tax notes international

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Reprinted from 10 *Tax Notes Int'l* 235 (January 16, 1995)

tax notes international

ISSN 1058-3971

Tax Policy Forum

Puerto Rico and Section 936: A Costly Dependence

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The authors would like to thank Elizabeth Chant, Harry Hjardemaal, and Jeffrey Hall for assistance with research and editing in the preparation of this report. The comments of Richard Ainsworth and Chung-Hee Lee on an earlier draft of this paper are greatly appreciated. All errors and omissions are the responsibility of the authors alone.

I. Introduction

For over 70 years, U.S. corporations have been granted tax incentives to operate in U.S. territorial possessions, most notably in Puerto Rico.[1] The purpose in so benefiting what have become known as "possessions corporations" is to attract U.S. capital to these developing territories, with the goal of creating jobs.[2]

At the outset, this approach—as expressed first in section 262 of the Revenue Act of 1921, and ultimately in section 936 of the Internal Revenue Code—was successful. In Puerto Rico during the 1950s and 1960s, it spurred the island's industrialization, infrastructure development, and the attendant growth in employment and gross national product (GNP). By the mid-1970s, however, the job-creation benefits of section 936 took a backseat to the tax planning that brought great financial gain to only a few U.S. companies, substantial cost to the U.S. Treasury, and a competitive disadvantage to "native" Puerto Rican enterprises.

This problem persists in large part because section 936 can have an immense impact on after-tax U.S. profits: possessions corporations receive full credit against U.S. taxes owed on the net income earned in a possession, regardless of whether that income is generated by the use of tangible property and labor within the possession or is attributable to the use of intangible property transferred to the possession corporation. Companies have been quick to see the benefit in transferring intangible assets and their related income streams to their possessions-based operations. Therefore, to the extent that corporations are able to claim tax credits for income sourced in the possessions that has been generated by properties temporarily located there but for which no real investments have been made, the cost of section 936 to the U.S. Treasury has been wholly unrelated to the intended development benefits that underlay adoption of section 936 in the first instance.

Some analysts, considering the section 936 problem solely from the perspective of the revenue loss caused by the artificial transfers of intangible assets to possessions

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[1] These territorial possessions now include Puerto Rico, the U.S. Virgin Islands, the Commonwealth of the Northern Marianas, the Federated States of Micronesia, the Marshall Islands, American Samoa, and Guam. The Philippines was considered a U.S. possession until 1946, when it was given its independence.

[2] A possessions corporation is a U.S. corporation, which is commonly the subsidiary of a U.S. parent corporation doing business in a U.S. territorial possession, and which otherwise qualifies for the special tax credit afforded to such corporations under section 936 of the Internal Revenue Code (IRC).

corporations, have sought remedies by linking section 936 with section 482 of the code. Other analysts, considering the 936 problem solely from the perspective of the lack of real, development-based investments in the possessions, have sought remedies in credit limitations based on measures of real investments in the possessions themselves. Recent additions to the Internal Revenue Code reflect solutions from both perspectives.

This paper argues that neither solution offers much hope of real success, and that the current mix of solutions, although well intended, most likely will have a serious negative impact on "native" possession enterprises and the revenues these enterprises contribute to possession treasuries.

It is time to admit that the attractiveness of section 936 as a tax scheme has come to far outweigh its role as an employment-producing incentive. The companies benefiting most from the credit have been capital-intensive firms such as pharmaceutical companies. Those benefiting least have been labor-intensive industries such as apparel manufacturers.

For example, in Puerto Rico during the 1980s, the pharmaceutical industry received about 50 percent of the total tax benefits from section 936 while providing only 15-18 percent of the section 936 jobs. In 1989, the latest year for which aggregate data are available, this translated into the pharmaceutical industry receiving $1.2 billion of all section 936 credits, while employing only about 18,000 of the 106,000 workers in section 936 firms. The average cost to the U.S. Treasury for each Puerto Rican job in the pharmaceutical industry that year was $66,081, while the average compensation was $30,447. Thus, for each dollar of employee compensation, pharmaceuticals received $2.17 in tax benefits from the U.S. Treasury.[3]

The total cost of the section 936 tax credit to the U.S. Treasury in 1989 was approximately $2.5 billion.[4] The present value of its cumulative cost during 1973-89 is approximately $52 billion.[5] The Treasury Department's Office of Tax Analysis projected that the costs of section 936, were it not revised, would continue rising at some 10 percent annually,[6] while the Congressional Budget Office calculated that the incentive scheme would bring losses of $15 billion in potential tax revenues during 1993-97.[7]

The cost of section 936 to the U.S. Treasury has been wholly unrelated to the intended development benefits that underlay adoption of section 936 in the first instance.

These conditions made section 936 a logical target for deficit-reduction legislation in President Clinton's 1993 budget. The revised section 936 provisions restructure and reduce the tax credit effective December 31, 1993. In particular, Congress has legislated a connection between the tax credit and employment and investment growth in the possessions.

Although reform is desirable, this paper argues on a historical basis that section 936 should not merely be fixed, and indeed, that it cannot be fixed. Our contention is that section 936 has:

- essentially operated as a costly tax benefit to a few corporations;
- resulted, through links with the Caribbean Basin Initiative, in substantial gains for possessions corporations with little corresponding boost in regional exports;
- created a tax-subsidy-oriented development strategy, which for the past 20 years has been a principal cause of stagnation in the Puerto Rican economy; and
- has generated, understandably, a powerful lobbying effort to perpetuate the 936 corporate financial benefits by delivering the message that the Puerto Rican economy would falter without the investment stimulus of 936.[8]

We find further that the revisions to section 936, as provided in President Clinton's 1993 budget, do not address these shortcomings. Moreover, like earlier attempts to fix the tax benefit, they promise a result that is inferior to the possibilities of abandoning the policy entirely.

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[3] J. Bradford, "U.S. Possessions Corporations Returns, 1989," U.S. Department of the Treasury, Office of Tax Analysis, p. 103.

[4] *Id.*

[5] U.S. Department of the Treasury, "The Operations and Effect of the Possessions Corporation System of Taxation, Sixth Report," 1989, Table 4-11. Figures for 1984 and 1986 were imputed by taking the mean between available data for 1985 and 1987. The discount rate used was 8 percent.

[6] P. Morrison, "Testimony before the Committee on Finance, United States Senate," April 26, 1990, p. 2.

[7] U.S. General Accounting Office, "Pharmaceutical Industry: Tax Benefits of Operating in Puerto Rico," Briefing Report to the Chairman, Special Committee on Aging, U.S. Senate, May 1992, p. 1.

[8] *See* J.T. Hexner, G. Jenkins, H.F. Ladd, and K.R. LaMotte, *Puerto Rican Statehood: A Precondition to Sound Economic Growth,* November 1993. This report shows that section 936 acts as an unsustainable crutch in the Puerto Rican economy and, in so doing, creates significant market distortions, thereby impeding the economic development of the island.

Section II of this article reviews the historical background of section 936, and section III examines its mechanics and looks at the technical aspects of related legislation. In particular, this article explores the relationship between section 936 and regulations issued to limit transfer pricing abuses. Section IV analyzes the impact of section 936 on Puerto Rico. Section V explores the legal relationship between section 936 and the Caribbean Basin Initiative—an act that will prolong the tax incentive. Section VI outlines the elements of the most recent attempts to reform the tax credit. Section VII concludes that section 936 cannot and should not be fixed because, as a development strategy, it is expensive and ineffective—expensive to U.S. taxpayers and ineffective in stimulating the growth of the Puerto Rican economy.

II. The Legislative History of Section 936

A. Background

Since the Revenue Act of 1921 (with its section 262, the predecessor of section 936), the U.S. government has provided a tax incentive for U.S. corporations operating in its territorial possessions.[9] The original goal was to help American corporations compete with foreign firms in the Philippines.[10]

Section 262 exempted qualified U.S. corporations from taxes on all income derived from sources outside the United States. To qualify, a corporation had to derive 80 percent or more of its gross income from its operations in U.S. possessions, and 50 percent or more of its gross income from active trade or business in the possessions.[11] These gross income tests had to be met on an aggregate basis for the year of the exemption and for the two preceding tax years if the corporation had conducted a trade or business in a possession during that period.

