7	29.6	0.6	25.1	0.4
Printing and publishing	11.2	3.9	22.6	2.4	58.8	1.2	65.4	1.1
Chemicals	9.8	3.4	109.3	11.4	1,583.2	32.9	2,120.0	36.8
Stone, clay and glass products	18.8	6.5	49.1	5.1	95.4	2.0	69.5	1.2
Machinery and metal products	54.7	18.9	191.5	19.4	1,453.7	30.2	1,953.3	33.9
Other manufacturing	43.7	15.1	148.0	15.5	597.0	12.4	432.4	7.5

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p - Preliminary figures

Source: Puerto Rico Planning Board, Economic Report to the Governor, 1980-1983, Table 7; and other years.

manufacturing sector experienced a basic change by moving from certain labor-intensive industries into high-technology industries. The combined income shares of the food, apparel, and stone & clay & glass industries fell from 40 percent to 19 percent. Chemicals became the largest industry by far, growing from 11 percent to 37 percent of the total income originating in Puerto Rican manufacturing, while the income of the machinery and metal products industries (including electrical and electronic equipment) grew from 19 percent to 34 percent of the total income in Puerto Rican manufacturing. Nearly all investments in these industries have been made by possessions corporations. The amount of current investment of possessions corporations, by industry, and the employment associated with these investments, is the subject of the next chapter.

As noted in Table 3-3, employment figures for 1971 through 1981 were revised downward in the 1982-83 Economic Report to the Governor. The data on distribution of employment in Puerto Rican manufacturing industries, published by the Puerto Rican Department of Labor in its Census of Manufacturing Industries in Puerto Rico and cited in the Fourth Report (Table 3-8, p. 53) have not been revised accordingly. However, the pattern presumably remains the same as indicated in the Fourth Report, namely a shift in employment away from tobacco, textiles, apparel, leather goods, wood products, and stone, clay and glass products to chemicals (including pharmaceuticals), electrical and electronic equipment, scientific instruments, and machinery and, to a lesser extent, to the food-processing, paper and plastics industries.

Chapter 4

CHARACTERISTICS OF POSSESSIONS CORPORATIONS AND REVENUE EFFECT OF SECTION 936

This chapter describes the characteristics, by industry, of possessions corporations. It presents data on their assets, income, tax benefits, employment, and payroll in tax year 1982 1/. The information presented is drawn from unaudited tax and employment returns filed by possessions corporations for tax year 1982 (pre-TEFRA). It is estimated that 554 corporations, of which 447 were manufacturing companies, claimed possessions tax credits in 1982. The 447 manufacturing firms claimed estimated possessions tax credits of $1,843 million, 2/ and derived estimated tax benefits of $1,679 million. In estimating the tax benefit, the total credit claimed is adjusted downward to take account of other tax benefits (e.g. accelerated depreciation, investment tax credits and foreign tax credits) which such corporations might have claimed if, instead of operating as possessions corporations, they had operated in the United States. Activities other than manufacturing generally did not qualify for exemption grants in Puerto Rico, and the evidence suggests that, in the absence of the section 936 credit, the foreign tax credit for Puerto Rican taxes paid would have offset most of their U.S. tax liability. For this reason, it is assumed that only corporations engaged in manufacturing derive tax benefits. Thus the tables in this chapter focus primarily on manufacturing possessions corporations.

Not all of the tax and employment information is available for all 447 manufacturing corporations. The most detailed information is available for 417 manufacturing corporations which had filed their returns prior to the cut-off date for processing the returns for this study. In the interests of completeness, that detailed information is shown in Tables 4-1 through 4-4, even though it does not represent the entire universe. Table 4-5 presents data on net income, credits claimed and estimated tax benefits both for that group of 417 corporations and for the full group of 447 manufacturing companies, including the 30 which filed after the cut-off date. Employment data is available for 324 of the manufacturing possessions corporations. Those figures are shown in Tables 4-6 and 4-7, and are the basis for the estimates in Table 4-6 for all manufacturing possessions corporations.

1/ Includes accounting periods ending between July 1, 1982 and June 30, 1983. As most possessions corporations file on a calendar year basis, tax year 1982 corresponds closely to calendar year 1982.

2/ If part-year returns are included in the total, credits claimed amount to $2,056 million. However, as there is insufficient data on those returns, only full year returns are reported on.

This chapter also presents summary data for 1974 through 1982. These data indicate the following trends for this period:

-- The number of possessions corporations in manufacturing has tended to fluctuate between 400 and 500, ranging from a low of 385 (in 1977) to a high of 502 (in 1979).

-- The possessions corporation tax benefits rose from about $400 million in 1974 to approximately $1.7 billion in 1982, a change of 255 percent in inflation-corrected dollars.

-- Between 1974 and 1982, the tax benefits rose from 92 percent to 147 percent of total compensation of employees of possessions corporations.

The final section of this chapter explains the method used in estimating the tax benefits of section 936. It also examines the extent to which Federal tax revenues would increase in the absence of section 936.

I. Assets and Income in Tax Year 1982

As noted above, Tables 4-1 through 4-4 contain 1982 data for those possessions corporations which filed tax returns before the cut-off date for processing the return for this study. They include data for 522 corporations, of which 417 are manufacturing corporations.

A. Asset Composition of Puerto Rican Investment. 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 a corporation's books at a zero basis. Table 4-1, which is based on corporate balance sheets filed as part of U.S. tax returns, indicates that the total assets of the possessions corporations included in this table were $17.8 billion at year-end 1982. Seventy-seven percent of the total assets, or $13.8 billion, were 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 4-1) amounted to $1.6 billion, of which $691 million, or 43 percent, was owned by the pharmaceutical industry. The chemical industry, other than pharmaceuticals, accounted for an additional 15 percent of the total. The electrical and electronic equipment, and food products industries also had substantial amounts of plant and equipment in Puerto Rico, with 11 percent and 10 percent of the total, respectively.

Relative to corporations operating in the United States, possessions corporations have a disproportionately small share of their assets in real fixed assets. Net plant, equipment, and property 3/ represented 12 percent of the total book assets of manufacturing

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3/ The value of property (i.e., land holdings) reported by manufacturing possessions corporations was $45 million. These assets are included in the "Other assets" category on Table 4-1.

Table 4-1

Selected Balance Sheet Information by Industry, 1982

(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	522	417	21	5	60	7	79	48	31
Total Assets	17,830,919	13,774,788	996,325	20,247	408,580	39,309	7,227,780	6,317,284	910,495
Cash	2,497,750	2,134,072	270,987	10,635	72,792	2,615	838,304	816,765	21,539
Accounts receivable	3,746,667	2,855,476	263,284	3,901	143,857	7,320	1,459,807	1,031,214	428,592
Inventories	1,499,052	1,328,604	166,335	3,405	48,880	2,915	487,900	374,798	113,101
Government obligations	469,257	412,662	812	857	3,302	0	282,853	257,764	25,088
Other current assets	1,085,922	1,053,457	15,439	42	10,470	240	364,379	357,167	7,212
Mortgage & real estate loans	1,104,947	147,634	0	0	3,049	0	38,468	38,468	0
Other investments	4,296,358	3,846,468	62,535	493	92,113	23,803	2,650,459	2,598,131	52,328
Depreciable assets	4,014,026	2,610,719	241,009	2,372	36,786	3,632	1,483,547	926,056	557,491
Less: Accumulated depreciation	1,408,086	991,314	83,020	1,523	16,907	1,380	554,524	235,029	319,495
Net depreciable assets	2,605,939	1,619,405	157,989	848	19,879	2,252	929,022	691,026	237,995
Other assets	525,023	377,005	58,939	62	14,235	161	176,583	151,947	24,636
Total Liabilities and Stockholders' Equity									
Accounts payable	1,465,044	679,072	82,954	670	40,392	2,732	210,707	169,034	41,673
Notes payable in less than 1 year	238,338	162,301	20,716	43	2,923	0	92,144	86,392	5,752
Other current liabilities	1,366,760	323,432	57,512	339	10,126	787	148,761	144,798	3,963
Notes payable in 1 year or more	726,394	177,673	20,600	0	4,291	0	122,136	115,881	6,255
Other liabilities	215,282	157,826	19,226	0	1,116	0	100,443	86,693	13,750
Capital stock	1,701,816	733,829	42,365	142	16,214	911	444,366	241,960	202,405
Retained earnings, total	12,117,281	11,540,651	752,948	19,051	333,514	34,878	6,109,220	5,472,525	636,695
Appropriated	91,424	37,902	13,577	0	0	0	2,900	2,265	634
Unappropriated	12,025,857	11,502,749	739,371	19,051	333,514	34,878	6,106,319	5,470,259	636,060

Table 4-1 - continued

	Nonmanufacturing Total	Construction	Transportation, Communications and Utilities	Wholesale Trade	Retail Trade	Finance, Insurance, Real Estate	Other Services and Industry Not Reported
	Nonmanufacturing Industries						
Number of corporations	105	6	6	26	12	23	32
Total Assets	4,056,131	36,064	910,940	662,699	219,305	2,149,617	77,503
Cash	363,678	1,493	42,828	180,766	16,500	116,274	5,813
Accounts receivable	891,191	5,050	52,250	224,784	45,984	532,691	30,430
Inventory	170,447	2,372	15,840	99,597	43,884	4,993	3,757
Government obligations	56,595	0	0	447	0	56,130	16
Other current assets	32,465	2,798	3,927	2,489	17,254	4,854	1,140
Mortgage & real estate loans	957,313	32	0	0	0	957,281	0
Other investments	449,889	1,096	13,175	29,928	23,640	377,697	4,350
Depreciable assets	1,403,306	8,302	1,049,462	190,679	99,768	21,448	33,645
Less: Accumulated depreciation	416,772	3,291	276,854	82,213	41,595	1,933	10,885
Net depreciable assets	986,533	5,011	772,608	108,466	58,173	19,514	22,759
Other assets	148,018	18,208	10,310	16,219	13,866	80,179	9,234
Total Liabilities and Stockholders' Equity							
Accounts payable	785,971	2,524	19,871	51,483	49,384	649,127	13,581
Notes payable in less than 1 year	76,037	16,846	10,891	3,513	8,649	35,196	939
Other current liabilities	1,043,327	5,710	42,361	6,690	11,659	970,848	6,057
Notes payable in 1 year or more	548,721	5,536	111,537	9,446	41,609	376,151	4,439
Other liabilities	57,456	281	54	194	3,104	51,190	2,631
Capital stock	967,987	293	714,789	137,715	25,241	66,679	23,267
Retained earnings, total	576,629	4,871	11,435	453,655	79,656	423	26,587
Appropriated	53,522	0	10,159	2	8,603	34,757	0
Unappropriated	523,107	4,871	1,276	453,653	71,053	-34,333	26,587

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Table 4-1 - 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	10	14	4	24	10	100	34	49
Total Assets	75,054	95,056	18,143	234,467	291,405	2,679,623	732,678	956,114
Cash	4,360	22,873	4,141	15,957	18,692	614,335	146,745	111,630
Accounts receivable	27,366	15,458	1,529	63,243	52,216	438,817	177,317	201,356
Inventory	8,736	15,570	1,833	36,762	29,389	254,106	63,036	209,731
Government obligations	0	18,440	0	323	23,983	55,267	25,281	1,538
Other current assets	123	608	115	25,964	55,797	480,741	7,438	92,095
Mortgage & real estate loans	0	332	0	0	1,261	101,001	0	3,521
Other investments	8,422	17,442	10,254	21,377	85,398	519,449	206,130	148,588
Depreciable assets	31,354	7,564	435	71,563	24,041	317,915	122,232	268,263
Less: Accumulated depreciation	7,452	3,342	282	23,733	7,810	131,681	33,038	126,614
Net depreciable assets	23,901	4,222	152	47,829	16,230	186,233	89,193	141,648
Other assets	2,143	108	116	23,007	8,437	29,670	17,535	46,001
Total Liabilities and Stockholders' Equity								
Accounts payable	3,795	6,587	239	20,320	23,537	123,261	53,380	110,491
Notes payable in less than 1 year	787	822	200	6,240	1,000	26,708	1,419	9,294
Other current liabilities	1,745	1,850	244	3,001	4,550	65,812	12,885	15,815
Mortgages more than 1 year	0	3,278	0	8,101	1	14,060	1,182	4,020
Other liabilities	1,566	64	1	1,180	4,575	15,389	3,194	11,066
Capital stock	7,415	-3,721	3,346	10,602	7,276	97,236	26,518	81,153
Retained earnings, total	59,743	86,173	14,111	185,020	250,462	2,337,155	634,098	724,271
Appropriated	0	3,588	0	0	0	8,403	8,870	561
Unappropriated	59,743	82,585	14,111	185,020	250,462	2,328,751	625,227	723,710

Table 4-2

Possessions Corporations and Corporations Operating in the U.S. -- Net Plant, Equipment and Property as a Percentage of Total Assets, Year-end 1982

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		Column 2 ÷ Column 3
		936 Corporations	Corporations Operating in the U.S.	
All Manufacturing Industries	100.0%	12%	30% 2/	40%
Food and kindred products	7.2	17	36	46
Textile mill products	*	4	34	12
Apparel	3.0	5	n.a.	--
Paper and allied products	*	6	56	11
Pharmaceuticals	45.9	11	28	40
All other chemicals	6.6	26	45	58
Rubber products	0.5	34	37	92
Leather products	0.7	4	n.a.	--
Stone, clay, & glass products	*	1	49	2
Fabricated metal products	1.7	22	32	67
Machinery, except electrical	2.1	6	32	19
Electrical and electronic equipment	19.5	7	27	26
Instruments and related products	5.3	13	32	40

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* Less than 0.5%.

1/ The percentages by industry sum to 93 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 is a weighted average with industry weights based on the industrial mix of possessions corporations. The unweighted average for all corporations operating in the U.S. is 40%.

n.a. - not available

Source: Tax return Form 1120 filed by possessions corporations; and Federal Trade Commission, Quarterly Financial Report, Fourth Quarter, 1983.

possessions firms 4/, compared to 30 percent for the same industries in the United States. Table 4-2 shows that the relatively small share of fixed real assets in total book assets of possessions companies was borne out in all industries for which data are available. The value of possessions corporations' fixed real assets is also small in relation to their income. At year-end 1982, manufacturing possessions corporations' net property, plant and equipment was 44 percent of net income per return, compared to almost 600 percent of before-tax net income in the case of manufacturing corporations operating in the United States. 5/

Table 4-3 compares, for possessions corporations and mainland firms, ratios of operating profits to operating assets in selected manufacturing industries. Operating income, which includes the return to intangibles, is expressed as a percentage of operating assets, which include property, plant and equipment, inventories, and net receivables. In 1982, the before-tax return on operating assets for all manufacturing possessions corporations was more than 5 times the ratio for mainland manufacturing operations, 56.6 percent compared to 10.2 percent.

To some extent the possessions corporations ratios may be overstated. The operating assets of possessions corporations do not include the value of land and buildings leased from the Puerto Rican government. (See footnote 3 on this page.) Possessions corporations are less likely than mainland corporations to include corporations with start-up losses. There are also cost differentials between Puerto Rico and the mainland, although they can go both ways; lower wages in Puerto Rican manufacturing, for example, may be offset by high costs for utilities and transportation. However, as indicated in the _Fourth Report_ 6/ such factors can explain only part of the large discrepancy in profitability of manufacturing in Puerto Rico and the United States. Taken together, they may account for up to one-third of the difference. Income from intangible assets assigned to possessions corporations is an important factor in explaining the balance. It is notable, for example, that the range of profit ratios for the mainland firms is only 8 points, from 10 to 18 percent, while for possessions corporations the range is much wider, from 22 to 79 percent, with the highest profit ratios in the high-technology sectors.

4/ The Commonwealth government owns land and buildings which it leases to private investors (936 firms, foreign firms, and Puerto Rican-chartered firms). Not all of that plant and property, valued at $297 million in June 1983, is under lease at any given time. Assuming that three-fourths of the government-owned plant and property was under lease to 936 firms in 1982, and treating this property as 936 fixed assets, increases the ratio of 936 fixed assets to total assets from 12 to 14 percent.

5/ See Tables 4-1 and 4-2 and Federal Trade Commission, _Quarterly Financial Report, Fourth Quarter 1982_.

6/ See pages 61-65.

Table 4-3

Possessions Corporations and Corporations Operating In The United States: Before Tax Operating Income as a Percent of Operating Assets, 1982 1/

Industry	Before Tax Operating Income as a Percent of Operating Assets - 1982: Mainland Operations	Before Tax Operating Income as a Percent of Operating Assets - 1982: 936 Corporations
All Manufacturing	10.2%	56.6%
Food and kindred products	15.5	35.6
Fabricated metal products	11.4	21.8
Chemicals and related products	10.2	62.1
Pharmaceuticals	17.6	78.8
Machinery, except electrical	11.4	58.0
Instruments and Related products	14.4	62.3
Electrical and Electronic equipment	12.1	67.8

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 net property, plant and equipment, inventories and net accounts receivable.

