The Operation and Effect of the Possessions Corporation System of Taxation

Sixth Report

Department of the Treasury
March 1989

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THE SECRETARY OF THE TREASURY
WASHINGTON

March 31, 1989

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

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. The Deficit Reduction Act of 1984 specified that the possessions report be issued every two years rather than annually.

Pursuant to these provisions, I hereby submit the sixth annual report entitled, The Operation and Effect of the Possessions Corporation System of Taxation. This report covers tax return information for 1983.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) provided new rules for the allocation of income between a U.S. parent corporation and an affiliated possessions corporation. This report provides the first evidence on the impact of the TEFRA rules.

I am sending a similar letter to Lloyd Bentsen, Chairman of the Senate Finance Committee.

Sincerely,

Nicholas F. Brady

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Enclosure

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Chapter 1

INTRODUCTION AND SUMMARY

This is the sixth 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] that are effectively 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. Data used in the report include tax return information for possessions corporations filing tax returns for calendar year 1983 or for a fiscal year ending after June 30, 1983, and on or before June 30, 1984. (Most economic data other than from tax returns cover years through 1988.) The analysis reflects the amendments to section 936 made by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). Changes made by the Tax Reform Act of 1986 are also noted. However, the Puerto Rican Incentives Act of 1987 and Regulation 3582, governing financial assets, will not be reviewed in detail until the next Possessions report.

The requirement to produce possessions reports was created by the Tax Reform Act of 1976. The legislative history to the provision contained the following guidance:

> It is the understanding of the committee that the Department of Treasury is to review operation of section 936 corporations in order to appraise the committee of the effects of the changes made by the bill. 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. Among other things, the report is to include an analysis of the revenue effects of the provision as well as the effects on investment and employment in the possessions. (S. Rept. 94-938, p. 282; also H. Rept. 94-658 p. 259).

Chapter 2 of the report summarizes U.S. and Puerto Rican legislation concerning possessions corporations, including the modifications to U.S. law introduced in TEFRA. TEFRA provided special rules for the allocation to a possessions corporation of income from patents, trademarks, and other intangibles. These amendments reflect Congressional concern that corporations operating in the United States were shifting substantial income from intangibles to their section 936 subsidiaries in order to increase the tax savings provided under section 936. Because the TEFRA provisions were implemented for taxable years beginning after 1982, this report is the first to include post-TEFRA tax data.

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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 1986, as amended (the "Code").

Chapter 3 surveys Puerto Rican economic growth since 1948 and the impact of 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 probably also contributed to the sustained high rate of Puerto Rican industrialization and economic growth in the 1948-1972 period. Puerto Rican real gross national product (GNP) grew at an average annual rate of six percent, and real GNP per capita grew by five percent per year. The most important sector of growth was manufacturing, where employment rose from 55,000 in 1950 to 142,000 in 1972.

After 1972, however, Puerto Rican economic progress slowed and only in 1987 and 1988 did this rate of growth approach the levels of the pre-1972 period. 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 reduced Puerto Rico's ability to compete with foreign locations as a site for U.S. investment. Employment in manufacturing was relatively stagnant in the period 1972-83 despite an expansion of jobs in high-technology industries such as pharmaceuticals and electronics. After recovering from the 1982-1983 recession, manufacturing employment was flat in 1985 and 1986 but then grew to new peak levels in 1987 and 1988. Employment in construction also increased strongly in 1987 and 1988.

In constant dollars, private investment in plant and equipment declined in the ten years after 1973, so that its level in 1983 was about half of its level ten 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 also resumed. Private fixed investment began to recover, and by 1988 was in real terms almost at the peak levels of the early 1970s. The unemployment rate reached an all-time annual high of 23.4 percent in the year ending June 1983, but declined slightly from 1983 to 1986. In 1987 and 1988, the drop in the unemployment rate accelerated. In September 1988, it stood at 14.4 percent. This improvement reflected the growth of real GNP by 5.0 percent per year in 1987 and 1988.

Chapter 4 describes the characteristics, by industry, of possessions corporations. It presents data for tax year 1983 on assets, income, tax benefits, employment, and payroll. In 1983, there were 527 possessions corporations engaged in manufacturing; they earned net income of $4.1 billion and derived tax benefits of $1.6 billion. The average ratio of operating income to operating assets for the companies not electing the profit-split method of income allocation under TEFRA (accounting for 80 percent of all assets of 936 corporations) was more than five times that ratio for all mainland manufacturing companies.

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[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).

By 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 indicates 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 to be 88,579 persons, which represents 12 percent of total employment in Puerto Rico and 62 percent of employees in Puerto Rico's manufacturing sector in 1983.

Possessions corporations' U.S. tax benefits in relation to their employment vary substantially by industry. In 1983, tax benefits per employee averaged $57,761 in the pharmaceutical industry and $3,000 to $4,000 in the low-technology, labor-intensive industries. Over all manufacturing industries, possessions corporations' tax benefits averaged $18,523 per employee, or 125 percent of the average compensation per employee. This represents a decline from tax benefits per employee of $20,699 in 1982, or 148 percent of compensation. While this report does not make any attempt to estimate the impact of the Tax Reform Act of 1986 (TRA), the tax benefits of section 936 can be expected to be lower than if pre-TRA law had been in effect because of the large decrease in the statutory corporate tax rate and other provisions.

Chapter 4 also presents summary data for the period 1974 through 1983. Net income of possessions corporations in the manufacturing sector rose from about $800 million in 1974 to $4 billion in 1983. 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, 54 percent in 1982, and 29 percent in 1983. The share of net income earned by the electrical and electronics industry varied between 15 percent and 20 percent in most years, except 1981 and 1983, when the respective percentages were 26 and 24.

Chapter 5 explores the effect of the TEFRA legislation on the credits that possessions corporations took and the ratio of tax benefits to employee compensation. Conclusions are tentative, because not all possessions corporations in the 1983 data set were eligible for the TEFRA changes, not all that were eligible reported accurately under the new law, and not all relevant data were collected. With these caveats in mind, one can nevertheless speculate that the legislation was somewhat effective. In a group of firms with matched 1982 and 1983 tax returns that were required to use the TEFRA rules, accounting for 73 percent of all 1983 possessions credits, tax benefits declined from 137 percent of compensation in 1982 to 101 percent in 1983. In contrast, tax benefits received by companies not required to use the TEFRA provisions increased substantially.

Possessions corporations held approximately $15 billion in Puerto Rican financial assets as of year-end 1986. Chapter 6 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. It concludes that is very difficult to identify any significant reduction in interest rates or increase in real investment as a result of 936 funds. While private real fixed investment has recovered in recent years, in 1988 it was still below the peak levels reached in the early 1970s before the enactment of the Qualified Possession Source Investment Income Provision (QPSII) in section 936.

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

Appendix B reports the assets, income, and tax benefits of possessions corporations in Puerto Rico in tax year 1982.

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 is a set of rules under which a U.S. corporation deriving qualifying income from possessions and Puerto Rico pays no income tax to the United States. As a U.S. corporation, a possessions 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.[1] Not only is no federal tax assessed, possessions corporations in manufacturing industries currently pay an average of only approximately 5 percent of the income in taxes to Puerto Rico.

Puerto Rico has primary taxing jurisdiction over Puerto-Rican-source income; the United States has secondary taxing jurisdiction over Puerto-Rican-source income of U.S. corporations, citizens, and residents. Because the Puerto Rican rules have been fashioned to take advantage of the federal rules and have changed with the federal rules, however, 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 (which was a U.S. possession before 1946). Under these provisions, U.S. corporations that 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 in the two preceding tax years if the corporation had conducted a trade or business in a possession during that period. A corporation that met the 80-50 income tests was commonly 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 tests were met. Under the 1921 Act, dividends paid by a possessions corporation to a corporate shareholder were fully taxable.

[1] The dividend may be subject to tax under the book income provision in the Alternative Minimum Tax enacted in the Tax Reform Act of 1986.

Therefore. a U.S. corporate shareholder could defer U.S. tax on the foreign-source income of a possessions corporation (from both within and without the possessions) until it was repatriated.[2] Liquidation would result in no U.S. tax because of section 332 and this became the major vehicle for repatriations.

B. Tax Reform Act of 1976

The possessions corporation exemption remained unchanged until the Tax Reform Act of 1976. Many U.S. firms established plants in Puerto Rico after 1948. when Puerto Rico enacted a program of tax exemption for manufacturing firms. Before the 1976 Act was implemented. 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 that tended to reduce Puerto Rico's ability to compete with neighboring countries for U.S. investment.

By enacting the Tax Reform Act of 1976, Congress wanted to leave undisturbed the tax exemption of earnings from a trade or business in Puerto Rico or from investments made with those earnings for Puerto Rican use. 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 if not used in the possession. 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.[3]

To continue promoting Puerto Rico's industrial development. the Tax Reform Act of 1976 therefore left intact the exemption for income derived by U.S. corporations from operations in a possession. It also exempted from tax the dividends remitted by a possessions corporation to its U.S. parent. To prevent the avoidance of tax on income invested in foreign countries by possessions corporations. however. the Tax Reform Act eliminated the exemption for income derived outside 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 into a newly created Code section 936. The differences between sections 931 and 936 are:

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[2] 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 did not generally 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.

[3] 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.

o 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

-- QPSII, which is non-business income derived from the possession in which the corporation has its trade or business[4] and which is attributable to the investment of funds derived from such trade or business for use within the possession.

Rather than exempting the income from U.S. taxation, section 936 provides a credit equal to (and, therefore, fully offsetting) the U.S. tax on the 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 that 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. Before 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 tax-exempt. As a consequence, 931 corporations accumulated substantial earnings and invested them in the Eurodollar market in anticipation of a tax-free liquidation.[5] 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 was a wholly owned subsidiary (as most were and continue to be), the deduction equaled 100 percent of the dividend so the dividend was free of any U.S. tax.

o Requirement that a possessions corporation elect the benefits of section 936 for ten years. Under section 931, as construed by the courts,[6] a possessions corporation

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[4] The requirement that QPSII be derived from the possession in which the corporation has its trade or business means that a possessions corporation with a trade or business in Puerto Rico cannot convert interest on Eurodollar deposits into possession source income by routing such deposits through, say, a Guamanian bank. This practice was popular under section 931 (before 1976).

[5] Possessions companies were not generally subject to the U.S. accumulated earnings tax.

[6] 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.

which suffered a loss in a given year could join its parent and other affiliated corporations in filing a consolidated return for such year. For years in which the 931 corporation had income, it filed separately to receive 931 benefits. The parent of a 931 corporation thus avoided taxes on the 931 corporation's profit but could offset the 931 corporation's losses against other taxable income. Under section 936, a possessions corporation can elect the benefits of section 936, with the election being irrevocable for ten years. During the ten years it cannot join with its parent in filing a consolidated return, although it can delay electing 936 status until it shows a profit.

C. Tax Equity and Fiscal Responsibility Act of 1982

1. Treatment of Income from Intangibles

Before 1982, there were no explicit statutory guidelines on the allocation to a possessions corporation of income from intangibles (such as patents, trademarks, and trade names) which had typically 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 that was exempt from tax under section 931 or 936 by transferring to an affiliated possessions corporation such income-producing intangible assets. These corporations interpreted the law as requiring no allocation of income generated by the intangibles to the U.S. parent. 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. As a result, the parent would obtain deductions for the research and development that gave rise to the patent, while the 936 company would realize tax-free income. The view of the Internal Revenue Service, however, is that income generated by the transferred intangibles must be allocated to the U.S. parent corporations.[7] This issue has resulted in lengthy litigation.[8]

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."[9] TEFRA added a new section 936(h) to the Internal Revenue Code, which provides that income from intangibles

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[7] 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.

[8] See, for example, Eli Lilly and Co. v. Commissioner, 84 T.C. no. 65 (May 28, 1985); aff'd in part and rev'd in part, 856 F.2d 855 (7th Cir. 1988).

[9] 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.

is generally 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. The options provide a framework within 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"). Regulations issued by the Treasury Department under section 936(h)[10] provide rules for the computation of income from the "possession product," including cases where 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.

a. Eligibility

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:

- o <u>25% value-added test</u>. The possessions corporation must show that it incurred production costs (other than the cost of materials and interest excluded by regulation) with respect to the product that are not less than 25 percent of the difference between (a) gross receipts from sales or other dispositions of the product to unrelated parties by the possessions corporation or its affiliates, and (b) direct costs of materials purchased by the possessions corporation or its affiliates from unrelated parties in connection with the manufacture of the product. This test is equivalent to a 25 percent value-added requirement.

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

Start-up operations of new 936 corporations and new possession products of existing 936 corporations can meet the "significant business presence" requirement by satisfying a lower threshold of value-added or labor cost than the percentages referred to above. For such operations, the applicable percentages under the regulations are as follows:

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[10] Proposed regulations appeared in the <u>Federal Register</u> on January 10, 1984 (pp. 1.227-1.243) and were finalized by T.D. 8090 on July 7, 1986.

[11] 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.

Business presence tests for start-up operations	Year 1	2	3
Value-added test	10%	15%	20%
Labor test	35%	45%	55%

b. Cost-Sharing Option

Under the cost-sharing option, a possessions corporation is required to make a payment to its U.S. parent. The payment equals a fraction of the current year's research expenditures of the affiliated group in the "product area" in which the possession product falls.[12] The fraction equals the ratio of third-party sales of the possession product made by the affiliated group to third-party sales of all products in the product area made by the affiliated group. The cost-sharing payment therefore reduces the amount of deductions allowable for U.S. affiliates.

The cost-sharing payment is the quid pro quo that allows the possessions corporation to be treated as the owner of the manufacturing intangibles (but not marketing intangibles) associated with the possession product. Therefore, a determination must 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 is therefore tax-exempt income to the possessions corporation) and what portion is a return to marketing intangibles (and is therefore taxable income to the affiliates that perform the marketing). Section 482 regulations are intended to be applied in making this determination.

c. 50/50 Split of Combined Taxable Income from the Possession Product

Under the profit-split option, 50 percent of the combined taxable income of the possessions corporation and its U.S. affiliates that is derived from sales of the possession product to foreign affiliates or unrelated persons is allocated to the possessions corporation. The remainder is generally allocated to 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.

The regulations under section 936(h) provide a flexible definition of the term "possession product." The term includes any item of property which is the result of a production process, including components and so-called "end-product forms." (End-product

[12] As a variant of this test, the regulations under current section 936(h) permit certain Puerto Rican construction costs rather than labor costs to be used to meet the business presence requirement.

forms are products that 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.)

2. Passive Income Limitation under TEFRA

In addition to the new guidelines on income from intangibles. TEFRA raised from 50 to 65 percent the qualifying share of the gross income that a corporation must derive from the active conduct of a possessions trade or business to be eligible for the 936 credit. This increase was phased in so that the percentage rose 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 have been met for the three-year period immediately preceding the close of the taxable year (or for such part of such period as was applicable). The greater level of required business activity means that proportionately less passive investment income could have been earned by a corporation still wishing to qualify for effective tax exemption under section 936.

D. Tax Reform Act of 1986

The Tax Reform Act of 1986 makes several adjustments to the possessions tax credit. These include the following: (1) the cost-sharing payment equals the greater of 110 percent of the payment required under prior law or the royalty payment that would be required with respect to manufacturing intangibles if the possessions corporation were a foreign corporation (see sections 482 and 367(b)). (2) the amount of product area research expenditures is increased by 20 percent over the amount required under prior law for purposes of computing combined taxable income under the profit-split method. (3) the passive income limitation is reduced from 35 percent to 25 percent. and (4) QPSII is expanded to include income attributable to loans made by the Government Development Bank for Puerto Rico and other financial institutions for the acquisition or construction of active business assets or for development projects in qualified Caribbean Basin Initiative (CBI) countries.[13] Although no amount of CBI fund commitment is specified. Puerto Rico is expected to demonstrate a good faith effort to implement a program to encourage companies to develop or expand manufacturing operations in qualified CBI countries.

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[13] On August 6. 1983. President Reagan signed legislation containing the "Caribbean Basin Economic Recovery Act," commonly known as the Caribbean Basin Initiative (CBI). The legislation enables U.S. taxpayers to deduct expenses for conventions held in the eligible countries. provided that such countries enter into a tax information exchange agreement with the U.S. The potentially eligible countries are the twenty-one Caribbean jurisdictions and Bermuda. The first country to take advantage of the CBI benefits was Barbados: other countries currently qualifying are Grenada. Jamaica. and Dominica.

II. Puerto Rican Tax Provisions

Since 1948, Puerto Rico generally has provided its own tax incentives for manufacturing and other specified business activities.[14] Puerto Rico currently grants partial exemptions from income tax and other taxes to approved businesses for specified periods of time (usually ten to twenty-five 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. The following paragraphs describe the Puerto Rican Industrial Incentives Act of 1978 including a discussion of 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. The Puerto Rican Tax Incentives Act of 1987 will be reviewed in the next Possessions report.

A. Taxation of Non-Exempt Corporations

Puerto Rico's authority to enact its own income tax system comes from the Organic Act of 1917 (the Jones Act). In 1954, the Puerto Rican legislature adopted its present income tax system, which is 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 before 1987 were 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 similar to those specified in the U.S. Internal Revenue Code. (Under changes in the Puerto Rican tax code enacted in 1987, the new marginal tax rates range from 22 percent to 39 percent.) However, the Puerto Rican code contains a "flexible depreciation" provision. This provision 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. The tax is reduced further, to 5 percent, if the Puerto Rican company retains a specified percentage of its profits.

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[14] Pages 23-25 of the Fourth Report summarize the history of the Puerto Rican Industrial Incentives Act.

B. Taxation Under an Old (1963) Exemption Grant

In general, a firm that 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.[15] This tax-exempt 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 ten to thirty years, depending on the location of the plant.

Dividends paid from 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 if 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 did not affect the terms of tax-exemption grants which were issued before June 1978, but it allowed 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.

1. Option One

During the years remaining until the end of the existing grant, the exempted business paid a maximum effective tax rate of 3 to 12 percent of income, with the higher rate applicable to a firm that had fewer years left on its original grant, as follows:

Years left on original grant	Exemption percentage	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

[15] 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 6.

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

2. Option Two

A company that had six or more years remaining on its tax exemption could have made an alternative election. It could exclude 90 percent of its income from taxation and could credit two-thirds of the corporate income taxes actually paid against the tollgate tax on dividends paid from current earnings. A company that elected this second option could apply for a ten-year extension when the grant expired, but the extension was not automatic.

As a further inducement to firms to convert to partial tax exemption, the 1978 Act provided that, under either conversion option, a firm could credit tollgate taxes paid on distributions from pre-1978 earnings against the income taxes due in future years (for up to 50 percent of such liability in any given year). In addition, dividends paid by converted firms out of pre-1978 earnings could benefit from a reduced tollgate tax rate. On liquidation, pre-1978 earnings of "converted" firms were exempt from tollgate tax.

D. Taxation of Companies with an Exemption Grant Under the 1978 Industrial Incentives Act

New grants issued under the 1978 Industrial Incentives Act provided 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[16]	
		Minimum	Maximum
1-5	90%	2.20%	4.50%
6-10	75	5.50	11.25
11-15	65	8.75	15.75
16-20	55	9.90	20.25
21-25	50	11.00	22.50

[16] The minimum and maximum tax rates during a given five-year period are computed on the basis of the statutory tax rates, which now vary from 22 percent to 39 percent. Companies which were granted exemptions under prior Industrial Incentives Acts are subject to the higher rate of tax (if applicable) in effect when exemptions were granted.

The duration of a firm's grant varied from ten to twenty-five years. depending upon the location of its plant.

The effective tax rates are 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 Act allow firms an added deduction of 5 percent of production worker payroll from manufacturing income (for up to 50 percent of such income). As an alternative to the payroll deduction. a firm with profits of less than $500.000 in any year is allowed a 100-percent tax exemption on the first $100.000 of income.

If a firm with a partial exemption grant reinvests all or part of its earnings in Puerto Rican 2(j) assets (i.e.. assets designated in section 2(j) of the Industrial Incentives Act). then the dividends. interest. and rents derived from those assets are 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 1978 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

The Puerto Rican and U.S. economies are closely integrated, sharing a common currency and common external tariffs. There are no barriers to the free flow of goods, labor, or capital between the two countries. During 1983, approximately 75 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 are generally enforced in 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 (other than Supplemental Security Income) 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 several 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 from 1973 to 1983, however, Puerto Rican economic progress slowed. Total employment and employment in the manufacturing sector were stagnant. Real GNP per capita changed little between 1972 and 1983. 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. Since 1983 growth has improved. After the recovery from the 1982 recession in 1984 and 1985, growth from 1985 to 1988 has been significant. Per capita real GNP increased at a compound annual rate of 4.5 percent from 1985 to 1988. Private fixed investment has recovered to 8.5 percent of GNP.

I. Growth Since 1948[1]

Puerto Rico's economic growth from 1948 to 1973 has often been referred to as an "economic miracle." Table 3-1 shows total and per capita GNP for Puerto Rico during the 1947-1988 period. According to this information, Puerto Rican GNP (expressed in 1972

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

TABLE 3-1

TOTAL AND PER CAPITA GROSS NATIONAL PRODUCT OF PUERTO RICO, 1947-1988

Fiscal year	GNP ($ million) (constant 1972 dollars)	GNP per capita[a] (constant 1972 dollars)	Fiscal year	GNP ($ million) (constant 1972 dollars)	GNP per capita[a] (constant 1972 dollars)
1947	1,260.0	586	1968	4,385.2	1,650
1948	1,307.9	601	1969	4,793.6	1,780
1949	1,462.0	667	1970	5,181.9	1,911
1950	1,569.4	711	1971	5,488.2	1,995
1951	1,652.1	742	1972	5,770.9	2,045
1952	1,814.4	813	1973	6,059.7	2,112
1953	1,931.2	871	1974	6,134.2	2,129
1954	1,972.5	893	1975	6,026.3	2,068
1955	2,033.4	911	1976	6,176.7	2,073
1956	2,117.7	941	1977	6,471.6	2,125
1957	2,182.1	968	1978	6,817.9	2,201
1958	2,247.5	986	1979	7,188.7	2,289
1959	2,435.4	1,054	1980	7,281.0	2,287
1960	2,631.1	1,124	1981	7,369.8	2,284
1961	2,791.2	1,173	1982	7,104.9	2,183
1962	3,007.4	1,240	1983	6,955.1	2,131
1963	3,251.8	1,316	1984	7,229.7	2,212
1964	3,462.9	1,373	1985	7,452.8	2,275
1965	3,749.2	1,458	1986	7,647.1	2,332
1966	4,001.7	1,534	1987	8,031.0	2,445
1967	4,178.2	1,586	1988p	8,425.7	2,558

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Office of Tax Analysis

SOURCE: Puerto Rico Planning Board, Economic Report to the Governor, (various issues).

[a] Based on average of population estimates at the beginning and end of the fiscal year.

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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 rose at an average annual rate of 4.7 percent in the 1950s and 5.5 percent in the 1960s, compared to an annual 2.2 percent during the 1950-70 period in the United States. (The per capita figures reflect substantial emigration from Puerto Rico.)

Total Puerto Rican employment grew much less quickly than GNP and more slowly than U.S. employment. Puerto Rican employment grew by 15 percent between 1950 and 1970, compared to a 35 percent increase in civilian U.S. employment. Emigration was substantial during the period. 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 1982-1988 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 1988. 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. Government employment grew almost as rapidly through the 1950s and 1960s, and employment in construction and other services increased strongly in the 1960s. Total non-government employment declined in the 1950s but increased in the 1960s and early 1970s.