Under the 1921 act, dividends paid by the possessions corporation to corporate shareholders were fully taxable. In the Revenue Act of 1935, however, this policy was abandoned. Moreover, amounts received upon liquidation were made tax-exempt.[12]

In 1948, by coupling these U.S. tax incentives with various local tax incentives, Puerto Rico initiated a more aggressive program to attract major capital investment. This program, known as

The original goal of section 936 was to help American corporations compete with foreign firms in the Philippines.

"Operation Bootstrap,"[13] attracted a surge of U.S. corporations, particularly in labor-intensive industries. From 1948 to 1972, Puerto Rico's real GNP grew at an average annual rate of 6 percent (compared to a rate of 3.7 percent for the United States).[14] At the same time, the island's economy shifted from its traditional agricultural base to manufacturing, where employment increased from 55,000 in 1950 to 142,000 in 1972.[15] Indeed, the program was so successful that during the 1950s and 1960s, Puerto Rico was dubbed the "economic miracle" of the Caribbean.[16]

After this boom, however, the Puerto Rican economy stagnated. And while the section 936 lobby has attempted to maintain and disseminate the historical boom illusion, the annual rate of physical investment declined by nearly 30 percent between 1973 and 1978, from $1.5 billion to $1.1 billion.[17] In the next five years, from 1978 to 1983, new physical investment fell another 35 percent, from $1.1 billion to $0.7 billion.[18] Private investment in plant and equipment also fell steadily from 10.3 percent of GNP in 1973 to 4.6 percent in 1983.[19]

By the mid-1970s, the possessions tax benefit began to be criticized as an insufficient stimulus for employment-producing investments in Puerto Rico and the other possessions. Later, during the 1980s, other criticism emerged to the effect that, because the tax incentive provided that liquidation receipts were tax-exempt, possessions corporations were accumulating and investing earnings in the Eurodollar market and other foreign markets for long periods before liquidating and repatriating these earnings

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[9]Revenue Act of 1921, ch. 136, section 262, 42 Stat. 227, 314.

[10]The vast majority of section 936 companies conduct business in Puerto Rico. In 1987, nearly 97 percent of all U.S. possessions corporations operated in Puerto Rico and over 99 percent of the total section 936 credit was claimed by companies with operations in Puerto Rico. *See* J. Bradford, "U.S. Possessions Corporations Returns," p. 51. Consequently, this article will focus on the operation of section 936 in Puerto Rico.

[11]U.S. Department of the Treasury, "Sixth Report," p. 5.

[12]Revenue Act of 1935, ch. 829, sec. 112(b)(6), 49 Stat. 1014, 1020.

[13]The Operation Bootstrap program was conceived by Puerto Rican Governor Luis Munoz Marin and promised U.S. corporations "cheap labor, exemptions from island taxes for up to 25 years (along with total exemption from U.S. federal corporate and private income taxes), and assistance in the building of plants." Tansill, "Puerto Rico: Independence or Statehood?" *Revista del Colegio de Abogados de Puerto Rico* 41 (1980): 93.

[14]U.S. Department of the Treasury, "Sixth Report," pp. 17, 19.

[15]*Id.*, p. 17.

[16]*Id.*

[17]*Id.*, p. 24.

[18]*Id.*

[19]*Id.* p. 17.

tax-free to the United States.[20] By the mid-1980s, opponents of the tax benefit further argued that its cost in foregone tax revenue contradicted deficit-reduction efforts by the U.S. Treasury.[21]

Those favoring a continuation of the tax exemption countered that the incentives were needed to offset the costs of federally imposed requirements in the possessions. U.S. law, for example, set minimum wages and mandated the use of U.S. flag vessels to transport goods to the mainland. This was said to disadvantage Puerto Rico, and other U.S. possessions generally, in competition with other developing countries for U.S. investment.[22]

Congress responded to the early criticisms by creating a new section 936 of the Internal Revenue Code in the Tax Reform Act of 1976.[23] 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.[24]

The essence of the 1976 legislation remained intact and continued to apply until December 31, 1993. Its unsatisfactory performance, with respect to the goals of Congress, is, however, broadly apparent. The benefit to much-needed employment in Puerto Rico continues to be low (the unemployment rate in Puerto Rico is now 18.1 percent) relative to its mounting cost ($2.5 billion in 1989) to the U.S. Treasury. This result has occurred because the legislation supported (and continued to support until December 31, 1993) possessions corporations and their affiliates in the exploitation of transfer pricing.

B. Combating Transfer Pricing Abuses

Before 1982, there were no explicit statutory guidelines on transfer pricing.[25] This statutory silence provided possessions corporations with tacit permission to minimize their tax liability by shifting the taxable income attributable to property transferred from U.S. affiliates. A U.S. pharmaceutical company, for example, might develop a patentable drug in its U.S. laboratory and receive deductions on its U.S. federal income tax obligations for the research and development costs it incurred. The company would then transfer the patent to its wholly owned possessions corporation, which would produce the patented drug and would claim the resulting income as possession-source income. As a result, the corporate group would owe little or no income tax, either in the United States or in Puerto Rico, for producing this drug.[26]

> The 1976 legislation supported (until December 31, 1993) possessions corporations and their affiliates in the exploitation of transfer pricing.

Congress and the Treasury have repeatedly reacted to this problem but have met with limited success. Congress enacted the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), which added a new section 936(h) to the Internal Revenue Code to ensure that a sufficient percentage of income generated by such transferred intangibles would be allocated to the U.S. parent.[27] Section 936(h) was revised again in 1986 to coordinate with section 482 provisions, which address transfer pricing in general. And, as recently as January 1993, Congress once again revised the regulations when it issued new temporary section 482 regulations, which refer to section 936(h).

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[20] *Id.*, p. 7.

[21] *Id.*, p. 6.

[22] *Id.*

[23] *See generally* U.S. House of Representatives, "Report of the Committee on Ways and Means, U.S. House of Representatives, on H.R. 10612," Report No. 94-658, November 12, 1975; and U.S. Senate, "Report of the Committee on Finance, U.S. Senate, on H.R. 10612," Report No. 94-938, June 10, 1976.

[24] U.S. House of Representatives, "Report on H.R. 10612," p. 255; and U.S. Senate, "Report on H.R. 10612," p. 279.

[25] U.S. Department of the Treasury, "Sixth Report," p. 8. U.S. corporations operating in the possessions usually show profits in two ways. First, they earn profits from real investment in plant and equipment in Puerto Rico. Second, they are sometimes able to increase the amount of accounting profits reported in the possessions without any new physical investment by allocating to a possessions corporation income from intangibles (such as patents, trademarks, and trade names) that had typically been developed and paid for by an affiliated U.S. corporation and subsequently were transferred to the possessions corporation at a transfer price that does not reflect the market cost or the costs of development.

[26] *Id.; see also* U.S. General Accounting Office, "Pharmaceutical Industry," p. 2. The U.S. Treasury took the opposite position, however, and argued that income obtained from drug sales in these transactions should be allocated to the U.S. parent and was subject to federal taxation. This issue resulted in lengthy litigation. *See, for example, Eli Lilly and Co. v. Comm'r.*, 84 T.C. 996 (1985) and *G.D. Searle & Co. v. Comm'r.*, 88 T.C. 252 (1987).

[27] U.S. Department of the Treasury, "Sixth Report," p. 8.

C. Section 936 Eligibility and Links to Investment and Employment

Congress has undertaken a parallel effort to tighten the eligibility requirements for the tax exemption. It has repeatedly revised the gross income test (the minimum percentage of a section 936 firm's income that must be earned from the active conduct of trade or business in the possessions to qualify for the tax credit). Revisions to section 936 in 1976 set the minimum at 50 percent—the same figure required under the antecedent legislation. The 1982 revision increased the minimum to 65 percent, and in 1986 it was raised again to 75 percent.[28] Hence, a section 936 firm may now derive no more than 25 percent of its gross income from passive investments.