Source: Tax return Form 1120 filed by possessions corporations; Federal Trade Commission, Quarterly Financial Report, First Quarter, 1983.

At year-end 1983, all possessions corporations held over $10 billion in financial assets -- cash, net accounts receivables, certificates of deposit (CDs), and other financial investments 7/. The cash assets category, which may include short-term CDs, was $2.1 billion. The $10 billion in total financial assets in 1982 were more than six times the value of 936 manufacturing corporations' physical plant and equipment net of depreciation. As explained in Chapter 5, the tax exemption for Qualified Possession Source Investment Income (QPSII) 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 qualified financial investments which can be made by a possessions corporation out of its retained earnings 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 was 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 should lead to real investments. However, the data presented in Chapter 5 suggest that 936 financial investments in the Puerto Rican capital market made only a small contribution to the financing of physical investment in Puerto Rico through 1981. The large inflows of 936 funds to Puerto Rico through 1981 tended to flow out again through the banking system or to result in shifts in the ownership of Puerto Rican government debt and in investment abroad by Puerto Rican government corporations. Between year-end 1981 and year-end 1982, the level of 936 corporations' financial investments in Puerto Rico declined slightly. The resumption of the accumulation of 936 financial investments in 1983 did not seem to be reflected in a comparable increase in real investment in Puerto Rico. 8/

B. **Retained Earnings.** Table 4-1 also shows the incentive for 936 manufacturing companies to retain earnings. At the end of tax year 1982, these companies reported $11.5 billion of retained earnings on their balance sheets. Forty-seven percent of these retained earnings, or $5.5 billion, were held by possessions corporations in the pharmaceuticals industry. One-fifth of the retained earnings, or $2.3 billion, were held by the electrical and electronics industry. Retained earnings represented 84 percent of total liabilities and stockholders' equity of manufacturing possessions corporations. The comparable figure for manufacturing corporations operating in the

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7/ See Table 5-1 for the composition of these financial investments.

8/ See Chapter 5 for a discussion of the impact of financial investments of possessions corporations through 1983.

United States in the same industries was 42.3 percent. 9/ The high level of 936 retained earnings is a response to limited alternative opportunities under the Internal Revenue Code for making tax-free financial investments, as well a response to Puerto Rico's tollgate tax on 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 retains within Puerto Rico a specified percentage of its profits.

C. Total Receipts. Table 4-4 shows that total receipts of the manufacturing possessions corporations included in the table were $10.7 billion, of which $10.1 billion was attributable to business receipts. Most of the remainder, or $578 million, was attributable to interest on nongovernment securities, such as 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 4-4. The amount of such exempt interest income reported by possessions corporations for tax year 1982 was $12 million.

The pharmaceutical industry accounted for 34 percent of the business receipts of all manufacturing possessions companies. After pharmaceuticals, the manufacturing industries with the greatest business receipts were electrical and electronic equipment, food products, and chemicals other than pharmaceuticals.

D. Net Income per Tax Return. Net income per return (total receipts minus total deductions on Table 4-4, or taxable income on the U.S. corporation income tax return) amounted to $3.8 billion for all manufacturing possessions corporations included in the table. This amounts to 2.4 times the net depreciable assets of those corporations. (See Table 4-1). The industry with the greatest amount of net income was pharmaceuticals with $2.0 billion of net income, 52 percent of the total net income of manufacturing possessions corporations and 2.8 times the net depreciable assets of the pharmaceutical corporations. The electrical and electronic equipment industry accounted for 19 percent of the combined net income of manufacturing firms; their net income of $725 million represented 3.9 times the net depreciable assets.

9/ Data for manufacturing corporations operating in the United States are from U.S. Department of Commerce, Bureau of the Census, Quarterly Financial Report, Fourth Quarter 1983. There are significant differences between the industry mix of possessions corporations and that of manufacturing corporations operating in the United States. To correct for the differing industrial mix, the ratio of retained earnings to total liabilities and stockholders' equity, by mainland industry, was weighted according to the share of 936 assets in the industry to total 936 assets. The unweighted ratio for firms operating in the United States was 36.4 percent.

Table 4-4

Selected Income Statement Information and Tax Benefits by Industry, 1982

(Dollar amounts in thousands)

	All Industries	Manufacturing Industries							
		Manufacturing Total	Food & Kindred Products	Textile Mill Products	Apparel	Paper	Chemicals		
							Total	Pharmaceuticals	All Othe
Number of corporations	522	417	21	5	60	7	79	48	31
Total receipts	13,304,156	10,745,101	1,104,385	35,097	419,480	37,232	4,455,106	3,729,417	725,68[illegible]
Business receipts	12,374,153	10,061,778	1,066,256	35,062	401,956	34,904	4,108,368	3,394,785	713,582
Interest	752,587	577,562	35,087	10	15,763	2,280	294,725	283,884	10,841
Other receipts	177,415	105,760	3,041	25	1,760	47	52,012	50,747	1,265
Total deductions	9,309,940	6,957,987	868,497	31,179	335,186	24,716	2,358,518	1,772,918	585,599
Cost of sales	6,666,966	5,128,592	624,751	29,496	308,013	20,796	1,356,664	861,727	494,937
Depreciation	230,932	140,566	12,465	69	2,049	384	72,051	48,070	23,980
All other deductions	2,412,041	1,688,827	231,280	1,613	25,123	3,535	929,802	863,120	66,681
Estimated net income per return	3,994,215	3,787,114	235,888	3,918	84,294	12,516	2,096,588	1,956,498	140,090
Estimated net income per books	3,920,810	3,716,425	232,216	5,073	80,502	12,373	2,016,667	1,878,076	138,590
Reduction in U.S. tax liability	1,538,292	1,538,292	97,534	1,785	35,144	5,668	846,744	792,695	54,048
Distributions	2,767,424	2,290,440	113,680	209	25,695	1,000	1,432,599	1,349,297	83,302

Table 4-4 - 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	10	14	4	24	10	100	34	49
Total receipts	87,511	124,653	7,838	185,885	224,490	1,823,086	568,798	1,671,532
Business receipts	86,272	120,531	5,843	177,809	209,878	1,673,217	530,562	1,611,116
Nongovernment interest	806	3,607	192	5,436	13,673	145,509	32,010	28,457
Other receipts	433	513	1,802	2,639	939	4,359	6,225	31,959
Total deductions	63,104	103,162	5,181	148,703	153,948	1,097,697	331,219	1,436,872
Cost of sales	47,515	93,208	3,530	126,895	135,083	915,735	238,956	1,227,946
Depreciation	1,404	552	20	5,189	2,799	21,051	8,400	14,127
All other deductions	14,185	9,401	1,630	16,617	16,065	160,910	83,863	194,798
Estimated net income per return	24,407	21,490	2,657	37,182	70,542	725,389	237,578	234,660
Estimated net income per books	23,609	21,598	2,776	40,151	67,843	754,025	232,791	226,794
Reduction in U.S. tax liability	10,369	9,606	1,259	15,705	29,093	294,087	103,348	87,944
Distributions	14,245	2,016	357	20,563	27,121	447,732	48,843	156,374

Table 4-4 - continued

	Nonmanufacturing Industries						
	Non-Manufacturing Total	Construction	Transportation Communications and Utilities	Wholesale Trade	Retail Trade	Finance, Insurance, Real Estate	Services and Industry Not Reported
Number of corporations	105	6	6	26	12	23	32
Total Receipts	2,559,054	46,848	341,068	1,207,286	659,747	177,817	126,287
Business receipts	2,312,375	43,950	328,936	1,174,934	635,705	19,338	109,509
Nongovernment interest	175,025	613	2,447	29,458	179	141,406	921
Other receipts	71,654	2,284	9,685	2,893	23,862	17,072	15,856
Total Deductions	2,351,953	43,216	267,769	1,072,360	655,062	196,508	117,036
Cost of sales	1,538,373	36,230	2,795	984,231	472,664	1	42,451
Depreciation	90,366	1,262	71,168	6,867	7,506	1,451	2,108
All other deductions	723,213	5,723	193,805	81,261	174,891	195,055	72,476
Estimated net income per return	207,101	3,632	73,299	134,926	4,684	-18,691	9,250
Estimated net income per books	204,384	4,108	73,244	128,666	6,167	-15,619	7,817
Reduction in U.S. tax liability	0	0	0	0	0	0	0
Distributions	476,983	519	9,672	277,624	24,773	65,084	99,308

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E. Distributions. The final line in Table 4-4 shows that manufacturing possessions corporations reported $2,290 million of distributions, which was 60 percent of their net income in tax year 1982. This represented a large increase over the 1981 level of distributions, which was 41 percent of net income. Fifty-nine percent of total distributions by manufacturing corporations in 1982 was attributable to the pharmaceutical industry.

II. Estimated Tax Benefits

Table 4-5 shows the net income, possessions tax credits claimed, and estimated reduction in U.S. tax liability for the 522 possessions corporations for which data is presented in Tables 4-1 through 4-4 and for the total group of 554 possessions corporation filing full year returns for tax year 1982.

The possessions credits claimed by all manufacturing corporations amounted to $1,843 million. This figure exceeds the estimated tax benefit received of $1,679 million. The tax benefit figure 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 1982 (i.e., accelerated depreciation and the investment tax credit), and then subtracting from the tentative U.S. tax liability income and tollgate taxes paid to Puerto Rico. In calendar year 1982, Puerto Rico collected $89 million in tollgate taxes. It also collected $180 million in income taxes from all corporations (including Puerto Rican corporations) which operated under partial income tax exemption grants. The combined tollgate and income tax collections paid by manufacturing possessions corporations in 1982 amounted to approximately 6 percent of their combined net income. Half of the tax benefit was accounted for by the pharmaceutical industry and another 20 percent by the electrical and electronic equipment industry. Other manufacturing industries typically accounted for less than 5 percent of the total.

The possessions credits claimed by nonmanufacturing companies amounted to $121 million. However, no tax benefit is attributed to those credits. It is assumed that 936 companies in nonmanufacturing industries did not qualify for a Puerto Rican tax exemption grant and that the taxes which they pay to Puerto Rico would, if viewed as creditable foreign income taxes, 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 possessions corporations in these industries was negligible in 1982. Moreover, a sample of the 1978 Puerto Rican tax returns filed by possessions corporations in all nonmanufacturing industries suggests that the average effective Puerto Rican tax rate for such companies was roughly 40 percent.

Table 4-5

Net Income, Possessions Tax Credits Claimed and Estimated
Tax Benefits by Industry, 1982

	Preliminary Data 522 companies; 417 manufacturing			Estimated Final Data 554 companies; 447 manufacturing 1/		
	Net Income ($000)	Credit Claimed ($000)	Tax Benefit ($000)	Net Income ($000)	Credit Claimed ($000)	Tax Benefit ($000)
All Manufacturing Industries	$3,787	1,690	1,538	$4,130	1,843	1,679
Food and kindred products	236	105	97	237	106	98
Textile mill products	4	2	2	9	4	4
Apparel	84	37	35	102	44	42
Chemicals	2,097	940	847	2,212	991	893
Pharmaceuticals	1,956	877	793	2,054	920	832
Other chemicals	140	63	54	158	71	61
Rubber and plastic products	24	11	10	24	11	10
Leather	21	10	10	31	14	14
Fabricated metal products	37	17	16	45	21	19
Machinery, except electrical	70	31	29	71	31	29
Electrical and electronic equipment	725	322	294	896	398	363
Instruments and related products	238	107	103	252	114	110
All other manufacturing	251	108	95	252	109	96
Nonmanufacturing	204	106	0	222	121	0
Total	3,991	1,796	1,538	4,352	1,964	1,679

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1/ The final number of corporations mentioned here is slightly understated. The data for the corporations which filed after the cut-off date exclude any loss corporations. An estimate of the income and employment of such loss companies was made, based on the preliminary sample, and added to the final numbers, but no attempt was made to assign those imputations to a specific number of companies. The adjustment was small.

According to Table 4-5, four industry groups accounted for 85 percent of the tax benefits provided to possessions corporations:

Industry	Reduction in U.S. tax liability (dollars in millions)	Percent of total
All industries	$1,679	100%
Pharmaceuticals	832	50
Electrical and electronic equipment	363	22
Instruments	110	7
Food and kindred products	98	6

III. Payroll and Employment in Tax Year 1982.

In enacting section 936 in 1976, Congress sought to assist Puerto Rico in obtaining employment-producing investments. Matching possessions 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 4-6 presents, by industry, section 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 the amount of income which it earns, not on the number of workers it employs. Table 4-6 is based on 324 possessions corporations in the manufacturing sector for which 1982 employment and payroll data could be obtained. The actual figures for those corporations are blown up to represent the total 447 manufacturing corporations by assuming that the relationship within each industry sector between employment and cost of goods sold is the same for the complete group of 447 companies as for the 324 companies for which employment and payroll data were available. The numbers used to make these extrapolations are shown in Appendix C, p. 105.

Table 4-6 shows that, for manufacturing in general, the estimated Federal tax benefits per employee averaged $20,656, or 147 percent of the average compensation per employee. Tax benefits as a percentage of total employee compensation varied substantially from industry to industry. In the pharmaceutical industry the average Federal tax benefits amounted to $69,200 per employee, or more than three 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 $13,931 per employee, or 105 percent of average compensation. In the apparel industry, in contrast, the average tax savings per employee were $3,030, only one-third of employee compensation.

Table 4-7 illustrates the distribution of tax benefits in relation to number of employees. The chemical industry (primarily pharmaceuticals) was the only manufacturing sector in which the share of tax savings exceeded the share of employment. Chemicals accounted

Tax Benefits per Employee and as a Percent of Compensation by Industry, 1982

	Actual data, 324 companies		Estimated totals, 447 companies 1/				
	Employees	Compensation ($000)	Employees 2/	Compensation 2/ ($000)	Average Compensation per employee	Tax Benefit per employee	Tax Benefit 3/ as % of Compensation
All manufacturing industries	59,063	$839,438	81,257	$1,143,307	14,070	20,656	146.8
Food and kindred products	4,697	72,123	5,934	91,117	15,355	16,494	107.4
Textile mill product	766	7,106	1,184	10,986	9,279	3,547	38.2
Apparel	11,581	103,703	14,015	125,490	8,954	3,030	33.8
Mens and boys	2,945	26,292	--	--		--	--
Womens and children	5,884	52,757	--	--		--	--
Hats, caps, etc.	566	4,783	--	--		--	--
All other	2,186	19,871	--	--		--	--
Chemicals	11,469	245,515	14,278	301,908	21,145	62,580	296.0
Industrial chemicals	1,435	39,058	--	--	--	--	--
Pharmaceuticals	9,104	189,045	12,027	249,741	20,765	69,200	333.3
Soaps, cleaners, etc.	479	7,347	--	--	--	--	--
Other	451	7,065	2,251	52,174	23,178	23,057	99.5
Rubber and plastic products	1,076	12,883	1,585	18,977	11,973	6,552	54.7
Leather	1,783	16,414	3,517	32,374	9,206	3,888	42.2
Footwear	1,460	13,232	--	--	--	--	--
Other	323	3,182	--	--	--	--	--
Fabricated metal products	673	9,977	1,564	23,185	14,824	12,157	82.0
Can and containers	317	5,305	--	--	--	--	--
Other	356	4,672	--	--	--	--	--
Machinery, except electrical	1,268	20,228	1,309	20,882	15,953	22,205	139.2
Electrical and electronic equipment	16,109	214,482	26,065	347,029	13,314	13,931	104.6
Radio, TV, communication	3,047	38,394	--	--	--	--	--
Electronino components	3,624	47,163	--	--	--	--	--
Other	9,438	128,925	--	--	--	--	--
Instruments and related products	5,500	76,242	6,625	91,836	13,862	16,545	119.4
Scientific instruments	531	6,339	--	--	--	--	--
Other	4,969	69,903	--	--	--	--	--
All other manufacturing 4/	4,141	63,783	5,181	79,523	15,349	18,441	120.1

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1/ The final number of corporations mentioned here is slightly understated, perhaps by 2 to 4 companies. The data for corporations which filed after the cut-off date exclude any loss corporations. An estimate of the income and employment of such loss companies was made, based on the preliminary sample, and added to the final number, but no attempt was made to assign those imputations to a specific number of companies. The adjustment was small.