A number of factors contributed to the growth of Puerto Rican employment during the 1960s. Exemptions from local taxes induced U.S. firms to build plants in Puerto Rico. As explained in the Fourth Report, Puerto Rican labor was low-cost relative to mainland labor and contributed to Puerto Rico's attraction as an investment site. Puerto Rico also had the advantage of being inside the U.S. tariff wall, compared to low-wage foreign countries. Additionally, it 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 through 1981, but declined in the recession of 1982-83. However, manufacturing employment was virtually stagnant in the period 1970-1986 and total non-government employment remained steady or declined throughout the decade 1974-1983. The Puerto Rican petrochemical industry suffered from the sharp increase in the price of foreign oil in 1973-74. Traditional Puerto Rican manufacturing industries, such as apparel, shoes, and textiles, faced increased competition from low-wage foreign countries. In the period 1974-75 and again in the early 1980s, the entire Puerto Rican economy was adversely affected by the U.S. recession and high U.S. interest rates. A reduction in real Federal transfer payments in the latter period exacerbated the adverse effect. The Puerto Rican economy experienced a recession in

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
1950-1960	-493,000	-2.19%
1960-1970	-201,000	- .79
1970-1977	- 43,640	- .22
1978	- 20,282	- .65
1979	- 6,078	- .19
1980	- 16,101	- .51
1981	- 10,460	- .32
1982	- 33,297	-1.02
1983	- 44,433	-1.36
1984	- 34,484	-1.06
1985	- 28,609	- .87
1986	- 46,619	-1.42
1987	- 22,325	- .68

Department of the Treasury
Office of Tax Analysis

SOURCE: Puerto Rico Planning Board, Economic Report to the Governor (various issues); 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 - 1988
(thousands of workers)

Fiscal Year	Unemployment rate	Total employment[a]	Government[b]	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	19.4	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	38	143	*	44	138	21	47	135
1981	17.9	759	185	574	37	141	*	44	142	23	49	137
1982	21.7	719	171	548	34	134	*	36	141	21	48	132
1983	23.4	703	170	533	36	131	*	30	136	22	45	132
1984	22.0	743	177	562	40	142	*	34	145	22	41	140
1985	21.4	758	180	578	38	138	*	36	147	23	43	151
1986	20.5	777	180	597	40	140	*	36	149	26	49	157
1987	17.7	834	197	637	35	152	*	41	159	30	52	167
1988p	15.9	873	201	672	31	157	*	48	173	30	50	182
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
1980–1986		0.4	-0.3	0.7	0.7	-0.3	—	-2.8	1.1	3.1	0.6	2.2
1985–1986		2.5	0.0	3.3	5.3	1.4	—	0.0	1.4	13.0	14.0	4.0
1986–1987		2.3	9.4	6.7	-12.5	8.6	—	13.9	4.7	15.4	6.1	6.4
1987–1988p		4.7	2.0	5.8	-11.4	3.3	—	17.1	8.8	0.0	-3.8	9.0

Department of the Treasury
Office of Tax Analysis

SOURCES: Puerto Rico Planning Board, Economic Report to the Governor (various issues); 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] Figures may not add to total due to rounding errors.

[b] Includes only public administration.

* Less than 2,000

n.a. not available

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1974-76, 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 2.1 percent in the year ending June 1983. The economy turned around in 1984, with both government and non-government employment increasing. Except for transportation and utilities, all sectors of the economy enjoyed increases in employment rates in that year. Real GNP grew by 4.8 percent for fiscal year 1984, and real per capita GNP grew by 4.7 percent. Employment in utilities and transportation boomed in 1985 and 1986, while government employment stayed about the same. Real GNP grew by 3.1 percent in 1985 and 2.6 percent in 1986; real per capita GNP grew by 2.8 percent in 1985 and 2.3 percent in 1986. Growth accelerated in 1987 and 1988 with real GNP growing at an annual rate of 5.0 percent. Manufacturing employment grew by 6.0 percent per year from 1986 to 1988, suggesting strong growth in the 936 sector.

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 rose steadily in the period 1970-77, when it peaked at 20 percent. With 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. The decline in the unemployment rate has paralleled the growth in real GNP since 1983. For FY 1988, the unemployment rate averaged 15.9 percent.

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 $4,135 million in 1986. As a percentage of income from productive activity (Puerto Rican GNP), net federal payments rose from 7.7 percent in 1968 to 26.2 percent in 1986. Both the current-dollar and real amounts of net federal payments continued to increase between 1981 and 1986.

II. Investment in Puerto Rico

A. Overall Investment

A primary 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

TABLE 3-4

NET FEDERAL PAYMENTS TO PUERTO RICO SELECTED FISCAL YEARS 1968-1986[a]

($ million)

	1968	1981	1982	1983	1984	1985	1986
Federal grants to Puerto Rican Commonwealth and municipal governments, total	**129**	**1,893**	**1,779**	**1,722**	**1,768**	**2,348**	**2,296**
Food and nutrition assistance[b]	5	993	1,016	946	990	935	946
Education programs	--	97	92	74	71	82	163
Public assistance[c]	31	103	118	124	122	141	156
Community development block grants	15	115	94	95	122	127	92
Low-rent public housing	11	96	86	118	111	123	141
Employment and training programs	8	220	90	82	80	105	113
All other grants	59	269	283	283	272	835	685
Federal taxes transferred to Commonwealth government, total	**93**	**290**	**298**	**280**	**318**	**327**	**333**
Alcoholic beverage and tobacco excise taxes	66	235	245	245	255	260	264
Customs duties	27	55	53	35	63	67	69
Net federal transfer payments to individuals, total[d]	**64**	**846**	**1,144**	**1,220**	**1,278**	**1,364**	**1,506**
Old age, survivors, and disability insurance	1	502	648	714	734	733	801
Veterans' benefits	59	231	274	289	303	325	336
All other payments	4	113	222	217	241	306	369
TOTAL	**286**	**3,029**	**3,221**	**3,322**	**3,364**	**4,039**	**4,135**

Department of the Treasury
Office of Tax Analysis

SOURCES: U.S. Department of Commerce, Bureau of the Census, Federal Expenditures by State, (various years); 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, (various years).

[a] In 1968, both the federal and Puerto Rican fiscal years ended on June 30, so all data for FY 1968 is based on the same time period. In 1976, however, the federal fiscal year was changed to October 1-September 30, while the Puerto Rican fiscal year remained unchanged. With the exception of certain federal transfer payments to individuals, data for 1981-1986 are based on the federal fiscal year.

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

[c] Includes Medicaid, child support enforcement, maintenance assistance (AFDC), and low-income home energy assistance.

[d] All transfer payments (such as employer, employee and self-employment contributions for Social Security) are net of associated payments by or on behalf of current or future recipients.

constant dollars). Part of the increase was spurred by increasing investment. Physical investment can lead to an increase in income in two ways: by providing the capital to create new, more productive jobs, and by increasing the productivity of those currently employed.[2]

Components of fixed investment in Puerto Rico are illustrated in Table 3-5 for the years 1960-1988. 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 increase in OPEC oil prices in 1973 and the consequent termination of the federal quota system eliminated Puerto Rico's 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.

Total and private investment (expressed in 1972 dollars) grew rapidly in the period 1960-73, but dropped off during the 1974-76 recession and continued to drop until 1983. 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. Similarly, housing construction, which rose almost continuously until 1972 to a peak of $472 million, declined sharply in nearly every year until 1984. Machinery and equipment investment rose slightly in 1983 to a level equal to 60 percent of the average in the early 1970s. It also recovered modestly in 1984 but still remained far below the levels of the early 1970s. Investment in machinery and equipment then increased strongly from 1984 to 1988. In 1986-1988 it was substantially above the levels reached in the early 1970s.

Puerto Rican government investment has also expanded since 1960. Total government investment by public enterprises rose from about $300 million in 1969 to almost $600 million in 1975, then fell sharply to under $300 million in 1984. Commonwealth investment was financed largely by external borrowing, from 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.

Aggregate physical investment in Puerto Rico (except private refinery construction) rose 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. From 1978 to 1983, annual investment fell by another 35 percent, from $1.1 billion to $0.7 billion. However, real investment has recovered strongly since 1983. Total fixed investment almost doubled

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

TABLE 3-5

COMPONENTS OF REAL FIXED INVESTMENT IN PUERTO RICO
FISCAL YEARS 1960-1988
(millions of 1972 dollars)

Year	Total excluding private refinery construction	Private non-residential investment: Industrial and commercial buildings: Total	Private non-residential investment: Industrial and commercial buildings: Total, excluding refinery construction[a]	Private non-residential investment: Machinery and equipment	Housing	Government and public enterprise investment
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	1,500	194	170	432	437	462
1974	1,419	203	181	357	398	483
1975	1,438	186	117	312	336	673
1976	1,272	152	125	360	295	493
1977	1,059	93	81	354	249	387
1978	1,090	81	71	379	291	348
1979	1,087	77	67	375	250	395
1980	1,072	85	64	361	228	419
1981	998	97	84	331	192	391
1982	781	82	72	228	165	316
1983	712	68	59	262	149	242
1984	825	115	108	291	134	292
1985	945	102	96	380	151	320
1986	973	104	96	453	146	278
1987	1,184	141	133	487	181	383
1988p	1,427	172	166	544	215	502

Department of the Treasury
Office of Tax Analysis

SOURCES: Puerto Rico Planning Board, Economic Report to the Governor, Tables 2, 12, and 20 (various issues); unpublished estimates of private refinery construction by the Puerto Rico Planning Board.

[a] 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.

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from 1983 to 1988 and is almost back to the peak levels of the early 1970s. From 1983 to 1988 total fixed annual investment in Puerto Rico was on the average about 16 percent of annual GNP, compared to 25 percent in the period 1966-73. In 1988 it was about 20 percent of GNP.

Several factors were responsible for the 1972 to 1983 decline in investment in Puerto Rico. As explained in detail in the Fourth Report,[3] 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 wage 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 and before the 1986 Tax Reform Act (such as the investment tax credit and the reduction in the maximum statutory corporate income tax 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 1981 further reduced the effective tax rate on income from capital, as shown below:

Effective U.S. Tax Rates on New Depreciable Assets, Selected Industries[4]

Industry	1979-1981 Law	1981-82 Law	Post-1982, Pre-1986 Law
Food and kindred products	43.5	20.4	26.7
Apparel	40.6	23.1	28.9
Chemicals	28.6	8.5	17.7
Fabricated metal products	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

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 1981 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

[3] See pages 43-47.

[4] 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.

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 to 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.[5]

B. Industry Composition

Changes in Puerto Rico's 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.[6] Until the enactment of TEFRA, when a possessions corporation produced (in whole or in part) a product in Puerto Rico, the return on the R&D and other intangible property associated with the product enjoyed unique tax advantages under U.S. law. As TEFRA's changes have been phased in, some of these tax advantages have lessened.

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 the chemical industry increased sharply as a percent of the total. Between 1970 and 1988, however, the 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, and glass industries fell from 40 percent to 18 percent. Income earned by the chemical industry grew from 11 percent to 44 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 29 percent. Nearly

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[5] This exemption is also available for subsidiaries incorporated in the U.S. possessions.

[6] In 1980, electrical and electronic equipment was first among sixteen 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, 1983, AND 1988
($ million)

	1960		1970		1980		1983		1988p	
	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[a]	Amount of net income	Percent of total
All Manufacturing industries	288.8	100.0%	957.6	100.0%	4,808.7	100.0%	5,734.9	100.0%	9,432.5	100.0%
Food and kindred products	66.7	23.1	161.3	16.8	548.5	11.4	564.8	9.8	1,152.0	12.2
Tobacco products	10.4	3.6	36.4	3.8	46.3	1.0	55.2	1.0	84.8	0.9
Textile mill products	13.9	4.8	41.1	4.3	39.6	0.7	31.7	0.6	48.3	0.5
Apparel	50.7	17.6	172.0	18.0	360.7	7.5	408.2	7.1	458.7	4.9
Furniture and wood products	8.8	3.0	26.2	2.7	29.6	0.6	27.3	0.5	36.2	0.4
Printing and publishing	11.2	3.9	22.6	2.4	58.8	1.2	69.5	1.2	104.5	1.1
Chemicals	9.8	3.4	109.3	11.4	1,583.2	32.9	2,268.9	39.6	4,180.8	44.3
Stone, clay, and glass products	18.8	6.5	49.1	5.1	95.4	2.0	77.3	1.3	138.9	1.5
Machinery and metal products	54.7	18.9	191.5	19.4	1,453.7	30.2	1,752.5	30.6	2,744.8	29.1
Other manufacturing	43.7	15.1	148.0	15.5	597.0	12.4	479.4	8.4	483.6	5.1

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SOURCE: Puerto Rico Planning Board, Economic Report to the Governor, Table 7 (various years).

[a] Percentages do not add to 100 due to rounding errors.

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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.[7]

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[7] 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 of possessions corporations by industry. It presents data on their assets, income, tax benefits, employment, and payroll in tax year 1983.[1] The information is drawn from unaudited tax and employment returns filed by possessions corporations for tax year 1983. Returns with accounting periods beginning on or after January 1, 1983, were subject to new law under TEFRA; returns with accounting periods beginning before that date were subject to old law. A total of 625 corporations, of which 527 were manufacturing companies, claimed possessions tax credits in 1983. The 527 manufacturing firms claimed estimated possessions tax credits of $1,895 million and derived estimated tax benefits of $1,641 million.

To estimate the tax benefit received by possessions corporations, the total possessions tax 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. Only corporations engaged in manufacturing are assumed to derive tax benefits. Activities other than manufacturing generally did not qualify for exemption grants in Puerto Rico. Moreover, 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 the U.S. tax liability for non-manufacturing activities. Therefore, the tables in this chapter focus primarily on manufacturing possessions corporations.

Employment data are available for only 378 of the manufacturing possessions corporations. Therefore, the figures in Tables 4-6 and 4-7 for number of employees and compensation by industry had to be estimated. Actual data on wages and number of employees for the 378 firms were weighted up by industry-specific cost-of-goods-sold and asset data, as explained in section III of this chapter and in appendix C. Over all manufacturing industries, the average compensation per employee was approximately $14,800 and the average tax benefit per employee was approximately $18,500.

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[1] Returns are for accounting periods ending between July 1, 1983 and June 30, 1984. Because most possessions corporations file on a calendar year basis, tax year 1983 corresponds closely to calendar tax year 1983. A few returns used different accounting periods for 1982 and 1983 in order to delay eligibility under TEFRA rules. For example, some companies used a January 1, 1982 to December 30, 1982, accounting period for 1982 and a December 31, 1982 to December 30, 1983 accounting period for 1983.

This chapter also presents summary data for 1974 through 1983. These data indicate the following trends:

-- 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 527 (in 1983).

-- Possessions corporations' tax benefits rose from about $400 million in 1974 to about $1.8 billion in 1982 and then decreased to $1.6 billion in 1983. The increase from 1974 to 1983 amounts to an increase of over 100 percent in inflation-corrected dollars.

-- Between 1974 and 1982, the tax benefits rose from 92 percent to 148 percent of total compensation of employees of possessions corporations. Following the passage of TEFRA, however, tax benefits as a percentage of compensation fell to 125 percent in 1983. (Some 1983 returns still fell under the pre-TEFRA rules because their fiscal years began before 1983. A comparison of tax benefits in 1982 and 1983 received by companies required to use the TEFRA provisions is presented in Chapter 5.)

The final section of this chapter explains the method used in estimating the tax benefits of section 936 and discusses the possibility of indirect employment effects arising from section 936 provisions. 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 1983

A. Asset Composition of Puerto Rican Investment

Table 4-1 is based on corporate balance sheets filed as part of U.S. tax returns. Only physical and financial assets are directly observable from balance sheets because intangible assets are generally carried on a corporation's books at a zero basis. The table shows that the total assets of the possessions corporations filing 1983 U.S. tax returns were $22.2 billion. Seventy-eight percent of the total assets, or $17.3 billion, was held by manufacturing companies which benefited from total or partial exemption from Puerto Rican taxes. Net plant and equipment of 936 manufacturing firms (shown as "net depreciable assets" on Table 4-1) amounted to $1.9 billion, of which $794 million (42 percent) was owned by the pharmaceutical industry. The electrical and electronic equipment and food products industries also had substantial amounts of plant and equipment in Puerto Rico, with 16 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 represented 11 percent of the total book assets of manufacturing possessions

TABLE 4-1
SELECTED BALANCE SHEET INFORMATION BY INDUSTRY, 1983
($ thousand)

	All industries	Manufacturing industries							
		Manufacturing total	Food and kindred products	Textile mill products	Apparel	Paper	Chemicals		
							Total	Pharmaceuticals	All other
Number of corporations	625	527	25	6	82	9	99	62	37
Total Assets	22,204,669	17,320,908	1,484,123	68,815	579,215	36,226	7,977,321	7,386,638	590,683
Cash	3,343,079	3,189,927	629,766	4,993	123,457	2,603	1,044,419	897,233	147,186
Accounts receivable	3,993,481	3,108,894	300,941	10,921	200,594	6,449	1,174,392	999,710	174,683
Inventories	1,686,131	1,609,619	164,889	3,406	73,423	3,054	419,430	366,455	52,975
U.S. Government obligations	616,440	541,055	0	0	5,551	56	189,239	158,383	30,856
Other current assets	1,254,684	1,216,979	13,905	694	8,872	717	711,085	688,798	22,287
Mortgage and real estate loans	1,654,979	72,173	12,226	0	2,423	0	0	0	0
Other investments	5,676,554	4,740,488	88,883	1,164	126,882	21,332	2,990,685	2,916,541	74,145
Depreciable assets	4,117,925	2,894,746	265,191	3,963	57,728	3,334	1,237,633	1,123,482	114,152
Less: Accumulated depreciation	1,388,479	1,015,546	84,265	2,824	30,688	1,564	373,181	329,237	43,944
Net depreciable assets	2,729,447	1,879,200	180,926	1,139	27,040	1,771	864,452	794,245	70,208
Other assets	1,249,878	962,575	92,587	46,497	10,971	244	583,618	565,273	18,345
Total Liabilities and Stockholders' Equity									
Accounts payable	1,680,183	927,423	244,674	381	49,680	821	228,070	185,528	42,542
Notes payable in less than one year	657,779	320,965	28,490	7	2,840	626	179,881	170,374	9,507
Other current liabilities	2,403,976	364,012	40,698	306	19,430	1,609	157,393	133,574	23,819
Notes payable in one year or more	571,139	222,536	7,237	47	13,095	136	121,590	103,725	17,865
Other liabilities	764,564	336,766	18,405	616	1,529	0	128,040	119,830	8,210
Capital stock	1,992,953	1,185,250	230,146	371	25,739	1,198	419,574	342,824	76,750
Retained earnings, total	14,134,075	13,963,956	914,472	67,085	466,902	31,837	6,742,772	6,330,782	411,989
Appropriated	238,429	191,878	13,149	0	0	1,689	2,857	2,266	591
Unappropriated	13,895,647	13,772,078	901,323	67,085	466,902	30,148	6,739,915	6,328,517	411,398

TABLE 4-1 - continued

	Manufacturing industries - continued							
	Rubber and plastic 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	13	17	9	29	12	134	42	50
Total Assets	110,457	191,026	55,235	310,337	169,425	3,668,945	1,047,066	1,622,717
Cash	7,337	24,069	6,401	44,392	23,296	980,290	197,223	101,681
Accounts receivable	24,854	66,247	30,062	62,731	53,146	623,227	151,413	403,916
Inventories	11,590	34,762	2,637	35,948	26,203	477,633	84,012	272,630
U.S. Government obligations	0	2,955	0	7,414	3,030	91,975	223,521	17,313
Other current assets	1,406	419	175	4,003	824	338,807	44,476	91,594
Mortgage and real estate loans	0	327	0	0	0	48,727	8,051	417
Other investments	31,282	46,058	11,247	60,698	37,289	742,375	179,922	402,670
Depreciable assets	44,665	20,307	8,559	95,461	19,749	495,298	178,963	463,895
Less: Accumulated depreciation	13,189	7,223	6,504	31,863	5,875	202,084	48,582	207,704
Net depreciable assets	31,476	13,084	2,054	63,599	13,874	293,214	130,381	256,191
Other assets	2,512	3,104	2,658	31,552	11,763	72,697	28,068	76,305
Total Liabilities and Stockholders' Equity								
Accounts payable	2,630	17,670	652	20,625	21,457	185,957	48,749	106,058
Notes payable less than 1 year	1,585	2,281	595	6,451	2,920	31,256	26,850	37,182
Other current liabilities	6,501	5,549	728	3,950	3,891	83,786	18,314	21,858
Notes payable 1 year or more	2,219	3,243	2,500	8,020	172	51,250	5,107	7,919
Other liabilities	484	423	1,115	1,911	1,115	146,856	5,292	30,977
Capital stock	14,724	-4,030	470	30,801	5,927	183,386	68,419	208,526
Retained earnings, total	82,314	165,890	49,175	238,579	133,943	2,986,455	874,336	1,210,197
Appropriated	9,715	0	3,646	0	0	101,324	51,599	7,899
Unappropriated	72,599	165,890	45,529	238,579	133,943	2,885,130	822,736	1,202,298

TABLE 4-1 - continued

	Nonmanufacturing industries						
	Nonmanu-facturing total	Construction	Transportation, communications, and utilities	Wholesale trade	Retail trade	Finance, insurance, real estate	Other services and industries not reported
Number of corporations	98	8	5	25	7	23	30
Total Assets	4,883,763	36,573	946,914	63,570	124,899	3,620,076	91,730
Cash	153,152	934	30,751	1,635	10,174	104,647	5,009
Accounts receivable	884,586	9,469	62,114	17,408	11,120	735,629	48,847
Inventories	76,512	130	22,565	10,760	23,833	17,756	1,468
U.S. Government obligations	75,385	0	0	0	0	75,385	0
Other current assets	37,705	2,538	3,982	1,959	18,526	9,184	1,515
Mortgage and real estate loans	1,582,806	38	0	0	0	1,582,687	81
Other investments	936,067	1,053	18,145	7,408	18,292	879,220	11,949
Depreciable assets	1,223,179	5,925	1,084,292	14,710	57,537	33,296	27,420
Less: Accumulated depreciation	372,933	2,446	327,945	3,798	24,581	1,804	12,359
Net depreciable assets	850,246	3,480	756,347	10,912	32,956	31,492	15,061
Other assets	287,304	18,931	53,009	13,489	9,997	184,076	7,801
Total Liabilities and Stockholder Equity							
Accounts payable	752,761	4,380	38,084	7,638	41,055	654,249	7,354
Notes payable in less than one year	336,814	156,677	15,183	3,917	3,290	294,158	4,589
Other current liabilities	2,039,964	4,104	39,244	3,598	1,121	1,989,935	1,962
Notes in payable one year or more	348,603	4,092	100,002	7,726	28,846	205,131	2,806
Other liabilities	427,798	161	4,771	39	1,214	418,941	2,672
Capital stock	807,703	294	730,129	14,757	14,199	28,837	19,487
Retained earnings, total	170,120	7,865	19,501	25,895	35,174	28,824	52,861
Appropriated	46,551	0	14,020	43	0	32,488	0
Unappropriated	123,569	7,865	5,481	25,852	35,174	-3,664	52,861

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firms, compared to 30 percent for the same industries in the United States.[2] This reflects, at least in part, the tax benefits from holding financial assets in Puerto Rico. 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. In 1983, manufacturing possessions corporations' net property, plant and equipment for companies not electing the profit-split method was 46 percent of before-tax net income per return, compared to almost 500 percent for U.S. manufacturing corporations.

Table 4-3 compares, for non-profit-split possessions corporations and mainland firms, ratios of operating profits to operating assets in selected manufacturing industries. The assets of these non-profit-split corporations account for 80 percent of all of the assets of possessions corporations in Puerto Rico. 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 1983, the before-tax return on operating assets for non-profit-split manufacturing possessions corporations (54.1 percent) was more than 5 times the ratio for mainland manufacturing operations (10.3 percent).