Stipulations in the Clinton administration budget adopted in 1993 represent the most recent attempt to make section 936 "work." These provisions, which came into effect on December 31, 1993, aim to reduce the tax credit while strengthening its link to investment, employment, and wage growth in the possessions.

The following sections evaluate the specifics of the evolving section 936 legislation and related provisions.

III. The Mechanics of Section 936 and Related Legislation

A. The Section 936 Tax Credit

Section 936 grants to subsidiaries of U.S. corporations operating in the possessions a tax credit[29] equal to the U.S. federal income tax liability from such operations.[30] This credit is based on the taxable income derived from: (1) trade or business within the possession,[31] (2) the sale or exchange of substantially all of the assets used by the subsidiary in this trade or business,[32] and (3) "qualified possession source investment income, (QPSII)" (i.e., passive income resulting from investment in the possessions of the exempted profits).[33]

The credit is available to any U.S. corporation that during the three years prior to the close of the tax year (or for such part of such period immediately preceding the close of the tax year as may be applicable) earned 80 percent or more of its gross income from possession sources,[34] and earned 75 percent or more of its gross income from the active conduct of trade or business within the possessions.[35]

> A section 936 firm may now derive no more than 25 percent of its gross income from passive investments.

U.S. parent corporations are eligible for a dividends-received deduction on dividends received from a possessions corporation.[36] If the possessions corporation is a wholly owned subsidiary—as most of them are—the deduction equals 100 percent of the dividend.[37] Such a possessions corporation can therefore repatriate to its U.S. parent, free of any U.S. federal income tax liability, its income earned in the possessions. Possessions governments may, however, impose their own taxes on earnings of the possessions corporations. This can include, as is the case for Puerto Rico, a tollgate tax on the repatriated earnings.[38]

Gross income received on the mainland by a possessions corporation is only considered possession-source income if it is derived from trade or business with unaffiliated parties.[39] If a U.S. corporation deposits payments into a bank account on the mainland of a possessions corporation subsidiary as payment for goods manufactured by that subsidiary in Puerto Rico, the payment will not be considered possession-source income of the subsidiary.[40] The subsidiary must receive payment in Puerto Rico for goods and services in order for the payment to be considered possession-source income that qualifies for the section 936 tax credit.[41]

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[28]The 1986 act also expanded the range of types of investment income that qualify for the tax exemption. Income from deposits in Puerto Rican financial institutions that are used to finance development projects in Caribbean Basin Initiative countries now qualify.

[29]The dollar amount of the section 936 credit is determined as follows:

$$\text{Tax Credit} = \frac{\begin{array}{c}\text{Taxable Business and}\\\text{Investment Income}\\\text{From Sources Within Puerto Rico}\end{array}}{\begin{array}{c}\text{Worldwide Taxable Income}\\\text{of Possessions Corporation}\end{array}} \times \text{U.S. Tax}$$

See R.J. Boles, "Tax Incentives for Doing Business in Puerto Rico," *International Lawyer* 22, no. 1 (Spring 1988): 123, which explains the basis for this calculation.

[30]IRC section 936(a)(1) (1989).

[31]IRC section 936(a)(1)(A)(i).

[32]IRC section 936(a)(1)(A)(ii).

[33]IRC section 936(a)(1)(B). The operation of the qualified possession-source investment income provision of section 936 will be discussed in Section V.

[34]IRC section 936(a)(2)(A).

[35]IRC section 936(a)(2)(B).

[36]IRC section 243(b)(1)(C).

[37]U.S. Department of the Treasury, "Sixth Report," p. 7.

[38]Puerto Rican tax laws applicable to U.S. possessions corporations are discussed in the next part of this section.

[39]IRC section 936(b).

[40]*Pacific Basin Mfg. & Trade Co. v. Comm'r.*, 716 F.2d 638 (9th Cir. 1983); Rev. Rul. 79-168, 1979-2 C.B. 283.

[41]Nevertheless, the standard foreign tax credit may be claimed for foreign taxes paid or accrued on income that does not qualify for the section 936 credit. *See* U.S. Department of the Treasury, "Sixth Report," p. 7.

A possessions corporation may not join in a consolidated return with its parent or any affiliated corporations, even in a year in which it fails to satisfy either the 80-percent possessions-source test or the 75-percent active trade or business test.[42] Hence, operating losses incurred by a possessions corporation may not offset the taxable income of the parent or an affiliated corporation. This means that a subsidiary engaged in trade or business in a possession ordinarily will not elect to file under section 936 until it is no longer incurring start-up losses.[43]

The section 936 tax credit is not available for use against the environmental tax,[44] the tax on accumulated earnings,[45] the personal holding company tax,[46] or taxes arising out of recoveries of foreign expropriation losses.[47] For purposes of the accumulated earnings tax, the accumulated taxable income of a possessions corporation does not include taxable income eligible for the section 936 credit.[48] The credit is also unavailable to a corporation for any tax year in which that corporation is a domestic international sales corporation (DISC) or former DISC,[49] or for any tax year in which it owns stock in a DISC or former DISC,[50] or in a foreign sales corporation (FSC) or former FSC.[51]

A possessions corporation may elect to use section 936 by filing Treasury Form 5712. For the first tax year in which a possessions corporation applies for the section 936 credit, the form must be submitted on or before the date on which the federal income tax return is filed.[52] An election to use the credit may not be revoked for a period of 10 years without consent from the secretary of the Treasury.[53]

B. Complementary Puerto Rican Tax Incentives

In addition to the tax credit provided under section 936, the Puerto Rican government has, since 1948, provided its own complementary tax incentives for manufacturing and other specified business activities. Puerto Rico currently grants partial exemptions (of 90 percent) from income tax and other taxes to approved businesses for specified periods of time, usually from 10 to 25 years.[54] A business is generally eligible for an exemption if it is producing on a commercial scale in Puerto Rico a "designated service unit"[55] or a manufactured product not produced in Puerto Rico before January 1, 1947.[56]

Companies that meet that criterion are entitled to a 90-percent income tax exemption, for a period that varies according to the level of business activity in the area where the business is located:[57]

Location	Duration of Exemption
High Development Zone	10 years
Intermediate Development Zone	15 years
Low Development Zone	20 years
Vieques or Culebra	25 years

Qualified manufacturers also receive partial exemptions (up to 90 percent) from property taxes on the personal or real property that generates the exempted income. Moreover, a manufacturing company with gross income of less than $500,000 in any year and with average employment that year of at least 15 persons receives a 100-percent deduction of its first $100,000 of income. A 60-percent exemption from municipal license (gross receipts) taxes is also granted. Businesses that qualify for these exemptions are subject to a special surcharge equal to the lesser of 0.075 percent of sales or 0.5 percent of net income if their income is in excess of $100,000 in a tax year.[58]

A tollgate tax of up to 10 percent may be imposed on earnings repatriated to the United States or to a foreign country. The rate depends on the amount and the length of time that these earnings were invested in Puerto Rico prior to their repatriation. Holding earnings in certain designated investments in Puerto Rico (such as Puerto Rican bonds, bank savings certificates, participation in construction loans, or investment in the company's own additional plant and equipment) for five or more years will decrease the tollgate tax rate by 1 percentage point for each year that the investment is maintained. Thus, earnings invested in these instruments for six years will result in a 4-percent tollgate tax rate when the earnings are repatriated. If

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[42]R.J. Boles, "Tax Incentives," p. 125.

[43]To the extent that any losses prior to electing section 936 status have been used beneficially to offset the U.S.-source income of an affiliated group, the possessions corporation will ultimately be required to "recapture" such losses by treating them as U.S.-source income under the overall foreign loss recapture rules of IRC section 904(f).

[44]IRC section 936(a)(3)(A); IRC section 59A.

[45]IRC section 936(a)(3)(B); IRC section 531.

[46]IRC section 936(a)(3)(C); IRC section 541.

[47]IRC section 936(a)(3)(D); IRC section 1351.