2/ Number of employees and compensation are estimates calculated by weighting the actual figures shown in columns 1 and 2 (for the 324 firms for which payroll and employment data were available) by the ratio of the cost of goods sold for that group, by industry, for the 447 companies to the cost of goods sold in that same industry by the sample of 324 corporations for which employment data was available. The industry data on cost of goods sold are shown in Appendix C Table 1, p. .

Table 4-7

Distribution of Tax Benefits and Employment, by Industry, 1982
(percent of total)

	Tax Benefits	Employees
All Manufacturing Industries	100%	100%
Food and kindred products	5.8	7.3
Textile mill products	0.3	1.4
Apparel	2.5	17.2
Chemicals	53.2	18.0
Pharmaceuticals	49.6	14.7
Other	3.6	3.2
Rubber and plastic products	0.6	1.9
Leather	0.8	4.3
Fabricated metal products	1.1	1.9
Machinery, except electrical	1.7	1.6
Electrical and electronic equipment	21.6	31.9
Instruments and related products	6.5	8.1
Other manufacturing	5.7	6.4

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Source: Tax benefits from Table 4-5, column 6. Employees from Table 4-6, column 3.

for 53 percent of the benefits but only 18 percent of the employees. Within chemicals, the pharmaceutical industry provided 15 percent of the employment of all manufacturing companies, and accounted for 50 percent of the total section 936 tax savings. The electrical and electronic equipment industry accounted for 22 percent of the tax benefits, but provided 32 percent of the employment of all manufacturing possessions corporations. The next largest shares in the tax benefits were derived by the instruments and related products industries (7 percent of the tax benefits, 8 percent of the manufacturing employment) and the food industry (6 percent of the tax benefits and 7 percent of the employment). The apparel industry derived only 2.5 percent of the tax benefits but contributed 17 percent of the manufacturing employment.

Table 4-8 ranks by the amount of tax benefit per employee the corporations for which this information is available. There is not sufficient company by company information to include all of the manufacturing possessions corporations in this table; it includes 324 of the 447 corporations (72 percent), which contribute 78 percent of the combined net income.

At the top of the ranking are 14 companies for which the U.S. tax benefits represented $100,000 or more 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 14 possessions corporations accounted for 29 percent of the tax benefits but provided only 5 percent of the employment of the 324 manufacturing companies. The top 38 possessions corporations, those for which tax savings per employee equalled or exceeded $50,000 in 1982, collectively accounted for 55 percent of the tax benefits and 13 percent of employment tax benefits.

IV. Summary Data for 1974-1982

Table 4-9 presents data for the period 1974-1982 on the number of possessions corporations, their net income, estimated tax benefits, and tax benefits in relation to payroll and employment. The data include the complete sample of the returns for all years, including 1982. The table reveals a number of trends:

o The number of possessions corporations in manufacturing was 399 in 1974 and 447 in 1982. Throughout the period 1974-82, the pharmaceutical industry and electrical and electronic equipment industry accounted for approximately 10 percent and 20 percent, respectively, of the total number of possessions manufacturing corporations.

o Net income of manufacturing possessions corporations rose from approximately $800 million in 1974 to $4 billion in 1982. In inflation-corrected dollars, net income in 1982 amounted to 295 percent of income in 1974. The percentage of total net income earned by the pharmaceutical industry stood at approximately 50

Table 4-8

Tax Benefits, Employment, and Compensation of Employees
By Size of Tax Benefits Per Employee, 1982

	Number of Returns	Qualified Possession Net Income ($000) 1/	Tax Benefits		Employees	
			Amount ($000)	Percent of Total	Number	Percent of Total
All Manufacturing Corporations	324	3,209,553	1,349,031	100.0	59,063	100.0
$100,000 or more	14	960,930	396,697	29.4	2,955	5.0
$ 50,000 under $100,000	24	823,496	346,849	25.7	4,834	8.2
$ 10,000 under $ 50,000	118	1,129,183	482,644	35.8	20,836	35.8
$ 5,000 under $ 10,000	47	188,540	78,225	5.8	10,744	18.2
$ 1,000 under $ 5,000	77	104,583	43,453	3.2	14,944	25.3
$ 500 under $ 1,000	6	1,899	732	*	986	1.7
$ 1 under $ 500	18	1,444	431	*	1,723	3.0
No tax benefits	20	-513	0	0	2,041	3.5

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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.

Table 4-9

Summary Data on Possessions Corporations, 1974-1982

	1974	1975	1976	1977	1978	1979	1980	1981	1982
Number of corporations, all industries	596	595	528	519	637	672	709	635	554
Manufacturing industries	399	394	395	385	460	502	458	497	447
Pharmaceuticals	44	47	52	53	58	65	61	56	48
Electrical and electronic equipment	76	76	81	80	90	112	116	120	100
All other manufacturing	279	271	262	252	312	325	281	321	269
Nonmanufacturing industries	197	201	133	134	177	170	251	138	107
Net income, all industries ($000)	852,058	1,108,881	1,627,213	1,800,313	2,484,572	3,088,304	3,629,761	4,216,511	4,351,853
Manufacturing industries	813,057	1,055,060	1,551,677	1,714,321	2,361,446	2,798,156	3,161,116	4,100,561	4,130,105
Pharmaceuticals	405,355	547,060	779,954	876,576	1,053,252	1,325,309	1,507,001	1,867,684	2,212,197
Electrical and electronic equipment	167,389	195,593	323,249	231,475	417,629	543,195	744,981	1,049,049	895,690
All other manufacturing	240,313	312,407	448,474	606,270	890,565	929,652	909,134	1,183,828	1,180,247
Nonmanufacturing industries	39,002	54,059	75,536	85,992	123,126	290,148	468,645	115,950	221,748
Estimated tax benefits ($000)									
Manufacturing industries 1/	397,021	478,367	698,839	771,444	998,120	1,167,529	1,326,406	1,711,352	1,678,535
Pharmaceuticals	181,508	245,486	350,941	394,459	438,695	552,020	626,376	791,535	832,267
Electrical and electronic equipment	75,231	89,106	145,575	104,164	184,501	219,771	326,036	433,059	363,130
All other manufacturing	140,282	143,819	202,322	272,821	374,924	395,738	373,994	486,758	483,138
Tax benefits per employee, ($)									
Manufacturing industries 2/	6,310	8,512	11,454	11,217	14,250	15,690	17,297	18,007	20,656
Pharmaceuticals	38,129	39,031	47,166	39,337	48,669	51,417	57,632	62,078	69,200
Electrical and electronic equipment	6,237	9,488	10,816	11,315	11,988	15,439	14,169	19,930	13,931
All other manufacturing	3,479	3,987	5,300	4,432	9,639	8,415	8,943	8,584	11,192
Tax benefits as a percent of compensation of employees									
Manufacturing industries 2/	91.7	116.1	143.3	135.9	133.2	135.4	145.2	137.9	146.8
Pharmaceuticals	425.5	389.1	428.1	327.5	357.3	343.8	368.4	346.0	333.3
Electrical and electronic equipment	93.5	126.0	129.2	126.6	122.6	138.9	126.1	152.3	104.6
All other manufacturing	52.7	55.8	72.3	62.2	94.6	77.7	65.5	70.6	88.4

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1/ The estimated tax benefits shown here differ from the corresponding years shown in Table 4-11 because that table is based on calendar and Federal fiscal years, whereas the data above are based on the tax years of possessions corporations.

2/ These figures are weighted averages based on those returns for which employment and compensation of employees were available. See Table 4-6 for details.

percent through this period. The share of the electrical and electronics industry varied between 15 percent and 20 percent in most years, except 1981, when it rose to 26 percent; in 1982 it amounted to 22 percent.

- The estimated U.S. tax benefits of possessions corporations increased from $400 million in tax year 1974 to about $1.7 billion in tax year 1982, a change in inflation-corrected dollars of 255 percent.

- The U.S. tax benefits in relation to the number of employees in possessions corporations rose from about $6,300 per employee in 1974 to $20,650 per employee in 1982.

- Despite the increase in the average compensation paid by 936 companies (from $6,973 in 1974 to $14,070 in 1982) tax benefits rose from 92 percent to 147 percent of average employee compensation in this period.

V. 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 new industry 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 4-10 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 United States and foreign markets would appear larger than Table 4-10 indicates.

Table 4-10

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

Industry Group	Puerto Rico	United States1/	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.

Table 4-10 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 entire 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 and electrical and electronic equipment industries 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 72 percent of the business receipts of all possessions manufacturing corporations. The evidence of Table 4-10 would therefore suggest that possessions corporations are not generally an important stimulant to the development of "downstream" industries. There could be subsequent rounds of downstream effects not captured by the sales data of Table 4-10, but they are not likely to be quantitatively important.

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 First 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 and all other companies.

The Puerto Rican government views the electronics industry as the centerpiece for expanding locally-owned electronics, metal products, and plastics industries. Locally-owned firms are increasing their sales of materials to 936 electronics firms. Puerto Rico's apparel industry also obtains much of its inputs from locally owned companies. A substantial service sector in Puerto Rico provides banking, transportation, and utilities to all 936 manufacturing firms. Employment in these "supplier" industries is not included in employment figures reported in Table 4-6, above.

Several studies have attempted to use Puerto Rican input-output tables to estimate the indirect effect on the island of purchases by 936 corporation and services. For example, Dr. H. Calero concludes that 1.35 jobs are created indirectly for each 936 job. 10/ This employment multiplier is similar to the employment multiplier for Puerto Rican manufacturing by the Puerto Rican Government Planning Board in May 1985. Similarly, Fernando Zalacain used the Puerto Rico input-output table to find that employment multipliers for 936 companies in Puerto Rico range from 1.4 to 3.3 in major manufacturing industries. 11/

10/ Calero, H., Economic Challenges Facing Puerto Rico, Citibank Conference, March 1985.

11/ Zalacain, Fernando "Los Multiplicadores del Sector Manufacturero 936 en la Economia de Puerto Rico", April 1985.

However, these mechanical applications of Puerto Rican input-output data to 936 employment levels in order to estimate indirect employment effects do not give valid results. Input-output tables are based on transactions between establishments, not corporations. Thus, a shipment from a 936 corporation's bulk chemical plant to its final processing plant would be recorded as an indirect effect based on the input-output table, when in fact the enterprise's entire employment is already included in the direct employment levels in Table 4-6. In addition, 936 corporations obtaining goods and services in Puerto Rico must frequently use other 936 corporations as suppliers simply because 936 corporations dominate many Puerto Rican manufacturing industries. Again these "indirect" effects would have been counted in the Table 4-6 employment levels. The estimates of 936 indirect employment effects using conventional input-output tables therefore involve a substantial amount of double-counting and are seriously overstated.

The Puerto Rican Government Planning Board has recognized the difficulties inherent in using published input-output tables to estimate the indirect employment created by 936 operations and are undertaking to calculate new employment multipliers that will not contain double counting of employment. However, these new corrected multipliers unfortunately were not completed in time for inclusion in this report.

VI. Revenue Impact of Section 936

A. Revenue Estimates and Estimating Procedure. Table 4-11 presents the estimated U.S. tax benefits provided by the possessions corporation system for calendar and fiscal years 1973-1982. Adjusting the income of possessions corporations from the tax years of the corporations to Federal fiscal years requires apportioning the income reported on those returns filed for corporate tax years which overlap the fiscal year. This results in an estimate of $1,662 million in tax benefits under section 936 for calendar year 1982 (and of $1,678 million for fiscal year 1982).

As explained above, the section 936 tax benefits for tax year 1982 are estimated by (1) subtracting from the qualified income of possessions 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 thereby obtained is then reduced by the amount of the investment tax credit which would have been available and by the tollgate and income taxes paid to Puerto Rico. The combined tollgate and income taxes paid by manufacturing possessions corporations in 1982 amounted to approximately 6 percent of their net income.

For accounting periods beginning after December 31, 1982, possessions corporations are subject to the provisions of section 936(h), added to the Internal Revenue Code by TEFRA. Section 936(h) provides that only certain income from intangibles developed by a U.S. corporation may be allocated to an affiliated possessions corporation.

Table 4-11

Federal Revenue Cost Estimates,
Possessions Corporation Provisions, 1973-1982

(millions of dollars)

Year	Calendar Year Receipts Foregone 1/	Fiscal Receipts Foregone 1/
1973	269	254
1974	393	325
1975	473	429
1976	692	572
1977	763	724
1978	988	864
1979	1,156	1,121
1980	1,312	1,234
1981	1,694	1,503
1982	1,662	1,678

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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 of 1976.

Source: The 1973 through 1975 figures are based on book income data taken primarily from Federal income tax forms (Form 1120). The figures for 1978-1982 are based on the estimated tax benefits as noted in Table 4-9, adjusted for each firm's tax year as noted on Form 5735.

The remainder of the income from such intangibles must be allocated to the U.S. parent and be subject to U.S. tax. Because of the complexity of section 936(h) and the uncertainty in the interpretation of prior law relating to the allocation of income from intangibles, it is extremely difficult to estimate accurately what the revenue effect of the new provision will be; and many of the returns showing the first year effect of TEFRA are not in yet. Thus no revenue projections have been provided.

In addition to the 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 law applicable to tax years beginning in 1982, a possessions corporation could receive up to 50 percent of its gross income in passive investment income. This is reduced to 45 percent for tax years beginning in 1983, 40 percent for tax years beginning in 1984, and 35 percent thereafter. These reductions affect only those corporations which currently earn passive income in amounts 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 roughly 16 percent of their combined gross income in 1982 12/), the revenue effect of the new passive income limitation under TEFRA is expected to be small.

B. Alternative Tax-saving Routes. 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. The relative tax advantages of a Puerto Rican location vary for physical and financial investments and for the use of intangible assets. 13/ Puerto Rico can be, on tax grounds, a more attractive

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12/ A rough measure of income from financial assets in 1982 may be obtained by summing the taxable interest ($578 million) and the tax exempt interest ($12 million) reported by possessions manufacturing corporations in tax year 1982. The total of $590 million in gross interest income represented 16 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 1982 because of the rise in interest rates and the reinvestment of interest income.

13/ "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.

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 under section 936 offers unique advantages for financial assets, such as deposits and bonds, and for the use of certain intangible assets.

1. **Physical assets.** If section 936 were repealed, a possessions corporation could continue to obtain the benefit of U.S. tax exemption on current income from physical assets by remaining in Puerto Rico as a Puerto Rican chartered corporation or by moving to a foreign country, because the foreign earnings of a corporation incorporated outside the United States are generally not subject to U.S. tax until the earnings are repatriated to the United States. Where a U.S. parent corporation derives foreign source income, the U.S. tax on that income may be reduced by a credit for foreign income taxes paid.

If a possessions corporation derives most of its income from investment in physical assets, it might elect to reincorporate in Puerto Rico or in a foreign country if section 936 were repealed. With respect to firms that took this course, the repeal of the possessions corporation credit would not transfer to the U.S. Treasury a large proportion of the tax benefits provided under section 936. Those possessions corporations with the highest percentage of their income attributable to physical assets are in the low-technology industries -- including food products, apparel, and fabricated metal products. 14/ In 1982, the combined income of possessions companies in low-technology industries represented only 11 percent of the income of all 936 manufacturing corporations.

2. **Financial Assets.** A possessions corporation could continue to benefit from U.S. tax exemption on current income from financial assets by incorporating in Puerto Rico and not distributing the earnings to the United States, provided that it met the tests of section 957(c) by deriving 80 percent of its gross income from sources within Puerto Rico or a U.S. possession and 50 percent or more of its gross income from the active conduct of any of the enumerated trades or businesses. Income from financial assets represented approximately 16 percent of total 936 income in 1982, and will rise somewhat in later years.

14/ For a discussion of the relative shares of possessions corporations' income from physical and intangible assets, see the Fourth Report, pp. 61-66. Low-technology industries are defined as those industries where R&D as a percentage of capital spending and of sales is below the average for all U.S. manufacturing industries. Low-technology industries include textiles; stone, clay, and glass products; paper; and rubber products; as well as those industries mentioned in the text. Industry data are for 1982, from Annual McGraw-Hill Survey of Business' Plans for Research and Development Expenditures, 1982-85, Tables IV and V.

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. Prior to the enactment of TEFRA, many U.S. parent corporations transferred intangibles (tax-free) to affiliated possessions corporations, which in turn claimed as part of their income the return attributable to the intangibles. As explained in Chapter 2, TEFRA provides that 936 corporations which meet a significant business presence test in a possession are eligible for tax exemption on certain income from intangibles developed by their affiliates.