The possessions corporations ratios may be slightly misstated. The operating assets of possessions corporations do not include the value of land and buildings leased from the Puerto Rican government. Possessions corporations are less likely than mainland corporations to have initial losses. There are also cost differentials between Puerto Rico and the mainland. For some inputs Puerto Rican costs are lower, while for others the reverse is true. Lower wages in Puerto Rican manufacturing, for example, may be offset by higher costs for utilities and transportation. However, as indicated in the Fourth Report,[3] such factors can explain only part of the large discrepancy in profitability of manufacturing in Puerto Rico and the United States. 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 10 points (9 to 19 percent), while for possessions corporations the range is much wider (27 to 77 percent), with the highest profit ratios in the high-technology sectors.

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[2] The Commonwealth government owns land and buildings that it leases to private investors (936 firms, foreign firms, and Puerto-Rican-chartered firms). Not all of the property, valued at $297 million in June 1983, is under lease at any given time. If three-fourths of the government-owned plant and property were under lease to possessions corporations in 1982 and if this property were included in fixed assets, the ratio of 936 fixed assets to total assets would increase from 11 to 14 percent.

[3] See pages 61-65.

TABLE 4-2

NET PLANT, EQUIPMENT AND PROPERTY AS A PERCENTAGE OF TOTAL ASSETS FOR POSSESSIONS CORPORATIONS AND CORPORATIONS OPERATING IN THE U.S., 1983

Industry	936 Assets by industry as a percent of all 936 assets[a]	Net plant, equipment, and property as a percentage of total assets by industry: 936 corporations	Corporations operating in the U.S.	Column 2 ÷ Column 3
All manufacturing industries	100.0%	11%	30%[b]	37%
Food and kindred products	8.6	12	36	33
Textile mill products	*	2	32	6
Apparel	3.3	5	n.a.	n.a.
Paper and allied products	*	5	57	9
Pharmaceuticals	42.6	11	29	38
All other chemicals	3.4	12	44	27
Rubber and plastic products	0.6	28	35	80
Leather products	1.1	7	n.a.	n.a.
Stone, clay, and glass products	*	4	46	9
Fabricated metal products	1.8	20	31	65
Machinery, except electrical	1.0	9	30	30
Electrical and electronic equipment	21.2	8	26	31
Instruments and related products	6.0	12	30	40

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SOURCES: Tax Form 1120 filed by possessions corporations; Federal Trade Commission, Quarterly Financial Report, Fourth Quarter 1984.

* Less than 0.5%.

[a] The percentages by industry sum to 90 percent, rather than 100 percent, because 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.

[b] 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 39%.

n.a. not available

TABLE 4-3

BEFORE-TAX OPERATING INCOME AS A PERCENT OF OPERATING ASSETS FOR POSSESSIONS CORPORATIONS NOT ELECTING PROFIT-SPLIT METHOD[a] AND CORPORATIONS OPERATING IN THE U.S., 1983[b]

Industry	Before-tax operating income as a percent of operating assets: Mainland operations	Before-tax operating income as a percent of operating assets: 936 corporations
All manufacturing	10.3%	54.1%
Food and kindred products	13.7	40.2
Chemicals and related products	10.1	72.1
Pharmaceuticals	18.7	77.5
Fabricated metal products	10.6	27.8
Machinery, except electrical	9.1	42.6
Electrical and electronic equipment	8.5	67.3
Instruments and related products	12.1	69.5

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SOURCE: Tax return Form 1120 filed by possessions corporations; Federal Trade Commission, Quarterly Financial Report, First Quarter, 1984.

[a] Because firms electing the profit-split method did not report most of the income statement information, they are excluded from this table.

[b] 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.

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.[4] The cash assets category, which may include short-term CDs, was $2.1 billion. The amount of total financial assets in 1983 -- over $10 billion -- was more than six times the value of 936 manufacturing corporations' physical plant and equipment net of depreciation. As explained in chapter 6, 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 45 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 for tax years beginning in 1985 and 1986. It has been further reduced under the Tax Reform Act of 1986 to 25 percent for tax years beginning in 1987 and thereafter.)

B. Retained Earnings

Table 4-1 also shows evidence of the 936 manufacturing companies' incentive to retain earnings. In 1983, these companies reported $14.0 billion of retained earnings. Forty-five percent of retained earnings ($6.3 billion) was held by possessions corporations in the pharmaceuticals industry. Twenty-one percent ($3.0 billion) was held by the electrical and electronics industry. Retained earnings represented 81 percent of total liabilities and stockholders' equity of manufacturing possessions corporations. The comparable figure for manufacturing corporations operating in the United States in the same industries (using the 936 industry mix) was 35.5 percent. The high level of 936 retained earnings is probably a response to limited alternatives under the Internal Revenue Code for making low-tax financial investments, as well as 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 a specified percentage of its profits, and, of course, is not paid at all on funds as long as they are retained.

C. Total Receipts

Table 4-4 shows that total receipts of the manufacturing possessions corporations not electing the profit-split method[5] were $10.9 billion, of which $10.3 billion were attributable to business receipts. Most of the remainder was attributable to interest on

[4] See Table 6-1 for the composition of these financial investments.

[5] Because firms electing the profit-split method did not generally report income statement information, they were not included in the table.

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 electrical and electronic industry accounted for 24 percent of the business receipts of manufacturing possessions companies not electing the profit-split method. Pharmaceuticals followed close behind, with 22 percent of business receipts. In 1982, pharmaceuticals accounted for 34 percent; the drop in pharmaceuticals' share is partly due to their greater adoption of the profit-split method. Companies electing the profit-split method are not represented in the table.

D. Net Taxable Income per Tax Return

Net taxable income reported on the U.S. corporation income tax return amounted to $3.3 billion for manufacturing possessions corporations not electing the profit-split method. (For all corporations including those electing the profit-split method, the figure is $4.1 billion. See Table 4-5.) This amounts to 220 percent of the net depreciable assets of those corporations. The industry with the greatest amount of net income for non-profit-split firms was pharmaceuticals with $1.3 billion of net income, which represents 39 percent of the total net income of non-profit-split manufacturing possessions corporations. The figures for all pharmaceutical firms, including profit-split firms, are $1.9 billion and 46 percent. Both profit-split and non-profit-split pharmaceutical firms had income equal to about 240 percent of net depreciable assets. The electrical and electronic equipment industry had net income of $1008 million, accounting for 24 percent of the combined net income for manufacturing firms. Electrical and electronic equipment firms not electing the profit-split method had net income of $916 million, which represented 28 percent of income for all non-profit-split manufacturing firms. Net income for the electrical and electronic equipment firms, both profit-split and non-profit-split, represented 340 percent of their net depreciable assets.

E. Distributions

The final line in Table 4-4 shows that non-profit-split manufacturing possessions corporations reported $2,262 million of distributions, which was 68 percent of their net income in tax year 1983. This represents an increase over the 1982 level of distributions (60 percent of net income) and a large increase over the 1981 level (41 percent of net income). Fifty-four percent of distributions by non-profit-split manufacturing corporations in 1983 was attributable to the electrical and electronic equipment industry. In 1982, the dominant industry for distributing profits was pharmaceuticals, which accounted for 59 percent of all distributions. Again, this drop is partly attributable to the greater adoption of the profit-split method by the pharmaceutical industry.

TABLE 4-4

SELECTED INCOME STATEMENT INFORMATION BY INDUSTRY FOR COMPANIES NOT ELECTING PROFIT METHOD, 1983
($ thousand)

	All industries	Manufacturing industries							
		Manufacturing total	Food and kindred products	Textile mill products	Apparel	Paper	Chemicals		
							Total	Pharmaceuticals	All other
Number of corporations[a]	557	463	21	6	82	8	66	39	27
Total receipts	12,329,146	10,944,350	962,897	36,440	588,742	31,151	2,733,513	2,491,375	242,138
Business receipts	11,329,654	10,272,964	907,456	34,916	572,116	28,889	2,468,393	2,251,262	217,130
Interest	749,790	450,538	29,989	1,470	14,231	2,248	156,145	149,343	6,802
Other receipts	249,702	220,851	25,441	54	2,395	14	108,976	90,770	18,206
Total deductions	8,857,516	7,633,561	725,763	28,429	461,716	23,126	1,355,276	1,194,906	160,370
Cost of sales	6,497,471	6,033,023	613,986	23,765	411,224	20,105	715,479	596,645	118,834
Depreciation	214,055	129,468	10,425	413	3,188	324	40,200	37,207	2,993
All other deductions	2,145,990	1,471,073	101,352	4,251	47,304	2,697	599,597	561,054	38,543
Estimated net income per return	3,471,630	3,310,789	237,134	8,011	127,026	8,025	1,378,237	1,296,469	81,768
Estimated net income per books	3,292,876	3,131,757	223,943	4,652	124,448	7,960	1,331,046	1,234,393	96,653
Distributions	2,381,677	2,261,848	80,780	600	30,939	2,097	624,242	595,916	28,326

TABLE 4-4 - continued

	Manufacturing industries - continued							
	Rubber and plastic 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	12	15	7	29	11	125	34	47
Total receipts	71,123	184,754	17,019	203,172	159,017	2,707,540	596,758	2,652,224
Business receipts	68,603	181,059	14,021	190,738	154,841	2,534,699	556,236	2,560,987
Nongovernment interest	1,472	3,159	926	7,506	3,808	149,804	34,194	45,585
Other receipts	1,048	536	2,072	4,928	368	23,038	6,328	45,652
Total deductions	53,920	156,890	12,774	150,521	120,228	1,791,192	357,219	2,396,507
Cost of sales	40,585	143,817	9,151	130,666	98,265	1,405,211	263,517	2,157,252
Depreciation	1,641	1,106	266	6,318	1,419	32,648	10,069	21,451
All other deductions	11,694	11,967	3,357	13,537	20,545	353,334	83,634	217,804
Estimated net income per return	17,203	27,864	4,245	52,651	38,789	916,348	239,539	255,717
Estimated net income per books	16,427	26,633	4,157	54,204	38,428	808,200	242,988	248,671
Distributions	4,226	1,870	332	21,962	2,120	1,236,405	136,558	119,717

TABLE 4-4 - continued

	Nonmanufacturing industries						
	Nonmanu- facturing total	Construction	Transportation, communications, and utilities	Wholesale trade	Retail trade	Finance, Insurance, real estate	Other services and industries not reported
Number of corporations	94	7	5	23	7	22	30
<u>Total Receipts</u>	1,384,796	23,119	407,460	86,724	459,269	326,496	81,728
Business receipts	1,056,691	21,643	399,769	86,376	455,883	20,161	72,858
Nongovernment interest	299,253	350	4,301	125	299	293,291	886
Other receipts	28,853	1,126	3,390	223	3,086	13,044	7,984
<u>Total Deductions</u>	1,223,955	23,021	289,053	76,105	448,683	310,455	76,638
Cost of sales	464,449	14,090	4,167	56,272	351,645	124	38,150
Depreciation	84,588	1,157	73,629	1,263	4,069	2,282	2,188
All other deductions	674,919	7,774	211,257	18,570	92,969	308,049	36,300
<u>Estimated net income per return</u>	160,841	98	118,407	10,619	10,586	16,041	5,090
<u>Estimated net income per books</u>	161,120	-17	118,247	9,986	6,162	22,113	4,628
<u>Distributions</u>	119,829	0	114,830	326	1,592	0	3,082

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[a] Because firms electing the profit-split method did not report most of the income statement information, they are excluded from this table.

II. Estimated Tax Benefits in Tax Year 1983

Table 4-5 shows the net income, possessions tax credits claimed, and estimated reduction in U.S. tax liability for all 625 possessions corporations for tax year 1983. The possessions credits claimed by all manufacturing corporations amounted to $1,824 million. This figure exceeds the estimated tax benefit received of $1,641 million. The tax benefit figure was estimated by applying to manufacturing possessions corporations the same U.S. tax rules which applied to corporations operating within the United States in 1983 (i.e., accelerated depreciation and the investment tax credit), and then subtracting from the tentative U.S. tax liability the income and tollgate taxes paid to Puerto Rico. Puerto Rican taxes are subtracted out because, in absence of the possessions tax credit, a foreign tax credit would be permitted. In calendar year 1983, Puerto Rico collected $136 million in tollgate taxes. It also collected $116 million in income taxes from 936 corporations operating under partial income tax exemption grants. The pharmaceutical industry accounted for nearly half of the tax benefit, with the electrical and electronic equipment industry adding another 23 percent of the total. Other manufacturing industries each typically accounted for less than 5 percent of the total.

The possessions credits claimed by nonmanufacturing companies amounted to $71 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 close to 100 percent of their U.S. tax liability. While the Puerto Rican Industrial Incentive Acts 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 1983. Moreover, a sample of the 1978 Puerto Rican tax returns filed by possessions corporations in all non-manufacturing industries suggests that the average effective Puerto Rican tax rate for such companies was roughly 40 percent. This validates the assumption that Puerto Rican taxes would offset nearly 100 percent of U.S. tax liability if a foreign tax credit (rather than a possessions tax credit) were applied.

According to Table 4-5, four industry groups accounted for 83 percent of the tax benefits provided to possessions corporations:

Industry	Reduction in U.S. tax liability ($ million)	Percentage of total
All industries	$1,641	100%
Pharmaceuticals	760	46
Electrical and electronic equipment	382	23
Instruments	115	7
Food and kindred products	113	7

TABLE 4-5

NET INCOME, POSSESSIONS TAX CREDITS CLAIMED AND ESTIMATED TAX BENEFITS BY INDUSTRY, 1983
($ million)

	625 companies; 527 manufacturing		
	Net income	Credit claimed	Tax benefit
All manufacturing industries	$4,131	$1,895	$1,641
Food and kindred products	279	128	113
Textile mill products	6	3	3
Apparel	123	56	51
Chemicals	2,013	925	809
Pharmaceuticals	1,888	867	760
Other chemicals	125	58	49
Rubber and plastic products	29	13	12
Leather	40	18	17
Fabricated metal products	52	24	21
Machinery, except electrical	41	19	17
Electrical and electronic equipment	1,008	461	382
Instruments and related products	286	131	115
All other manufacturing	254	117	101
Nonmanufacturing	157	71	0
Total	**$4,228**	**$1,966**	**$1,641**

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It should be noted that the net tax benefits obtained by Puerto Rican companies do not necessarily represent the amount of tax revenue that would immediately be transferred to the U.S. Treasury if section 936 were to be repealed. In the event of repeal, Puerto Rican companies could choose to stay in Puerto Rico or transfer to another low-tax foreign jurisdiction and defer U.S. tax until dividends were repatriated to the U.S. Section VI discusses this issue in detail.

III. Payroll and Employment in Tax Year 1983

By 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 indicates whether 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 on the amount of income earned, not on the number of workers employed.) Table 4-6 is based on 378 possessions corporations in the manufacturing sector for which 1983 employment and payroll data could be obtained. The actual figures for those corporations are weighted up to represent the total 527 manufacturing corporations by assuming that the relationships within each industry sector between employment and cost of goods sold (where available) or between employment and assets are the same for the complete group of 527 companies as for the 378 companies for which employment and payroll data were available. See Appendix C for a discussion of the weighting procedure. The figures produced by the weighting refer to direct employment associated with section 936 companies. It is shown in section V that the indirect effects of section 936 on employment are likely to be small; furthermore, indirect effects are not generally included in the evaluation of tax provisions.

Table 4-6 shows that, for manufacturing in general, the estimated federal tax benefits per employee averaged $18,523, or 125 percent of the average compensation per employee. This percentage contrasts sharply with the 1982 figure of 148 percent. 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 $57,761 per employee, or nearly 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 $15,005 per employee, or 96 percent of average compensation. In the apparel industry, by contrast, the average tax savings per employee were $3,295, only one-third of employee compensation.

Table 4-7 illustrates the distribution of tax benefits in relation to the number of employees. The chemical industry (primarily pharmaceuticals) was the only manufacturing sector in which the share of tax savings significantly exceeded the share of employment. Chemicals accounted for 49 percent of the benefits but only 17 percent of the employees. Within the chemical industry, the pharmaceutical industry provided 15 percent of the employment of all manufacturing companies and accounted for 46 percent of the total tax benefits. The electrical and electronic equipment industry accounted for 23 percent of tax

TABLE 4-6
TAX BENEFITS PER EMPLOYEE AND AS A PERCENT OF COMPENSATION, BY INDUSTRY, 1983

	Actual data, 378 companies		Estimated totals, 527 companies				
	Employees	Compensation ($000)	Employees[a]	Compensation[a] ($000)	Average employee compensation	Tax benefits per employee	Tax benefits[b] as a percentage of employee compensation
All manufacturing industries	75,966	$1,122,785	88,579	$1,314,182	$14,836	$18,523	124.8%
Food and kindred products	7,167	106,493	8,098	123,132	15,205	14,003	92.1
Textile mill products	381	3,634	996	9,498	9,538	2,720	28.5
Apparel	13,514	140,122	15,628	162,658	10,408	3,295	31.7
Men's and boy's	3,253	36,207	—	—	—	—	—
Women's and children's	5,998	60,086	—	—	—	—	—
Hats, caps, etc.	1,487	14,953	—	—	—	—	—
All other	2,776	28,876	—	—	—	—	—
Chemicals	12,937	277,594	15,227	326,761	21,460	53,155	247.7
Industrial chemicals	712	16,218	—	—	—	—	—
Pharmaceuticals	11,184	244,178	13,149	286,961	21,823	57,761	264.7
Soaps, cleaners, etc.	446	7,682	—	—	—	—	—
Other	595	9,516	—	—	—	—	—
Rubber and plastic products	986	12,692	1,173	15,094	12,872	10,015	77.8
Leather products	3,906	41,662	4,720	50,369	10,672	3,567	33.4
Footwear	3,609	38,605	—	—	—	—	—
Other	297	3,057	—	—	—	—	—
Fabricated metal products	1,254	19,651	1,965	30,792	15,671	10,532	67.2
Cans and containers	327	5,294	—	—	—	—	—
Other	927	14,357					
Machinery, except electrical	829	13,403	843	13,629	16,168	20,611	127.5
Electrical and electronic equipment	22,002	345,056	25,439	398,352	15,659	15,005	95.8
Radio, TV, communication	3,683	50,480	—	—	—	—	—
Other	8,355	130,852	—	—	—	—	—
Electronic components	9,964	163,724	—	—	—	—	—
Instruments and related products	8,577	86,399	12,649	124,731	9,861	9,072	92.0
Scientific instruments	3,357	4,661	—	—	—	—	—
Other	5,220	81,738	—	—	—	—	—
All other manufacturing[c]	4,413	76,079	6,109	102,937	16,851	16,476	97.8

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[a] The number of employees and the amount of compensation are estimated by weighting up the sample of 378 companies for which employment data were available. For those firms with cost-of-goods-sold amounts reported, the weight is the ratio of the total cost of goods sold for the industry to the cost of goods sold for the employment sample for the same industry. For firms with no reported cost of goods sold, the weight is the analogous asset ratio.

[b] Tax benefit figures are shown in Table 4-5.

[c] Includes paper; stone, clay, and glass; transportation; and manufacturing industries for which data were available for fewer than three corporations.

benefits but provided 29 percent of the employment of all manufacturing possessions corporations. The next largest percentages of tax benefits were derived by the instruments and related products industries (7 percent of the tax benefits, 14 percent of the manufacturing employment) and the food industry (7 percent of the tax benefits and 9 percent of the employment). The apparel industry derived only 3.1 percent of the tax benefits but contributed 18 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. At the top of the ranking are sixteen 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 therefore derived no immediate tax benefit from section 936. The top sixteen possessions corporations accounted for 24.2 percent of the tax benefits but provided only 3.6 percent of the employment of the 378 manufacturing companies. The top thirty-nine possessions corporations (those for which tax savings per employee equaled or exceeded $50,000 in 1983) collectively accounted for 48.6 percent of the tax benefits and 9.7 percent of employment.

Table 4-8 also presents a breakdown for only those firms eligible for the new tax treatment under TEFRA. For these 292 companies, the top twenty-seven (which had tax savings per employee of at least $50,000) accounted for 33.8 percent of the tax benefits and 8.1 percent of employment.

IV. Summary Data for 1974-1983

Table 4-9 presents data for the period 1974-1983 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 1983. The table reveals a number of trends:

- The number of possessions corporations in manufacturing was 399 in 1974 and 527 in 1983. Throughout the period 1974-83, 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.

- Net income of manufacturing possessions corporations rose from approximately $800 million in 1974 to over $4 billion in 1983. In constant dollars, net income in 1983 amounted to nearly 300 percent of income in 1974. The percentage of total net income earned by the pharmaceutical industry stood at approximately 50 percent through the period 1974 to 1982 but dropped to 45 percent in 1983. The share of the electrical and electronics industry varied between 15 percent and 20 percent in years before 1981. In 1981, it rose to 26 percent, in 1982 it was 22 percent, and in 1983 it was 24 percent.

- The estimated U.S. tax benefits of possessions corporations increased from $400 million in tax year 1974 to about $1.8 billion in tax year 1982, a change in inflation-corrected dollars of 255 percent. In 1983, tax benefits fell somewhat, to about $1.6 billion.

TABLE 4-7

DISTRIBUTION OF TAX BENEFITS AND EMPLOYMENT, BY INDUSTRY, 1983

	Percentage of tax benefits	Percentage of employees
All manufacturing industries	100%	100%
Food and kindred products	6.9	9.1
Textile mill products	0.2	1.1
Apparel	3.1	17.6
Chemicals	49.3	17.2
Pharmaceuticals	46.3	14.8
Other	3.0	2.6
Rubber and plastic products	0.7	1.3
Leather	1.0	5.3
Fabricated metal products	1.3	2.2
Machinery, except electrical	1.1	1.0
Electrical and electronic equipment	23.3	28.7
Instruments and related products	7.0	14.3
Other manufacturing	6.1	2.2

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SOURCE: The amount of tax benefits is from Table 4-5, column 3. The number of employees is from Table 4-6, column 3.

TABLE 4-8

TAX BENEFITS, EMPLOYMENT, AND COMPENSATION OF EMPLOYEES BY SIZE OF TAX BENEFITS PER EMPLOYEE, 1983

	Number of returns	Qualified possession net income [a] ($ thousand)	Tax benefits		Employees	
			Amount ($ thousand)	Percent of total	Number	Percent of total
ALL FIRMS						
All manufacturing corporations	378	4,059,624	1,406,406	100.0	75,966	100.0
$100,000 or more	16	951,128	340,417	24.2	2,319	3.1
$ 50,000 under $100,000	23	967,573	343,204	24.4	5,018	6.6
$ 10,000 under $ 50,000	142	1,673,172	562,671	40.0	25,955	34.2
$ 5,000 under $ 10,000	57	283,731	103,338	4.3	15,511	20.4
$ 1,000 under $ 5,000	91	167,147	55,229	3.9	19,327	25.4
$ 500 under $ 1,000	11	2,983	1,126	*	1,599	2.1
$ 1 under $ 500	13	1,365	421	*	1,206	1.6
No tax benefits	25	12,525	0	0	5,031	6.6
FIRMS ELIGIBLE FOR TEFRA REQUIREMENTS						
All manufacturing corporations	292	2,959,327	1,010,705	100.0	58,877	100.0
$100,000 or more	10	550,004	198,553	19.6	1,354	2.3
$ 50,000 under $100,000	17	688,492	245,305	24.2	3,488	5.9
$ 10,000 under $ 50,000	115	1,364,772	449,380	44.5	21,638	36.8
$ 5,000 under $ 10,000	45	195,452	69,759	6.9	9,979	16.9
$ 1,000 under $ 5,000	71	144,819	46,578	4.6	15,902	27.0
$ 500 under $ 1,000	8	2,226	810	*	1,227	2.1
$ 1 under $ 500	9	1,037	320	*	923	1.6
No tax benefits	17	12,525	0	0	4,366	7.4

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* Less than 0.5 percent

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

- 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 $20,699 per employee in 1982. Benefits per employee fell in 1983 to $18,523.