[48]IRC section 936(g).

[49]IRC section 936(f)(1).

[50]IRC section 936(f)(2)(A).

[51]IRC section 936(f)(2)(B).

[52]IRC section 936(e)(1); R.J. Boles, "Tax Incentives," p. 123.

[53]IRC section 936(e)(2).

[54]Puerto Rico Tax Incentives Act, section 3, 13 L.P.R.A. section 256b(a) (Supp. 1988) (approved Jan. 24, 1987).

[55]13 L.P.R.A. section 255a(d)(4). The term "designated service unit" applies to certain service production activities such as distribution, investment banking, public relations, publicity, consulting, and computer services.

[56]13 L.P.R.A. section 256a(d)(1).

[57]13 L.P.R.A. section 256(b)(d).

[58]13 L.P.R.A. section 256b(a).

Example No. 1

XYZ Corporation
Hypothetical Subsidiary Operation in the U.S. and Puerto Rico Pharmaceutical Industry

	Manufacturing United States	Plant Location Puerto Rico
Sales	$150,000,000	$150,000,000
Income Before Taxes	50,000,000	50,000,000
Effective Corporate Tax Rate	35%	4.5%
Income Taxes	17,500,000	2,228,750
Special Surtax Rate	—	0.075%
Special Surtaxes	0	112,500
Tollgate Tax[1]	0	4,765,875
Net Income After Tax	32,500,000	42,892,875
Tax Savings[2]	0	10,392,875

[1]The 10-percent tollgate tax applied assumes immediate repatriation of earnings.

[2]Tax savings is the difference in potential income tax obligations between the U.S. and Puerto Rico. In this example, the tax savings equal $17.5 million minus $7.11 million.

the amount invested is at least 50 percent of the income of the exempted business for a given year, then all of that year's earnings will qualify for the reduced tollgate tax rate. The 50 percent (or less) of net income not invested can be repatriated immediately at the reduced rate. At the end of the investment period, the invested funds also can be repatriated at the reduced rate.[59]

Example No. 1 illustrates how these rules operate.[60] It shows that if located in Puerto Rico, 90 percent of the income of the subsidiary of XYZ company would be exempt from local income taxes. The remaining 10 percent would be taxed at a rate of 45 percent. Also, the 0.075-percent surtax on sales and the tollgate tax on repatriated earnings would apply. Consequently, the tax would be $2,250,000 (10 percent of the $50,000,000 in income taxed at a rate of 45 percent) less $21,250.[61]

This amounts to a total of $7.11 million owed to the government of Puerto Rico on income of $50 million, compared to an estimated $17.5 million that would be owed on similar income derived from mainland operations. The effective tax rate for this company thus is only 14.22 percent (the sum of $7.11 million in income tax, surtax, and tollgate tax divided by $50 million in income), compared to the 35-percent maximum corporate tax rate the corporation would face on similar operations in the United States. As this example shows, a U.S. company that operates in Puerto Rico under section 936 stands to reap a substantial increase in net after-tax profits through the drastic reduction in tax liability available on the island.

C. The TEFRA Amendments to Section 936

Since 1982, the Tax Equity and Fiscal Responsibility Act (TEFRA) has provided statutory rules for the allocation to a possessions corporation of income from intangibles that were developed or purchased by its affiliated corporations. The act is one in a series of attempts by the U.S. Congress to stem transfer pricing abuse.

TEFRA added a new section 936(h) to the Internal Revenue Code. This section provides that income from intangible property that is not owned by a possessions corporation is not eligible for the section 936 tax credit. Rather, it is generally taxable to the U.S. shareholders of the possessions corporation. TEFRA provides further that a possessions corporation and its affiliates may elect out of this general rule under either a "cost-sharing" option or a "50/50 profit-split" option.[62]

These two options provide methods by which a possessions corporation may claim an appropriate portion of the income from intangible property that is transferred from its affiliates. If the possessions corporation does not elect either method, it must compute its income from intangible property based on a reasonable profit on the costs that are attributable to such income.[63]

The cost-sharing and profit-split options apply only to "possession products," products produced wholly or partially by a possessions corporation.[64] The possessions corporation must elect to treat all products in the same pro-

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[59]13 L.P.R.A. section 256c(b).

[60]Based on examples given by the U.S. Department of the Treasury, Internal Revenue Service, in C.F.R.

[61]*See* R.J. Boles, "Tax Incentives," Appendix B, p. 142, which explains the basis for this calculation.

[62]IRC section 936(h)(5).

[63]R.J. Boles, "Tax Incentives," p. 129.

[64]The regulations under IRC section 936(h) provide a flexible definition of the term "possession product." The term includes any item of property that is the result of a production process, including components and so-called "end-product forms." End-product forms are products that are treated as not including certain other components for purposes of meeting the business-presence test and for the computation of the amount of income derived from the possession product.

duct area (defined by reference to three-digit classification using the Standard Industrial Classification (SIC) code) in a like manner.[65] If a corporation elects one of these options, it may, however, make a different election for export and domestic sales.[66] To be eligible to use either the cost-sharing or profit-split option, a possessions corporation must have a "significant business presence" with respect to a particular product in a possession. This requires meeting one of two tests:

25-Percent Value Added Test: The possessions corporation must show that it incurred production costs[67] with respect to the product that are not less than 25 percent of the difference of (1) gross receipts from sales or other disposition of the product to unrelated parties by the possessions corporation or its affiliates less (2) direct costs of materials purchased by the possessions corporation or its affiliates from unrelated parties in connection with the manufacture of that product.[68]

65-Percent Labor Test: Alternatively, the possessions corporation must show that it incurred at least 65 percent of the total direct labor costs[69] of the possessions corporation and its affiliates in producing the product or service during the tax year. The 65 percent refers to compensation for labor services performed in the possession.[70]

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 above. For such operations, a transition period is provided, as follows:

	Year 1	Year 2	Year 3
Value Added Test	10%	15%	20%
Labor Test	35%	45%	55%

1. The Cost-Sharing Option

Under the cost-sharing option, a possessions corporation is required to make a payment to its U.S. parent for 110 percent of its share of the cost (if any) of product-area research that is paid or accrued by the affiliated group during the tax year.[71] "Product area research" costs include research, development, and experimental costs, losses, expenses, and other related deductions, including amounts paid for the use of, or right to use, a patent, invention, formula, process, design, pattern, or know-how (or the amount paid for the acquisition of any of these) that are allocable to the same product area as that in which the possessions corporation conducts its activities. Also included is a pro rata portion of any costs, expenses, and other deductions that cannot definitely be allocated to a particular product area.[72]

The payment required of the possessions corporation is therefore 110 percent of a portion of the year's research expenditures of the affiliated group in the product area in which the possession product falls.[73] This portion is defined as the ratio of (1) third-party sales of the possession product made by the affiliated group to (2) third-party sales of all products in the product area made by the affiliated group.[74] The cost-sharing payment is determined separately for each product by using the following formula:

$$\frac{\text{Sales to Unrelated Persons of Possession Product}}{\text{Total Sales of Products in 3-digit SIC Code}}$$
$$x$$
$$\text{110\% of Worldwide Product-Area Research}$$
$$=$$
$$\text{Cost-Sharing Payment}$$

A possessions corporation may credit its payments under cost-sharing arrangements with unrelated persons against its share of the cost of product area research paid or accrued by the affiliated group. On the other hand, amounts paid to, or on behalf of, related persons and amounts paid under any sharing agreements with related persons may not be credited against the possessions corporation's cost-sharing payment for the tax year.[75]

Accordingly, a possessions corporation electing the cost-sharing payment method is treated as the owner of the manufacturing intangibles (but not marketing intan-

[65] IRC section 936(h)(5)(C).

[66] IRC section 936(h)(5).

[67] For purposes of the value added test, the term "production costs" has the same meaning as in 26 C.F.R. section 1.471-11(b) except that the term does not include direct material costs and interest. Thus, production costs include direct labor costs and fixed and variable indirect production costs (other than interest). Fixed indirect production costs may include, among other costs, rent, and property taxes on buildings and machinery incident to and necessary for manufacturing operations and processes. Variable indirect production costs may include, among other costs, indirect materials, factory janitorial supplies, and utilities. *See* 26 C.F.R. section 1.471-11(b).