In the absence of section 936, income from intangibles developed or purchased by a U.S. corporation would, in general, be fully subject to U.S. tax regardless of whether the intangibles are used in the United States or abroad. U.S. law, as amended by the Deficit Reduction Act of 1984, provides that in the case of an otherwise tax-free transfer of intangible property from a U.S. person to a foreign corporation, the transferor is treated as receiving an annual payment equal to the value of the intangible in that year. Such deemed payments are U.S. source income. 15/ This provision is intended to retain the U.S. taxing authority over income from an intangible even if transferred to a foreign corporation. The Fourth Report estimated that, in tax year 1980, roughly 50 percent of the income of 936 manufacturing corporations may have been a return on intangibles developed or purchased by an affiliated corporation. 16/

15/ Under pre-1984 law, a U.S. corporation which transferred to a foreign corporation the U.S. rights to an intangible was required to include in the transfer's gross income the fair market value of the intangible, less the adjusted basis in the hands of the transferee, which was normally zero. Such income would be subject to tax. However, in general, no tax was imposed on the transfer by a U.S. corporation of the foreign rights to an intangible if the intangible was used in foreign manufacture. The special treatment of transfers of foreign rights to intangibles was eliminated by the Deficit Reduction Act of 1984.

16/ See Fourth Report, pages 61-66, 128.

CHAPTER 5

THE IMPACT OF 936 FINANCIAL ASSETS ON PUERTO RICAN GROWTH - RECENT DEVELOPMENTS -

I. Introduction

This section reviews recent developments in the continuing attempt by the Puerto Rican government to use the financial assets retained in Puerto Rico by 936 corporations to promote Puerto Rican development. Table 5-1 presents the financial portfolios of all 936 corporations in Puerto Rico at the end of 1983. The size of these financial investments are enormous for an economy the size of Puerto Rico's. They amount to more than $3,000 for each person living on the island.

The goal of the Puerto Rican government's efforts has been to use these financial assets to reduce the cost of capital in Puerto Rico compared to that in world capital markets and thereby to stimulate real investment on the island. This chapter first reviews the recent changes in the Puerto Rican regulations governing the use of 936 funds. 1/ It then attempts to evaluate the impact of the financial investments by 936 corporations on the Puerto Rican capital market. The relationship between the volume of financial investments by 936 corporations in Puerto Rico on the one hand, and net capital flows and real investment on the other, is examined. In addition, the forces determining the interest rate paid on 936 funds are described, because a low rate relative to world capital markets creates the opportunity for 936 funds to have a beneficial impact on Puerto Rico. The evidence suggests that, while the Puerto Rican government has recently been successful in forcing down the interest rate paid to 936 corporations, the impact of the Qualified Possession Source Investment Income provision on real investment in Puerto Rico has been very modest.

II. Recent Regulatory Changes by the Government of Puerto Rico

In order to make sure that increasing financial investment in Puerto Rico by 936 corporations leads to increased real investment on the island, it is necessary to separate the market for 936 funds from world capital markets by preventing arbitrage between them. The Puerto Rican government has therefore since 1976 issued a series of rulings and regulations which have progressively limited the discretion of financial institutions in using 936 funds. These rulings and regulations identify the assets whose acquisition are "eligible" uses of 936 funds by financial institutions. They also specify the financial investments by 936 corporations that have to be matched with eligible assets by financial institutions, and how the matching is implemented. For example, they give the base period for

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1/ An explanation of the provisions in the U.S. Internal Revenue Code and Puerto Rican law on which the exemption for Qualified Possession Source Investment Income is based is given in Chapter 2.

Table 5-1

Estimated Composition of the Financial Investments of Possessions Corporations at Year-end 1983*

Financial Investments :	$ billions
Total	11.1+
Investments in Puerto Rico, total	10.6+
Deposits in Puerto Rican banks, including repurchase agreements	6.0**
Repurchase-Resale agreements not included in banks funds	.9
Puerto Rican source GNMA mortgages	1.4
Loans to other possessions corporations	.4+
Puerto Rican government obligations	.4+
Mortgage and real estate loans	1.3+
Other investments in Puerto Rico	.2+
Investments outside of Puerto Rico, including U.S. municipals and preferred stock of U.S. corporations	.5

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\+ Denotes approximation.

* 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.

The financial assets listed do not include accounts receivable or other working capital.

** This includes about $800 million in savings banks.

the calculation of incremental eligible assets and incremental eligible 936 funds. This section reviews regulatory developments since the end of 1981.

A. **Summary of the February 1, 1982 Regulations.** On December 17, 1981, the Puerto Rican Treasury announced new regulations governing the use of 936 funds that became effective on February 1, 1982. The most important changes from previous rules included:

(1) The base for the calculation of incremental eligible assets in banks was moved up to July 1, 1981 from April 30, 1975.

(2) The regulations for the first time covered ultimate recipients of eligible funds. Banks had to be able to establish to the satisfaction of the Puerto Rican Secretary of the Treasury that eligible funds had been used properly and not simply to purchase financial assets.

(3) Brokers could become eligible to act as intermediaries for the use of eligible 936 funds. They could use any underlying assets in obtaining 936 funds in a repurchase agreement ("repo"). However, the proceeds of the repo had to be invested in the same range of eligible assets that banks were restricted to in their use of 936 funds.

In addition, the February 1, 1982 regulations mandated that a certain portion of eligible assets be in the form of mortgage loans for new housing. At the same time that it announced the new regulations, the Puerto Rican Treasury issued an administrative ruling which restricted the use of 936 funds loaned by banks to brokers to the financing of eligible Puerto Rican assets.

B. **Summary of Regulations Effective September 1, 1983.** On August 2, 1983, the Puerto Rican Treasury issued a series of amendments to the December 17, 1981 regulations to remedy what it perceived to be continuing defects in the regulatory regime. The changes included:

(1) A limit on the number of times 936 funds can be redeposited or transferred among banks and brokers before being loaned to the ultimate eligible recipient. After September 1, 1983, a bank or broker receiving eligible funds from a 936 corporation may only transfer or redeposit them once. At that point, the bank or broker receiving the funds becomes the "ultimate recipient" and must invest them in eligible assets, which means that the funds cannot be invested in CDs, repos, or other financial assets.

(2) A change in the burden of proof on the bank or broker in establishing that 936 funds have been invested in eligible activities. There is a presumption that the funds

have not been properly applied if the collateral provided in support of the loan includes assets not related to eligible activities, such as CDs or other financial assets owned by the ultimate recipient for less than 45 days. On the other hand, there is a presumption of proper use if the collateral is made up of assets resulting from or related to the production and sale of goods or services in Puerto Rico by the ultimate recipient.

(3) A restatement of the list of eligible activities. Instead of a long list of items specifically identified as eligible, the amended regulation indicates which activities are not eligible, e.g., consumer loans and offshore investments. Eligible activity is described in rather broad terms, apparently to give eligible institutions more flexibility in generating new areas of eligible activity.

(4) An attempt to move from a base period-incremental system to a transaction-by-transaction tracing system in determining eligible activities. A bank is no longer free to make unrestricted use of 936 deposits, even if it has excess eligible assets when the 936 funds are received. If a relationship is established between an inflow of 936 funds and the acquisition of ineligible financial assets, there is a presumption of improper use of the funds.

(5) Banks and brokers who receive 936 funds indirectly as "ultimate recipients" have to report to the Secretary of the Treasury on how the funds were utilized.

Most of these changes appear to affect the timing of transactions without necessarily having a substantive impact on the assets that are acquired. For example, the 45-day rule mentioned above may require merely that banks and brokers acquire their collateral a little earlier, and, since they accrue interest during that time, there is little added cost. Similarly, the attempt to introduce "tracing" or a "transaction-by-transaction" system is not significant as long as an excess of eligible assets over 936 funds tends to be generated. In that case, a bank or broker can time its acquisition of eligible assets to meet the tracing requirements, e.g., by not booking eligible loans until they have a 936 deposit in hand.

C. <u>**The April 17, 1984 Regulations.**</u> As indicated later in this chapter, the September 1, 1983 regulations did not seem to have a substantial impact on the market for 936 funds, at least as reflected in the interest rate on 936 deposits compared to Eurodollars and in the excess of eligible assets over investment requirements. In contrast, the regulations effective on April 17, 1984, had a much more immediate and dramatic effect on the Puerto Rican capital market.

By far the most important change in the April 17 regulation was the linking of the interest paid on 936 funds and the amount of eligible assets a bank or broker is required to generate. If banks or brokers pay interest on the 936 funds that is less than 65 percent of the comparable Eurodollar rate, the amount of eligible activity required matches the amount of 936 funds received. However, if the 936 rate is 65 percent or higher, the eligible activity has to exceed the amount of 936 funds received, with the penalty increasing as the interest rate rises. The complete schedule is as follows:

Interest rate on 936 funds as a percentage of the Eurodollar rate	Eligible Activity to be generated per dollar of 936 funds
0 to 64.9	$1.00
65 to 69.9	$1.05
70 to 74.9	$1.15
75 to 79.9	$1.22
80 to 84.9	$1.36
85 to 89.9	$1.54
90 and upwards	$2.00

The purpose of this penalty schedule is to drive down the interest rate on 936 funds by restricting the ability of banks or brokers to bid for funds when rates are high.

In the first few months after the promulgation of the April 17, 1984 regulations, there was some ambiguity about their exact application. Some banks interpreted the penalty on the schedule to apply only to the first month of a 936 CD's term. For example, they thought that they could issue a 6-month CD to a 936 corporation at the end of the month and only have to generate the penalty amount of additional eligible activity for the day remaining in the first month and not for the remainder of the CD's term. Interest rates therefore rose at the long end of the term structure relative to short term rates. However, the reporting forms issued by the Puerto Rican Treasury in July made it clear that this interpretation was not correct, and that the penalty amount of extra eligible activity had to be maintained to cover the original 936 deposit. Rates therefore dropped at the long end of the market, because banks and brokers were unwilling to risk locking themselves into a long term penalty.

The other major changes made by the April 17, 1984, regulations were:

(1) An eligible institution can consider one-twelfth of its annual operating expenses (excluding cost of funds) as eligible activity.

(2) A full 100 percent of 936 funds is subject to the investment requirements, instead of 95 percent.

(3) Eligible assets can no longer include cash on hand, cash items in process of collection, demand deposits with banks, interest and accounts receivable, prepaid expenses, or (imputed) interest on bad loans.

III. Empirical Analysis

A. The Inflow and Accumulation of 936 Funds, Net Capital Inflows, and Real Investment in Puerto Rico. One indication of whether the Qualified Possession Source Investment Income (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. 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. This section reviews the relationship between increased financial investments in Puerto Rico by 936 corporations and net capital inflows. In addition, because increased real investment is the ultimate goal of the QPSII provision, the relationship between 936 financial investment and real investment in Puerto Rico is examined.

Table 5-2 presents the various components of the capital account of the Puerto Rican balance of payments and also the net overall balance through fiscal year 1983. It gives both changes in foreign holdings of Puerto Rican assets and changes in Puerto Rican holdings abroad. Financial investments by 936 corporations are included in direct investment. While direct investment also includes investment in plant, equipment, and working capital, the data on 936 deposits in Puerto Rican banks indicate that the large swings in direct investment are attributable almost exclusively to changes in financial investments.

For the 10 years from 1972 through 1981, there were only modest changes in the net annual inflow of capital into Puerto Rico. There were very large changes in individual components, such as the large increase in foreign direct investment after 1975. This mainly reflected the large inflow of 936 funds from the Eurodollar market as a result of the Qualified Possession Source Investment Income provision in 936 enacted in 1976. Foreign direct investment was also very high in 1980 and 1981 as 936 corporations continued to invest their retained earnings in Puerto Rican financial assets. This increase in Puerto Rican investments by 936 corporations was offset by outflows through the banking system, investments offshore by Puerto Rican public corporations, and shifts in the ownership of Puerto Rican public debt. The changes in the 1976 law regarding investment income therefore seemed to have a relatively modest impact on net capital inflows in Puerto Rico through 1981. In addition, there seemed to be little relationship between the large swings in direct investment in Table 5-2 and the small changes in private real investment in Table 5-3.

Table 5-2

Components of the Puerto Rico Capital Account, 1970-1982

(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	1982	1983
Direct investment in Puerto Rico - change in the assets of corporations (mainly 936's) controlled offshore	330	686	626	792	735	625	1,483	1,698	1,682	878	2,305	2,636	-115	621
Net short-term banking flows	182	32	-25	114	39	306	59	-544	-211	-440	-557	-1,362	-655	-871
Foreign holdings of bank debts	45	20	102	248	227	453	48	-91	-72	197	-13	-384	114	-357
Investment by Puerto Rican banks abroad	-110	79	-4	-174	-25	-168	70	-457	-197	-763	-490	-1,007	-827	-533
External deposits in Puerto Rican banks	247	-67	-123	40	-163	21	-59	4	58	133	-95	29	58	19
Net foreign investment in long-term Puerto Rican Government obligations	181	307	448	404	590	896	175	352	-139	637	344	186	349	719
Puerto Rican investment in U.S. Government securities	-15	-20	66	9	113	13	-29	-310	124	-191	-142	24	-96	5
Net foreign investment in short-term debts of Puerto Rican public corporations	25	67	42	64	15	153	-37	111	-13	31	289	-11	169	-36
Short-term investment abroad by Puerto Rican public corporations	-7	-2	-15	0	-21	-88	-25	-48	-204	77	-631	-41	175	40
All other	195	86	184	-131	-59	-9	18	94	321	370	-25	161	301	210
Total, Net	891	1,156	1,327	1,252	1,412	1,896	1,644	1,353	1,560	1,362	1,583	1,593	128	688

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

Table 5-2 indicates that in fiscal 1982 net capital inflows almost disappeared compared to the level that had been maintained in the previous decade. There was a reduction of more than $2.5 billion in foreign direct investment, presumably reflecting the large repatriations by 936 corporations in response to low financial returns in the first half of 1982. This is consistent with the decline in 936 deposits in the first part of 1982, as will be discussed later. Somewhat surprisingly, the other components of the capital account did not act to offset the change in direct investment in order to leave net inflows unchanged. In other words, 1982 was not the mirror image of years in which there were large increases in financial investments in Puerto Rico by 936 corporations and capital flowed out through the banking system. Outflows through the banking system, while below the 1981 peak, continued at a high level.

Several factors may have contributed to this decline in net capital inflows. Table 5-3 indicates that there was a decline in private investment in Puerto Rico in 1982. The demand for capital may not have been sufficient to attract capital from offshore. In addition, the continued increase in exports combined with the recession-induced decline in imports reduced the requirements for capital inflows. In any case, whatever the independent contribution of the changes in the demand for capital or in the trade account, the fact that direct investment and 936 financial assets declined in 1982 suggests that 936 funds could have had little positive impact on Puerto Rico in that year.

Does the fact that in 1982 the substantial decline in real private investment coincided with the large drop in both direct investment and the accumulation of 936 financial assets suggest that real investment had been stimulated by the inflow of 936 funds before 1982? Probably not, because in 1982 real private investment and 936 funds were each subject to different forces, and their parallel behavior is largely coincidental. Real investment was strongly affected by the 1982 recession, as is clear from the fact that the change in inventory investment explains most of the decline. On the other hand, financial investments by 936 corporations declined because the more restrictive February 1, 1982 regulations drove down the interest rate on 936 funds and caused large repatriations. If anything, the dramatic decline in the interest rate on 936 funds in early 1982 as a result of the new regulations should have stimulated investment, not discouraged it. To the extent that real investment and 936 funds are related, it is probably the level of real investment which influences the inflow of 936 funds rather than the reverse. The extent to which banks can acquire 936 funds depends on the amount of "eligible" loans available which are, in turn, related to the amount of real investment taking place. The fact that fluctuations in Puerto Rican real investment are almost exclusively due to cyclical changes in inventories suggests that the impact of 936 funds on real investment is weak.

Foreign direct investment, which reflects the assets of 936 corporations, did recover somewhat in fiscal 1983, suggesting that the pace of repatriations diminished. Net inflows largely matched the recovery in direct investment. Banking outflows increased but not by

Table 5-3
Gross Private Investment in Puerto Rico
(millions of current dollars)

Fiscal Year	Total	Residential Construction	Industrial and Commercial Building	Machinery and Equipment	Change in Inventories*
1970	1,065	289	344	382	50
1971	1,234	312	391	417	114
1972	1,268	374	332	426	136
1973	1,227	392	208	435	192
1974	1,138	411	248	375	104
1975	1,183	385	261	398	139
1976	1,197	357	220	482	138
1977	873	309	133	492	-61
1978	1,255	428	133	569	125
1979	1,317	394	136	611	176
1980	1,569	343	162	657	407
1981	1,312	305	210	671	126
1982	416	290	193	475	-542
1983	747	269	164	540	-226

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Source: Puerto Rico Government Development Bank

* Part of the net change in inventories may include inventories held by public agencies.

as much as the increase in direct investment. Therefore, in fiscal 1983, net capital inflows paralleled the change in direct investment more closely. This may reflect some success in the attempt by the Puerto Rican Treasury to control the use of 936 funds, particularly through the February 1, 1982 regulations. Still, net inflows in absolute terms remained below the level in the early 1970s prior to the passage of the Qualified Possession Source Investment Income provision in 1976. Furthermore, Table 5-3 indicates that the resumption of the growth of 936 financial assets in 1983 was not associated with a comparable recovery of private investment.