- The average compensation paid by 936 companies increased from $6,973 in 1974 to $14,836 in 1983. However, tax benefits rose at a faster rate until 1982. Tax benefits grew from 92 percent of compensation in 1974 to 148 percent in 1982, then fell to 125 percent in 1983.

V. Estimates of Linkages

The preceding sections relate the tax benefits of the possessions corporation system of taxation to the employment and payroll of 936 companies. The employment and payroll of 936 companies may overstate the direct benefits of the section 936 provisions for Puerto Rico because some of the workers would have been employed elsewhere, although probably at lower wages. On the other hand, the 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 plants in Puerto Rico creates jobs in the construction industry. Finally, the wages earned by 936-company employees may generate greater consumption expenditures than there would be in the absence of section 936, which would increase the amount of employment in consumer-related industries.

This report makes no attempt to estimate the indirect effects of section 936 because they are very difficult to evaluate. Forward linkages are weak because most 936 products are exported out of Puerto Rico. Backward linkages may exist, especially for services, but the service sector includes some 936 companies (which are counted in direct employment). Backward linkages to manufacturing firms are primarily to 936 companies, where employment is counted in direct employment. Estimating consumer linkages is very speculative in nature because it requires a choice among competing macroeconomic theories. In addition, any program that generates the same direct benefits as 936 in terms of disposable income will result in equivalent consumer linkages. Adding consumer linkages does not, therefore, contribute much to the assessment of the relative efficiency of section 936.

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, forward linkages could occur. 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.

TABLE 4-9

SUMMARY DATA ON POSSESSIONS CORPORATIONS, 1974-1983

	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
Number of corporations, all industries	596	595	528	519	637	672	709	635	620	625
Manufacturing industries	399	394	395	385	460	502	458	497	502	527
Pharmaceuticals	44	47	52	53	58	65	61	56	59	62
Electrical and electronic equipment	76	76	81	80	90	112	116	120	119	134
All other manufacturing	279	271	262	252	312	325	281	321	324	331
Nonmanufacturing industries	197	201	133	134	177	170	251	138	118	98
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	4,543,091	4,287,339
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	4,335,740	4,130,827
Pharmaceuticals	405,355	547,060	779,954	876,576	1,053,252	1,325,309	1,507,001	1,867,684	2,228,390	1,887,903
Electrical and electronic equipment	167,389	195,593	323,249	231,475	417,629	543,195	744,981	1,049,049	895,638	1,007,729
All other manufacturing	240,313	312,407	448,474	606,270	890,565	929,652	909,134	1,183,828	1,211,712	1,235,195
Nonmanufacturing industries	39,002	54,059	75,536	85,992	123,126	290,148	468,645	115,950	208,219	156,512
Estimated tax benefits ($000)										
Manufacturing industries[a]	397,021	478,367	698,839	771,444	998,120	1,167,529	1,326,406	1,711,352	1,772,671	1,640,716
Pharmaceuticals	181,508	245,486	350,941	394,459	438,695	552,020	626,376	791,535	905,996	759,517
Electrical and electronic equipment	75,231	89,106	145,575	104,164	184,501	219,771	326,036	433,059	368,904	381,693
All other manufacturing	140,282	143,819	202,322	272,821	374,924	395,738	373,994	486,758	497,771	499,506
Tax benefits per employee,[b] ($)										
Manufacturing industries	6,310	8,512	11,454	11,217	14,250	15,690	17,297	18,007	20,699	18,523
Pharmaceuticals	38,129	39,031	47,166	39,337	48,669	51,417	57,632	62,078	69,751	57,761
Electrical and electronic equipment	6,237	9,488	10,816	11,315	11,988	15,439	14,169	19,930	14,879	15,005
All other manufacturing	3,479	3,987	5,300	4,432	9,639	8,415	8,943	8,584	10,401	9,957
Tax benefits as a percentage of compensation of employees										
Manufacturing industries[b]	91.7	116.1	143.3	135.9	133.2	135.4	145.2	137.9	148.3	124.8
Pharmaceuticals	425.5	389.1	428.1	327.5	357.3	343.8	368.4	346.0	347.4	264.7
Electrical and electronic equipment	93.5	126.0	129.2	126.6	122.6	138.9	126.1	152.3	108.4	95.8
All other manufacturing	52.7	55.8	72.3	62.2	94.6	77.7	65.5	70.6	84.2	79.0

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[a] 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.

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

The latest year for which detailed census data on the destination of Puerto Rican shipments are available is 1977. Some data are also available for 1982. Table 4-10 shows the percentages of manufacturing industries' shipments in 1977 and 1982 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 in 1982, 18.6 percent of direct shipments went to Puerto Rico, 74.2 percent to buyers (including parent companies) in the United States, and 7.8 percent to foreign purchasers. If indirect shipments outside of Puerto Rico (i.e., goods sold to other Puerto Rican companies which are eventually sold to the United States or foreign countries) could be estimated separately, Puerto Rico's sales to the United States and foreign markets would be larger than in Table 4-10.

Table 4-10 shows that some industries' forward linkages with other sectors of the Puerto Rican economy are stronger than others. The stone, clay, and glass industry sells 80 percent of its limited output to Puerto Rican users. The lumber and wood industry sold all its output to Puerto Rican consumers and industries in 1977, and its primary customers -- the furniture and paper industries -- also sold largely to the local market. By contrast, the chemical industry sold 9.3 percent of total production to Puerto Rico in 1982, and the electrical and electronic equipment industry sold 7.3 percent to Puerto Rico in 1982. These two industries, together with the consumer good industries, apparel, and food products, account for over 80 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. Further, downstream effects would not cause a multiplier effect on employment to the extent that the sales were to 936 companies, because the downstream employment would already be included in the employment and payroll figures of 936 companies discussed above.

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 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 input 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 most of its inputs from locally owned companies. A substantial service sector in Puerto Rico provides banking, transportation, and utilities to

TABLE 4-10

DESTINATION OF SHIPMENTS BY PUERTO RICAN MANUFACTURING INDUSTRIES, 1977 AND 1982

(percentages of known destination totals)

Industry Group	1977			1982		
	Puerto Rico	United States[a]	Foreign Countries	Puerto Rico	United States[a]	Foreign Countries
All Manufacturing Industries	33.4%	59.2%	7.4%	18.6%	74.2%	7.8%
Food and kindred products	55.1	39.2	5.8	48.8	49.5	1.7
Tobacco products	45.3	54.7	*	(D)	(D)	(D)
Textile mill products	27.8	72.2	*	(D)	(D)	(D)
Apparel	18.6	76.3	*	9.3	89.3	1.4
Lumber and wood products	100.0	*	*	(D)	(D)	(D)
Furniture and fixtures	87.1	12.2	*	46.4	50.7	2.9
Paper and allied products	87.6	4.0	8.2	73.0	(D)	(D)
Printing and publishing	53.8	44.4	1.7	(D)	(D)	0.0
Chemicals	9.2	74.2	16.6	4.0	84.3	11.7
Pharmaceuticals	1.6	71.2	27.2	(D)	(D)	(D)
Petroleum refining	68.9	28.7	2.4	(D)	(D)	(D)
Rubber and plastic products	20.0	79.8	0.5	(D)	(D)	(D)
Leather and leather products	2.5	97.2	0.1	(D)	(D)	(D)
Stone, clay, and glass products	83.8	15.3	0.8	80.4	16.5	3.1
Primary metal industries	49.1	34.0	16.9	(D)	(D)	(D)
Fabricated metal products	76.5	20.9	2.5	70.6	20.2	9.2
Machinery, except electrical	27.8	71.7	0.5	1.0	92.9	6.1
Electrical and electronic equipment	7.3	84.8	8.8	(D)	(D)	(D)
Transportation equipment	9.1	84.6	6.2	(D)	90.0	(D)
Instruments and related products	0.4	95.4	4.1	(D)	(D)	(D)
All other manufacturing	3.4	95.2	1.1	5.4	94.5	0.1

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SOURCE: U.S. Department of Commerce, 1977 Economic Censuses of Outlying Areas, Manufactures, Puerto Rico, November 1980, U.S. Department of Commerce, 1982 Economic Censuses of Outlying Areas, Manufactures, Puerto Rico, November 1985.

[a] 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.

(D) Suppressed for disclosure reasons.

all 936 manufacturing firms. Employment in these "supplier" industries is not included in employment figures reported in Table 4-6. Significant questions arise, however, from attempts to measure this backward linkage employment.

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.[6] This employment multiplier is similar to the one used 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.[7]

However, these mechanical applications of Puerto Rican input-output data to 936 employment levels used to estimate indirect employment effects do not give valid results. Input-output tables are based on transactions between establishments, not corporations. Therefore, 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 studies that have attempted to correct for this double-counting do not seem entirely valid because of the limitations of the procedures used.[8]

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[6] Calero, H., Economic Challenges Facing Puerto Rico, Citibank Conference, March 1985.

[7] Zalacain, Fernando, "Los Multiplicadores del Sector Manufacturero 936 en la Economia de Puerto Rico", April 1985.

[8] 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 has calculated new employment multipliers that allegedly do not double count employment. These multipliers appear in Table 4 of a report prepared by Robert Nathan Associates titled "Section 936 and Economic Development in Puerto Rico" (August 1987). Although no supporting data are provided in the report, the statements backing their findings seem unusual. The report claims that 936 firms generate employment in non-936 industries by purchasing non-labor inputs locally. The locally purchased inputs cited (on pp. 37-38) are chemicals, office supplies, packaging materials, and professional services, particularly finance, insurance, and real estate. However, the chemical industry in Puerto Rico is composed almost exclusively of 936 firms, and workers in the chemical industry are already counted under direct employment. In addition, the other three categories represent a very small proportion of the Puerto Rican economy and could not be responsible for the extraordinarily large numbers of workers that the report claims are indirectly affected by section 936. For example, Puerto Rican workers in finance, insurance, and real estate total only

(Continued)

C. Consumption-Related Linkages

To the extent 936 employees' wages exceed alternative earnings, some indirect effect on local consumer-product industries might be associated with section 936. However, attempting to estimate the significance of these consumption linkages is very difficult because it requires choosing among a variety of alternative macro-economic theories. It is similar to the problem of forecasting the impact of a tax cut on GNP. Accordingly, this report focuses on direct benefits, which can be estimated from tax returns and other data, rather than indirect benefits, which are much more a matter of judgment and speculation.

(Continued)
28,000. Puerto Rican workers in paper and allied products (which includes packaging materials) total approximately 40,000, some of which are counted in direct employment. The numbers generated by the Nathan report do not seem realistic in light of these facts.

The methodology used to compute the employment multipliers in the Nathan report is also seriously flawed, leading the report to overstate multipliers substantially. According to correspondence received from Robert Nathan Associates (February 2, 1988), the input-output table was adjusted for double-counting. Each entry in the unadjusted table represents the impact of a given sector i on a given sector j. For example, let sector 1 be chemicals and sector 2 be printing and publishing. Entry (1, 2) would represent how an increase of output in the printing and publishing industry would lead to an increase in the output of the chemical industry, because chemicals are used in the production of printing and publishing products. Suppose the entry equals 0.1. Nathan Associates' consultants recognize that this entry must be adjusted because only a portion of the printing and publishing industry is 936 firms, and the interest lies with the effect of the 936 firms only. Therefore, they state that if the proportion of 936 firms to all firms in the printing and publishing industry is one-half, they would multiply the entry by one-half to come up with an adjusted entry (1,2). However, this adjustment procedure does not correct for the basic source of the double-counting in the multipliers.

The error in their reasoning lies in their failure to recognize that the <u>input</u> industry is also part-936, part-non-936 firms. For example, suppose the chemical industry is 100-percent 936 firms. Then the entry in table should be 0, because there can be no backward linkage into the chemical industry. All the chemical industry's employment would already be counted in the direct employment figures. However, according to their correspondence, Nathan Associates completely disregarded this necessary adjustment. Nathan Associates also apparently adjusted for indirect employment effects resulting from consumption but did not explain how this was done.

A further memorandum from Fernando Zalacain has not entirely clarified matters. It does not specify whether the necessary adjustments were made on the direct requirements matrix, as is necessary, or the inverse. Furthermore, it does not indicate whether the adjustments reflect the special nature of 936 operations. He claims that if the whole manufacturing sector were assumed to be 936, the 936 manufacturing multiplier would only be reduced by 18 percent. First, this is not entirely to the point because some 936 corporations may perform their own warehousing, distribution and transportation services. In addition, most 936 products are not marketed in Puerto Rico and require few local retail or wholesale services. The 18 percent reduction also seems modest when compared with U.S. input-output tables. It is hoped that Treasury and Puerto Rican Government staffs will resolve these problems before the next possessions 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 1973-1983. It is necessary to apportion the income reported on corporate returns filed for corporate tax years which overlap the federal fiscal year. This results in an estimate of $1.619 million in tax benefits under section 936 for calendar year 1983 (and of $1.633 million for fiscal year 1983). As noted previously, the section 936 tax benefits for tax year 1983 are estimated by first subtracting from the qualified income of possessions corporations the additional deductions and credits which these corporations would have enjoyed had they been eligible for the accelerated cost recovery system and the investment tax credit, and then applying the U.S. statutory tax rate to the adjusted qualified income. The revenue estimate is then reduced by the tollgate and income taxes paid to Puerto Rico.

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. The remainder of the income from such intangibles must be allocated to the rest of the U.S. group. 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, many of the 1983 returns did not report income correctly. Furthermore, the new tax forms reflecting the changes in section 936 made by TEFRA were not available until mid-1983. Therefore, many calendar-year taxpayer filed on unrevised tax forms. As a result, the 1983 figures are tentative. This issue will be discussed in detail in the next chapter.

In addition to the rules relating to income from intangibles, TEFRA reduces the amount of passive investment income that a corporation can receive and still 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 was reduced to 45 percent for tax years beginning in 1983, 40 percent for tax years beginning in 1984, and 35 percent for tax years beginning in 1985. The 1986 Tax Reform Act reduced the percentage to 25 percent. 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 revenue effect of the 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

TABLE 4-11

FEDERAL REVENUE COST ESTIMATES,
POSSESSIONS CORPORATION PROVISIONS, 1973-1983
(millions of dollars)

Year	Calendar Year Receipts Foregone[a]	Fiscal Year Receipts Foregone[a]
1973	269	254
1974	393	325
1975	473	429
1976	692	572
1977	763	724
1978	988	864
1979	1,156	1,121
1980	1,233	1,195
1981	1,694	1,463
1982	1,643	1,668
1983	1,619	1,633

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[a] Estimates for 1973 through 1975 are based on the original possessions corporation provisions enacted in the Revenue Act of 1921. Estimates for 1976 to 1982 are based on the section 936 provisions of the Tax Reform Act of 1976. Estimates for 1983 are based on the provision of TEFRA.

Source: The 1973 through 1975 figures are based on book income data taken primarily from 936 election forms filed for 1976 (Form 5712). The 1976 and 1977 estimates are based on net income data taken primarily from Federal income tax forms (Form 1120). The figures for 1978-1983 are based on qualified possession taxable income taken from possessions credit computation forms (Form 5735).

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.[9] For tax reasons, Puerto Rico can be a more attractive location than the United States for plant and equipment and other operating assets. But these advantages 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 was not available, a possessions corporation could still 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 derived foreign-source income, the U.S. tax on that income could be reduced by a credit for foreign income taxes paid.

If a possessions corporation derived 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. For firms taking this course, the repeal of the possessions corporation food products, apparel, and fabricated metal products.[10] In 1983, the combined income of possessions companies in low-technology industries represented only 8 percent of the income of all 936 manufacturing corporations.

2. Financial Assets

In the absence of section 936, a possessions corporation could have still benefited from U.S. tax exemption on income from financial assets in 1983 by incorporating in Puerto Rico and deferring distribution of 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

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[9] "Physical investment" consists of expenditures to buy newly produced capital goods, plants, 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.

[10] 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.

conduct of any of the enumerated trades or businesses). Income from financial assets represented over 15 percent of total 936 income in 1983. The Tax Reform Act of 1986 repealed section 957(c) for tax years starting in 1987, so income from financial assets of a Puerto Rican subsidiary would now be taxed currently under subpart F if section 936 were repealed.

3. Intangible Assets

Income from intangible assets generally refers to income derived from patents, know-how, trademarks, brand names, access to established marketing and distribution channels, and goodwill. Before 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.[11] 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.[12] Although TEFRA has reduced the tax benefits derivable from intangibles, the benefits were still large in the tax year covered by this report. While these benefits may be further reduced somewhat because of the provisions of the Tax Reform Act of 1986, available data suggest that repeal of section 936 could have a substantial tax revenue impact.

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[11] 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 transferor'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.

[12] See Fourth Report, pp. 61-66, 128.

Chapter 5

EFFECTS OF THE TEFRA LEGISLATION

I. Introduction

This report is the first to contain taxpayer data from returns filed after the TEFRA provisions become effective. This chapter explores, as far as possible, the effects TEFRA seemed to have had on 936 companies. For several reasons, primarily concerned with data quality, conclusions are tentative. The main contribution of this chapter is setting up a framework for future reports and speculating on the possible effects TEFRA had.

The General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 called attention to the unduly high revenue loss attributable to allocation of intangible income to possessions corporations (particularly in comparison with average wages paid in Puerto Rico) before the passage of TEFRA. This chapter takes a first look at the effectiveness of the TEFRA provisions in reducing the revenue loss relative to wages paid.

This chapter contains several frequency tables, which break down firms by method of filing (cost-share or profit-split) and evaluate the change in the tax-benefit to compensation ratio across industries and across methods. Companies with manufacturing intangibles (such as firms selling ethical pharmaceuticals, electrical and electronic equipment, and instruments) tend to select the cost-share method. Those with marketing intangibles such as trade names (for example, firms in the food and beverage industry and in the over-the-counter drug industry) adopt the profit-split method. All firms using a specified method experienced a drop in the tax-benefit to compensation ratio. Although the level of the ratio was much greater for profit-split firms both before and after TEFRA, the percentage fall in the ratio was also much greater, being 33.3 percent for profit-split firms and 12.5 percent for cost-share firms.

The relatively greater effect of the legislation on profit-split firms also shows up in the tax credits per worker ratio, which falls by nearly a quarter for profit-split firms but rises for cost-share firms. The annual growth in income (other than QPSII) per company from 1974 to 1982 was approximately 19.8 percent. (Note that this figure does not correct for changes in firm size.) Income fell by about 10 percent from 1982 to 1983. The concomitant fall in tax credits may therefore be partly attributable to the TEFRA changes.

II. The Data

Taxpayers were required to follow TEFRA rules for allocating the income of possessions corporations if their tax year began on or after January 1, 1983.[1] Because this sample contains 122 firms with tax years ending after June 30, 1983 and before December 31, 1983, only the remaining 405 firms were eligible for the TEFRA treatment.

Although Table 5-1 shows that 77 percent of 1983 firms qualified for TEFRA rules, an inspection of the returns as filed leads to the impression that only about half of those eligible actually appeared to comply with the new law.[2] This may have happened partly because the 1983 tax forms were issued late in 1984, so many companies originally filed on out-of-date forms. Furthermore, the TEFRA provisions are complicated, and not all taxpayers may have understood the provisions in the first year after enactment.

A. Frequencies By Method of Filing

Table 5-1 reports the breakdown of all 1983 firms by type of method used in filing the tax return. It also presents data on a sample of 456 firms for which information from both 1982 and 1983 tax years was available ("matched 1982-1983 firms"). Of the 527 total firms, 77 percent were eligible for the TEFRA rules; these firms accounted for 73 percent of assets. Of the 405 eligible firms, 42 percent used the cost-share method, 13 percent used the profit-split method, and 45 percent did not clarify which method was used.[3] The respective percentages by assets are 37, 20, and 16. The percentages were similar for the matched firms.

B. Frequencies by Industry

Tables 5-2 and 5-3 present industry breakdowns by type of method used. The percentages in Table 5-2 are to be read across rows, so that the proportion of a particular industry using, for instance, the cost-share method can be deduced. For example, 34 percent of pharmaceutical companies used the cost-share method; these companies held 44 percent of the assets in this industry. The percentages in Table 5-3 are read down columns, so that the

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1 Some taxpayers seemed to have rearranged their filing years, filing part-year returns with accounting periods January 1, 1982, to December 30, 1982 and full-year returns with accounting periods December 31, 1982, to December 30, 1983.

2 Note that a 936 company is eligible for an exemption from the TEFRA rules by statute with respect to intangible property that has been licensed to it since 1948 (Code section 936(h)(3)(A)).

3 Some taxpayers used different methods for different products. A total of 26 firms used both profit-split and cost-share methods in 1983, and 24 "matched" firms used both methods in 1983. Approximately 42 percent of income was attributable to cost-share products. Therefore, the figures for the 170 total "cost-share" firms represent an imputation: 159 firms that used only the cost-share method, plus 42 percent of the twenty-six firms (approximately eleven firms) that used both methods.

TABLE 5-1

FREQUENCIES BY METHOD OF FILING

	Number	Percentage of total	Percentage of eligible	Assets ($ billion)	Percentage of total	Percentage of eligible
ALL 1983 FIRMS						
Total	527	100%		$17.3	100%	
Eligible	405	77%	100%	$12.6	73%	100%
Cost-share method	170	32	42	6.4	37	51
Profit-split method	53	10	13	3.4	20	27
Unknown	182	35	45	2.8	16	22
Ineligible	122	23%		4.8	27%	
MATCHED 1982-1983 FIRMS						
Total	456	100%		$16.0	100%	
Eligible	348	76%	100%	11.7	73%	100%
Cost-share method	149	33	43	6.1	38	52
Profit-split method	45	10	13	3.3	21	28
Unknown	154	34	44	2.3	14	20
Ineligible	108	24%		4.4	27%	

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proportion of firms using a particular method that is represented by a given industry is shown. For example. 9 percent of cost-share firms by number and 36 percent by asset were in the pharmaceutical industry.

As mentioned previously, one would expect industries with substantial marketing intangibles to use the profit-split method, because this method allows the possessions corporations to obtain part of the return on the intangibles while the cost-share method does not. Industries with large manufacturing intangibles would be expected to choose the cost-share method because the entire return from such intangibles can be allocated to the possessions corporation under this method.

Table 5-2 shows that the food (including beverages) industry tended toward the profit-split method, with profit-split users accounting for 44 percent of the assets in the industry. The marketing intangibles associated with food and beverage products make the profit-split method a logical choice. Firms manufacturing instruments and electrical and electronic equipment tend to use the cost-share method, with cost-share users accounting for 76 and 70 percent, respectively, of attributable assets in those industries. Both industries have substantial manufacturing intangibles, so their choice of the cost-share method is not surprising. Chemical firms, including pharmaceuticals, were about evenly split between profit-split and cost-share products. Again, this is not surprising. The pharmaceutical industry produces both prescription drugs, which would tend to be cost-share products because they have substantial manufacturing intangibles, and over-the-counter drugs, which would tend to be profit-split products because they have marketing intangibles. The apparel industry had more than half its assets ineligible for TEFRA, while the apparel, fabricated metal, and food industries had substantial amounts of business that apparently did not file under a TEFRA method. (The chemical and instruments industries had a higher fraction of companies that appeared to comply with the TEFRA changes, perhaps because the size of the firm is larger and such industries tend to have more sophisticated tax departments.)

Table 5-3 shows that the chemical industry accounted for 46 percent of manufacturing assets and 70 percent of assets attributable to profit-split products. The electrical and electronic industry accounted for 21 percent of manufacturing assets and 37 percent of assets attributable to cost-share products.