[68] IRC section 936(h)(5)(B).

[69] Direct labor costs include the cost of labor that can be identified or associated with particular units or groups of units of a specific product. The elements of direct labor include such items as basic compensation, overtime pay, vacation and holiday pay, sick leave pay, shift differential, payroll taxes, and payments to a supplemental unemployment benefit plan paid or incurred on behalf of employees engaged in direct labor. IRC section 936(h)(5)(B).

[70] IRC section 936(h)(5)(B).

[71] IRC section 936(h)(5)(C)(i)(I).

[72] IRC section 482 is to be applied if no intangible property is related to a product produced in whole or in part by a possessions corporation (discussed in Section VI).

[73] IRC section 936(h)(5)(C).

[74] U.S. Department of the Treasury, "Sixth Report," p. 10.

[75] Treas. reg. section 1.936-6.

Example No. 2

XYZ is a possessions corporation engaged in the manufacture and sale of four products (A, B, C, and D), all of which are classified under the same three-digit SIC code. XYZ sells its production to a U.S. affiliate, P, which resells it to unrelated parties in the United States. P's third-party sales of each of these products produced in whole or in part by XYZ are $2,000,000 per product, or a total of $8,000,000 for A, B, C, and D. P's other sales of products in the same SIC code are $8,000,000. The worldwide product-area research of the affiliated group is $500,000. XYZ must compute its cost-sharing amount for each individual product A, B, C, and D as follows:

$$\frac{\text{Sales to Unrelated Persons of Possession Product}}{\text{Total Sales of Products in 3-digit SIC Code}} \times \text{110\% of Worldwide Product Area Research} = \text{Cost-Sharing Payment}$$

$$\frac{\$2{,}000{,}000}{\$16{,}000{,}000} \times \$550{,}000 = \$68{,}750$$

gibles) associated with the possession product.[76]

By virtue of a 1986 amendment to section 936(h)(5), the payment made under any cost-sharing option cannot be less than what would be required under section 367(d) or section 482 of the Internal Revenue Code if the electing corporation were a foreign corporation.[77] Section 367(d) and section 482 provisions essentially authorize the IRS to reallocate gross income and deductions between affiliated businesses. Such a reallocation is performed when the IRS, following specific guidelines, questions transfer prices and determines that a reallocation is required to stem tax evasion or to reflect income clearly.

Example Nos. 2 and 3 show how to determine the amount of the cost-sharing payment. They are based on examples given by the Treasury Department.[78]

Example No. 2 shows that the amount of the cost-sharing payment would be $68,750. If, however, XYZ also received $10,000 in royalty income from an unrelated person for the licensing of certain manufacturing intangible property rights, the amount of the product area research ($500,000) would be reduced by that amount, to $490,000.

Example No. 3 shows that a payment by the possessions corporation to an unrelated party under a cost-sharing arrangement will serve to reduce the cost-sharing payment, in this case by 31.36 percent.[79]

2. The 50/50 Profit-Split Method

If, for any product, the possessions corporation elects the profit-split method, it must also have manufactured that product in the possessions. In the case of Puerto Rico, this requirement is met if: (1) the product has been substantially transformed by the possessions corporation in Puerto Rico; (2) the operations conducted by the possessions corporation in connection with the product are substantial in nature and generally are considered to constitute manufacture or production; or (3) the conversion costs incurred by the possessions corporation in Puerto Rico (including direct labor, factory burden, and testing of components) account for 20 percent or more of the total cost of goods sold by the possessions corporation. In this context, packaging, labeling, and minor assembly operations are not deemed to constitute the manufacture or production of product.[80]

Under the profit-split option, 50 percent of the combined taxable income of the possessions corporation and its U.S. affiliates, as derived from "covered sales" of the possession product, is allocated to the possessions corporation.[81] The remainder of the combined taxable income is generally

Example No. 3

The facts are the same as Example No. 2 except XYZ manufactures product D under a license from an unrelated person. XYZ pays the unrelated party an annual license fee of $25,000. Consequently, the worldwide product-area research amount increases to $525,000.

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[76]IRC section 936(h) distinguishes between these forms of intangible property. "Manufacturing intangibles" refers to any patent, invention, formula, process, design, or know-how. "Marketing intangibles" includes any intangible property defined in IRC section 936(h)(3)(B), if it is used in marketing a 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 constitutes 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). Regulations under IRC section 482 are applied to make this determination.

[77]IRC section 936(h)(5)(c)(i)(I).

[78]Treas. reg. section 1.936-6.

[79]In neither example may the payment be less than the payment that would be required under IRC sections 367(d) or section 482 if the electing corporation were a foreign corporation.

[80]R.J. Boles, "Tax Incentives," p. 130.

[81]"Covered sales" are sales by members of the affiliated group (other than foreign affiliates) to foreign affiliates or to unrelated persons. *See* Treas. reg. section 1.936-6.

Example No. 4

XYZ, a possessions corporation, manufactures 200 units of possession product S. XYZ sells 100 units of S to an unrelated person in an arm's length transaction for $10 per unit. XYZ sells the remaining 100 units to its U.S. affiliate, A, which leases the 100 units to unrelated persons. The combined taxable income for the 200 units of S is determined as follows:

Sales	
1. Total sales by XYZ to unrelated persons (100 x $10)	$1,000
2. Total deemed sales by A to unrelated persons (100 x $10)	1,000
3. Total gross receipts	$2,000
Total Costs	
4. Total expenses[1]	$1,200
Combined Taxable Income and Allocation of Income Attributable to the 200 Units of S	
5. Combined taxable income (line 3 minus line 4)	$ 800
6. Share of combined taxable income apportioned to XYZ (50% of line 5)	400
7. Share of combined taxable income apportioned to A (line 5 minus line 6)	400

[1]Research, development, and experimental costs are the higher of (1) the research and development allocation under section 861 or (2) 120 percent of total research costs multiplied by the ratio of sales by the possessions corporation to total sales.

allocated to U.S. affiliates. For purposes of computing the combined taxable income from the possession product, all direct and indirect expenses relating to the product are taken into account, including income attributable to both manufacturing and marketing intangibles associated with the product. The combined taxable income is computed separately for each product produced, or type of service rendered, by the possessions corporation in the possession.

Example No. 4 shows how to determine the combined taxable income under the profit-split method. It is based on a Treasury Department example.[82] The combined taxable income in Example No. 4 ($800) is the total gross receipts from the possession product ($2,000) minus the total expenses attributable to the development and production of this product ($1,200). The income from the subsequent leasing of the 100 units by A to unrelated persons is attributed entirely to A.

IV. The Economic Impact of Section 936 on Puerto Rico

A. The Broad Economic Trends

The special tax credit afforded to U.S. corporations operating in the possessions clearly was helpful in promoting Puerto Rican economic growth in the 1950s and the 1960s. During this period, the credit was instrumental in transforming Puerto Rico from an agricultural economy to one primarily based on manufacturing. Puerto Rico became the "economic miracle" of the Caribbean, as real GNP per capita rose at an average annual rate of over 5 percent, compared to an annual rate of 2.2 percent for the United States during the same period.[83]

Since the mid-1970s, however, the section 936 tax incentives have proved to be both ineffective and inefficient as a vehicle for sustained economic growth. Consistent with this conclusion are three telling concerns. First, both employment and new physical investment in Puerto Rico have stagnated. Second, the composition of section 936 production has declined in labor intensity and has become increasingly capital-intensive. Third, the total cost of the tax credit to the U.S. Treasury has increased substantially. Collectively, these trends indicate that the limited benefit of the incentive to the Puerto Rican employee is increasingly unjustifiable in relation to the tax revenues foregone by the deficit-plagued U.S. Treasury.