The Use of Data on Capital Flows to Evaluate the Impact of 936 Funds - Is it Valid?

It is true that the balance of payments data cannot be looked at in isolation without also consulting data on real savings and investment in Puerto Rico. For example, an inflow of capital to Puerto Rico could lead to increased capital investment and eventually to increased domestic saving because of higher Puerto Rican income. If the increased domestic saving is invested abroad, there would in the long run be no net capital inflow. In other words, the additional capital investment would appear to have been financed by increased domestic saving. The data on Puerto Rican investment in Table 5-3 suggest that this is not the case.

It can also be argued that 936 funds can be lent to exporters who will expand their operations, increase the export surplus, and thereby reduce capital inflows. Although this may happen in the long run, it implies a large change in 936 exports as a direct response to the increased investment. Again, the data do not support the argument.

B. **Distribution of 936 Funds Among Banks and Brokers in Puerto Rico.** Table 5-4 gives the distribution of 936 funds among Puerto Rican banks on April 1984 and the change from December 1981.

The market for 936 funds continued to become more competitive from December 1981 through April 1984. There were several factors contributing to increased competition for 936 funds over the period. One was the entry of the First National Bank of Boston branch in Puerto Rico. Another was the disproportionate growth of 936 funds in the local commercial banks. The smaller Puerto Rican banks, included in the "other local banks" category, in particular became significant participants in the 936 market. They accounted for almost 20 percent of the total growth of 936 funds in banks over the period. The savings banks accounted for about another 25 percent of the growth.

Table 5-4 shows that the increasing role of the smaller commercial banks and the savings banks occurred through the intervention of brokers. Approximately 75 percent of their 936 funds were derived from repos arranged by brokers. The excess eligible assets in the system have tended to be concentrated in these small commercial and saving banks. The brokers' intermediation is frequently necessary to mobilize these excess eligible assets because of the added security, usually in the form of explicit guarantees, which brokers provide to 936 depositors.

Table 5-4
Distribution of 936 Funds and Excess Eligible Assets - April 1984
(Millions of dollars)

Bank	Direct Deposits and Repos	Funds Obtained through brokers	Redeposits from other banks	Total 936 funds	Change in Total 936 funds from December 1981	Excess Eligible Assets April 1984
Chase Manhattan	1,355	0	0	1,355	+420	125
Citibank	1,312	117	0	1,429	-21	114
Bank of America	421	0	0	421	+18	7
Continental Illinois	176	13	7	196	-111	9
First National Bank of Boston	145	0	3	148	+148	10
Total, U.S. Banks	3,409	130	9	3,549	+455	265
Banco Popular	420	138	79	637	+188	37
Banco de Ponce	248	47	77	372	+96	35
Scotia bank de Puerto Rico	80	0	27	107	+6	2
Banco Central	106	129	112	347	+4	31
Banco de San Juan	49	40	20	109	+32	11
Banco de Santander	80	2	2	164	+16	63
Roig	7	77	13	97	+44	11
Other local banks	61	162	5	228	+192	126
Total, Local Commercial Banks	1,051	595	415	2,061	+578	316
Bank of Nova Scotia	166	0	0	166	-118	7
Royal Bank	209	0	48	257	-77	28
Total, Canadian Banks	374	0	48	422	-196	34
Federal Saving Banks	181	619	9	809	+266	247
Grand Total, All Banks	5,015	1,343	481	6,358*	+1,057*	862

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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.

Source: Puerto Rico Government Development Bank

The overall activities of brokers, both in receiving 936 funds and in generating eligible assets, are presented in Table 5-5. The table covers the period from February 1982 through April 1984, because brokers were first included in the Puerto Rican reporting system in February 1982. The $1,287 million of eligible activities generated through banks in April 1984, essentially matches the $1,343 million obtained through brokers by banks that is given in column 2 of Table 5-4. It does not represent a net addition to the amount of 936 activity presented for banks on Table 5-4. However, Table 5-5 indicates that brokers have become much more active in generating eligible activity directly rather than going through banks. Table 5-5 also indicates that brokers became much more important overall intermediaries for 936 funds in the period. These are further indications of the competitiveness of the 936 market.

C. **936 Funds, Eligible Assets, and the Interest Rate on 936 Deposits.** Table 5-6 gives the level of eligible activity in all Puerto Rican banks, the eligible investment required which reflects the level of 936 funds, and the amount of eligible assets in excess of requirements. The table indicates that there was relatively steady growth of eligible assets and 936 funds from early 1980 through January of 1982. The amount of excess eligible assets in the system was substantial and remained in the range of from $700 million to $1.1 billion. As indicated in the Fourth Report, 2/ this substantial level of eligible assets meant that banks and brokers could actively bid for 936 funds. As a result, the interest rates offered on 936 funds remained high from early 1980 through the end of 1981, generally in excess of 80 percent of the rate on Eurodollars.

The February 1, 1982 regulations reduced the amount of excess eligible assets to less than $200 million. In part this was due to moving up the beginning date for computing incremental assets from April 30, 1975 to July 1, 1981. In addition, the Federal Savings banks did not choose to be declared eligible institutions and their assets were not available for supporting 936 deposits.

Table 5-6 shows that the amount of eligible activity declined from $6,059.8 million in January 1982 to $5,155.6 million in February 1982, which was lower than the investment requirement of $5,480.5 million in December 1981. The only way the system could remain in equilibrium, at least in the short run when a major expansion in eligible assets is unlikely, was for 936 corporations to reduce 936 funds through repatriation. This is evident in the decline in investment requirements of almost $800 million from the end of 1981 through July 1982. Eligible assets remained only slightly in excess of requirements from February 1982 to April 1983.

2/ See pages 89-94.

Table 5-5

Brokers Activities in February 1982 and April 1984
(Monthly averages in millions of dollars)

	February 1982	April 1984
Eligible Activities		
Eligible Activities Directly Generated	116	726
Eligible Activities Generated Through Other Eligible Institutions (Banks)	819	1,287
936 Funds Received		
Received Directly Through Repos With Exempt Businesses	385	1,797
Received Through Loans and Repos from Banks	477	179

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Source: Puerto Rico Government Development Bank

Table 5-6

Total Incremental Eligible Activity
vs.
Total Investment Requirement
All Banks

(monthly averages in millions of dollars)

	Month	Incremental Eligible Activity	Investment Requirement on 936 Funds	Excess Eligible Assets
1980	May	4,203.7	3,414.2	789.5
	June	4,158.0	3,342.8	815.2
	July	4,097.4	3,132.7	964.7
	August	3,995.2	3,094.9	900.3
	September	4,201.1	3,094.2	1,106.9
	October	4,371.4	3,397.3	974.1
	November	4,641.1	3,622.5	1,018.6
	December	4,776.1	3,777.9	998.2
1981	January	4,750.3	3,837.0	913.3
	February	4,799.6	3,918.1	881.5
	March	4,808.7	3,854.5	954.2
	April	4,847.9	3,854.6	993.3
	May	5,069.1	4,025.8	1,043.3
	June	5,197.7	4,233.6	964.1
	July	5,121.1	4,236.0	885.1
	August	5,463.7	4,540.8	922.9
	September	5,701.3	4,855.3	846.0
	October	5,865.7	5,100.3	765.4
	November	6,085.9	5,375.8	710.1
	December	6,202.0	5,480.5	721.5
1982	January	6,059.8	5,272.1	787.7
	February	5,155.6	4,998.1	157.5
	March	5,293.9	5,137.4	156.5
	April	5,366.6	4,978.9	387.7
	May	5,275.4	4,950.7	324.7
	June	5,085.3	4,740.7	344.6
	July	5,079.2	4,682.5	396.7
	August	5,265.0	4,949.7	315.3
	September	5,198.8	4,860.5	338.3
	October	5,158.7	4,968.2	190.5
	November	5,322.9	5,132.2	199.7
	December	5,397.8	5,105.1	292.7
1983	January	5,380.0	4,996.4	383.6
	February	5,401.6	5,231.9	169.7
	March	5,563.2	5,323.7	239.5
	April	5,502.1	5,155.7	346.5
	May	6,493.0	5,915.2	577.8
	June	6,641.2	5,986.9	654.2
	July	6,422.3	5,670.1	752.2
	August	6,542.7	5,869.2	673.5
	September	6,628.2	5,967.7	660.5
	October	6,721.3	6,116.5	604.7
	November	6,956.7	6,381.5	575.2
	December	6,978.0	6,244.5	733.4
1984	January	6,896.2	6,087.1	809.2
	February	7,164.3	6,429.8	734.5
	March	7,175.1	6,387.0	787.5
	April	7,384.2	6,521.7	862.4

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Source: Puerto Rico Government Development Bank

Table 5-7 indicates that 936 interest rates after their steep decline in February 1982 continued to be low in relation to the rates on Eurodollars through April 1983. For much of the period from February 1982 to April 1983, interest rates on 936 funds were barely enough to make 936 corporations indifferent between investing in exempt 936 deposits and investing in taxable Eurodollar deposits.

This market equilibrium, in which 936 corporations had to withdraw funds from the 936 market in order to balance assets with investment requirements, was disturbed in May 1983 with the reentry of the savings banks into the regulatory system. As a result, the level of excess eligible assets almost returned to the level prior to February 1982. The increased ability of banks and brokers to compete for 936 funds drove up the interest rates offered. Table 5-7 indicates that 936 interest rates were generally 80 percent or more of the Eurodollar rates from June 1983 to March 1984.

The April 17, 1984 regulations forced the 936 interest rates back to the 60-65 percent range in May and June of 1984. This is frequently the pattern after a new round of regulations, but the effect may be longer lasting in this instance. The severe 36 percent penalty in terms of additional required eligible assets if the 936 rate is 80-85 percent of the Eurodollar rate, makes it unlikely that the interest rate will ever rise to that level.

Table 5-6 indicates that the system has tended to have excess eligible assets equal to about 12 percent of requirements. In the light of the penalty schedule, this suggests that if all the excess eligible assets are mobilized, the long run 936 rate will be in the range of from 65 to 75 percent of the Eurodollar rate. This expectation is based on the assumption that 936 firms will not substantially increase repatriations if the rate remains in this range. The possibility of repatriations as the rate goes lower may further suggest that 70-75 percent of Eurodollars is the most likely range in the long run. Another factor restraining the drop in 936 rates is the possibility of disintermediation as 936 corporations make direct loans to local firms in order to avoid the penalty.

Table 5-7

Interest Rates on 936 Deposits
As a Percentage of Eurodollar Rates*
February 1982 - June 1984

	Month	Ratio of 936 Rates to Eurodollar Rates
1982	Feb.	71.0
	March	57.0
	April	53.5
	May	62.0
	June	64.0
	July	66.0
	Aug.	64.0
	Sept.	71.5
	Oct.	64.5
	Nov.	61.5
	Dec.	63.5
1983	Jan.	64.5
	Feb.	65.5
	March	62.5
	April	70.0
	May	73.0
	June	78.0
	July	83.5
	Aug.	81.0
	Sept.	81.5
	Oct.	86.0
	Nov.	77.5
	Dec.	80.0
1984	Jan.	87.5
	Feb.	84.5
	March	86.0
	April	79.0
	May	63.0
	June	65.0

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* Rates used for comparison are interest rates on 3-month certificates of deposit. Monthly data are averages of published semimonthly ratios.

Source: Puerto Rico Government Development Bank.

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, and other smaller U.S. territories. 1/ 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. 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 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 $1.5 million in tax year 1982.

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) 2/, all "inhabitants" of the Virgin Islands satisfy 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 3/ 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 1982, the amount of income tax rebated under the Virgin Islands tax-incentive program is estimated at $8.3 million, of which $4.2 million is attributable to Virgin Islands subsidiaries of U.S. corporations.

1/ Other territories to which section 936 benefits apply are the Northern Mariana Islands and Wake and Midway Islands. Section 936 also applied to the Panama Canal Zone until September 30, 1979. 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/ 48 U.S.C. 1642.

3/ 48 U.S.C. 1397.

I. American Samoa and Guam

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 for at least five years. Tax exemption grants generally last 10 years and are subject to renewal. However, the period of tax exemption may terminate sooner 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 4/ 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 the 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

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4/ 48 U.S.C. 1421i.

file a single return with the United States. In addition, Code section 881(b) provides that, under certain conditions relating to stock ownership and the source of the corporation's total income, 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 1982 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 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.

B. **Characteristics of Possessions Corporations Operating Outside Puerto Rico**. For tax year 1982, we have data for 7 active 936 corporations operating in possessions other than Puerto Rico. The qualified possession net income of the 7 corporations was $3.9 million, of which 58 percent was attributable to possessions corporations operating in Guam. These 7 corporations claimed tax credits of $1.7 million under section 936, representing an estimated $1.5 million reduction in U.S. tax compared to the liability in the absence of section 936.

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.

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). TEFRA 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 or 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 not 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.

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

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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).

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

by a subsidiary incorporated in the Virgin Islands. 7/ Thus, 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 satisfied 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 were 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 qualify as 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.** 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.

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)).

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

D. Characteristics of Corporations, Partnerships, and Sole Proprietorships Eligible for Virgin Islands Tax Rebates. Tables A-1 and A-2 present data on assets, income, tax rebates, and employment for corporations and other entities which qualified in 1982 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 1982, and are based on income tax returns filed with the Virgin Islands. Tables A-1 and A-2 are based on the 40 active 934(b) entities for which both balance sheet and income statement data are available.

1. Assets, Income, and Income Tax Benefits by Type of Entity. Table A-1 presents data on the assets, income, and income tax benefits of 934(b) entities by type of entity. Of the 40 active 934(b) entities for which data are available, 6 were Virgin Islands-chartered subsidiaries of U.S. corporations, and 30 were Virgin Islands corporations with no parent or Virgin Islands partnerships or sole proprietorships. The remaining four 934(b) corporations were U.S.-chartered corporations.

The 40 entities had assets of $1,464 million. Ninety-three percent of these assets, or $1,360 million, were held by Virgin Islands subsidiaries of U.S. corporations. Locally controlled Virgin Islands corporations, partnerships, and sole proprietorships accounted for an additional $66 million, or 5 percent, of the total assets of 934(b) entities; and the remainder, or 2 percent, were U.S.-chartered companies.

Net plant and equipment of 934(b) entities (shown in Table A-1 as net depreciable assets) were $406 million, or 27.7 percent of total assets. The share of net depreciable assets in total assets was more than twice as large in 934(b) entities as in 936 manufacturing corporations. The comparable figure for 936 manufacturing corporations was 11.8 percent, as shown in Table 4-1, above.

Ninety-four 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 $5.2 billion in 934(b) total receipts.

Business receipts provided 91 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.

Table A-1

934(b) Corporations in the Virgin Islands - Selected Balance Sheet and Income Statement Items and Tax Benefits by Type of Corporation, 1982

(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	U.S. Corporations
Number of corporations	40	6	30	4
Total assets	1,464,316	1,360,471	65,866	37,979
Inventories	490,333	482,175	6,480	1,678
Depreciable assets	871,558	834,824	30,719	6,015
Accumulated depreciation	465,619	454,662	9,777	1,181
Net depreciable assets	406,485	380,262	21,389	4,834
Total receipts	5,185,170	5,121,441	49,869	13,860
Business receipts	4,732,162	4,675,086	45,275	11,801
All other receipts	453,008	446,355	4,594	2,059
Total deductions	4,865,551	4,805,555	46,919	13,077
Cost of sales and operations	4,582,798	4,548,572	28,017	6,209
All other deductions	282,753	256,983	18,902	6,868
Taxable income	319,619	315,886	2,950	783
Virgin Islands income tax rebates	8,333	4,247	1,772	2,315 1/

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1/ Rebates may exceed taxable income due to losses, as the taxable income figure is net of loss.

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 40 entities shown in the table amounted to approximately $320 million, of which Virgin Islands subsidiaries of U.S. corporations reported $316 million, U.S.-chartered firms $1 million, and locally-controlled V.I. entities $3 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 $8 million. U.S.-controlled Virgin Islands firms accrued somewhat more than $4 million in tax rebates for 1982, while Virgin Islands entities with no parent and U.S. corporations each accrued approximately $2 million in tax rebates.