C. Tax Benefit and Employment Information, By Method

Table 5-4 presents a breakdown by method of filing for the manufacturing firms for which it was possible to match 1982 and 1983 data. It reports possessions tax credits, credits per possessions corporation worker, estimated tax benefits, estimated compensation, and the ratio of benefits to compensation for each method.

Total credits fell by 27.9 percent for profit-split firms and 31.4 percent for firms which did not report a filing method. In contrast, credits rose by 6.9 percent for cost-share firms and 12.7 percent for firms ineligible for TEFRA treatment in 1983. In

TABLE 5-2
FREQUENCIES BY METHOD OF FILING, BY INDUSTRY, ALL 1983 FIRMS
($ million)

	Total		Percentages of total								Percentages of eligible											
			Ineligible				Eligible				Cost-Share				Profit-Split				Unknown			
	No.	Assets	No.	%	Assets	%	No.	%	Assets	%	No.	%	Assets	%	No.	%	Assets	%	No.	%	Assets	%
All manufacturing	527	$17,320	122	23%	$4,758	27%	405	77%	$12,563	72%	169	42%	$6,353	51%	54	13%	$3,397	27%	182	45%	2,814	22%
Food and kindred products	24	1,240	3	13	280	23	21	87	960	77	5	24	154	16	4	19	425	44	12	57	382	40
Apparel	82	579	29	35	303	52	53	65	276	48	10	19	54	20	0	0	0	0	43	81	222	80
Chemicals	99	7,977	25	25	2,215	28	74	75	5,762	72	23	31	2,495	43	27	36	2,393	42	24	32	875	15
Pharmaceuticals	62	7,387	18	45	2,187	30	44	55	5,200	70	15	34	2,308	44	18	41	2,212	43	11	25	680	13
Fabricated metal products	29	310	10	34	116	37	19	66	194	63	5	26	70	36	0	0	0	0	14	74	124	64
Electrical and electronic equipment	134	3,669	20	15	330	9	114	85	3,339	91	75	66	2,351	70	8	7	335	10	31	27	653	20
Instruments and related products	42	1,047	11	26	165	16	31	74	882	84	17	55	672	76	6	19	159	18	8	26	50	6
Other	117	2,498	24	21	1,348	54	93	79	1,150	46	34	37	557	49	9	10	85	7	50	54	508	44

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NOTE: Percentages should be read across rows. For example, the percentage of ineligible firms (by number) plus the percentage of eligible firms (by number) for each row sum to 100 percent. In addition, the sum of the percentage of cost-share firms (by number) the percentage of profit-split firms (by number), and the percentage of unknown firms (by number) equals 100 percent for each row. The same relationship applies to the asset percentages. "Eligible" firms are ones with taxable years such that the TEFRA change apply to them.

As an example, 55 percent of pharmaceutical companies were eligible to file under the TEFRA rules; 70 percent of assets in pharmaceutical firms belonged to eligible companies. Of the eligible pharmaceutical firms, 34 percent used the cost-share method, 41 percent the profit-split method, and 25 percent used unknown methods. The assets attributable to each method were 44 percent, 43 percent, and 13 percent.

these same categories, credits per worker fell 23.5 percent, fell 20.4 percent, rose 6.1 percent, and rose 19.3 percent, respectively. Note that the comparison across years does not necessarily indicate an effect from TEFRA. The relevant comparison would be credits (or credits per worker) under TEFRA and in the absence of TEFRA. The latter is clearly unobservable. However, provided that income continued growing as it did from 1974 to 1982, credits would have increased in the absence of TEFRA. Therefore, at least the profit-split and unknown-method firms appeared to have been affected by TEFRA. Tax benefits for each eligible category fell (most markedly in the profit-split and unknown companies), while they rose for ineligible firms.

Table 5-4 indicates that the ratio of tax benefits to compensation decreased from 137 percent to 101 percent in companies required to use the TEFRA provisions. In contrast, tax benefits in relation to compensation increased sharply in companies not eligible for the TEFRA rules.

D. Tax Benefit and Employment Information, By Industry

Table 5-5 breaks down matched firms by industry and reports possessions tax credits, credits per worker, estimated tax benefits, estimated compensation, and the ratio of benefits to compensation. Table 5-6 presents tax credits and tax benefits for firms that were eligible for TEFRA treatment in 1983 and were matched to 1982 tax records.

Total credits fell 6.9 percent for all firms and by 12.1 percent for eligible firms. The aggregate numbers mask industry differences, however. The chemical industry took 12.5 percent fewer credits in 1983 for all firms and 25.5 percent fewer for eligible firms. The electrical and electronic industry had 4.6 percent more credits for all firms and 4.1 percent more for eligible firms. In the instruments industry, total credits rose by 4.3 percent for all firms and 2.8 percent for those eligible.

In general, tax benefits fell in all major industry categories. Particularly notable is the 28.2 percent fall in tax benefits in the chemical industry's eligible companies. In the electrical and electronics industry, tax benefits fell 9.1 percent, and in instruments they decreased by 7.8 percent. Table 5-4 indicates that for the companies with matched 1982 and 1983 returns the ratio of tax benefits to compensation declined from 137 percent to 101 percent in eligible firms as a whole while it increased sharply for companies not using the TEFRA rules.

III. Analysis

The information to be obtained from these data is sketchy at best. A few observations may nevertheless be made. From Table 4-9, we can deduce that reported income per firm in manufacturing industries rose from $2,037,700 in 1974 to $8,637,000 in 1982, then fell to $7,838,000 in 1983. The annual average growth rate from 1974 to 1982 was 19.8 percent and from 1982 to 1983 was -10.2 percent. If nothing had changed between 1982 and 1983 or if the

TABLE 5-3

PERCENTAGES BY INDUSTRY FOR EACH FILING CATEGORY
ALL 1983 FIRMS

	Total		Ineligible		Eligible		Cost-share		Profit-split		Unknown	
	Number	Assets	Number	Assets	Number	Assets	Number	Assets	Number	Assets	Number	Assets
All manufacturing	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Food and kindred products	5	7	2	6	5	8	3	2	7	13	7	14
Apparel	16	3	24	6	13	2	6	1	0	0	24	8
Chemicals	19	46	20	47	18	46	14	39	50	70	13	31
Pharmaceuticals	12	43	15	46	11	41	9	36	33	65	6	24
Fabricated metal products	6	2	8	2	5	2	3	1	0	0	8	4
Electrical and electronic equipment	25	21	16	7	28	27	44	37	15	10	17	23
Instruments and related products	8	6	9	3	8	7	10	11	11	5	4	2
Other	22	14	20	28	23	9	20	9	17	11	27	18

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NOTE: Percentages should be read down columns. For example, 19 percent of all manufacturing firms were in chemicals but 46 percent of all manufacturing assets were owned by chemical firms. Furthermore, although 19 percent (by number) of all firms were chemical, 50 percent (by number) of profit-split firms were chemical. The percentages by asset are 46 for all firms and 70 for profit-split firms. "Eligible" firms are ones with taxable years such that the TEFRA changes apply to them.

TABLE 5-4

TAX BENEFIT AND EMPLOYMENT INFORMATION FOR MATCHED FIRMS, BY METHOD

	Number	Tax credits ($ million)		Estimated tax credits per worker		Tax benefits ($ million)		Estimated compensation ($ million)		Estimated benefit/ compensation (%)	
		1982	1983	1982	1983	1982	1983	1982	1983	1982	1983
All manufacturing	456	1,879	1,758	22,308	21,914	1,717	1,505	1,172	1,214	147	125
Eligible	348	1,455	1,279	20,767	20,997	1,329	1,086	968	1,070	137	101
Cost-share	149	698	746	21,244	22,549	642	631	502	563	128	112
Profit-split	45	438	316	45,150	34,558	398	265	179	179	222	148
Unknown	154	318	218	14,651	11,667	290	190	287	328	101	58
Ineligible	108	424	478	21,481	24,755	387	418	204	144	190	290

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TABLE 5-5

TAX BENEFIT AND EMPLOYMENT INFORMATION FOR MATCHED FIRMS, BY INDUSTRY

		Tax credits ($ million)		Estimated tax credits per worker		Estimated tax benefits ($ million)		Estimated compensation ($ million)		Estimated benefit/ compensation (%)	
	Number	1982	1983	1982	1983	1982	1983	1982	1983	1982	1983
All manufacturing	456	1,879	1,758	22,380	21,914	1,717	1,505	1,172	1,214	147	124
Food and kindred products	18	85	80	15,110	10,908	78	69	72	63	108	110
Apparel	75	41	54	2,584	3,815	38	49	144	140	26	35
Chemicals	85	991	867	65,514	62,872	892	748	309	305	289	245
Pharmaceuticals	53	930	818	72,874	68,693	840	706	255	273	329	259
Fabricated metal products	27	22	23	10,078	12,921	19	20	30	29	63	70
Electrical and electronic equipment	118	410	429	16,839	18,621	357	345	334	343	107	100
Instruments and related products	35	117	122	16,994	10,649	106	105	94	115	113	91
Other	98	213	183	15,275	21,110	227	169	189	219	120	77

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TABLE 5-6

TAX BENEFIT INFORMATION FOR MATCHED ELIGIBLE FIRMS, BY INDUSTRY

	Number	Tax credits ($ million)		Tax Benefits ($ million)		% Change in Tax Benefits
		1982	1983	1982	1983	1982 to 1983
All manufacturing	348	1,455	1,279	1,329	1,086	-18.3
Food and kindred products	17	81	80	74	69	- 6.8
Apparel	47	19	26	17	24	41.1
Chemicals	63	737	549	662	475	-28.2
Pharmaceuticals	35	677	500	611	434	-28.9
Fabricated metal products	18	111	13	9	11	22.2
Electrical and electronic equipment	101	388	404	359	326	- 9.1
Instruments and related products	25	108	111	103	95	-7.8
Other	77	111	96	105	86	-18.1

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time trend of rising income had stayed constant absent TEFRA, these figures would indicate that the TEFRA legislation substantially reduced the amount of income that possessions corporations could effectively exempt from U.S. tax.

The reported income and credit figures thus would seem to indicate that TEFRA had a substantial effect on the amount of income possessions corporations may effectively exempt from U.S. tax. Several caveats must be made, however. A recession occurred in 1982, which might have contributed to a downturn in income. Investment income (such as QPSII) fell partly because interest rates fell. Changes in firm composition could also have affected the aggregates in absence of legislative change. A change in the number of workers or their productivity could certainly have affected total credits, and the credit-per-worker numbers reported in the last section reflect different percentage changes (even, in some cases, different signs) than the credit numbers.

In spite of these caveats, some information may be extracted from Tables 5-1 to 5-6. Net income grew every year from 1974 to 1982, even though business cycles may have caused the growth rate to vary from year to year. Net income undeniably fell in 1983. Credits certainly fell more for eligible firms than for firms overall (although credits per worker did not change much for either group). Credits, benefits, and the benefit/compensation ratio all fell for eligible firms and rose for ineligible firms. Profit-split firms seem to have been substantially more affected by the legislation than cost-share firms, although profit-split firms continued to have a greater ratio of tax benefits to employee compensation. Finally, certain industries (such as chemicals) which used the profit-split method tended to have relatively large reductions in tax benefits.

This analysis is not comprehensive, principally because the data do not stand up to much empirical testing. In the future, a more reliable dataset may become available, and a more rigorous analysis isolating the effects of the TEFRA legislation may be possible. Only the most tentative statements about these data can be made at this time: that TEFRA appears to have reduced the amount of income possessions corporations may effectively exempt from tax, with profit-split firms relatively more affected.

CHAPTER 6

THE IMPACT OF 936 FINANCIAL ASSETS ON PUERTO RICAN INVESTMENT - 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 6-1 presents the financial portfolios of all 936 corporations in Puerto Rico at the end of 1986. Although the growth has been moderate in recent years (i.e., from a total of $10.6 billion at the end of 1983 to $14.7 billion at the end of 1986), the size of these financial investments is nevertheless enormous for an economy the size of Puerto Rico's. They amount to more than $4,000 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 changes in the Puerto Rican regulations governing the use of 936 funds since the beginning of 1984. It also summarizes the provisions of the Tax Reform Act of 1986 which apply to financial investments by 936 corporations. It then attempts to evaluate the impact of the financial investments by 936 corporations in Puerto Rico by looking at three ways in which this impact would be visible. One is through an increased net inflow of capital into Puerto Rico. Another way of tracing the role of 936 funds is noting their relationship with the level of real investment in Puerto Rico. 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.

II. Recent Regulatory and Statutory Changes

To ensure 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 assets the acquisition of which constitutes "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 held by financial institutions, and how the matching is implemented. For example, they give the base period for the calculation of incremental eligible assets and incremental eligible 936 funds. This section reviews regulatory developments from the end of 1983 through the end of 1986.

TABLE 6-1

ESTIMATED COMPOSITION OF THE FINANCIAL INVESTMENTS OF POSSESSIONS CORPORATIONS AT YEAR-END 1986[a]

Financial investments	$ billion
Total	15.2[b]
Investments in Puerto Rico, total	14.7[b]
Deposits in Puerto Rican banks, including repurchase agreements	8.8[c]
Repurchase-Resale agreements not included in banks funds	.8
Puerto Rican source GNMA mortgages	2.2
Loans to other possessions corporations	.5[b]
Puerto Rican government obligations	.5[b]
Mortgage and real estate loans	1.5[b]
Other investments in Puerto Rico	.4[b]
Investments outside of Puerto Rico, including U.S. municipals and preferred stock of U.S. corporations	.5[b]

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[a] 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.

[b] Denotes approximation.

[c] This includes about $1.6 billion in savings banks, mostly obtained indirectly through brokers.

A. The April 17, 1984 Regulations

The Puerto Rican regulatory system governing the use of 936 funds was basically unchanged from the time of implementation of the April 17, 1984, regulations until March 1, 1988 when Regulation 3582 was issued. By far the most important change brought about by the April 17, 1984, regulations is 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 required amount of eligible activity is just equal to 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:

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 (or "tablita") 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.

B. The Tax Reform Act of 1986

As indicated in Chapter 2, the Tax Reform Act of 1986 made two changes in rules that apply to qualified possession source investment income. One change increased the share of a 936 corporation's gross income that has to be derived from the active conduct of a trade or business in a possession from 65 to 75 percent. (A three-year moving average continues to be used to evaluate the percentage.) Accordingly, 936 corporations will be required to limit their qualified possession source investment income to less than 25 percent of their gross income.

Section 936(d) provides that qualified possession source investment income must be "attributable to the investment in such possession (for use therein) of funds derived from the active conduct of a trade or business in such possession, or from such investment." The Tax Reform Act of 1986 extended the "for use therein" requirement to include investment through a Puerto Rican financial institution in a qualified Caribbean Basin country.

Caribbean Basin countries can qualify as eligible sites for such investments by entering into a tax information exchange agreement with the United States. The investment by the Puerto Rican financial institution in the qualified Caribbean Basin country must finance either active business assets or development projects in accordance with specific authorization granted by the Puerto Rican Government.[1]

At the time of the Tax Reform Act of 1986, only Barbados was a qualifying Caribbean Basin country. Since that time, Jamaica, Grenada, and St. Lucia have also entered into tax information exchange agreements that qualify them as eligible sites for such investments.

The Conference Committee Report to the 1986 Act noted the conferees' expectation that the Government of Puerto Rico would make a good faith effort to carry out the twin plant initiative outlined in a draft Memorandum of Agreement between the Government of Puerto Rico and the Government of the United States dated November 14, 1985.[2] That Agreement described Puerto Rico's goal of generating $100 million of new private direct investment annually in Caribbean Basin countries. These funds were anticipated to be derived, without additional cost to the United States Treasury, from a variety of sources, including possessions corporations (in exchange for future Puerto Rican tax concessions), funds of the Government Development Bank for Puerto Rico, and grants by the Government of Puerto Rico.

C. Brief Summary of Regulation 3582

Puerto Rican Regulation 3582 became effective on March 1, 1988 and replaced the regulation enacted in April 1984.

One of the major changes made by regulation 3582 was to penalize banks who used a large portion of their non-936 Puerto Rican deposits to invest in offshore assets. The Puerto Rican government recognized that the QPSII provisions do not fulfill their goals if the availability of 936 funds simply frees Puerto Rican banks to use their "normal" sources of funds to invest outside of Puerto Rico. Accordingly, if a financial institution's ratio of Puerto Rican (noneligible) assets (such as consumer loans) to local non-936 funds is less than 80 percent, additional eligible activity has to be generated per dollar of eligible 936 funds. The penalty starts at 10 percent and increases up to a maximum of 25 percent for banks with a Puerto Rican asset/liability ratio of less than 60 percent. These additional requirements are over and above the "tablita" first introduced in 1984 and slightly revised in regulation 3582.

Regulation 3582 also changed the percentage of eligible funds that financial institution had to invest in Puerto Rican government obligations. Under the new regulations, 15 percent of eligible assets have to be in deposits with the Government Development Bank or in Puerto

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1 The Tax Reform of 1986 required such authorization to come from the Government Development Bank for Puerto Rico. The Technical and Miscellaneous Revenue Act of 1988 substitutes the Commissioner of Financial Institutions of Puerto Rico as the authorizing agency.

2 H. Report 99-841, Vol. II, p. 634

Rican government obligations not exempt under section 103 of the U.S. Internal Revenue Code. A further 1-2 percent must be loaned to the new Economic Development Bank. In addition, at least 7 percent of eligible assets must be invested in specified types of eligible assets including loans to finance projects in a qualified Caribbean Basin country, loans to rehabilitate low and middle income housing and loans to tourism hotels.

Finally, 3582 provides incentives for CBI loans. For example, a financial institution can reduce its required eligible activities by 25 percent of the principal amount of loans for active business assets or development projects in a qualified Caribbean Basin country.

III. Net Capital Inflows Into Puerto Rico and 936 Funds

One indication of the success of 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 first to cause the large pool of funds that had been invested in the Eurodollar market under section 931 to flow back into Puerto Rico. In addition, 936 corporation would have the incentive to reinvest their earnings in Puerto Rico. 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 6-2 gives an overview of the net contribution of capital inflows, including the accumulation of 936 funds, to the financing of real investment in Puerto Rico. The change in available 936 funds is reflected in the first row of the table, which gives changes in assets in Puerto Rico of corporations controlled outside Puerto Rico. These assets include operating assets such as plant and equipment as well as financial investment, but most of the substantial variations in direct investments are attributable to changes in the accumulation and repatriation of 936 funds. (Balance sheet data in past reports, of the type presented in Table 6-1 in this report, indicate that the year to year changes in gross depreciable assets and inventories held by 936 corporation are relatively modest and are usually on the order of $100 million per year.) The bottom row of Table 6-2 is the overall level of net inflows into Puerto Rico, i.e., the sum of all positive and negative contributions. In the eight years from 1974 through 1981, the level of net capital inflows in Puerto Rico was very stable, ranging from $1.3 billion to $1.9 billion per year. In addition, this stable level of net flows seems to have been unrelated to the large swings in foreign direct investment that reflected the variations in the inflow and accumulation of 936 funds. In 1982 and 1983, net inflows declined to very low levels. This paralleled the sharp decline of private real investment in Puerto Rico (given in Table 6-3) and the large liquidation of inventories in particular. Direct investment inflows decreased very sharply

TABLE 6-2

COMPONENTS OF THE PUERTO RICO CAPITAL ACCOUNT, 1974-1986
($ million)

[(+) 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	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Direct investment in Puerto Rico - change change in the assets of corporations (mainly 936's) controlled offshore	735	625	1,483	1,698	1,702	1,164	2,048	2,215	577	1,306	1,001	4,050	1,011
Net short-term banking flows	39	306	59	-544	-211	-337	-694	-1,362	-655	-871	1,586	-2,249	-36
Foreign holdings of bank debts	64	474	-12	-87	-15	330	-108	-355	172	-338	396	275	69
Investment by Puerto Rican banks abroad	-25	-168	70	-457	-197	-667	-586	-1,007	-827	-533	1,190	-2,524	-105
Net foreign investment in long-term Puerto Rican Government obligations	590	900	184	352	-156	690	423	166	462	949	478	-93	320
Puerto Rican investment in U.S. Government securities	113	13	-29	-310	124	-132	-190	13	-114	-260	-423	-458	-67
Other investments of public pension funds	-1	8	1	-4	-19	-32	-63	-38	33	-17	-82	10	-88
Net foreign investment in short-term debts of Puerto Rican public corporations	15	153	-37	111	-13	-5	141	-14	67	-17	103	11	-198
Short-term investment abroad by Puerto Rican government corporations	-21	-88	-25	-48	-249	-322	-255	395	-425	-730	-610	316	-52
Miscellaneous short term investment abroad by the Puerto Rican private sector	-54	-93	4	19	17	54	-2	-29	-39	-9	-530	164	233
Federal loans to Puerto Rico farm sector	29	35	47	71	134	172	143	133	146	94	47	120	64
Drafts on Puerto Rican importers held for collection	54	-40	21	-46	49	24	5	-23	-7	52	3	93	105
All other	-87	109	-55	53	121	33	-193	137	83	121	238	23	45
Total: Net	1,412	1,900	1,653	1,352	1,499	1,309	1,583	1,593	128	618	1,811	1,987	1,337

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

TABLE 6-3

ANNUAL GROSS DOMESTIC INVESTMENT IN PUERTO RICO, 1973-1988
($ million)

	Current Dollars						1954 Dollars
		Private					
Fiscal year (Ending June 30)	Total	Total private	Change in inventories	Residential and Nonresidential Construction	Machinery and equipment	Government and public enterprises	Gross Private Fixed Investment
1973	1,793	1,226	192	599	435	567	563
1974	1,799	1,138	104	659	375	661	305
1975	2,218	1,183	139	646	398	1,035	436
1976	1,974	1,196	138	576	482	778	433
1977	1,499	873	-61	442	492	626	375
1978	1,870	1,255	125	561	569	615	415
1979	2,063	1,318	176	531	611	745	390
1980	2,458	1,569	407	505	657	889	363
1981	2,265	1,312	126	515	671	953	330
1982	1,246	416	-542	483	475	830	250
1983	1,429	759	-230	432	557	670	256
1984	2,392	1,595	417	527	651	797	292
1985	2,296	1,435	37	549	849	861	352
1986	2,012	1,279	-308	564	1,023	733	401
1987	2,914	1,895	-2	737	1,160	1,019	457
1988p	3,677	2,303	50	908	1,345	1,374	523

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SOURCE: Economic Report of the Governor of Puerto Rico, 1986, Puerto Rican Planning Board.

in 1982 as well, which is consistent with modest increase in 936 funds in 1982 indicated in the Fifth Report. This parallel movement of 936 funds and net capital inflows in a recession suggests that real investment demand in Puerto Rico can influence the flows of 936 funds. Whether the causation also runs in the opposite direction, from 936 funds to real investment, remains an open question.

In the three years from 1984 through 1986, net capital inflows returned to the levels of the 1972-1981 period. Again this tracked the recovery in Puerto Rican investment that is evident from Table 6-3. Furthermore, the pattern visible in previous years was again apparent in that the level of net capital inflows was largely unrelated to the changes in direct investment by 936 companies, which reflect changes in 936 funds. For example, the very large growth of direct investment of more than $4.0 billion in fiscal 1985 compared to 1984 is barely visible in the change in net inflows. The various other components of the capital account tended to offset the changes in 936 funds. For example, the large increase in the assets of 936 corporations in 1985 was largely offset by a $2.2 billion dollar outflow of short term funds through the Puerto Rican banking system. The large outflow of funds in the form of short-term investments offshore by Puerto Rican government corporations continued in 1984 although there was a modest reduction in holdings in 1985. In addition, in the three years from 1983 through 1985 the Puerto Rican government corporations acquired almost $1.0 billion of U.S. government long-term securities. (This was a period in which the Puerto Rican government was raising substantial funds offshore.) At the end of June 1986, Puerto Rican public corporations held $2.2 billion of short term assets offshore and $1.8 billion of long-term U.S. government securities. (This number does not include holdings of public employee pension funds.) In addition, the private Puerto Rican banks held offshore bank deposits and short-term U.S. government securities of $5.4 billion. This compares with a total amount of 936 funds in banks of $8.8 billion.