Manufacturing employment in Puerto Rico virtually stagnated during 1970-86, and total non-government employment remained steady or declined throughout 1974-83.[84] The island is currently experiencing very high unemployment (18.1 percent), low labor-force participation (45.7 percent), and a high rate of migration to the mainland in search of jobs.[85] Similarly, during the past two decades, aggregate physical investment in Puerto Rico has remained stagnant. The annual rate of investment declined sharply during the 1970s and early 1980s, and total fixed annual investment is only

[82]Treas. reg. section 1.936-6(1)(b), Q&A 11. On January 11, 1994, the IRS proposed controversial regulations under section 936(h) that amend the rules under the profit-split method for determining combined taxable income attributable to a possessions product that is a component product or an end-product form. For a summary of the proposed regulations (IL-068-92), *see* 8 *Tax Notes Int'l* 226 (January 24, 1994). For coverage of an IRS public hearing on the proposed regulations, *see* 9 *Tax Notes Int'l* 129 (July 18, 1994).

[83]U.S. Department of the Treasury, "Sixth Report," p. 19.

[84]*Id.*

[85]National Bureau of Labor Statistics, by phone, August 1993. This rate of migration is currently hovering around 1 percent per year. *See* J.T. Hexner *et al.*, *Puerto Rican Statehood*, p. 5.

now approaching the levels of the early 1970s.[86]

The change in the composition of section 936 corporations parallels this trend and is equally dramatic. Specifically, the share of section 936 activity during the past three decades in such labor-intensive industries as textiles has diminished significantly, while the share in capital- and technology-intensive industries such as pharmaceuticals has increased commensurately. In 1960, for example, chemicals and machinery, two very technology-intensive industries, made up 22 percent of the net manufacturing income in Puerto Rico; by 1989, that share had increased to over 73 percent.[87] Clearly, capital-intensive firms—rather than the labor-intensive industries that section 936 was designed to attract—have made the most use of the provision.

The part of the section 936 tax incentive that goes toward wages could be the most meaningful contribution of external capital to the economic health of Puerto Rico. With the high level of capital intensity, the ratio of wages and salaries to the total value added of section 936 firms is low. One indicator of this is the ratio of proprietors' income (profits, interest, etc.) to total value added for section 936 firms. In 1991, this figure was 92.3 percent for the pharmaceutical industry and 81.2 percent for the electrical machinery industry. These two industries collectively account for over 60 percent of the entire section 936 credit. Therefore, for those corporations that benefit from the majority of the incentive, wages, and salaries accounted for less than 20 percent of the total value added.

In light of stagnant employment and investment on the island and the declining labor intensity of section 936 industries, the concern, therefore, is the increasing cost-ineffectiveness of section 936. In 1989, the average revenue cost of the tax credit per employee in a section 936 corporation was $22,375. Before-tax annual wages for the year were, however, only $20,540. Hence, the federal government paid approximately $1.08 for each dollar paid to employees of section 936 corporations. Section 936 is also ineffective with respect to its low impact on physical investment, as measured by total assets of section 936 corporations per dollar of foregone tax revenues. In 1989, the total assets of section 936 manufacturing firms amounted to $5.9 billion. Given the $2.5 billion tax revenue cost of the program in that year, it would take less than 2.5 years for the value of foregone tax resources to equal net assets. Put simply, raw cost-effectiveness would have supported buying the section 936 manufacturing plant and equipment and literally giving it away to the corporations to operate, rather than prolonging the tax credit.

The problems with section 936 are most evident in the pharmaceutical industry. For the period 1980-90, the amount of estimated income exempt from taxes for 26 pharmaceutical firms examined by the General Accounting Office (GAO) totaled about $24.7 billion.[88] This translates into an estimated total tax savings of about $10.1 billion in 1990 dollars for the Puerto Rican operations of these firms.[89] In 1989, however, the total assets of the pharmaceutical industry in Puerto Rico were only $2.53 billion. Perhaps the strongest indicator of the profitability of the Puerto Rican operations of these pharmaceutical firms is that 17 of the 21 most-prescribed drugs in the United States were authorized for manufacture in Puerto Rico.[90] One senator has stated that the GAO document "undeniably demonstrates that the American government has given the pharmaceutical industry a blank check to pillage the federal Treasury through the section 936 tax credit."[91]

B. The Relationship Between Section 936 and Transfer Pricing Abuse: The Results of the TEFRA Amendments

The cost-ineffectiveness of section 936 generally testifies to the ineffectiveness of the TEFRA amendments. These amendments were supposed to limit substantially the amount of profits a possessions corporation could claim as tax-free earnings from the transfer of intangible assets. The facts show that this goal has not been met.

Indeed, the data since 1982, the year in which the amendments were promulgated, show the continued role of transfer pricing in artificially increasing the profit rates of the possessions corporations. For example, in 1983, the reported before-tax annual rate of return on operating assets for manufacturing corporations participating in the section 936 program was 54.1 percent, more than five times the rate of return for mainland manufacturing operations (10.3 percent).[92] If the true rate of return for section 936 investments in Puerto Rico were this high, firms would have strong incentives to increase their real investment on the island, and investment would be booming.

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[86] *Id.*, pp. 25-26.

[87] U.S. Congressional Budget Office, "Potential Economic Impacts of Changes in Puerto Rico's Status under S.712," report prepared for the U.S. Senate Committee on Finance, April 1990, Table 3.

[88] U.S. General Accounting Office, "Pharmaceutical Industry," p. 21.

[89] *Id.*

[90] *Id.*, p. 6.

[91] Richardson, "Pryor Blasts Drug Company Tax Breaks With GAO Ammunition," 4 *Tax Notes Int'l* 1093 (May 25, 1992).

[92] U.S. Department of the Treasury, "Sixth Report," p. 36.

This has not been the case, however.[93] In 1988, for example, total fixed investment in Puerto Rico was about 20 percent of GNP, compared to 25 percent in the 1966-73 period. What this suggests is that the TEFRA amendments are not blocking the transfer by corporations of large amounts of income into Puerto Rico, the Puerto Rican source generation of which is attributable to factors that are unrelated to real investments in Puerto Rico. Yet, the section 936 lobby was able to convince the Reagan administration to continue to rely on the section 936 tax subsidy as a development tool for the Caribbean Basin.

V. Section 936 and the Caribbean Basin Initiative

A. Targeting Section 936 at the Broader Goals of Regional Development

The Caribbean Basin Initiative (CBI) was introduced by the Reagan administration in 1983 to allow qualified Caribbean countries to trade on more favorable terms with the United States.[94] This should have worked to increase exports to the United States from CBI countries. The Tax Reform Act of 1986 served to integrate section 936 with this development initiative. Prior to the 1986 act, section 936 allowed the active income earned by a possessions corporation to be invested tax-free in certain eligible activities in Puerto Rico and other U.S. possessions.[95] The income earned from these investments is referred to as "qualified possession source investment income" or QPSII. The 1986 act expanded the area in which investments could be made to include the U.S. Virgin Islands and qualified CBI countries, as long as the investments were made through qualified financial institutions.[96] The income generated by such investment qualifies as QPSII and is exempt from U.S. tax. A similar exemption from Puerto Rican tax applies under Puerto Rican law.[97]

The 1986 act imposes a number of requirements regarding when earnings of section 936 firms will qualify for investment in a CBI country or possession. The first requirement is that investments can only be made in qualified Caribbean Basin countries as designated under the Caribbean Economic Recovery Act of 1983.[98] Twenty-three countries have thus far qualified and are so designated.[99] To be eligible for these tax-exempt investments, CBI-qualified countries are required to enter into a Tax Information Exchange Agreement (TIEA) with the United States.[100] The purpose of the TIEA is to allow the United States and CBI governments to share tax and other information that could lead to the arrest of drug traffickers, tax evaders, and other criminals.[101]

Another requirement for these investments is that they be in "active business assets" or "development projects."[102] The Senate Finance Committee report that accompanied the CBI amendment to section 936 defines these as follows:

> A development project generally means an infrastructure investment, such as a road or water treatment facility, that directly supports industrial development. Active business assets generally means plant, equipment, and inventory associated with a manufacturing operation.[103]

Treasury Department regulations further define these terms so that qualified investment is generally permitted in tangible property used in a trade or business in qualified CBI countries, including reasonable incidental expenditures (such as installation costs).[104]

A section 936 company cannot receive a tax exemption if it invests funds directly in an otherwise-qualified CBI project. Instead, the section 936 company must invest through a "qualified financial institution."[105] The Government Development Bank for Puerto Rico and the Puerto Rico Economic Development Bank are both defined as qualified financial institutions. Other than those two, a financial institution in Puerto Rico may qualify if it is: (1) a "banking, financing, or similar business" that is "organized under the laws of the Commonwealth of Puerto Rico or is the Puerto Rican branch" of such a business and is an eligible depository institution for investments from section 936

[93] Hexner et al., *Puerto Rican Statehood,* for a discussion of why section 936 is incompatible with Puerto Rico's sustainable economic development and why statehood presents a much more efficient vehicle for continued growth.