2. **Assets, Income, and Tax Rebates by Industry**. Table A-2 covers the same entities as Table A-1, but presents the asset, income, and tax benefit data by industry.

Eight corporations in the chemical industry accounted for 77 percent of all net plant and equipment and 95 percent of the combined net income of 934(b) entities. These 8 corporations accrued tax rebates of slightly less than $3 million, or 35 percent of the Virgin Islands income tax rebates for all industries. Some of these companies had been listed under the category "Petroleum refining, alumina processing and concrete products" in the previous report.

Other 934(b) firms with substantial plant and equipment were hotels, with almost $32 million in net depreciable assets. The fifteen 934(b) hotels reported less than one million of taxable income, net of losses, in 1982.

The manufacture of other goods, including watches, was another principal activity of 934(b) firms in 1982. The 10 Virgin Islands manufacturers reported $4 million in net plant and equipment and earned almost $32 million in business receipts. These industry firms reported aggregate taxable income of nearly $11 million and accrued over $4 million in income tax rebates.

Table A-2

934(b) Corporations in the Virgin Islands - Selected Balance Sheet and Income Statement Items
and Tax Benefits by Industry, 1982

(Dollar amounts in thousands)

	All Industries	Chemicals	Watches	Other Manufacturing	Hotels	Other Services
Number of Corporations	40	8	3	7	15	7
Total Assets	1,464,316	1,284,773	4,132	55,461	50,473	69,477
Inventories	490,333	483,846	604	4,902	619	361
Depreciable assets	871,558	741,407	180	6,606	44,510	78,854
Accumulated depreciation	465,619	429,734	113	2,670	12,668	20,434
Net depreciable assets	406,485	312,120	67	3,936	31,842	58,520
Total Receipts	5,185,170	5,081,906	4,135	28,541	35,089	35,500
Business receipts	4,732,162	4,633,893	4,123	27,468	31,908	34,771
All other receipts	453,008	448,014	12	1,073	3,181	729
Total Deductions	4,865,551	4,776,638	3,841	18,114	34,374	32,583
Cost of sales and operations	4,582,798	4,558,145	3,539	13,628	6,601	884
All other deductions	282,753	218,493	302	4,486	27,773	31,699
Taxable income	319,619	305,268	293	10,427	715	2,916
V.I. income tax rebates	8,333	2,915	8	4,227	859 1/	324

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1/ Rebates may exceed taxable income due to losses, as the taxable income figure is net of loss.

Appendix B

Possessions Corporations in Tax Year 1981

This appendix presents data on the assets, income, and tax benefits of all possessions corporations in tax year 1981, which includes accounting periods ending between July 1, 1981, and June 30, 1982. Tax year 1981 corresponds closely to the calendar year because most possessions corporations have calendar year accounting periods. Tables B-1 through B-3A below are similar to Tables 4-1 through 4-4 in the text, covering tax year 1982. However, these tables include all of the returns filed for 1981, whereas those in Tables 4-1 through 4-4 exclude some returns filed after the cut-off date.

It is estimated that in tax year 1981 the tax benefits provided under section 936 were \$1.7 billion, up from \$1.3 billion for tax year 1980. The net income of possessions corporations in manufacturing rose 30 percent between 1980 and 1981, compared to a 19 percent increase in manufacturing profits in the U.S. The increase was particularly strong in electrical and electronic equipment, where profits rose 40 percent. The profits of the pharmaceutical industry rose 34 percent in this period. 1/

I. Assets and Income in 1981

A. Assets. Table B-1 shows that at year-end 1981, the book value of the total assets of possessions corporations was \$20.1 billion, of which \$15.2 billion were held in manufacturing industries. Net plant and equipment of 936 manufacturing firms amounted to \$1.9 billion at year-end 1981.

B. Retained Earnings. At the end of tax year 1981, possessions companies reported \$12.6 billion of retained earnings on their balance sheets, with 97 percent of these held by manufacturing companies. Nearly half, or \$5.5 billion, was held by pharmaceuticals. The electrical and electronics industries held \$2.8 billion in retained earnings. For all manufacturing possessions corporations, retained earnings represented 80 percent of total liabilities and stockholders' equity. The comparable figure for manufacturing corporations operating in the U.S. was 37 percent. 2/

C. Total Receipts. Table B-2 shows that the total receipts of manufacturing possessions corporations were \$12.5 billion in 1981. Ninety-four percent of total receipts was attributable to business receipts, and the remainder was attributable primarily to interest,

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1/ For data on possessions corporations in 1980, see Table 4-9, page 53.

2/ Federal Trade Commission, Quarterly Financial Report, First Quarter, 1982.

Table B-1

Selected Balance Sheet Information by Industry, 1981
(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	635	497	26	7	78	5	85	56	29
Total Assets	20,101,014	15,166,013	1,186,524	74,169	431,955	13,359	7,533,037	6,639,777	893,260
Cash	3,069,282	2,673,295	277,902	2,281	47,645	881	1,141,836	1,088,741	53,094
Accounts receivable	3,132,321	2,705,491	256,642	14,508	177,433	5,268	1,155,143	813,031	342,111
Inventories	1,739,695	1,604,881	215,913	6,561	56,961	4,190	511,307	391,229	120,078
U.S. Government obligations	426,815	415,447	0	0	745	0	274,800	262,957	11,843
State and local obligations	116,657	116,658	0	0	223	0	76,025	38,859	37,165
Other current assets	1,102,824	822,825	7,785	878	9,837	18	362,275	352,579	9,696
Mortgage & real estate loans	2,051,074	130,620	0	0	624	0	51,251	51,251	0
Other investments	4,574,251	3,943,964	78,118	45,734	92,407	0	2,381,403	2,341,325	40,078
Depreciable Assets	4,234,246	2,873,711	293,193	10,705	50,269	3,946	1,561,061	1,028,181	532,880
Less: Accumulated depreciation	1,372,145	1,012,426	92,318	6,598	25,176	1,303	530,102	241,483	288,618
Net depreciable assets	2,862,100	1,861,285	200,874	4,106	25,093	2,643	1,030,959	786,697	244,261
Other assets	1,025,980	891,542	149,288	96	20,981	357	548,034	513,102	34,931
Total Liabilities and Stockholders' Equity									
Accounts payable	1,423,517	867,696	96,857	2,763	51,266	2,155	276,617	208,952	67,664
Notes payable in less than 1 year	245,523	130,784	26,307	13,461	2,513	874	37,189	35,764	1,425
Other current liabilities	2,307,482	316,565	48,976	1,170	13,517	148	105,481	96,496	8,984
Notes payable in 1 year or more	744,835	275,894	26,318	469	3,649	0	200,672	195,404	5,268
Other liabilities	689,454	221,083	35,009	766	4,359	2,848	90,883	72,394	18,489
Capital stock	2,131,234	1,225,690	96,499	729	21,073	1,475	705,010	513,901	191,109
Retained earnings, total	12,558,958	12,128,299	856,556	54,807	335,576	5,857	6,117,181	5,516,863	600,318
Appropriated	492,566	433,681	0	0	0	0	397,280	20,007	377,273
Unappropriated	12,066,392	11,694,617	856,556	54,807	335,576	5,857	5,719,901	5,496,856	223,045

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	Instruments and Related Products	All Other Manufacturing
Number of corporations	10	16	10	27	11	120	42	60
Total Assets	56,720	108,567	46,601	215,780	262,055	3,230,795	739,088	1,267,358
Cash	4,635	23,868	3,068	32,494	26,960	808,849	132,962	169,909
Accounts receivable	19,159	29,079	24,832	37,177	31,952	551,222	140,566	262,504
Inventory	5,966	17,051	6,158	31,309	43,216	392,798	63,853	249,591
U.S. Government obligations	0	2,929	0	0	4,986	109,832	17,771	4,380
State and local obligations	0	17,012	0	0	18,412	983	0	4,000
Other current assets	546	510	506	17,172	9,941	285,867	13,301	114,182
Mortgage & real estate loans	0	0	0	0	0	74,533	3,897	312
Other investments	6,778	13,028	9,574	34,130	105,300	722,360	244,592	210,535
Depreciable assets	25,686	10,776	7,782	72,264	26,528	400,492	105,482	305,521
Less: Accumulated depreciation	7,289	5,883	5,657	18,687	7,780	153,923	28,947	128,757
Net depreciable assets	18,397	4,893	2,125	53,577	18,747	246,568	76,535	176,763
Other assets	1,236	193	335	9,917	2,536	37,778	45,607	75,179
Total Liabilities and Stockholders' Equity								
Accounts payable	2,574	6,972	1,978	18,562	12,163	143,114	60,773	191,896
Notes payable in less than 1 year	4,961	548	216	1,111	11,090	10,025	5,904	16,579
Other current liabilities	2,653	1,813	795	4,793	6,315	74,780	17,894	38,224
Notes payable in 1 year or more	452	1,357	67	3,738	65	14,601	2,513	21,988
Other liabilities	1,138	1,325	2,245	577	6,126	50,396	5,466	19,939
Capital stock	10,699	577	3,226	32,865	7,696	108,944	67,211	169,681
Retained earnings, total	34,240	95,973	38,070	154,131	218,597	2,828,932	579,325	809,047
Appropriated	1,885	0	2,118	409	1,480	13,745	6,201	10,559
Unappropriated	32,354	95,973	35,952	153,721	217,116	2,815,186	573,124	798,487

Table B-1 - continued

	Nonmanufacturing Industries						
	Nonmanu-facturing Total	Construction	Transportation Communications and Utilities	Wholesale Trade	Retail Trade	Finance, Insurance, Real Estate	Other Services and Industry Not Reported
Number of corporations	138	7	5	25	42	26	33
<u>Total Assets</u>	4,935,001	41,910	872,712	476,364	139,919	3,335,863	68,231
Cash	395,986	4,121	13,431	63,156	8,731	298,371	8,174
Accounts receivable	426,829	3,886	41,970	45,599	7,070	310,994	17,307
Inventory	134,814	8,840	15,803	75,483	29,561	0	5,125
U.S. Government obligations	11,368	0	573	352	30	10,413	0
State and local obligations	0	0	0	0	0	0	0
Other current assets	279,998	409	4,641	1,420	16,519	255,903	1,103
Mortgage & real estate loans	1,920,454	16	0	0	0	1,920,439	0
Other investments	630,287	2,384	10,317	167,421	21,656	419,588	8,919
Depreciable assets	1,360,534	6,790	1,000,687	185,659	72,010	66,734	28,653
Less: Accumulated depreciation	359,719	2,397	231,707	74,675	29,320	11,036	10,582
Net depreciable assets	1,000,815	4,393	768,979	110,984	42,689	55,698	18,070
Other assets	134,438	17,858	16,994	11,946	13,659	64,455	9,523
<u>Total Liabilities and Stockholders' Equity</u>							
Accounts payable	555,821	4,494	37,477	16,919	51,883	432,259	12,787
Notes payable in less than 1 year	114,739	19,258	6,379	2,238	5,452	74,230	7,180
Other current liabilities	1,990,916	933	29,354	4,055	2,594	1,949,633	4,344
Notes payable in 1 year or more	468,940	7,423	113,514	390	24,631	318,420	4,559
Other liabilities	468,371	200	78	3,633	2,699	457,446	4,314
Capital stock	905,543	2,755	674,942	131,422	15,776	63,786	16,860
Retained earnings, total	430,659	6,845	10,965	317,704	36,881	40,087	18,175
Appropriated	58,884	753	7,497	0	7,178	43,456	0
Unappropriated	371,775	6,091	3,468	317,704	29,702	-3,369	18,175

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including QPSII. Interest on Puerto Rican and 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 B-2. The amount of such excluded interest income reported by possessions corporations in tax year 1981 was $17.4 million.

The pharmaceutical industry accounted for 28 percent of the business receipts of all possessions manufacturing firms. After pharmaceuticals, the industries with the greatest business receipts were electrical and electronic equipment (with 21 percent), and food products (with 11 percent).

D. **Net Income per Tax Return.** Net income per return (total receipts minus total deductions on Table B-2) amounted to $4.1 billion for all possessions corporations in manufacturing. The industries with the greatest amount of net income were pharmaceuticals, with 46 percent of the total, and electrical and electronic equipment, with 26 percent of the total.

E. **Reduction in U.S. Tax Liability.** Table B-2 shows that U.S. tax liabilities were reduced by $1,711 million in tax year 1981 by the possessions corporation system. The pharmaceutical industry obtained tax benefits of $792 million, and the electrical and electronic equipment industry obtained tax benefits of $433 million. Other industries which obtained substantial tax benefits were food products ($113 million) and instruments ($98 million).

F. **Distributions.** The final line of Table B-2 shows that manufacturing possessions corporations reported $1,692 million of distributions. These distributions represented 41 percent of net income. Approximately one-half of the distributions by manufacturing corporations were attributable to the pharmaceutical industry.

II. Payroll and Employment in 1981

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 possessions firms in the manufacturing sector for which 1981 employment and payroll data could be obtained from the companies' Federal unemployment insurance tax returns. The 376 corporations included in the table represent 76 percent of the number and 80 percent of the net income of the manufacturing corporations included in Tables B-1 and B-2.

Table B-3 shows that, based on those 376 manufacturing firms the Federal tax benefits per employee in Puerto Rico for all manufacturing corporations are estimated to have averaged $18,007. Tax benefits per employee, or as a percentage of total employee compensation, varied substantially from industry to industry. In the pharmaceutical industry, the average Federal tax benefits amounted to $62,078 per employee, or more than triple the average compensation of the

Table B-2

Selected Income Statement Information and Tax Benefits by Industry, 1981

(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	635	497	26	7	78	5	85	56	29
Total receipts	14,770,300	12,473,198	1,364,715	66,833	525,365	23,436	4,534,289	3,659,603	874,685
Business receipts	13,382,732	11,662,944	1,307,666	64,963	509,495	23,180	4,120,956	3,260,401	860,555
Nongovernment interest	963,443	674,409	47,691	1,697	12,194	246	331,276	318,741	12,535
Other receipts	424,125	135,844	9,357	172	3,675	10	82,055	80,461	1,593
Total deductions	10,553,788	8,372,637	1,091,742	62,167	452,826	21,401	2,511,786	1,791,918	719,867
Cost of sales	7,893,484	6,521,170	862,034	52,883	384,753	19,145	1,623,501	983,736	639,765
Depreciation	227,332	141,375	14,895	955	2,727	257	66,926	44,870	22,056
All other deductions	2,432,971	1,710,091	214,812	8,328	38,345	1,998	821,357	763,312	58,045
Estimated net income per return	4,216,511	4,100,561	272,972	4,665	99,538	2,035	2,022,503	1,867,684	154,818
Estimated net income per books	4,013,782	3,922,218	262,414	3,654	96,579	1,998	1,952,998	1,824,306	128,691
Reduction in U.S. tax liability	1,711,352	1,711,352	113,444	1,275	40,459	852	853,049	791,535	61,514
Distributions	1,800,787	1,692,443	135,169	403	51,853	610	984,491	906,666	77,825

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	Instruments and Related Products	All Other Manufacturing
Number of corporations	10	16	10	27	11	120	42	60
Total receipts	64,885	117,678	44,324	164,190	269,654	2,647,755	556,585	2,093,483
Business receipts	62,455	113,450	42,122	153,900	257,655	2,447,631	514,697	2,044,767
Nongovernment interest	769	3,182	271	4,634	11,665	192,836	33,316	34,626
Other receipts	1,660	1,045	1,930	5,655	333	7,287	8,570	14,090
Total deductions	47,791	92,980	37,085	121,482	191,433	1,598,705	326,804	1,843,429
Cost of sales	38,974	83,814	31,560	107,895	163,087	1,308,696	237,548	1,607,273
Depreciation	875	933	540	3,277	2,641	24,475	6,735	16,132
All other deductions	7,941	8,232	4,984	10,309	25,704	265,532	82,519	220,023
Estimated net income per return	17,094	24,697	7,238	42,708	78,221	1,049,049	229,780	250,053
Estimated net income per books	17,854	26,689	7,222	41,685	75,166	983,861	222,069	230,022
Reduction in U.S. tax liability	7,027	10,767	3,357	16,799	33,725	433,059	98,006	99,527
Distributions	11,389	6,025	589	20,865	29,848	280,660	71,897	98,636