One development since 1983 is that short term holdings offshore, including the United States, by the Puerto Rican nonbanking private sector have made a larger contribution to changes in overall inflows and outflows. Table 6-2 indicates that short term (non U.S. Treasury) investments offshore by the private sector increased by more than $500 million dollars in 1984 and then most of these funds flowed back in 1985 and 1986.

While it is very difficult to make precise estimates of the impact of 936 funds on real investment in Puerto Rico, the basic investment data in Table 6-3 shed some light on the issue. They indicate that from 1980 to 1986 private investment in nominal terms was, at best, only slightly above the level in the early 1970's before the enactment of the present QPSII provision in section 936. The right hand column of Table 6-3 indicates that private real fixed investment in 1983-86 averaged only 70 percent of the investment in 1973-5. Prior to 1976 passive investments by possessions corporations could be held offshore. The very large accumulation of 936 funds in the Puerto Rican financial institutions began as a result of the 1976 legislation. In spite of the fact that no 936 funds were available, a much higher level of real private investment was financed in the early 1970's than in the first ten years after the enactment of the QPSII provision. The fact that most of the fluctuations of total private investment since 1976 have been attributable to cyclical changes in inventories also suggests that the availability of 936 funds has not had a major impact on Puerto Rican growth.

In 1987 and 1988, real private fixed investment increased strongly, but it is difficult to attribute this to the QPSII provision. Much of this growth in private investment may have been by the 936 corporations themselves, not the users of 936 funds. One reason for doubting that the strong recent growth in investment is due to 936 funds is that the Tax Reform Act of 1986 limited QPSII benefits. In addition, as indicated in the next section, the discount of the interest rate on 936 funds from Eurodollars has been smaller recently then in other periods in the 1980's. Furthermore, there was virtually no growth in total available 936 funds in 1986 and 1987. It is therefore unlikely that the QPSII provisions could have had a very stimulating effect in 1987 and 1988.

IV. Eligible Assets and the Interest Rate on 936 Funds

The April 17, 1984, regulations promulgated by the Puerto Rican Treasury were intended to drive down the interest rate on 936 funds compared to world rates by linking the level of eligible assets required to be held by financial institutions to the interest rate paid to 936 corporations. As shown in the "tablita" in section 6-1, a substantial penalty in terms of the requirement of additional eligible activity has to be paid if interest rates are 65 percent or more of the comparable Eurodollar rates. These additional requirements for eligible assets make it difficult for banks and brokers to bid for 936 funds as interest rates on 936 funds rise.

Table 6-4 presents data on the 936 funds and eligible assets in all commercial and savings banks from January 1984 to June 1987. Column three of Table 6-4 gives the amount of additional eligible assets required because of the penalties imposed by the April 17, 1984, regulations. Table 6-5 gives the interest rate paid on 936 funds compared to Eurodollars.

Table 6-5 indicates that the April 1984 regulations had the immediate impact of driving down the rate on 936 funds, from about 85 percent of Eurodollars to about 70 percent. However, as in previous episodes in which regulations were tightened, such as the April 1980 and February 1982 changes described in earlier reports, the effect was only temporary. After averaging about 75 percent of the Eurodollar rate in 1985, the 936 rate rose to an average of about 84 percent of Eurodollars in 1986, or where it had been in March 1984 before the April 1984 regulations. The rate on 936 funds then averaged 81.9 percent of the Eurodollar rate in the first 6 months of 1987. At these differentials the cost of capital in Puerto Rico could be 1.0 to 1.5 percentage points below world rates.

Table 6-4 indicates that 936 funds in banks grew at the rate of about $1.5 billion per year through 1984 and 1985. At the same time, eligible assets in banks continued to grow at the rate of about $2.0 billion per year in calendar 1984 and 1985. (This was equal to almost 100 percent of the level of aggregate public and private, residential and non residential gross investment annually in Puerto Rico in 1984 and 1985. This is somewhat surprising because nonbank financial investments by 936 corporations are not included in the total and other sources of funds such as depreciation allowances are presumably also available to finance new gross investment. The aggregate investment data also includes investment of the 936 corporations themselves, presumably not requiring financing by Puerto

Rican banks. The growth of eligible assets in 1984 and 1985 therefore suggests that the regulations were not very effective in restricting the use of 936 funds.) Accordingly, eligible activities increased by about $1.0 billion relative to 936 funds from the beginning of 1984 to the end of 1985.

There were apparently large repatriations of 936 funds at the end of 1985 and again at the end of 1986. Furthermore, the rate of accumulation of funds during calendar 1986 seems to have declined. As a result, the level of 936 funds in banks in June 1987 was about the same level as June 1986, and was only about $0.5 billion above the level in June 1985. Eligible activities grew by about $1.0 billion in 1986. While this rate of growth was less than in previous years, the fact that 936 funds were virtually flat in 1986 meant that the gap between eligible activities and funds continued to widen. In the first half of 1987 both 936 funds and eligible activities were virtually unchanged from the end of 1986.

The rapid growth of eligible assets relative to 936 funds in 1984, 1985, and 1986 made it possible for banks to offer high interest rates on 936 funds in spite of the additional investment in eligible assets required as a result of the penalty provisions of the April 1984 regulation. The growth in these additional asset requirements is clear in column three of Table 6-4. The amount of excess eligible assets, given in the last column of Table 6-4, has been relatively stable and usually fluctuates in a range of between $700 million and $1,200 million. Most of these excess eligible assets are in the smaller local commercial banks and savings banks. For example, the federal savings banks accounted for $804 million of the aggregate of $1,074 million of excess eligible assets in June 1987. The additional risk premium that has to be paid in order to "mobilize" the assets in the smaller local banks (in the form of additional collateral or compensation to brokers for guarantees) means that a substantial level of overall excess eligible assets is consistent with market equilibrium. The cost of 936 funds to the largest banks is 1.0 to 1.5 percentage points cheaper than non-936 funds. A relatively small risk premium would therefore eliminate any advantage of 936 funds.

One question is why 936 funds in Puerto Rican banks stopped growing after the fall of 1985. The substantial decline in world interest rates in 1986 may have played a role. Even though the 936 rate was much higher relative to the Eurodollar rate in 1986 compared to 1985, it was still down in absolute terms. U.S. corporations may simply have chosen to hold fewer financial assets at these low rates.

The Tax Reform Act of 1986 may also have had a significant effect. Three provisions are particularly relevant for the holding of passive financial assets in Puerto Rico. One directly applicable item is the increase in the percentage of 936 gross income that has to be derived from an active trade or business rather than from financial investments. In addition, the new rules on the allocation of interest expense to foreign-source income could reduce the benefits of exempt interest income in Puerto Rico if the parent corporation has to increase borrowing in the United States. The U.S. parent corporations may choose to repatriate 936 funds in order to hold down their interest expense which would in part have to be allocated to foreign income. (Because of the 3 year phase-in of the application of

TABLE 6-4

936 FUNDS AND ELIGIBLE ACTIVITIES OF ALL COMMERCIAL AND SAVINGS BANKS
(monthly averages in millions of dollars)

Year and month	Funds requiring investment in eligible activities	Incremental eligible activities	Eligible activities required as penalties	Excess eligible activities
1984				
January	6,087	6,846	0	760
February	6,429	7,114	0	685
March	6,387	7,125	0	738
April	6,519	7,383	0	864
May	6,904	7,469	89	475
June	6,907	7,621	120	593
July	6,899	8,057	339	819
August	7,141	8,345	155	1,047
September	7,185	8,390	417	788
October	7,119	8,445	706	618
November	7,303	8,565	692	568
December	7,230	8,641	678	732
1985				
January	7,467	8,938	766	704
February	7,626	9,104	512	966
March	7,676	9,539	810	1,053
April	8,046	9,735	904	784
May	8,209	9,899	828	861
June	8,249	10,074	952	872
July	8,268	10,056	1,002	786
August	8,607	10,221	849	764
September	8,631	10,425	817	977
October	8,829	10,553	1,014	710
November	9,022	10,761	897	842
December	8,460	10,766	1,118	1,187
1986				
January	8,075	10,819	1,588	1,206
February	8,151	10,829	1,643	1,034
March	8,368	10,997	1,679	949
April	8,547	11,038	1,596	894
May	8,603	11,127	1,626	898
June	8,744	11,271	1,691	836
July	8,777	11,269	1,729	763
August	8,791	11,314	1,590	933
September	8,881	11,493	1,609	1,004
October	8,961	11,573	1,695	917
November	9,083	11,646	1,502	1,060
December	8,333	11,657	1,760	1,563
1987				
January	7,810	11,602	2,220	1,571
February	8,024	11,604	2,366	1,214
March	8,389	11,644	2,079	1,175
April	8,648	11,702	1,993	1,060
May	8,532	11,686	1,895	1,257
June	8,776	11,676	1,825	1,074

Department of the Treasury
Office of Tax Analysis

SOURCE: Government Development Bank

TABLE 6-5

936 INTEREST RATES VS. OTHER SHORT TERM RATES
(three month rates)

Year and month	Eurodollar rates 3-months	Prime rate	Rate on 936 funds	Ratio of 936 rate to Eurodollar (percentage)
1984				
January	9.78	11.00	8.36	85.5
February	9.91	11.00	8.38	84.6
March	10.40	11.21	8.79	84.5
April	10.83	11.93	8.20	75.7
May	11.53	12.39	7.99	69.3
June	11.68	12.60	8.36	71.6
July	12.02	13.00	8.36	69.6
August	11.81	13.00	8.53	72.2
September	11.67	12.97	8.74	74.9
October	10.77	12.58	8.80	81.7
November	9.50	11.77	7.90	83.2
December	8.90	11.06	7.10	79.8
1985				
January	8.37	10.61	6.30	75.3
February	9.05	10.50	6.50	71.8
March	9.32	10.50	7.00	75.1
April	8.74	10.50	6.60	75.5
May	8.13	10.31	6.40	78.7
June	7.60	9.78	6.20	81.6
July	7.89	9.50	5.90	74.8
August	8.02	9.50	5.70	71.1
September	8.14	9.50	6.00	73.7
October	8.08	9.50	5.90	73.0
November	8.02	9.50	5.90	73.6
December	7.99	9.50	6.50	81.4
1986				
January	8.02	9.50	6.60	82.3
February	7.89	9.50	6.50	82.4
March	7.42	9.10	6.20	83.6
April	6.80	8.80	5.80	85.3
May	6.86	8.50	5.60	81.6
June	6.93	8.50	5.60	80.8
July	6.54	8.16	5.50	84.1
August	6.06	7.90	5.10	84.2
September	5.86	7.50	5.10	87.0
October	5.87	7.50	4.90	83.5
November	5.96	7.50	4.90	82.2
December	6.25	7.50	5.50	88.0
1987				
January	6.10	7.50	5.40	88.5
February	6.32	7.50	5.30	83.1
March	6.37	7.50	5.30	83.2
April	6.73	7.75	5.40	80.2
May	7.25	8.14	5.50	78.9
June	7.11	8.25	5.50	77.4

Department of the Treasury
Office of Tax Analysis

SOURCE: Government Development Bank

the interest allocation rule, its impact in early 1987 was probably relatively small.) Finally, dividends from a 936 corporation will be included in the parent corporation's alternative minimum tax base as part of the book income provision. This may have caused increased repatriations in 1986 before the 1987 effective date of the alternative minimum tax. It may also result in a smooth pattern of repatriations in the future because unusually large dividends might trigger the minimum tax.

V. Conclusions

The April 1984 regulations seem to have had little if any success in further reducing the cost of 936 funds relative to world interest rates. It is also very difficult to identify any substantial impact of 936 funds in stimulating additional real investment in Puerto Rico or contributing to a net inflow of capital. The inflow of 936 funds seems to be related to cyclical swings in inventory investment in Puerto Rico but otherwise the changes in 936 funds do not seem correlated with changes in plant and equipment spending or with overall net capital flows into Puerto Rico. The sincere and comprehensive effort by the Puerto Rican Government to exploit the benefits of 936 funds appears not yet to have achieved any very visible results. The most recent phase in this effort, regulation 3582, will be evaluated in the next possessions report.

Appendix A

OPERATION OF THE POSSESSIONS CORPORATION SYSTEM OF TAXATION IN AMERICAN SAMOA, GUAM, THE COMMONWEALTH OF THE NORTHERN MARIANAS 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 did not include the Virgin Islands before 1987. Beginning with tax years after 1986, section 936 does apply to 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 1983.

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 satisfied their liability for U.S. tax by paying tax to the Virgin Islands. The Virgin Islands was 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 was allowed to rebate tax that it collected on Virgin-Islands-source income earned by U.S.- or V.I.-chartered corporations operating primarily in the Virgin Islands. In 1983, the amount of income tax rebated under the Virgin Islands tax incentive program is estimated to have been $8 million, of which about half was attributable to Virgin Islands subsidiaries of U.S. corporations. The Tax Reform Act of 1986 continues this "mirror code" approach, although it repeals the V.I. inhabitant rule.

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1 Section 936 benefits also apply to the Northern Marianas Islands. Section 936 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

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 in their territories.

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 the words "American Samoa" for "United States" where appropriate.

The legislature of American Samoa has occasionally amended the locally applicable U.S. income tax laws and thus does not have a strict "mirror code." American Samoa also provides exemptions from tax on American Samoan source income to businesses whose investments are deemed to promote Samoan economic development. 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. (A resident is any person who has continuously resided in American Samoa for at least five years.) Tax exemption grants generally last ten years and are subject to renewal. However, the period of tax exemption may terminate earlier if the cumulative amount of all taxes forgiven under the grant equals 200 percent of the business' total investment in American Samoa.

Guam 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 that of the United States. The Organic Act of 1950[4] required 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 was generally applied as the Guam territorial income tax by substituting "Guam" for "United States" where appropriate. Former section 935 of the Internal Revenue Code provided that individuals who were residents of Guam but derived income from the United States filed a single income tax return with Guam; individuals who were residents of the United States but derived income from Guam filed a single return with the United States. The United States and Guam then reallocated taxes between their respective treasuries through the "cover-over" procedure in Code Section 7654. In addition, Code section 881(b) provided 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 was exempt

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[4] 48 U.S.C. 1421i.

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 was exempt from the Guam tax withheld at source on such gross amounts.

Under the 1986 Tax Reform Act, Guam is granted full authority to determine its own income tax laws, provided that (1) Guam signs an implementing agreement with the U.S. to exchange information and prevent tax evasion, and (2) the new system raises as much revenue as the mirror system. No such agreement has yet been signed, so pre-1986 law continues in effect. After an agreement is signed, residents of Guam receiving income from outside the possession in excess of minimum filing thresholds will have to file a U.S. tax return. The U.S. will collect tax on the non-possession income but will then transfer the money to Guam.[5]

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 generally allowed for ten years.

Most possessions corporations operating in Guam in 1983 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., Guamanian-source income derived from the reinvestment of income from the Guam trade or business). Many of these 936 corporations also enjoyed 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.

II. Virgin Islands

A. Taxation of Corporations Operating in the Virgin Islands

In 1983, the Virgin Islands was not treated as a possession for purposes of section 936, although V.I. corporations (and U.S. corporations operating in the V.I.) received benefits similar to those provided to 936 corporations. In the 1986 Tax Reform Act, however, the rules were modified to grant the Virgin Islands treatment under section 936 identical to the treatment given to other possessions.

The Naval Appropriations Act of 1922 required the Virgin Islands to administer the U.S. income tax laws 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 to allocate taxing responsibilities and to transfer additional revenues to the Virgin Islands. Section 28(a) provided that

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[5] Similar rules were enacted for the Commonwealth of the Northern Marianas Islands.

> [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" were subject to Virgin Islands tax on their worldwide income and generally paid no tax to the United States, even on U.S.-source income. "Inhabitants" of the Virgin Islands included U.S. citizens who were 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 operated primarily in the Virgin Islands. The 1986 Tax Reform Act repealed the V.I. inhabitant rule. Instead, it provided that any bona fide V.I. individual resident be taxable only in the Virgin Islands. A U.S. individual who derives income from the V.I. files two identical returns, one with the U.S. and one with the V.I., and pays a pro rata amount of tax to each jurisdiction; a special schedule is completed to make the pro ration. Corporations earning income in both the U.S. and the V.I. must file returns with each jurisdiction and may receive credit for taxes paid to the other jurisdiction.

Section 934(a), added to the Internal Revenue Code in 1960, prohibited the Virgin Islands from granting relief, directly or indirectly, from Virgin Islands income tax. However, an exception was made, under section 934(b), with respect to non-U.S.-source income of U.S. or Virgin Islands corporations that 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. TEFRA increased the 50-percent active trade or business test to 65 percent for taxable years beginning after December 31, 1984. The provision was phased in so that the required percentage of active trade or business income rose to 55 percent for taxable years beginning in 1983 and to 60 percent for taxable years beginning in 1984. This provision was repealed in 1986.

The Virgin Islands has established an industrial incentive program that provides tax rebates for corporations meeting 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 non-resident workers; and

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

In addition to these specific requirements, the Virgin Islands considers applications taking into account the following general considerations:

(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 Virgin Islands businesses.

Corporations benefiting from 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 up to 100 percent exemptions from the V.I. real property tax, gross receipts tax, and excise tax. Rebates of income tax do not, however, apply to corporate tax on interest income, capital gains, and certain types of rental income. The 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 ten years. A firm is allowed the option of determining when 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 ten 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 was deemed to be an "inhabitant" of the Virgin Islands within the meaning of section 28(a) of the Revised Organic Act, and which qualified under Code section 934(b) and the Industrial Development Program for a rebate of 75 percent of income taxes, paid 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 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.[6] 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 could not rebate this tax under section 934(b) as it existed before the Tax Reform Act of 1986 because the tax is on the U.S. recipient and not on the V.I. corporation.

To remove this disincentive to investment by U.S. persons in the Virgin Islands, legislation was enacted in January 1983 adding a new section 934A to the Internal Revenue Code. This section reduced 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.[7] The 1983 Act allowed the Virgin Islands to use rebates to further reduce or eliminate this 10-percent rate. However, the 1983 Act continued 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 treated dividends as coming first 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 applied only after a corporation operating in the Virgin Islands has distributed all pre-1983 earnings and profits. The Tax Reform Act of 1986 repealed Code section 934A and replaced it with a new Code section 934(b)(1), which allows the Virgin Islands to reduce V.I. tax on any income which is from V.I. sources or is effectively connected with the conduct of a trade or business in the Virgin Islands.

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, for the years prior to 1987, the United States generally did not allow a U.S. parent to take a dividends-received deduction for dividends paid by a subsidiary incorporated in the Virgin Islands.[8]

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[6] 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).

[7] Public Law 97-455, section 1 (1983).

[8] 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 for pre-1987 years was 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 from a U.S. trade or business for the thirty-six 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. The deduction is allowed only to the extent of the corporation's effectively connected income. A

Thus, even though the profits of a 934(b) Virgin Islands subsidiary might have been 75-percent or 90-percent tax-free in the Virgin Islands, the profits were subject to the normal U.S. corporate rate of income tax once they were repatriated.

In 1980, the Internal Revenue Service ruled that a U.S.-chartered corporation which satisfied the 80-50 gross income tests under former 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.[9] The ruling did 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 continued to operate through Virgin Islands-chartered corporations. Therefore, their income from the Virgin Islands became subject to U.S. tax at the time it was repatriated in the form of dividends, and a foreign tax credit was allowed (subject to the general foreign tax credit limitation) for taxes paid to the Virgin Islands. The 1986 Tax Reform Act exempts U.S.-source fixed or determinable, annual or periodic income from U.S. withholding tax if 65 percent of the V.I. corporation's income is effectively connected with a trade or business in the U.S. or in a possession, and the other requirements of section 881(b) are met.

A few U.S. corporations operating in the Virgin Islands took the position that, as "inhabitants" of the V.I., they satisfied their U.S. tax obligation by paying taxes to the V.I., but that they were taxable by the V.I. only on V.I.-source and V.I.-effectively connected income. U.S.-source income, these taxpayers contended, was not taxable in either the U.S. or the V.I. A 1987 decision by the U.S. Court of Appeals for the 3d Circuit (Danbury, Inc. v. Olive, 820 R.2d 618 (3d. Cir.) cert. denied, 108 S.ct. 453 (1987)) made clear that these taxpayers could not escape taxation on their non-V.I. income.

C. Allocation of Income Attributable to Intangibles

Under former section 934(e) (repealed by the 1986 Tax Reform Act), TEFRA's rules on the allocation of income from intangibles under the cost-sharing or the profit-split method applied to U.S. corporations described in former section 934(b0 in a manner similar to those compaines covered under section 936(h). The provisions were generally effective for taxable years beginning after December 31, 1982, and before January 1, 1987. As indicated above, section 936 itself has been expanded to cover qualifying U.S. companies doing business in the Virgin Islands for taxable years beginning after December 31, 1986.

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corporation which met the so-called "80-65 gross income tests" required to be eligible for V.I. tax relief would not qualify for the deduction even with respect to dividends attributable to U.S.-source income (Code section 245(a)).

[9] Revenue Ruling 80-40, 1980-2 C.B. 175.

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

Table A-1 presents data on asset and income items associated with former section 934(b) companies for 1983, by industry. The data were obtained from income tax returns filed in the Virgin Islands. The forty-seven companies were nearly evenly split between manufacturing (twenty-two) and services (twenty-five). Some of the more dominant industries were hotels, with 19 percent of the companies and 6.4 percent of the assets; chemicals, with 8.5 percent of the companies and 5.5 percent of the assets; and watches, with 12.8 percent of the companies and 3.6 percent of the assets. Jewelry and broadcasting were also important industries.

Total assets held by the 47 companies were $298 million. Nearly all of the assets were held by V.I. subsidiaries of U.S. corporations. Net plant and equipment of $99 million represented 33 percent of total assets, or three times the analogous share for 936 companies.

Business receipts provided 87 percent of the gross receipts of 934(b) entities. Information on non-government interest and other investment income of 934(b) corporations is not available, but the high share of business receipts in total receipts suggests that passive investment income represents a relatively insignificant share of the income of 934(b) entities. As noted above, the Virgin Islands Industrial Development Program, unlike the Puerto Rican Industrial Incentive Acts, does not provide relief from tax on interest and certain other kinds of passive investment income.

Taxable income equals the difference between total gross income and total (current) deductions, less net operating loss carryovers and certain special deductions for dividends received. The combined taxable income of the forty-seven entities shown in the table amounted to approximately $36 million; the nine hotels reported an aggregate loss of nearly $2 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 $1.8 million. This represents about 5 percent of aggregate taxable income.