[94] The Caribbean Basin Initiative is the common name of the Caribbean Basin Economic Recovery Act, Pub. L. No. 98-67, 97 Stat. 384 (1983) (codified as amended in scattered sections of 19 U.S.C. and 26 U.S.C.). Under the act, qualified countries receive a reduction or elimination of tariffs on certain products, along with access to relatively low interest rate loans, provided with certain section 936 funds.

[95] IRC section 936(d)(2).

[96] IRC section 936(d)(2)(B) and 936(d)(4).

[97] 13 L.P.R.A. section 256a(2)(j)(A).

[98] IRC section 936(d)(4).

[99] Those countries and possessions are Antigua and Barbuda, Aruba, the Bahamas, Barbados, Belize, British Virgin Islands, Costa Rica, Dominica, Dominican Republic, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Montserrat, Netherlands Antilles, Panama, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, and Trinidad and Tobago. Nicaragua has requested designation, and the U.S. is currently reviewing that request.

[100] IRC section 936(d)(4)(B).

[101] Flax-Davidson, "Tax-Exempt Investment for the Caribbean Basin Initiative Region," *International Lawyer* 25, no. 4 (Winter 1991): 1025.

[102] IRC section 936(d)(4)(A)(i).

[103] U.S. Senate, Committee on Finance, Tax Reform Act of 1986, S. Rep. No. 313, 99th Cong., 2d Sess. 384 (1986).

[104] "Requirements for Investments to Qualify under Section 936(d)(4) as Investments in Qualified Caribbean Basin Countries," Treas. Reg. section 1.936-10(c)(4), (5) (May 10, 1991).

[105] IRC section 936(d)(4)(A).

firms, as qualified by the commissioner of financial institutions under Puerto Rican regulations; (2) "such other entity as may be determined by the commissioner"; or (3) a "single-purpose entity" established in Puerto Rico as an eligible institution solely to invest funds from section 936 firms in qualified CBI assets.[106]

All lending of these funds to a qualified CBI recipient must be approved by the commissioner of financial institutions for Puerto Rico.[107] Additionally, the recipient of CBI funds must open its books to the United States and Puerto Rican governments to assure that the funds are being used in accordance with the law.[108] A 1990 congressional amendment to section 936 requires the government of Puerto Rico to ensure that at least $100 million is invested annually in qualified CBI investments.[109]

B. Evaluation of the CBI: A Weak Justification for Prolonging Section 936

Even among those who acknowledge the transfer pricing abuses of section 936 firms, there are proponents who justify the continued extension of section 936 benefits because of the tax credit's role in the CBI program. They argue that the elimination or any reduction in the section 936 tax credit would proportionately damage the CBI because of the close integration of the two programs. It has been asserted, for example, that at least $500 million of qualified funds have been appropriately invested under this program, creating close to 20,000 jobs in the CBI countries and more than 2,500 jobs in Puerto Rico.[110] These statistics have been used to support the claim that the program is functioning as intended and that section 936 should remain untouched.

Other evidence, however, suggests that the CBI program has been unsuccessful. The Latin American and Caribbean Economic Commission reported an average 17.2-percent reduction in per capita gross domestic product during the 1980s.[111] Latin America and the Caribbean also experienced a 0.8-percent decrease in real gross national product in 1990, and record loans in that year added to their already staggering foreign debts.[112] Thus, in relative terms, the very nations the CBI was intended to support have been steadily losing ground.[113] The claim of positive long-run development impact from the $500 million of CBI funds purported to have been allocated and the 20,000 jobs created in the CBI countries is dubious at best.

Despite the preferential treatment offered to CBI countries under the program, there has been a constant decline in the value of U.S. imports from these countries. U.S. imports from CBI countries reached an all-time high in 1983, the year in which the program was enacted.[114] Between 1983 and 1986, however, exports from the CBI countries to the United States declined by a total of 31 percent.[115] By contrast, the level of U.S. exports to these countries has remained steady.[116] According to the U.S. International Trade Commission:

> In 1986, for the first time in a number of years, the United States had a small surplus with the Caribbean countries collectively, making the basin one of the few areas in the world with which no U.S. trade deficit was recorded. This was the result of a significant decline in U.S. imports from the Caribbean Basin, from $9.0 billion in 1983 to $6.2 billion in 1986, while U.S. exports to the area remained approximately the same, fluctuating around $6.0 billion.[117]

Also, in 1986, U.S. imports from CBI countries represented only 1.7 percent of the total U.S. imports, while U.S. exports to these countries represented 3 percent of the total U.S. export market.[118]

Recent data suggest a continuation of these trends. In 1990, U.S. imports from CBI countries were approximately $1.4 billion less than in 1983.[119] This constitutes a 2.1-percent annual rate of reduction in the amount of imports and a 16-percent gross decline.[120]

Indeed, the CBI might be judged as a program of phantom benefits and phantom results. Over 93 percent of the exports generated from Caribbean countries designated under this program already entered the United States duty-free prior to the enact-

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[106] Treas. Reg. section 1.936-10(c)(3).

[107] IRC section 936(d)(4)(A)(ii).

[108] IRC section 936(d)(4)(C)(iii).

[109] *See* IRC section 936(d)(4)(D) (West Supp. 1991) (effective for calendar years after 1989); H.R. 1594, 101st Cong., 2d Sess., 136 Cong. Reg. H5887, H5896 (daily ed. July 30, 1990).

[110] Price Waterhouse, "Section 936 Report, Volume 1: Benefits and Costs of Section 936," prepared for Puerto Rico, U.S.A. Foundation, May 1991, Table IV.B. *See also* R.J. Sierra Jr., "Funding Caribbean Basin Initiative Activities with Section 936 Funds," *International Tax Journal* (Spring 1992): 57-58.

[111] "Mexico, Central American Countries Plan Free Trade Agreement to Be Reached by 1996," *Intl. Trade Rep.* (BNA) 8, no. 3 (Jan. 16, 1991): 87.

[112] "Latin American Economies Register Decline of 0.8 Percent in 1990, IDB Report Shows," *Intl. Trade Rep.* (BNA) 8, no. 15 (Apr. 10, 1991): 554.

[113] J.C. Malloy, "The Caribbean Basin Initiative: A Proposal To Attract Corporate Investment and Technological Infusion via an Inter-American Protection for Intellectual Property," *University of Miami Inter-American Law Review* 23, No. 1 (1991): 184.

[114] U.S. International Trade Commission, "Annual Report on the Impact of the Economic Recovery Act on U.S. Industries and Consumers, Second Report 1986," September 1987, p. 6.

[115] *Id.*, p. 8.

[116] *Id.*, p. 1.

[117] *Id.*

[118] *Id.*

[119] U.S. Department of Commerce, *Guidebook: Caribbean Basin Initiative* (1991), p. 55.

[120] *Id.*

ment of the CBI.[121] In addition, the elimination of already low U.S. tariffs (generally ranging from 5 to 7 percent) on Caribbean industrial products does not make these products significantly more competitive in the U.S. market.[122] Moreover, the CBI excludes from its list of qualified products a number of items produced by the most labor-intensive industries, including apparel and leather goods.