Table B-2 - continued

	Non-Manufacturing Total	Construction	Transportation Communications and Utilities	Wholesale Trade	Retail Trade	Finance, Insurance, Real Estate	Other Services and Industry Not Reported
	Nonmanufacturing Industries						
Number of corporations	138	7	5	25	42	26	33
Total Receipts	2,297,102	32,699	285,593	1,019,795	485,240	379,730	94,043
Business receipts	1,719,788	29,550	37,188	993,452	482,829	94,606	82,160
Nongovernment interest	289,033	678	2,357	23,155	1,452	261,032	357
Other receipts	288,280	2,470	246,047	3,187	958	24,091	11,525
Total Deductions	2,181,151	27,407	238,089	934,649	477,731	416,257	87,015
Cost of sales	1,372,314	24,251	39,696	877,324	363,228	16,334	51,479
Depreciation	85,956	714	67,998	6,536	4,916	3,573	2,216
All other deductions	722,880	2,440	130,394	50,788	109,586	396,349	33,319
Estimated net income per return	115,950	5,292	47,503	85,145	7,509	-36,527	7,026
Estimated net income per books	91,564	3,371	46,298	69,245	3,934	-38,909	7,623
Reduction in U.S. tax liability	0	0	0	0	0	0	0
Distributions	108,344	1,024	46,880	56,081	387	490	3,479

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Table B-3

Tax Benefits, Employment, and Compensation of Employees by Industry, 1981

Table B-3

Tax Benefits, Employment, and Compensation of Employees by Industry, 1981

	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 Compensation of Employees
All Manufacturing Industries	376	3,297,876	1,430,322	100.0	72,543	100.0	964,040	100.0	18,007 3/	13,059 3/	137.9 3/
Food and kindred products	17	155,318	67,762	4.7	8,393	11.6	109,930	11.4	8,073	13,097	61.6
Textile mill products	4	314	157	*	204	*	1,878	*	769	9,205	8.4
Apparel	66	87,976	37,746	2.6	14,892	20.5	139,041	14.4	2,534	9,336	27.1
Men's and boys'	17	20,495	7,904	.6	4,639	6.4	46,926	4.9	1,703	10,115	16.8
Women's and children's	27	40,374	17,474	1.2	6,838	9.4	61,288	6.4	2,555	8,962	28.5
Hats, caps, etc.	12	9,265	4,297	*	1,485	2.0	13,346	1.4	2,893	8,987	32.2
All other	10	17,842	8,071	.6	1,930	2.7	17,481	1.8	4,181	9,057	46.2
Chemicals	67	1,748,717	755,981	52.9	14,015	19.3	259,572	26.9	53,940	18,521	291.2
Industrial chemicals	8	97,004	38,284	2.7	1,765	2.4	44,590	4.6	21,690	25,263	85.9
Pharmaceuticals	44	1,605,939	698,013	48.8	11,244	15.5	201,745	20.9	62,078	17,942	346.0
Soaps, cleaners, etc.	8	37,478	16,110	1.1	803	1.1	10,933	1.1	20,062	13,615	147.4
All other	7	8,296	3,574	*	203	*	2,304	*	17,605	11,349	155.1
Rubber and plastic products	8	12,977	5,271	*	1,001	1.4	10,422	1.1	5,265	10,411	50.6
Leather	12	18,342	7,969	.6	2,358	3.3	21,107	2.2	3,379	8,951	37.8
Footwear	7	15,122	6,596	.5	2,015	2.8	17,857	1.9	3,273	8,862	36.9
All other	5	3,220	1,373	*	343	.5	3,250	*	4,002	9,475	42.2
Stone, clay, and glass	5	5,418	2,373	*	286	*	4,634	.5	8,297	16,202	51.2
Fabricated metal products	17	27,009	11,696	.8	1,193	1.6	17,048	1.8	9,803	14,290	68.6
Metal cans and containers	4	8,632	3,533	*	257	*	3,639	*	13,747	14,159	97.1
Cutlery, hand tools, screws, bolts	3	5,205	2,311	*	349	.5	4,356	.5	6,621	12,481	53.1
All other	10	13,172	5,852	*	587	.8	9,053	.9	9,969	15,422	64.6
Machinery, except electrical	9	56,250	23,797	1.7	1,956	2.7	25,456	2.6	12,166	13,014	93.5
Electrical and electronic equipment	94	824,631	362,064	25.3	18,166	25.0	237,658	24.7	19,930	13,082	152.3
Radio, TV, communication	11	91,911	39,454	2.8	3,537	4.9	41,379	4.3	11,154	11,698	95.3
Electronic components	27	158,769	71,535	5.0	3,097	4.3	36,998	3.8	23,098	11,946	193.3
All other	56	573,952	251,075	17.6	11,532	15.9	159,281	16.5	21,772	13,812	157.6
Transportation equipment	5	8,432	3,801	*	596	.8	6,465	.7	6,377	10,847	58.8
Instruments and related products	34	199,049	86,987	6.1	5,246	7.2	69,484	7.2	16,581	13,245	125.2
Scientific instruments	11	26,322	11,719	.8	682	.9	7,650	.8	17,183	11,217	153.2
All other	23	172,727	75,268	5.3	4,564	6.3	61,834	6.4	16,491	13,548	121.7
All other manufacturing 4/	38	153,443	64,718	4.5	4,237	5.8	61,345	6.4	15,274	14,478	105.5

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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 1.234 times payroll. The 23.4 percent reflects the employer-paid portion of social security, unemployment insurance, and other non-payroll costs. The 23.4 percent is the average for all U.S. manufacturing industries in 1981. Source: U.S. Department of Commerce, Survey of Current Business, July 1983, Tables 6.5B and 6.6B.

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 to income in this Table. The unweighted figures are the following: tax benefits per employee, $19,716 average employee compensation, $13,289; and tax benefits as a percent of compensation, 148.4%. The 1982 data in Chapter 4 have been weighted by cost of goods sold rather than income. The former gives a better measure of employment; however the necessary data were not available with which to revise the 1981 estimates.

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

comparatively well-paid Puerto Rican pharmaceutical employee. In the electrical and electronics industry, the average tax benefits amounted to $19,930 per employee, or 152 percent of average compensation. The industries where average tax benefits per employee were lowest were textiles and apparel. The sixty-six apparel firms included in Table B-3 provided 20 percent of the total employment and received, on average, $2,534 in tax benefits per employee.

Table B-4 is based on the same 376 possessions corporations shown in Table B-3, but ranked according to the Federal tax benefits per employee. At the top of the ranking are 19 companies for which the U.S. tax benefits under section 936 represented more than $100,000 per employee in Puerto Rico. At the low end are companies which incurred losses and thus claimed no immediate tax benefit from section 936. The top 19 possessions corporations in this table accounted for 25 percent of the tax benefits under section 936 but provided only 3 percent of the employment of the 336 manufacturing companies. The top 41 possessions corporations, those for which tax savings per employee were at least $50,000 in 1981, collectively accounted for 46 percent of the total tax benefits and 9 percent of total employment.

Table B-4

Tax Benefits, Employment, and Compensation of Employees
By Size of Tax Benefits Per Employee, 1981

	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	376	3,297,875	1,430,322	100.0	72,543	100.0	964,040	100.0	18,007 3/	13,059 3/	137.9 3/
$100,000 or more	19	815,305	352,165	24.6	2,196	3.0	40,620	4.2	160,366	18,497	867.0
$ 50,000 under $100,000	22	687,322	300,278	21.0	4,180	5.8	76,241	7.9	71,836	18,239	393.9
$ 10,000 under $ 50,000	140	1,465,716	629,245	44.0	26,083	36.0	410,511	42.6	24,124	15,738	153.3
$ 5,000 under $ 10,000	49	174,320	73,482	5.1	10,240	14.1	130,619	13.5	7,175	12,755	56.3
$ 1,000 under $ 5,000	92	173,654	72,828	5.1	23,074	31.8	232,817	24.2	3,156	10,090	31.3
$ 500 under $ 1,000	16	4,629	1,643	*	1,976	2.7	21,676	2.2	831	10,969	7.6
$ 100 under $ 500	14	2,613	657	*	2,266	3.1	21,256	2.2	289	9,380	3.1
$ 1 under $ 100	3	126	24	*	629	*	5,455	.6	38	8,672	*
No tax benefits	21	-25,792	0	0	1,899	2.6	24,845	2.6	0	13,083	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 1.234 times payroll. The 23.4 percent reflects the employer-paid portion of social security, unemployment insurance, and other non-payroll costs. The 23.4 percent is the average for all U.S. manufacturing industries in 1981. Source: U.S. Department of Commerce, Survey of Current Business, Tables 6.5B and 6.6B.

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 to income in Table B-3.

Appendix C

Sources and Limitations of the Data on Possessions Corporations

Coverage

The data in Chapter 4 on possessions corporations for tax year 1982 and the data in Appendix B for tax year 1981 include corporations which filed full year possessions corporation returns within 12 months of the end of the tax year. However, the more detailed data in Tables 4-1 through 4-4 for 1982 cover only those corporations which filed as possessions corporations within seven months of the tax year (522 of the estimated total of 554 corporations.) Figures for all years prior to 1981 (e.g., those in Table 4-7) have also been revised to include corporations which filed as possessions corporations within 12 months of the end of the tax year. The data in Tables 4-9 and 4-11 are based on all 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.

Income Statement and Balance Sheet Data

Income statement and balance sheet data for 1977-1982, 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 filed for 1976. An additional source of income and tax data for 1973-1975 were income tax returns (Form 480.20) filed with the Puerto Rican government.

Employment and Payroll Data

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 1982 Form 940 data were associated with taxable years ending between July 1, 1982 and June 30, 1983.

The number of employees was computed by dividing total taxable wages (line 5, 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 have occurred), 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. 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 few 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 1, Form 940) by a factor representing the ratio of total compensation to total wages and salaries for U.S. manufacturing industries. The value of this factor was 23.4 percent and 23.5 percent for 1981 and 1982, respectively. It is computed from Tables 6.5B and 6.6B of the Survey of Current Business, U.S. Department of Commerce, Bureau of Economic Analysis, July 1983. Total compensation exceeds wages and salaries by the amount of employer contributions to social security, private pensions, and health insurance, and by other fringe benefits.

Employment and payroll data were available for only 324 of the 447 possessions corporations in manufacturing. The information from that sample was blown up to represent the full group on the assumption that within each manufacturing sector the relationship between employment

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

and cost of goods sold for the sample group would also hold for the larger group of companies. The figures for cost of goods sold used in making this estimate are as follows:

	Cost of Goods Sold	
	324 Cos.	447 Cos.
	($000)	
All Manufacturing	$4,195,107	$5,553,684
Food	387,336	489,345
Textiles	28,861	44,628
Apparel	287,005	347,314
Chemical	1,174,332	1,461,964
Pharmaceuticals	718,650	949,386
Other Chemicals	455,682	509,493
Rubber and Plastic	33,115	48,789
Leather	61,116	120,549
Fabricated Metal	67,820	157,596
Machinery except Electrical	130,809	135,126
Electrical and electronic	772,434	1,249,872
Instruments	203,027	244,590
All Other Manufacturing	1,049,252	1,253,910

Office of the Secretary of the Treasury
Office of Tax Analysis

Appendix D

Tax Forms from Which Data Included in This Report Were Obtained

Form **5712**
(Rev. January 1982)
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)

OMB No. 1545-0215
Expires 9-30-84

The corporation named below 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

Submit the following information for each shareholder who owns 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 takes effect for the tax year beginning (month, day, year)	Date corporation began business in a U.S. possession	Annual return will be filed for the tax 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 ....

For Paperwork Reduction Act Notice, see instructions on back.

Instructions

Paperwork Reduction Act Notice

The Paperwork Reduction Act of 1980 says we must tell you why we are collecting this information, how we will use it, and whether you have to give it to us. We ask for the information to carry out the Internal Revenue laws of the United States. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax. You are required to give us this information.

Who Can Elect

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

When to File

File Form 5712 by the due date (including extensions) of the first return to which the election is to apply.

Where to File

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

U.S. Possessions

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

Period of Election

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

To revoke this election for any tax year that starts within 9 tax years after the tax year for which the election takes effect, you need the Secretary's consent. You do not need it to revoke the election after that.

Form 5735

For every year the election 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 this election 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 1982)
Department of the Treasury Internal Revenue Service

Computation of Possessions Corporation Tax Credit Allowed Under Section 936

▶ Attach to your tax return

OMB No. 1545-0217
Expires 5-31-84

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

Name	Employer identification number

Part I Gross Income in Applicable Period

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

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

	Gross income from the active conduct of a trade or business in a U.S. possession			Gross qualified possession source investment income	All other gross income		
	From sources in U.S. possessions (f)	From all other sources outside the U.S. (g)	From sources in the U.S. (h)	(i)	From sources in U.S. possessions (j)	From all other sources outside the U.S. (k)	From sources in the U.S. (l)
Totals							

1 Total gross income in applicable period (add totals of columns (f) through (l))	1	
2 Gross income in applicable period from sources in U.S. possessions (add total of columns (f), (i), and (j))	2	
3 Divide line 2 by line 1 (if less than 80%, do not complete Part II)	3	
4 Gross income from the active conduct of a trade or business in a U.S. possession (total of columns (f), (g), and (h))	4	
5 Divide line 4 by line 1 (if less than 50%, do not complete Part II)	5	

Part II Computing the Possessions Corporation Tax Credit

6 Qualified gross income in current year:				
(a) From sources outside the U.S. from the active conduct of a trade or business in a U.S. possession	6(a)			
(b) From sources outside the U.S. from sale or exchange of substantially all of assets used in a possessions trade or business	6(b)			
(c) Gross qualified possession source investment income	6(c)			
(d) Amounts received in the U.S.	6(d)			
(e) Total (add lines 6(a), 6(b), and 6(c) and subtract line 6(d))			6(e)	
7 Applicable deductions (attach schedule):				
(a) Definitely allocable deductions (see instructions)	7(a)			
(b) Ratable part of deductions not definitely allocable	7(b)			
(c) Total (add lines 7(a) and 7(b))			7(c)	
8 Qualified taxable income before loss adjustments (line 6(e) less line 7(c)). If loss, do not complete below			8	
9 Loss adjustments (attach schedule):				
(a) Current year losses from non-qualified sources (see instructions)	9(a)			
(b) Recapture of prior year overall foreign losses (see instructions)	9(b)			
(c) Net capital loss or short-term capital loss adjustment (see instructions)	9(c)			
(d) Total (add lines 9(a), 9(b), and 9(c))			9(d)	
10 Qualified taxable income (subtract line 9(d) from line 8)			10	
11 Total taxable income from all sources (enter taxable income from your tax return)			11	
12 Adjustments to taxable income from all sources (see instructions)			12	
13 Subtract line 12 from line 11			13	
14 Divide line 10 by line 13			14	
15 Total U.S. income tax against which section 936 credit is allowed (see instruction C)			15	
16 Section 936 credit (multiply line 14 by line 15). Enter here and on your tax return ▶			16	

For Paperwork Reduction Act Notice, see instructions on back.

Instructions

(References are to the Internal Revenue Code)

Paperwork Reduction Act Notice.—The Paperwork Reduction Act of 1980 says we must tell you why we are collecting this information, how we will use it, and whether you have to give it to us. We ask for the information to carry out the Internal Revenue laws of the United States. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax. You are required to give us this information.

GENERAL INSTRUCTIONS

A. Purpose.—A domestic corporation that has elected to be treated as a possessions corporation must attach Form 5735 to its income tax return for each year that the election is in effect. Complete Form 5735 to figure the possessions corporation tax credit under section 936. The credit is allowed against income tax imposed by Chapter 1. Puerto Rico is a U.S. possession for this credit, but the Virgin Islands are not.

B. Qualifying for the Credit.—To qualify for the possessions tax credit, a corporation must:

(1) have filed a valid Form 5712, Election to be Treated as a Possessions Corporation Under Section 936;

(2) have derived 80% or more of its gross income from sources in a U.S. possession during the applicable period immediately before the tax year ended; and

(3) have derived 50% or more of its gross income from the active conduct of a trade or business in a U.S. possession during the applicable period immediately before the tax year ended.

The "applicable period" is generally the shorter of 36 months or the period when the corporation actively conducted a trade or business in a U.S. possession.

C. Restrictions.—A corporation is ineligible to take the possessions tax credit for any tax year it is a DISC or former DISC, or for any tax year in which it owns stock in a DISC or former DISC. (Section 936(f).)

The credit is not allowed against the following taxes:

- minimum tax on tax preference items (section 56).
- tax on accumulated earnings (section 531).
- personal holding company tax (section 541).
- additional tax for recovery of foreign expropriation losses (section 1351).
- tax increase on the early disposition of investment credit property (section 47).
- tax on certain capital gains of electing small business corporations (section 1378).

D. Where to File.—Attach Form 5735 to your income tax return and file your return with the Internal Revenue Service Center, Philadelphia, PA 19255.