TABLE A-1

934(B) CORPORATIONS IN THE VIRGIN ISLANDS - SELECTED BALANCE SHEET AND INCOME STATEMENT ITEMS AND TAX BENEFITS BY INDUSTRY, 1983
($ thousand)

	All industries	Chemicals	Watches	Other manufacturing	Hotels	Other services
Number of Corporations	47	4	6	12	9	16
Total Assets	297,601	16,470	10,855	135,237	19,055	115,983
Inventories	50,310	693	2,567	44,578	386	2,086
Depreciable assets	136,708	4,790	1,294	9,023	18,129	103,472
Accumulated depreciation	37,669	376	606	3,597	4,063	29,027
Net depreciable assets	99,039	4,414	688	5,427	14,066	74,445
Total Receipts	308,153	15,863	14,572	169,277	17,829	90,612
Business receipts	269,024	14,438	13,498	168,264	16,497	56,326
All other receipts	39,129	1,425	1,074	1,013	1,332	34,285
Total Deductions	272,454	14,829	13,998	140,617	19,639	83,370
Cost of sales and operations	156,966	9,426	11,822	89,173	6,920	39,625
All other deductions	115,487	5,403	2,176	51,444	12,719	43,746
Taxable income	35,699	1,034	574	28,660	-1,810	7,241
V.I. Rebates	1,824	44	246	147	294	1,093

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Appendix B

POSSESSIONS CORPORATIONS IN TAX YEAR 1982

This appendix presents data on the assets, income, and tax benefits of all possessions corporations in tax year 1982, which includes accounting periods ending between July 1, 1982, and June 30, 1983. Tax year 1982 corresponds closely to the calendar year because most possessions corporations had calendar-year accounting periods. Tables B-1 through B-3 below are similar to Tables 4-1, 4-4, and 4-6, in the text. Both sets of tables include all of the returns filed for the given tax year. The 1982 tables in this appendix update the tables in the Fifth Report because they include 1982 tax returns filed after the report was written. The 1983 tables include all 1983 returns, so no appendix B will be necessary for the Seventh Report.

In tax year 1982, the estimated tax benefits provided under section 936 were $1.8 billion, up from $1.7 billion for tax year 1981 and $1.3 billion for tax year 1980. The net income of possessions corporations in manufacturing rose 6 percent between 1981 and 1982, compared to a 30 percent increase from 1980 to 1981. The increase in 1982 was particularly strong in the chemical industry, where profits rose 19 percent. The profits of the pharmaceutical industry rose 34 percent in this period.[1]

I. Assets and Income in 1982

A. Assets

Table B-1 shows that in 1982 the book value of the total assets of possessions corporations was $21.6 billion, of which $15.8 billion were held in manufacturing industries. Net plant and equipment of 936 manufacturing firms amounted to $1.9 billion in 1982.

B. Retained Earnings

In 1982, possessions companies reported $13.8 billion of retained earnings on their balance sheets, with 96 percent held by manufacturing companies. Nearly half, or $6.1 billion, was held by pharmaceuticals. The electrical and electronics industries held $3.0 billion in retained earnings. For all manufacturing possessions corporations, retained earnings represented 84 percent of total liabilities and stockholders' equity. The comparable figure for manufacturing corporations operating in the U.S. was 36 percent.[2]

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[1] For data on possessions corporations in 1980 and 1981, see Table 4-9.

[2] See the Quarterly Financial Reports, 1983 and 1984, put out by the Federal Trade Commission.

TABLE B-1

SELECTED BALANCE SHEET INFORMATION BY INDUSTRY, 1982
($ thousand)

	All industries	Manufacturing industries							
		Manufacturing total	Food and kindred products	Textile mill products	Apparel	Paper	Chemicals		
							Total	Pharmaceuticals	All other
Number of corporations	620	502	23	8	76	9	95	59	36
Total Assets	21,589,862	15,802,904	982,300	101,035	473,407	40,467	8,080,295	7,078,714	1,001,581
Cash	3,144,786	2,620,589	274,392	13,539	77,245	2,705	934,317	883,749	50,568
Accounts receivable	4,270,876	3,127,016	265,951	16,419	165,212	8,064	1,597,957	1,185,122	412,835
Inventories	1,690,181	1,525,979	153,768	5,237	55,408	3,050	537,833	418,271	119,561
U.S. Government obligations	525,744	448,731	0	858	3,303	0	318,401	257,765	60,636
Other current assets	1,262,897	1,214,033	14,731	52	11,267	241	478,879	470,100	8,779
Mortgage and real estate loans	1,960,467	147,810	0	0	3,226	0	38,468	38,468	0
Other investments	5,146,624	4,417,514	64,766	35,168	117,148	23,804	2,907,696	28,337,366	70,330
Depreciable assets	4,394,843	2,920,778	225,332	5,755	47,601	3,806	1,642,069	1,069,769	572,299
Less: Accumulated depreciation	1,533,243	1,101,419	75,694	3,914	22,528	1,381	607,449	282,398	325,051
Net depreciable assets	2,861,600	1,819,360	149,638	1,841	25,074	2,425	1,034,620	787,372	247,248
Other assets	726,688	481,874	59,054	27,921	15,525	178	232,126	200,503	31,623
Total Liabilities and Stockholders' Equity									
Accounts payable	1,513,880	722,088	85,788	693	42,859	2,819	224,024	180,535	43,488
Notes payable in less than one year	316,242	161,819	7,284	43	3,912	459	100,984	95,232	5,752
Other current liabilities	2,711,460	375,751	54,944	1,192	14,187	906	173,205	164,928	8,278
Notes payable in one year or more	836,303	199,606	17,000	64	5,958	0	145,026	138,771	6,255
Other liabilities	538,687	226,611	19,740	0	1,642	37	137,381	119,039	18,342
Capital stock	1,887,994	910,068	41,657	640	23,823	1,054	527,238	317,111	210,127
Retained earnings, total	13,785,296	13,206,962	755,887	98,402	381,027	35,191	6,772,437	6,063,099	709,338
Appropriated	106,624	39,640	13,605	0	0	0	2,900	2,266	635
Unappropriated	13,678,672	13,167,322	742,282	98,402	381,027	35,191	6,769,537	6,060,833	708,703

TABLE B-1 - continued

	Manufacturing industries - continued							
	Rubber and plastic 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	11	18	6	29	11	119	42	55
Total Assets	78,258	129,279	21,275	289,185	292,214	3,378,529	810,048	1,126,611
Cash	5,321	30,827	4,434	25,548	18,700	920,641	164,320	148,599
Accounts receivable	27,445	29,445	2,415	66,702	52,812	482,436	183,668	228,480
Inventories	9,435	23,706	2,624	36,766	29,390	366,381	69,311	233,070
U.S. Government obligations	0	18,441	0	324	23,983	55,267	25,282	2,873
Other current assets	158	716	352	26,032	55,807	523,225	10,078	92,497
Mortgage and real estate loans	0	333	0	0	1,261	101,002	0	3,521
Other investments	8,422	17,443	10,254	35,958	85,548	649,654	240,439	221,215
Depreciable assets	33,568	12,676	1,011	97,594	24,202	416,488	128,176	282,499
Less: Accumulated depreciation	8,245	4,595	559	28,873	7,927	173,006	35,165	132,082
Net depreciable assets	25,324	8,081	452	68,721	16,275	243,482	93,011	150,416
Other assets	2,144	289	744	29,135	8,437	36,441	23,939	45,940
Total Liabilities and Stockholders' Equity								
Accounts payable	3,934	9,314	259	19,148	23,438	141,721	55,190	112,901
Notes payable in less than 1 year	788	1,354	312	6,641	1,001	27,975	1,427	9,640
Other current liabilities	1,769	3,098	339	4,517	4,550	83,371	14,640	19,032
Notes payable in 1 year or more	0	4,499	66	4,815	2	14,345	1,233	6,598
Other liabilities	1,567	5,503	1	1,116	4,576	39,133	3,880	12,034
Capital stock	8,747	-3,593	3,562	40,781	7,427	110,816	28,180	119,735
Retained earnings, total	61,453	109,104	16,736	212,165	251,220	2,961,168	705,499	846,672
Appropriated	1,709	3,589	0	0	0	8,404	8,870	562
Unappropriated	59,744	105,515	16,736	212,165	251,220	2,952,764	696,629	846,110

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 industries not reported
Number of corporations	118	8	6	28	12	28	36
Total Assets	5,786,958	36,100	910,941	645,993	220,362	3,886,942	86,621
Cash	524,197	1,499	42,829	187,002	16,500	270,483	5,884
Accounts receivable	1,143,861	5,081	52,250	210,827	45,985	795,725	33,993
Inventories	164,202	0	15,841	99,381	43,885	630	4,465
U.S. Government obligations	77,012	0	0	448	0	76,548	16
Other current assets	48,864	2,799	3,928	1,429	18,311	21,007	1,390
Mortgage and real estate loans	1,812,657	32	0	0	0	1,812,624	0
Other investments	729,111	3,469	13,175	15,791	23,640	665,145	7,889
Depreciable assets	1,474,065	8,302	1,049,463	205,998	99,769	75,566	34,967
Less: Accumulated depreciation	431,824	3,291	276,854	84,583	41,595	13,862	11,638
Net depreciable assets	1,042,241	5,011	772,608	121,415	58,174	61,704	23,329
Other assets	244,814	18,208	10,310	9,699	13,867	183,075	9,655
Total Liabilities and Stockholders' Equity							
Accounts payable	791,792	2,524	19,871	52,872	49,385	650,994	16,146
Notes payable in less than 1 year	154,422	16,847	10,892	3,538	8,649	111,597	2,900
Other current liabilities	2,335,709	5,710	42,362	4,061	11,660	2,265,012	6,904
Notes payable in 1 year or more	636,697	5,537	111,537	9,377	43,532	462,310	4,404
Other liabilities	312,076	281	54	4,942	3,105	297,272	6,422
Capital stock	977,926	329	714,789	133,260	24,375	81,859	23,314
Retained earnings, total	578,335	4,872	114,436	437,943	79,656	17,898	26,530
Appropriated	66,984	0	10,159	3	8,603	48,219	0
Unappropriated	511,351	4,872	1,276	437,940	71,053	-30,321	26,530

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C. Total Receipts

Table B-2 shows that the total receipts of manufacturing possessions corporations were $15 billion in 1982. Ninety-two percent of total receipts was attributable to business receipts, and the remainder was attributable primarily to interest, 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 pharmaceutical industry accounted for 35 percent of the business receipts of all possessions manufacturing firms. After pharmaceuticals, the industries with the largest amount of business receipts were electrical and electronic equipment (with 20 percent), and food products (with 8 percent).

D. Net Income per Tax Return

Net income per return amounted to $4.3 billion for all possessions corporations in manufacturing. The industries with the most net income were pharmaceuticals, with 51 percent of the total, and electrical and electronic equipment, with 21 percent of the total.

E. Reduction in U.S. Tax Liability

Table B-2 shows that U.S. tax liabilities were reduced by $1,773 million in tax year 1982 by the possessions corporation system. The pharmaceutical industry obtained tax benefits of $906 million, and the electrical and electronic equipment industry obtained tax benefits of $369 million. Other industries which received substantial tax benefits were instruments ($110 million) and food products ($93 million).

F. Distributions

The final line of Table B-2 shows that manufacturing possessions corporations reported $2,563 million of distributions. These distributions represented 59 percent of net income. The pharmaceutical industry was responsible for 58 percent of the distributions. The percentage of profits distributed increased substantially from 1981 to 1982, going from 41 percent to 59 percent.

II. Payroll and Employment in 1982

Table B-3 provides an 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 1982 employment and payroll data could be obtained from the companies' federal unemployment insurance tax returns. The 378 corporations included in the table represent 75 percent of the manufacturing corporations included in Tables B-1 and B-2.

TABLE B-2

SELECTED INCOME STATEMENT INFORMATION AND TAX BENEFITS BY INDUSTRY, 1982
($ thousand)

	All industries	Manufacturing industries							
		Manufac- turing total	Food and kin- dred products	Textile mill products	Apparel	Paper	Chemicals		
							Total	Pharmaceuticals	All other
Number of corporations	620	502	23	8	76	9	95	59	36
Total receipts	14,953,719	12,246,742	983,765	63,685	501,868	37,748	5,173,049	4,333,070	839,979
Business receipts	13,722,598	11,418,410	937,218	62,119	459,284	35,419	4,763,627	3,941,610	822,017
Nongovernment interest	992,526	677,949	34,519	1,480	17,184	2,281	349,159	332,458	16,701
Other receipts	238,597	150,385	12,028	86	25,400	48	60,264	59,003	1,261
Total deductions	10,410,629	7,911,003	752,857	53,089	400,142	25,241	2,768,182	2,104,681	663,501
Cost of sales	7,245,183	5,712,013	508,925	47,577	341,912	21,210	1,554,839	1,034,459	520,380
Depreciation	251,415	157,889	10,363	433	3,112	397	83,319	58,929	24,390
All other deductions	2,914,033	2,041,102	233,569	5,078	55,118	3,633	1,130,024	1,011,293	118,731
Estimated net income per return	4,543,091	4,335,740	230,909	10,596	101,725	12,507	2,404,867	2,228,390	176,477
Estimated net income per books	4,360,146	4,151,927	225,914	8,295	97,746	12,407	2,317,335	2,146,411	170,924
Reduction in U.S. tax liability	1,772,671	1,772,671	92,739	4,122	41,415	884	973,752	905,996	67,756
Distributions	2,676,377	2,563,465	113,780	210	46,453	1,000	1,615,530	1,475,441	140,089

TABLE B-2 - continued

	Manufacturing industries - continued							
	Rubber and plastic 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	11	18	6	29	11	119	42	55
Total receipts	89,051	168,687	13,296	208,747	224,667	2,422,933	624,067	1,735,178
Business receipts	87,742	164,780	11,213	199,501	210,046	2,238,499	579,930	1,669,033
Nongovernment interest	874	3,609	252	7,437	13,682	177,599	35,732	34,141
Other receipts	435	299	1,830	1,810	939	6,836	8,405	32,005
Total deductions	64,597	150,147	10,001	162,450	154,094	1,527,296	367,834	1,475,072
Cost of sales	48,739	129,868	7,670	137,495	135,126	1,252,739	270,463	1,255,450
Depreciation	1,514	1,290	68	5,512	2,799	25,682	8,642	14,758
All other deductions	14,345	18,989	2,263	19,443	16,169	248,876	88,729	204,865
Estimated net income per return	24,454	18,541	3,295	46,297	70,573	895,638	256,233	260,106
Estimated net income per books	25,735	19,262	3,406	48,411	67,870	821,032	254,275	250,238
Reduction in U.S. tax liability	10,370	13,598	1,309	19,258	29,104	368,904	109,867	102,351
Distributions	14,245	2,016	357	32,386	27,121	460,107	93,843	156,416

TABLE B-2 - continued

	Non-manufacturing industries						
	Nonmanufacturing total	Construction	Transportation, communications, and utilities	Wholesale trade	Retail trade	Finance, insurance, real estate	Other services and industries not reported
Number of corporations	118	8	6	28	12	28	36
Total Receipts	2,706,977	40,881	341,068	1,182,766	659,747	350,057	132,458
Business receipts	2,304,188	36,460	328,936	1,155,680	635,705	31,722	115,684
Nongovernment interest	314,577	680	2,447	24,132	179	286,218	921
Other receipts	88,212	3,740	9,685	2,955	23,862	32,118	15,852
Total Deductions	2,499,627	36,402	267,769	1,041,849	655,063	372,935	125,609
Cost of sales	1,533,170	29,239	2,795	977,351	472,664	5,866	45,255
Depreciation	93,526	1,271	71,169	7,384	7,507	4,003	2,192
All other deductions	872,931	5,892	193,805	57,114	174,892	363,066	78,162
Estimated net income per return	207,351	4,479	73,299	140,918	4,684	-22,878	6,848
Estimated net income per books	208,219	3,317	73,244	134,332	6,167	-17,835	8,994
Reduction in U.S. tax liability	0	0	0	0	0	0	0
Distributions	112,912	7,708	75,392	22,678	1,528	0	5,605

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Table B-3 shows that the federal tax benefits per employee in Puerto Rico for all manufacturing corporations are estimated to have averaged $20,699. Tax benefits per employee, and 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 $69,751 per employee, or more than triple the average compensation of the comparatively well-paid Puerto Rican pharmaceutical employee. In the electrical and electronics industry, the average tax benefits amounted to $14,879 per employee, or 108 percent of average compensation. The industries where average tax benefits per employee were lowest were textiles and apparel. The 63 apparel firms included in Table B-3 provided 17 percent of the total employment and received only 2 percent of the tax benefits.

TABLE B-3

mTAX BENEFITS, EMPLOYMENT, AND COMPENSATION OF EMPLOYEES BY INDUSTRY, 1982

	Number of corporations	Qualified possession net income[a] ($ thousand)	Tax benefits		Estimated number of employees		Average employee compensation ($)	Tax benefits per employee ($)	Tax benefits as a percent of employee Compensation
			Amount ($ thousand)	Percentage of total	Number	Percentage of total			
All manufacturing industries	378	4,778,482	1,772,671	100.0	85,640	100.0	13,959[b]	20,699[b]	148.3[b]
Food and kindred products	15	256,561	97,739	5.5	5,807	6.7	15,050	16,830	111.8
Textile mill products	5	9,298	4,122	*	1,385	1.6	9,094	2,976	32.7
Apparel	63	106,901	41,415	2.3	16,213	18.9	2,554	9,075	28.1
Men's and boys'	10	19,995	8,444	*	4,082	4.8	9,517	2,069	21.7
Women's and children's	31	58,858	23,250	1.3	7,623	8.9	8,914	3,050	34.2
Hats, caps, etc.	8	6,087	2,346	*	1,041	1.2	8,937	2,254	25.2
All other	14	21,961	7,375	*	3,559	4.2	8,950	2,073	23.2
Chemicals	71	2,657,846	973,752	54.9	15,406	18.0	20,491	63,205	308.5
Industrial chemicals	8	99,210	36,651	2.1	1,698	2.0	26,446	21,586	81.6
Pharmaceuticals	43	2,470,225	905,996	51.1	12,989	15.2	20,077	69,751	347.4
Soaps, cleaners, etc.	10	56,179	18,400	1.0	572	0.7	15,080	32,185	213.4
All other	10	32,231	12,705	0.7	653	0.8	15,654	19,467	124.4
Rubber and plastic products	10	25,573	10,370	0.6	1,574	1.8	11,900	6,589	55.4
Leather and leather products	15	22,387	13,598	0.8	3,767	4.4	9,507	3,610	38.0
Footwear	10	18,287	12,321	0.7	3,420	4.0	9,465	3,603	38.1
All other	5	4,100	1,277	*	323	*	9,836	3,954	40.2
Stone, clay, and glass	4	3,226	1,309	*	133	*	16,212	9,839	60.7
Fabricated metal products	22	53,294	19,258	1.1	2,233	2.6	15,323	8,623	56.3
Metal cans and containers	6	20,397	7,312	*	1,003	1.2	17,668	7,287	41.2
All other	16	32,897	11,946	0.7	1,071	1.3	13,979	11,159	79.8
Machinery, except electrical	8	78,911	29,104	1.6	1,310	1.5	15,917	22,220	139.6
Electrical and electronic equipment	95	1,002,358	368,904	20.8	24,794	29.0	13,725	14,879	108.4
Radio, TV, communication	10	90,487	35,195	2.0	3,135	3.7	12,571	11,228	89.3
Electronic components	27	325,717	134,337	7.6	9,022	10.5	14,473	14,889	102.9
All other	58	586,153	199,372	11.2	12,452	14.5	16,011	13,534	118.3
Transportation equipment	5	10,285	4,048	*	594	0.7	11,220	6,815	60.7
Instruments and related products	32	287,039	109,867	6.2	7,057	8.2	13,747	15,568	113.2
Scientific instruments	10	57,520	19,899	1.1	1,187	1.4	11,974	16,764	140.0
All other	22	229,518	89,968	5.1	5,302	6.2	13,978	16,970	121.4
All other manufacturing[c]	33	264,804	99,187	5.6	4,601	5.4	15,464	21,559	139.4

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* Less than 0.5%

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

[b] Compensation and number of employees were weighted, by industry, by the ratio of costs of goods sold for the entire sample to cost of goods sold for the sample with employment data.

[c] Includes manufacturing industries in which data were available for fewer than 3 corporations.

Appendix C

SOURCES AND LIMITATIONS OF THE DATA ON POSSESSIONS CORPORATIONS

I. Coverage

The data in Chapter 4 on possessions corporations for tax year 1983 and the data in Appendix B for tax year 1982 include all corporations that filed possessions corporation returns within twelve months of the end of the tax year. Figures for all years prior to 1981 (e.g., those in Table 4-7) have been revised to include corporations which filed as possessions corporations within twelve 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 made an election under section 936.

II. Income Statement and Balance Sheet Data

Income statement and balance sheet data for 1977-1983, 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 1973-1976 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 was income tax returns (Form 480.20) filed with the Puerto Rican government.

III. 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 1983 Form 940 data were associated with taxable years ending between July 1, 1983 and June 30, 1984.

The number of employees was computed by dividing total taxable wages (line 5, Form 940) by $7,000,[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

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[1] For 1973-1977, the corresponding amount was $4,200, and for 1978 to 1982, the amount was $6,000.

than the actual number of persons employed at any particular time during the year. If the corporation paid its workers less than $7,000, the number of employees could be understated. (The minimum wage in several industries was sufficiently low in the 1970s that this could have occurred.) On the other hand, because the $7,000 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 123.2 percent in 1982 and 123.5 percent in 1983. It is computed from Tables 6.4B and 6.5B of the Survey of Current Business, U.S. Department of Commerce, Bureau of Economic Analysis, July 1986. 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 378 of the 527 possessions corporations in manufacturing. The information from that sample was weighted up to represent the full group. For firms with cost-of-goods-sold data, it was assumed that the relationship between employment and cost of goods sold for the employment sample would also hold for the larger sample within each industry group. If cost-of-goods-sold data were missing, a similar assumption was made for the relationship between employment and assets within each industry group. Although the cost of goods sold is more directly related to employment because wages are a large part of costs, many of the profit-split firms were missing detailed income statement data. Assets are indirectly related to employment, and therefore were used for an alternative relationship where cost-of-goods-sold data were missing.

Appendix D

TAX FORMS FROM WHICH DATA INCLUDED IN THIS REPORT WERE OBTAINED

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

U.S. Corporation Income Tax Return

For calendar year 1983 or other tax year beginning ____________, 1983, ending ____________, 19 ____

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

OMB No. 1545-0123

1983

Check if a—	Use IRS label. Otherwise please print or type.		
A. Consolidated return ☐		Name	D. Employer identification number
B. Personal Holding Co. ☐		Number and street	E. Date incorporated
C. Business Code No. (See page 9 of Instructions)		City or town, State, and ZIP code	F. Total assets (see Specific Instructions) $

G. Check box if there has been a change in address from the previous year . . . ▶ ☐

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 14(a), Part II (attach Form 4797)	9	
10	Other income (see instructions—attach schedule)	10	
11	TOTAL income—Add lines 3 through 10 and enter here ▶	11	

Deductions

12	Compensation of officers (Schedule E)			12	
13	(a) Salaries and wages $ ________ (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 and enter here ▶			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 1982 allowed as a credit				
	(b) 1983 estimated tax payments				
	(c) Less refund of 1983 estimated tax applied for on Form 4466	( )			
	(d) Tax deposited with Form 7004				
	(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 (Check ▶ ☐ if Form 2220 is attached. See instruction D.) ▶ $ ________			33	
34	**OVERPAYMENT** (subtract line 31 from line 32)			34	
35	Enter amount of line 34 you want: **Credited to 1984 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 number
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	1	
2 Merchandise bought for manufacture or sale	2	
3 Salaries and wages	3	
4 Other costs (attach schedule)	4	
5 Total—Add lines 1 through 4	5	
6 Inventory at end of year	6	
7 Cost of goods sold—Subtract line 6 from line 5. Enter here and on line 2, page 1	7	

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) X (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, page 1)

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. Percent of time devoted to business	Percent of corporation stock owned: 4. Common	5. Preferred	6. Amount of compensation
		%	%	%	
		%	%	%	
		%	%	%	
		%	%	%	
		%	%	%	
		%	%	%	
		%	%	%	

Total compensation of officers—Enter here and on line 12, page 1

SCHEDULE F.—Bad Debts—Reserve Method (See instruction for line 15, page 1)

1. Year	2. Trade notes and accounts receivable outstanding at end of year	3. Sales on account	Amount added to reserve: 4. Current year's provision	5. Recoveries	6. Amount charged against reserve	7. Reserve for bad debts at end of year
1978						
1979						
1980						
1981						
1982						
1983						

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

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 ▶ ☐		3	
4 (a) Foreign tax credit (attach Form 1118)	4(a)		
(b) Investment credit (attach Form 3468)	(b)		
(c) Jobs credit (attach Form 5884)	(c)		
(d) Employee stock ownership credit (attach Form 8007)	(d)		
(e) Research credit (attach Form 6765)	(e)		
(f) Possessions tax credit (attach Form 5735)	(f)		
(g) Alcohol fuel credit (attach Form 6478)	(g)		
(h) Credit for fuel produced from a nonconventional source (see instructions)	(h)		
5 Total—Add lines 4(a) through 4(h)		5	
6 Subtract line 5 from line 3		6	
7 Personal holding company tax (attach Schedule PH (Form 1120))		7	
8 Tax from recomputing prior-year investment credit (attach Form 4255)		8	
9 Minimum tax on tax preference items (see instructions—attach Form 4626)		9	
10 Total tax—Add lines 6 through 9. Enter here and on line 31, page 1		10	

Additional Information (See page 8 of instructions) — Yes / No

H 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? . . .