SPECIFIC INSTRUCTIONS

Follow sections 638 and 861–864 to determine if the source of gross income, deductions, and taxable income is in or outside the U.S. or in a U.S. possession. If you received any income in the U.S., regardless of its source, do not include it as income from sources outside the U.S. (section 936(b)).

You cannot take a deduction or foreign tax credit for taxes you paid or accrued to a foreign country or U.S. possession, if any of the income on which those taxes were paid or accrued is used in computing the possessions corporation tax credit.

Part I.—

Column (i).—Enter gross qualified possession source investment income in column (i). You must establish to the satisfaction of the Secretary that this income is from either the investment in a U.S. possession of funds derived in the active conduct of a trade or business in that possession, or from the investment itself. Temporary Regulation 7.936–1 gives information about certain deposits in Puerto Rican banks and other financial institutions that may earn qualified income.

In Part II subtract applicable deductions from this income to figure how much investment income qualifies for the credit.

Part II.—

Line 6(b).—Include gross income that came from sources outside the U.S. from selling or exchanging substantially all the assets the possessions corporation used in the active conduct of its trade or business.

Line 7(a).—On line 7(a) include the reduction for the "rate differential portion" (as defined in section 904(b)(3)(F)) of any net capital gain that comes from a foreign source and is included on line 6(e). Also, include the corporation's other definitely allocable deductions.

Line 7(b).—Enter on line 7(b) the ratable part of deductions that cannot be definitely allocated to qualified income. To obtain this figure, reduce the deductions by the amount entered on line 7(a). Multiply this result by the amount obtained when you divide the amount entered on line 6(e) by the gross income on your income tax return.

Line 8.—Do not include income from selling or exchanging any asset whose basis is determined by reference to its basis in another person's hands. If, however, the asset's basis is determined by reference to its basis in the hands of another person to whom section 931, 936, or 957(c) applied during the whole period the asset was held, the income may qualify (see section 936(d)(3)).

Line 9(a).—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 limit applies, allocate the loss to possessions income that qualifies for the credit in proportion to the ratio of that income to total taxable income, excluding the loss.

Line 9(b).—If you sustain an overall foreign loss in any year, the loss is recaptured in later tax years by treating part of your taxable income from sources outside the U.S. as income from sources in the U.S. (section 904(f)).

Line 9(c).—To the extent any net capital loss or short-term capital loss from sources outside the U.S. is used to determine capital gain net income, it is also used to reduce income against which the credit is allowed. First, however, decrease the loss by the "rate differential portion" of the excess of net capital gain from non-qualified sources over net capital gain. Enter on line 9(c) the amount by which the loss reduces the corporation's income that qualifies for the credit. Attach your computation.

Line 12.—If line 11 includes income from selling or exchanging capital assets, enter the reduction for the "rate differential portion" of net capital gain.

Form **1120**
Department of the Treasury
Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 1982 or other tax year beginning ...., 1982, ending ...., 19.........

▶**For Paperwork Reduction Act Notice, see page 1 of the Instructions**

OMB No. 1545-0123

1982

Check if a—
A. Consolidated return ☐
B. Personal Holding Co. ☐
C. Business Code No. (See page 9 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
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	5		
6 Gross rents	6		
7 Gross royalties	7		
8 Capital gain net income (attach separate Schedule D)	8		
9 Net gain or (loss) from Form 4797, line 11(a), Part II (attach Form 4797)	9		
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 jobs credit .... Balance ▶	13(c)		
14 Repairs (see instructions)	14		
15 Bad debts (Schedule F if reserve method is used)	15		
16 Rents	16		
17 Taxes	17		
18 Interest	18		
19 Contributions (not over 10% of line 30 adjusted per instructions)	19		
20 Depreciation (attach Form 4562) ... 20			
21 Less depreciation claimed in Schedule A and elsewhere on return ... 21(a) ( )	21(b)		
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 C) ... 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 1981 allowed as a credit			
(b) 1982 estimated tax payments			
(c) Less refund of 1982 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)	32		
33 TAX DUE (subtract line 32 from line 31—If line 32 is greater than line 31, skip line 33 and go to line 34). See instruction C3 for depositary method of payment	33		
(Check ▶ ☐ if Form 2220 is attached. See instruction D.) ▶ $			
34 OVERPAYMENT (subtract line 31 from line 32)	34		
35 Enter amount of line 34 you want: Credited to 1983 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 ▶ | 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)
- (iv) ☐ Other (Specify method used and attach explanation) ▶

(b) Check if the LIFO inventory method was adopted this tax year for any goods (If checked, attach Form 970.) ☐

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

(d) If you are engaged in manufacturing, did you value your inventory using the full absorption method (Regulations section 1.471–11)? ☐ Yes ☐ No

(e) Was there any substantial change in determining quantities, cost, or valuations between opening and closing inventory? ☐ Yes ☐ No
If "Yes," attach explanation.

Schedule C Dividends and Special Deductions (See instructions for Schedule C)

	(A) Dividends received	(B) %	(C) Special deductions: multiply (A) × (B)
1 Domestic corporations subject to 85% deduction		85	
2 Certain preferred stock of public utilities		59.13	
3 Foreign corporations subject to 85% deduction		85	
4 Wholly-owned foreign subsidiaries subject to 100% deduction (section 245(b))		100	
5 Total—Add lines 1 through 4. See instructions for limitation			
6 Affiliated groups subject to the 100% deduction (section 243(a)(3))		100	
7 Other dividends from foreign corporations not included in lines 3 and 4			
8 Income from controlled foreign corporations under subpart F (attach Forms 5471)			
9 Foreign dividend gross-up (section 78)			
10 DISC or former DISC dividends not included in line 1 (section 246(d))			
11 Other dividends			
12 Deduction for dividends paid on certain preferred stock of public utilities (see instructions)			
13 Total dividends—Add lines 1 through 11. Enter here and on line 4, page 1 ⟶			
14 Total deductions—Add lines 5, 6 and 12. Enter here and on line 29(b), page 1 ⟶			

Schedule E Compensation of Officers (See instruction for line 12)

Complete Schedule E only if your total receipts (line 1(a), plus lines 4 through 10, of page 1, Form 1120) are $150,000 or more.

1. Name of officer	2. Social security number	3. Time devoted to business	Percent of corporation stock owned: 4. Common	Percent of corporation stock owned: 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	Amount added to reserve: 5. Recoveries	6. Amount charged against reserve	7. Reserve for bad debts at end of year
1977						
1978						
1979						
1980						
1981						
1982						

Schedule J Tax Computation (See instructions for Schedule J on page 7)

Note: Fiscal year corporations, see *instructions on page 10. If you are not a member of a controlled group of corporations (sections 1561 and 1563), omit lines 1 and 2, and enter on line 3, the amount from line 44, Part III, of the fiscal year worksheet provided on page 11 of the instructions.*

Calendar year corporations, see instructions for Schedule J on page 7. If you are not a member of a controlled group of corporations (sections 1561 and 1563), omit lines 1 and 2, and start with line 3.

1 Check if you are a member of a controlled group (see sections 1561 and 1563) . . . . ▶ ☐

2 If line 1 is checked, 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) Jobs credit (attach Form 5884) . . . .
(d) Employee stock ownership credit (applies only to fiscal year 1982–83 corporations—see instructions) . . . .
(e) Research credit (attach Form 6765) . . . .
(f) Possessions tax credit (attach Form 5735) . . . .
(g) Alcohol fuel credit (attach Form 6478) . . . .
(h) Credit for fuel produced from a nonconventional source (see instructions) . .

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

Additional Information (See page 8 of instructions)

	Yes	No
G Did you claim a deduction for expenses connected with:		
(1) Entertainment facility (boat, resort, ranch, etc.)?		
(2) Living accommodations (except employees on business)? . .		
(3) Employees attending conventions or meetings outside the North American area? (See section 274(h))		
(4) Employees' families at conventions or meetings?		
If "Yes," were any of these conventions or meetings outside the North American area? (See section 274(h))		
(5) Employee or family vacations not reported on Form W-2? . .		
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.)		
I Refer to page 9 of instructions and state the principal:		
Business activity............		
Product or service............		
J Were you a U.S. shareholder of any controlled foreign corporation? (See sections 951 and 957.) If "Yes," attach Form 5471 for each such corporation		
K 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)?		
L 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.		
M 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.		
N During this tax year was any part of your tax accounting records maintained on a computerized system?		

Schedule L Balance Sheets

ASSETS	Beginning of tax year (A)	(B)	End of tax year (C)	(D)
1 Cash				
2 Trade notes and accounts receivable				
(a) Less allowance for bad debts				
3 Inventories				
4 Federal and State government obligations				
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

Do not complete this schedule if your total assets (line 14, column (D), above) are less than $25,000.

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)			
		8 Deductions in this tax return not charged against book income this year (itemize)	
5 Expenses recorded on books this year not deducted in this return (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)

Do not complete this schedule if your total assets (line 14, column (D), above) are less than $25,000.

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)	

E.I. NO. 22-158-1686

Form **940**

Department of the Treasury
Internal Revenue Service

Employer's Annual Federal Unemployment (FUTA) Tax Return

▶ For Paperwork Reduction Act Notice, see page 2.

OMB No. 1545–0028

1982

T	
FF	
FD	
FP	
I	
T	

If incorrect, make any necessary change. ▶

Name (as distinguished from trade name)

Calendar Year

1982

Trade name, if any

Employer identification number

Address and ZIP code

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 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(s) 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 Credit reduction for unrepaid advances to the States listed. Enter the wages included on line 5 above for each State and multiply by the rate shown.

(a) AR ________ × .003 ________	(g) MI ________ × .003 ________	(m) VT ________ × .006 ________	
(b) CT ________ × .007 ________	(h) MN ________ × .003 ________	(n) WV ________ × .003 ________	
(c) DE ________ × .006 ________	(i) NJ ________ × .006 ________	**Outside the U.S.**	
(d) DC ________ × .006 ________	(j) OH ________ × .003 ________	(o) PR ________ × .006 ________	
(e) IL ________ × .006 ________	(k) PA ________ × .006 ________	(p) VI ________ × .006 ________	
(f) ME ________ × .009 ________	(l) RI ________ × .006 ________		

7 Total credit reduction (add lines 6(a) through 6(p) and enter on line 2, Part II or line 4, Part III) . . . . . ▶

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 Enter amount from line 7, Part I . . . .

3 **Total FUTA tax (add lines 1 and 2)** . . . .

4 Less: Total FUTA tax deposited for the year from your records . . . . . .

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. Also complete Part V)

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 Enter amount from line 7, Part I . . . .

5 **Credit allowable (subtract line 4 from line 3)** . . . .

6 Total FUTA tax (subtract line 5 from line 1) . . . .

7 Less: Total FUTA tax deposited for the year from your records . . . . . .

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 Quarterly Federal Tax Liability for Unemployment Tax (Do not include State liability)

Quarter	First	Second	Third	Fourth	Total for Year
Liability for quarter					

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	State reporting number(s) as shown on employer's State contribution returns	Taxable payroll (as defined in State act)	State experience rate period		State experience rate	Contributions if rate had been 2.7% (col. 3×2.7%)	Contributions payable at experience rate (col. 3×col. 5)	Additional credit (col. 6 minus col. 7) If 0 or less, enter 0.	Contributions actually paid to State
			4						
			From—	To—					
1	2	3			5	6	7	8	9
10 Totals . . . . . . ▶									

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

Highlights

Changes for 1983.—Public Law 97–248 increased the wage base to $7,000 and increased the tax rate to 3.5% for 1983.

For deposit purposes, multiply by .008 that part of the first $7,000 of each employee's annual wages that you paid during the quarter. Follow the deposit rules in Part IV on page 4.

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 1981 or 1982.

2. Household and Other Employers Who File Form 940: If your total Federal unemployment (FUTA) tax for 1982 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

Paperwork Reduction Act Notice.—We ask for this information to carry out the Internal Revenue laws of the United States. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax. You are required to give us this information.

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 1982.

Who Must File.—In general, every employer who during 1981 or 1982 (a) paid wages of $1,500 or more in any calendar quarter or (b) 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. 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 1981 or 1982.

(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 1981 or 1982. Count aliens admitted to the U.S. on a temporary basis to perform farmwork to determine if you meet either of the above tests. However, wages paid to these aliens are not subject to FUTA tax prior to 1984.

(3) You paid cash wages of $1,000 or more in any calendar quarter in 1981 or 1982 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 1982, 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.

Due Date.—Form 940 for 1982 is due by January 31, 1983. However, if you made timely deposits in full payment of the tax due, your due date is February 10, 1983.

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. See **Publication 583,** Information for Business Taxpayers, for details on how to make tax deposits, file a return, etc. if these are due before you receive your number.

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. The law also provides a penalty of 25% of the overstatement if, without reasonable cause, you overstate the amount you deposited.

There are also penalties for willful failure to pay tax, keep records, make returns, and for filing false or fraudulent returns.

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 not take credit for voluntary payments or for penalties or interest payments to a State.

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 FUTA wages.

Special Credit for Successor Employers.—If you are claiming special credit as a successor employer, see Code section 3302(e) or Circular E (Rev. October 1981) for the conditions that you must meet.

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, skip Part II and 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

(Instructions continued on page 4.)

Form **940**

Department of the Treasury Internal Revenue Service

Employer's Annual Federal Unemployment (FUTA) Tax Return

OMB No. 1545–0028

1982

Calendar Year 1982

Employer identification number

YOUR COPY

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 paid to your State unemployment fund . . . . . ▶ $

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(s) as shown on State unemployment tax return . . . . ▶

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

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

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

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 . . .

Total exempt payments (add lines 2 and 3) . . . . .

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

Credit reduction for unrepaid advances to the States listed. Enter the wages included on line 5 above for each State and multiply by the rate shown.

(a) AR ____ × .003 ____	(g) MI ____ × .003 ____	(m) VT ____ × .006 ____
(b) CT ____ × .007 ____	(h) MN ____ × .003 ____	(n) WV ____ × .003 ____
(c) DE ____ × .006 ____	(i) NJ ____ × .006 ____	**Outside the U.S.**
(d) DC ____ × .006 ____	(j) OH ____ × .003 ____	(o) PR ____ × .006 ____
(e) IL ____ × .006 ____	(k) PA ____ × .006 ____	(p) VI ____ × .006 ____
(f) ME ____ × .009 ____	(l) RI ____ × .006 ____	

Total credit reduction (add lines 6(a) through 6(p) and enter on line 2, Part II or line 4, Part III) . . . . . ▶

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

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

Enter amount from line 7, Part I . . . . .

Total FUTA tax (add lines 1 and 2) . . . . .

Less: Total FUTA tax deposited for the year from your records . . . . .

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

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. Also complete Part V)

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

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

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

Enter amount from line 7, Part I . . . . .

Credit allowable (subtract line 4 from line 3) . . . . .

Total FUTA tax (subtract line 5 from line 1) . . . . .

Less: Total FUTA tax deposited for the year from your records . . . . .

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

Overpayment (subtract line 6 from line 7) . . . . . ▶

Part IV Record of Quarterly Federal Tax Liability for Unemployment Tax (Do not include State liability)

Quarter	First	Second	Third	Fourth	Total for Year
Liability for quarter					

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,** Employment Taxes, 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) If 0 or less, enter 0. 8	Contributions actually paid to State 9
10 Totals . . . . . . ▶									
11 Total tentative credit (add line 10, columns 8 and 9—see instructions for limitations) . . . . ▶									

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 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 1981 and 1982 AND did not employ 10 or more farmworkers during any part of a day during any 20 different weeks in 1981 or 1982, (b) paid wages to aliens admitted to the United States on a temporary basis to perform farmwork before 1984.

(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 1981 and 1982.

(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) Value of certain meals and lodging.

(8) Any other exempt service or pay.

For more detailed information, see Circular E, Employer's Tax Guide.

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 wages included on line 5 subject to the unemployment compensation laws of Arkansas, Connecticut, Delaware, District of Columbia, Illinois, Maine, Michigan, Minnesota, New Jersey, Ohio, Pennsylvania, Puerto Rico, Rhode Island, Vermont, Virgin Islands, or West Virginia. (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 allowable credit for payments to the State.

Part IV.—Record of Federal Tax Liability

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 1982,** multiply by .007 that part of the first $6,000 of each employee's annual wages you paid during the quarter. Enter this amount under that 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 in a qualified depositary. If it is $100 or less, you can either make a deposit or pay it with your Form 940 by January 31.

The total liability must equal your total tax. Otherwise, you may be assessed a failure to deposit penalty computed on your average liability.

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.

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.

Taxpayers who willfully claim credit for deposits not made are subject to fines and other criminal penalties.

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 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, claims for unemployment compensation by your former employees and other factors. 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.

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Department of the Treasury
Washington, D.C. 20220

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