I (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) before NOL and special deductions (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 I(1) and I(2), "highest amount owed" includes loans and accounts receivable/payable.)

J Refer to page 9 of instructions and state the principal:
Business activity ▶ ________
Product or service ▶ ________

K 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.

L 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 page 8 for exceptions and filing requirements for Form 90-22.1.) . . . .
If "Yes," write the name of the foreign country ▶ ________

M 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.

N 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.

O During this tax year did you maintain any part of your accounting/tax records on a computerized system? . . . .

P Check method of accounting: (1) ☐ Cash (2) ☐ Accrual (3) ☐ Other (specify) ▶

SCHEDULE L.—Balance Sheets

	Beginning of tax year		End of tax year	
Assets	(A)	(B)	(C)	(D)
1 Cash				
2 Trade notes and accounts receivable				
(a) Less allowance for bad debts				
3 Inventories				
4 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 Mortgages, notes, bonds payable in less than 1 year				
17 Other current liabilities (attach schedule)				
18 Loans from stockholders				
19 Mortgages, 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 schedule)				
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 line 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 line 7)	

Form **5735** (Rev. March 1984) 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 3/31/87

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 Parts II and III)	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 55%, do not complete Parts II and III)	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 (see instructions)			6(a)			
(b) From sources outside the U.S. from the sale or exchange of substantially all 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) Intangible property income subject to section 936(h)(2)			6(e)			
(f) Other intangible property income (see instructions)			6(f)			
(g) Add lines 6(a), 6(b), and 6(c)	6(g)					
(h) Add lines 6(d), 6(e), and 6(f)	6(h)					
(i) Subtract line 6(h) from 6(g)					6(i)	
7 Applicable deductions (attach schedule):						
(a) Cost sharing amount (see instructions)			7(a)			
(b) Definitely allocable deductions (see instructions)			7(b)			
(c) Ratable part of deductions not definitely allocable			7(c)			
(d) Total (add lines 7(a), 7(b) and 7(c))					7(d)	
8 Qualified taxable income before loss adjustments (line 6(i) less line 7(d)). 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	

Part III Summary From Schedule P (See instructions)

17 Enter the total sales of possession products to which each income method applies:		
(a) Cost sharing method	17(a)	
(b) Profit split method	17(b)	
18 Enter the total sales of possession products which qualify under each business presence test:		
(a) Start-up value-added test	18(a)	
(b) 25% value-added test	18(b)	
(c) Start-up labor test	18(c)	
(d) 65% labor test	18(d)	
(e) 50-70% labor/construction test	18(e)	
(f) None of the above	18(f)	

Instructions

(Section references are to the Internal Revenue Code, unless otherwise noted)

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 taxpayers 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.

New Law.—Effective for tax years beginning after 1982, new rules apply to the intangible property income of a possessions corporation. See section 936(h) and **Form 5712-A,** Election to Use the Cost Sharing or Profit Split Method Under Section 936(h)(5). Also see **Schedule P (Form 5735),** Allocation of Income and Expenses Under Section 936(h)(5).

General Instructions

A. Purpose of Form.—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 purposes of 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 55% (for taxable years beginning in 1983) 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 55% is increased to 60% for taxable years beginning in 1984, and to 65% for taxable years beginning in 1985 and thereafter.)

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 S corporations (section 1374).

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, 861-864 and 936 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 receive 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 (f).—Enter the gross income from the active conduct of a trade or business in a U.S. possession which is from sources in U.S. possessions. Include amount(s) reported on line 6 of Part II of Schedule(s) P.

Column (i).—Enter gross qualified possession source investment income in column (i). See section 936(d)(2).

Part II

Line 6(a).—Include amount(s) reported on line 6 of Part II of Schedule(s) P.

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 6(f).—Enter the amount of marketing intangible property income which is associated with any product(s) subject to the cost sharing method and which is not included in the gross income of a shareholder because such shareholder is a foreign person or a tax-exempt U.S. person. See proposed regulations section 1.936-6(a)(5).

Line 7(a).—Include the sum of all cost sharing amounts entered on line 7 of Part I of Schedule(s) P if the cost sharing method applies.

Line 7(b).—Include all amounts entered on line 7 of Part II of Schedule(s) P. Also 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(i). Also include the corporation's other definitely allocable deductions.

Line 7(c).—Enter on line 7(c) 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(b). Multiply this result by the amount obtained when you divide the amount entered on line 6(i) by the gross income on your income tax return.

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, include the reduction for the "rate differential portion" of net capital gain.

Part III.

You are not required to complete Part III if you have attached fewer than 10 Schedules P. Part III information will not affect your tax liability, but failure to complete this part, if you are required to do so, will delay the processing of your Form 5735.

Line 17.—Enter on line 17(a) the sum of sales of possession products (as reported on line 2 of Part I of Schedule(s) P) subject to the cost sharing method. Enter on line 17(b) the sum of sales of possession products (as reported on line 2 of Part I of Schedule(s) P) subject to the profit split method.

Line 18.—Enter on lines 18(a) through 18(f) the sum of sales of possession products (as reported on line 2 of Part I of Schedule(s) P) which have met the listed business presence test. Total sales included on lines 18(a) through 18(f) should equal the total of lines 17(a) and 17(b).

SCHEDULE P (Form 5735) (March 1984) Department of the Treasury Internal Revenue Service

Allocation of Income and Expenses Under Section 936(h)(5)

▶ Attach to Form 5735

OMB No. 1545-0217 Expires 3/31/87

Attach a separate Schedule P for each product to which the cost sharing or profit split method under section 936(h)(5) applies.

Name as shown on Form 5735	Employer identification number

Identify the product reported on this schedule. (See proposed regulations section 1.936-5(a).) ▶ ....

Check the box next to the business presence test under which the product qualifies, and show computations on an attached schedule. (See proposed regulations section 1.936-5(a) and (b).)

- ☐ Start-up value-added test (for a new product only)
- ☐ 25% value-added test
- ☐ Start-up labor test (for a new product only)
- ☐ 65% labor test
- ☐ 50-70% labor/construction test
- ☐ None of the above (see proposed regulations section 1.936-5(b))

Part I To be completed by all taxpayers.

1 Product area research (see instructions)	1	
2 Sales of the possession product (see instructions)	2	
3 Sales of all products in the product area (see instructions)	3	
4 Cost sharing fraction (divide line 2 by line 3)	4	
5 Gross cost sharing amount (multiply line 1 by line 4)	5	
6 Reductions (see instructions)	6	
7 Net cost sharing amount (subtract line 6 from line 5). Enter here. If the cost sharing method applies, also include on line 7(a) of Part II of Form 5735 and on line 26, page 1, Form 1120 of the possessions corporation	7	

Part II To be completed for profit split method only.

Combined Taxable Income from the Possession Product:				
1 Combined gross receipts			1	
2 Combined cost of goods sold				
(a) Inventory at beginning of year			2(a)	
(b) Merchandise bought for manufacture			2(b)	
(c) Salaries and wages allocable or apportionable to the product			2(c)	
(d) Other costs (attach schedule)			2(d)	
(e) Total (add lines 2(a) through 2(d))			2(e)	
(f) Inventory at end of year			2(f)	
(g) Cost of goods sold (subtract line 2(f) from line 2(e))			2(g)	
3 Combined gross income (subtract line 2(g) from line 1)			3	
4 Other combined expenses allocable or apportionable to the product				
(a) Marketing			4(a)	
(b) Cost sharing amount from line 7, Part I	4(b)			
(c) Research and development expenses	4(c)			
(d) Enter the greater of line 4(b) or 4(c)			4(d)	
(e) Other deductions (attach schedule)			4(e)	
(f) Total (add lines 4(a), 4(d), and 4(e))			4(f)	
5 Combined taxable income (subtract line 4(f) from line 3)			5	
6 Possessions corporation's gross income from the product (50% of line 3). Enter here and include in column (f) of Part I of Form 5735, and on line 6(a) of Part II of Form 5735			6	
7 Possessions corporation's applicable deductions (50% of line 4(f)). Enter here and include on line 7(b) of Part II of Form 5735			7	
8 Possessions corporation's taxable income from the product (50% of line 5). Enter here and include on line 10, page 1, Form 1120 of the possessions corporation			8	

Part III To be completed for profit split method only.

1	Adjustment to research deduction. Enter line 4(b) minus line 4(c) of Part II, but not less than zero	1	
2	Enter line 5 of Part II	2	
3	Enter line 8 of Part II	3	
4	Combined taxable income to be allocated below to U.S. affiliates (Enter line 1 plus line 2 minus line 3)	4	

Schedule of affiliates' shares of combined taxable income reported on line 4 of Part III.

(a) Name of affiliate	(b) Identifying number	(c) Amount of share. Enter here and include on line 10, page 1, Form 1120 of the appropriate affiliate.

Part IV To be completed for cost sharing method only.

Schedule of affiliates' shares of cost sharing amount and marketing intangible income

(a) Name of affiliate	(b) Identifying number	(c) Share of cost sharing amount. Enter here and reduce line 26, page 1, Form 1120 of the appropriate affiliate by this amount.	(d) Share of marketing intangible income. Enter here and include on line 10, page 1, Form 1120 of the appropriate affiliate.

Instructions

(Section references are to the Internal Revenue Code, unless otherwise noted.)

Purpose of Schedule.—Schedule P must be attached to Form 5735 by a possessions corporation which has elected to use either the cost sharing method or the profit split method of computing taxable income under section 936(h)(5).

Specific Instructions

A separate Schedule P must be filed for each product to which the cost sharing method or profit split method under section 936(h)(5) applies. If you have elected a different method for export sales than for domestic sales of the possession product, two Schedules P must be filed for that product. All taxpayers must complete Part I. Complete Parts II and III if the profit split method applies to the product. Complete Part IV if the cost sharing method applies to the product.

Part I

Line 1.—Enter the amount of product area research expenditures incurred by the possessions corporation and all other members, including foreign persons, of the affiliated group within the meaning of section 482. Product area research includes expenditures deductible under section 174; qualified research expenses within the meaning of section 44F(b); and certain other expenditures. See proposed regulations section 1.936-6(a)(1).

Line 2.—Enter the total sales or other dispositions of the possession product by the affiliated group to persons who are not members of the affiliated group. See proposed regulations section 1.936-6(a)(2).

Line 3.—Enter the total sales or other dispositions of all products in the product area by the affiliated group to persons who are not members of the affiliated group.

Line 6.—Enter the amount of product area research expenditures paid or accrued solely by the possessions corporation. However, do not include amounts paid or accrued to or on behalf of related persons and amounts paid or accrued under any cost sharing arrangement with a related person.

Part II

Use this Part to compute the combined taxable income of the possessions corporation and its U.S. affiliates derived from the possession product.

Line 1.—Enter the combined gross receipts from the sale or other disposition of the possession product by the possessions corporation and its U.S. affiliates to unrelated persons or foreign affiliates.

Line 2.—Enter the sum of the costs of goods sold of the possessions corporation and of its U.S. affiliates which are attributable to the possession product.

Line 4.—Enter the sum of the expenses incurred by the possessions corporation and by its U.S. affiliates which are allocable or apportionable to the possession product.

Note: *The share of combined taxable income of the possessions corporation entered on line 8 of Part II should be reported on line 10, page 1, Form 1120 of the possessions corporation. The shares of combined taxable income of the U.S. affiliates entered in column (c) of Part III should be reported on line 10, page 1, Form 1120 of each affiliate. Gross receipts, costs of goods sold, and expenses of the possessions corporation and its affiliates which are included in Part II should* **not** *be reported on any Form 1120 filed by the possessions corporation or its affiliates.*

Part III

The amount on line 4 will be allocated to the members of the affiliated group in accordance with proposed regulations section 1.936-6(b)(1). The total of column (c) should equal the amount entered on line 4, Part III.

Part IV

Enter in column (c), Part IV the share of the cost sharing amount (computed in line 7 of Part I) which is allocated to each of the members of the affiliated group in accordance with proposed regulations section 1.936-6(a)(5). Also use column (d), Part IV to enter the share of marketing intangible income which is allocated to each of the members of the affiliated group in accordance with proposed regulations section 1.936-6(a)(5).

Form **5712**
(Rev. March 1984)
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 4-30-87

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

(Section references are to the Internal Revenue Code, unless otherwise noted.)

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 taxpayers 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).

Generally, 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 Commissioner's consent. However, the Commissioner will consent to all requests for revocation that are made with respect to your first taxable year beginning after 1982, provided that you agree not to re-elect section 936(a) prior to your first taxable year beginning after 1988. This can be done by attaching a 'statement of revocation -- section 936' to your timely filed return (including extensions) in which you state that you will not re-elect section 936(a) prior to your first taxable year beginning after 1988. (See proposed regulation 1.936–7(c).)

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 (1) the 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 officier, or other corporate officer (such as tax officer) who is authorized to sign.

Form **5712-A** (March 1984)
Department of the Treasury
Internal Revenue Service

Election to Use the Cost Sharing or Profit Split Method Under Section 936(h)(5)

▶ Attach to your tax return.

OMB No.1545-0215
Expires 4-30-87

The corporation named below elects under section 936(h)(5) of the Internal Revenue Code to use the cost sharing method or profit split method for income tax purposes. The election takes effect for the possessions corporation's first tax year beginning after December 31, 1982.

Name of corporation	Employer identification number

Part I Cost Sharing Method

	SIC Code	Check appropriate box(es)	
		Domestic Sales	Export Sales
List the product area(s) by SIC code to which the election to use the cost sharing method will apply.		☐	☐
		☐	☐
		☐	☐

Part II Profit Split Method

	SIC Code	Check appropriate box(es)	
		Domestic Sales	Export Sales
List the product area(s) by SIC code to which the election to use the profit split method will apply.		☐	☐
		☐	☐
		☐	☐

Part III List all other persons in the affiliated group, including foreign affiliates.

Name of affiliated possessions corporations	Identifying number	SIC Code(s)

Name of other affiliates	Identifying number (if none, enter address)	SIC Code(s)

Under penalties of perjury, I declare that I have been duly authorized by the above-named corporation to make this election, and that to the best of my knowledge and belief, the statements made are true, correct, and complete; and that I have received signed statements in which an authorized officer of each corporation listed in Part III consents to the above election.

Signature and title of officer of electing corporation

Date

For Paperwork Reduction Act Notice, see instructions on back.

Instructions

(Section references are to the Internal Revenue Code.)

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 taxpayers 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.

New Law

Effective for tax years beginning after 1982, new rules apply to the intangible property income of possessions corporations. Generally, this type of income (defined in section 936(h)(3)) is to be included in the gross income of the U.S. shareholders of a possessions corporation. However, the possessions corporation may elect out of this tax treatment if it satisfies a significant business presence test for products within a specific product area, or if it was producing the product in a possession on or before September 3, 1982. The possessions corporation may elect either the cost sharing method or the profit split method of computing taxable income.

If the cost sharing method is elected for a product area, the possessions corporation will be required to make a cost sharing payment which will reduce the amount of deductions otherwise allowable to the appropriate affiliates.

If the profit split method is elected for a product area, the possessions corporation will be required to compute the combined taxable income of the possessions corporation and its U.S. affiliates derived from sales of the products within such product area. Fifty percent of the combined taxable income will be allocated to the possessions corporation, and the remainder will generally be allocated to the appropriate affiliates.

Purpose of Form

You must file this form if you elect to use the cost sharing method or the profit split method of computing taxable income under section 936(h)(5).

Who Can Elect

Only domestic corporations which have completed Form 5712, Election to be Treated as a Possessions Corporation Under Section 936, may elect to use the cost sharing or profit split method under section 936(h)(5).

When to File

Form 5712-A must be filed on or before the due date (including extensions) of the return for your first tax year beginning after December 31, 1982.

Where to File

Attach this form to your regular income tax return and file your return with the Internal Revenue Service Center, Philadelphia, PA 19255.

Scope of Election

An election to use the cost sharing method or profit split method covers all products in a product area. A product area is defined by reference to the three-digit classification of the Standard Industrial Classification (SIC) code. See the Standard Industrial Classification Manual. You may make different elections for different product areas. In addition, you may choose whether an election for a given product area covers all sales, domestic sales only, or export sales only, of products produced in the product area.

Note: *All possessions corporations in an affiliated group within the meaning of section 482 that produce any products in a given product area must make the same election for that product area. You must list in Part III the name and employer identification number (or address if taxpayer does not have a EIN) of all members of the affiliated group (including foreign affiliates not required to file a U.S. return). All members of the affiliated group must consent to the election. If subsequent to filing Form 5712-A, there are changes in the make-up of the affiliated group, an amended Form 5712-A must be filed by attaching it to the possessions corporation's timely filed tax return (including extensions).*

Period of Election

Once an election is made, it is binding and must be used for each taxable year in which the domestic corporation qualifies under sections 936(a) and (h)(5) until revoked.

In general, you may revoke this election only with the consent of the Commissioner. However, you may change your election for any product area once (from the cost sharing method to the profit split method, or vice versa) without the consent of the Commissioner if the change is made before the later of the following dates:

(a) January 1, 1986, or

(b) 90 days after the date of publication of final regulations under section 936(h)(5)(C)(i) and (ii).

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 **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

1983

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If incorrect, make any necessary change. ▶

Name (as distinguished from trade name) — Calendar Year 1983

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)

			Amount paid		
1	Total payments (including exempt payments) during the calendar year for services of employees			1	
2	Exempt payments. (Explain each exemption shown, attaching additional sheets if necessary) ▶ ________	2			
3	Payments for services in excess of $7,000. Enter only the excess over the first $7,000 paid to individual employees exclusive of exempt amounts entered on line 2. Do not use State wage limitation	3			
4	Total exempt payments (add lines 2 and 3)			4	
5	**Total taxable wages** (subtract line 4 from line 1). (If any portion is exempt from State contributions, see instructions) ▶			5	

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 ______ x .006 ______	(g) MI ______ x .006 ______	(m) VT ______ x .006 ______	
(b) CT ______ x .007 ______	(h) MN ______ x .006 ______	(n) WV ______ x .006 ______	
(c) DE ______ x .006 ______	(i) NJ ______ x .006 ______	**Outside the U.S.**	
(d) DC ______ x .011 ______	(j) OH ______ x .006 ______	(o) PR ______ x .006 ______	
(e) IL ______ x .007 ______	(k) PA ______ x .007 ______	(p) VI ______ x .006 ______	
(f) KY ______ x .003 ______	(l) RI ______ x .006 ______		

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

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 .008 and enter here	1	
2	Enter amount from line 7, Part I	2	
3	**Total FUTA tax** (add lines 1 and 2)	3	
4	Less: Total FUTA tax deposited for the year from your records	4	
5	**Balance due** (subtract line 4 from line 3—if over $100, see Part IV instructions). Pay to IRS . . . ▶	5	
6	**Overpayment** (subtract line 3 from line 4). Check if to be: ☐ Applied to next return, or ☐ Refunded . . . ▶	6	

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 .035			1	
2	Maximum credit. Multiply the wages on line 5, Part I, by .027.	2			
3	Enter the smaller of the amount on line 11, Part V, or line 2, Part III	3			
4	Enter amount from line 7, Part I			4	
5	**Credit allowable** (subtract line 4 from line 3)			5	
6	Total FUTA tax (subtract line 5 from line 1)			6	
7	Less: Total FUTA tax deposited for the year from your records			7	
8	**Balance due** (subtract line 7 from line 6—if over $100, see Part IV instructions). Pay to IRS . . . ▶			8	
9	**Overpayment** (subtract line 6 from line 7). Check if to be: ☐ Applied to next return, or ☐ Refunded . . . ▶			9	

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 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 x 2.7%) 6	Contributions payable at experience rate (col. 3 x 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) . . . . ▶									

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 and 1984.

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.

Special assessments (surcharges, surtaxes,etc.) by a State to pay the interest on Title XII loans to a State from the Federal government are not includible as "contributions." Contact your State unemployment agency if you are not sure whether your payments to the fund include these charges.

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 1982 or 1983.

2. Household and Other Employers Who File Form 940: If your total Federal unemployment (FUTA) tax for 1983 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 taxpayers 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.—Use it for the annual reporting of tax under FUTA. **This tax is paid only by the employer.** The gross tax rate is 3.5% (.035) on the first $7,000 of wages paid to each employee during 1983.

Who Must File.—In general, every employer who during 1982 or 1983 (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 1982 or 1983.

(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 1982 or 1983. 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 1986.

(3) You paid cash wages of $1,000 or more in any calendar quarter in 1982 or 1983 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 Form 940 and are not liable for Federal unemployment tax for 1983, 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 1983 is due by January 31, 1984. However, if you made timely deposits in full payment of the tax due, your due date is February 10, 1984.

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 preaddressed 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. Nor may you take credit for any special assessment, surtax, surcharge, etc. by the State for paying interest on unrepaid Title XII loans from the Federal government.

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 for the conditions that you must meet.

Specific Instructions

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

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.)

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 4		State experience rate	Contributions if rate had been 2.7% (col. 3 x 2.7%)	Contributions payable at experience rate (col. 3 x col. 5)	Additional credit (col. 6 minus col. 7) If 0 or less, enter 0.	Contributions actually paid to State
1	2	3	From—	To—	5	6	7	8	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) did not pay cash wages of $20,000 or more for such labor for any calendar quarter in 1982 and 1983 AND did not employ 10 or more farmworkers during any part of a day during any 20 different weeks in 1982 or 1983, (b) paid wages to aliens admitted to the United States on a temporary basis to perform farmwork before 1986.

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

(3) Household service if you did not pay cash,wages of $1,000 or more in any calendar quarter in 1982 and 1983.

(4) Certain family employment.

(5) Certain fishing activities.

(6) Noncash payments for farmwork 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 $7,000. For example, if you have 10 employees whom you paid $8,000 each during the year, enter $80,000 on line 1 and $10,000 on line 3. The $7,000 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 the states listed. (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 .008 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 1983**, multiply by .008 that part of the first $7,000 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 your liability for the first 3 quarters of the year.** If this plus any undeposited amount from earlier quarters 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. To avoid a possible penalty, do not mail deposits directly to IRS. Records of your deposits will be sent to IRS for crediting to your business accounts.

Beginning January 1, 1984, new coupon forms will be used for depositing taxes. In December 1983, IRS will send you a Federal Tax Deposit Coupon Book (Form 8109) containing 15 coupons for depositing all types of taxes. Indicate the type of tax on the coupon (940 in this case) and include a coupon with each deposit you make.

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 each State.

Column 3.—Enter the taxable payroll on which you must pay taxes to the unemployment fund of each 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, unemployment compensation paid to your former employees and other factors. If you do not know your rate, contact your State unemployment 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. Do not include any special assessments, surtaxes, surcharges, etc., used by the State to pay interest on unrepaid advances from the Federal government.

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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