What the CBI program has successfully done, however, is expand the scope of political leverage for section 936 companies by broadening the scope of their potential investment. As dollars have been invested in more CBI countries, section 936 companies have gained increasing clout with these countries and enlisted their help in lobbying against the curtailment of the tax credit. Nevertheless, because of the lack of real benefits from the CBI and because the actual amount of imports from the CBI countries has been steadily decreasing, while U.S. exports have remained steady, the continued existence of the section 936 tax credit cannot be justified by linking it to the CBI program.

VI. Further Reforms Affecting Section 936

A. Effects of Section 482 Regulations on Section 936

Section 482 of the Treasury regulations provides most of the guidelines concerning the proper allocation of income in a transfer pricing transaction. On July 1, 1994, final regulations were issued under section 482 that contain provisions that alter the manner in which transfer prices for intangible property will be reviewed by the IRS and that specifically coordinate with the transfer pricing requirements of section 936. The final section 482 regulations provide for greater taxpayer flexibility, at the cost of more stringent documentation requirements.[123] The IRS anticipates that this will diminish the number of disputes between the IRS and taxpayers. Some practitioners contend, however, that the policy, in its move toward greater flexibility, imposes an unmanageable administrative burden on the IRS.

The regulations reaffirm the applicability of the arm's length standard and continue to emphasize analysis that relies on the structure and circumstances of the individual transaction. However, added flexibility now comes via the applicability of a range of acceptable arm's length results as opposed to a single arm's length price. Also, consistent with the reality of varying market conditions and transaction circumstances, there is now no strict priority of pricing methods. Instead, the accuracy of the pricing method, with respect to the case in question, decides its appropriateness. In another move towards taxpayer flexibility, the prices actually charged in controlled transactions need not reflect the arm's length price that must be reported on the income tax return. Where reported price differs from the price actually charged, compensating adjustments are made to reflect the disparity.[124] Finally, the standards that must be met before transactions are considered comparable have been relaxed. Under all pricing methods, a reasonable number of adjustments is permitted where transactions are not exactly comparable.

With regard to possessions corporations, section 482 regulations provide that when a controlled taxpayer has elected for cost-sharing under section 936(h), the amount of the cost-sharing payment that is required under this section will not be less than the payment that would be required under the section 482 regulations (if the electing taxpayer were a foreign corporation). Also, the 936 corporation must apply the section 482 pricing methods for intangibles before giving effect to the provisions that treat the 936 corporation as the owner of this property.

One reviewer of the tax changes makes the following claim:

> It is almost impossible using the arm's length method of section 482 of the Internal Revenue Code to determine accurately the tax obligations of multinational corporations dealing only in tangible goods; it is impossible to do so when these corporations are earning money from intangibles. . . . In short, the IRS's section 482 enforcement efforts are unworkable because the system is too complex, cumbersome and expensive to catch all but the most blatant tax evaders.[125]

This claim is troubling given the findings of a 1993 Ernst & Young study, which estimated that the government's transfer pricing initiatives would collect less than 10 percent of Treasury Department projections.[126]

In effect, the complexity of the section 482 regulations has the potential to render them unadministerable. Indeed, the true price of taxpayer flexibility is that the circumstances of transfer pricing arrangements will gain in subjectivity and will increasingly call for judgment on a case-by-case basis. Accordingly, cases involving highly differentiated products, for which benchmark arm's length transactions are not

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[121] T.L. Raleigh, "The U.S. Caribbean Basin Initiative," *International Business Lawyer* 15, no. 3 (March 1987): 137.

[122] *Id.*

[123] J. Turro, "U.S. Releases Final Transfer Pricing Regulations Under Section 482," 9 *Tax Notes Int'l* 79 (July 11, 1994).

[124] Reg. section 1.482-1(e)(2).

[125] Lobel, Banta, and Gueron, "Barclays: A Test of the Administration's Willingness To Collect Taxes from Multinational Corporations," *Tax Notes,* June 28, 1993, p.1841.

[126] *Id.*

Example No. 5

XYZ is a possessions corporation operating in the 1998 tax year with an active business income from possession-based operations of $900,000. QPSII is $100,000. With no section 936 tax credit, U.S. tax liability on this income would amount to $315,000 and $35,000, respectively. The corporation's section 936 credit would be limited to $161,000 (40 percent of $315,000 plus a full credit on the QPSII tax liability).

Further, XYZ incurred $60,000 in possession taxes. A partial deduction of possession income tax is permitted. This is calculated as the total in possession income tax ($60,000) multiplied by the ratio of (a) total U.S. income tax liability with no section 936 credit less the amount of the credit ($350,000 - $161,000 = $189,000) to (b) the total U.S. income tax liability with no section 936 credit ($350,000). The deduction in this case would be $32,400 ($60,000 x $189,000/$350,000). This reduces total taxable income to $967,600. Hence, the pre-section-936-credit tax liability is $338,660, and the post-credit liability is $177,660 ($338,660 - $161,000).

easily identified (more often true of intangibles), will rely on extensive cost, pricing, and market data—often from unwilling competitors.

In practical terms, then, the auditing requirements of the policy leave the short-staffed IRS at a disadvantage compared to the multinational corporations with their batteries of highly paid lawyers, accountants, and economists.

B. Further Limitations on the Section 936 Tax Credit

As a result of concerns about transfer pricing abuse by pharmaceutical and other capital-intensive firms and because of the low levels of employment-producing investments made by section 936 firms, section 936 has been increasingly opposed by the U.S. Treasury Department and members of Congress. Indeed, on December 31, 1993, legislation designed to curb transfer pricing abuses and increase levels of investment in employment-producing activities, enacted as part of the Omnibus Budget Reconciliation Act of 1993, came into effect.[127]

Under the new legislation, the section 936 credit will be calculated in a manner consistent to that used prior to December 31, 1993.[128] However, the amount of the credit will then be limited in one of two ways,[129] with the choice of method left to the taxpayer. The first, the percentage limitation, limits the credit by a statutorily defined percentage (that decreases in future years) of the section 936 credit allowable under present law. The second alternative, the economic activity limitation, links the limitation on the credit to a composite of factors that serve as proxy for the firm's level of economic activity in the possessions. All affiliated[130] possessions corporations are required to choose the same credit-limitation alternative.[131]

1. The Percentage Limitation

Under the percentage limitation, the section 936 credit allowed to a possessions corporation against U.S. tax on business income for a tax year is limited to a specific percentage of the credit that would be permitted under the laws prior to the 1993 revision. A five-year transition rule governs the phase-in. The percentages are:[132]

Start of Tax Year	Percentage Limitation
1994	60
1995	55
1996	50
1997	45
1998, and thereafter	40

A taxpayer that utilizes the percentage limitation is permitted a deduction for a portion of its possession income taxes paid or accrued during the tax year. The

[127] *See* H.R. 2264, 103rd Congress, 1st Sess.

[128] Under the new legislation, there is a new separate foreign tax credit limitation category for computing the alternative minimum tax (AMT) foreign tax credit. The new category includes the portion of dividends received from a possessions corporation for which the dividends-received deduction is generally disallowed, and thus is included in alternative minimum taxable income.

[129] In a measure to support Puerto Rican tax revenues, given the credit limitations, the revised legislation temporarily increases the cover-over of rum excise taxes to Puerto Rico and the Virgin Islands from $10.50 to $11.30 per proof gallon. The increased cover-over rate applies through 1998.

[130] The consolidated return rules are used to determine whether a possessions corporation is part of an affiliated group. However, stock owned by attribution under the rules of IRC section 1563 is treated as if it were owned directly, and the exclusions from the definition of "includible corporation" listed in IRC section 1504(b) are disregarded.

[131] Should a possessions corporation that employs the percentage limitation become a member of a group that uses the economic activity limitation, then the first corporation will be deemed to have revoked its election to use the percentage limitation. The Treasury secretary is authorized to develop regulations to treat two or more possessions corporations as members of the same affiliated group in order to prevent avoidance of the consistency rule.

[132] IRC section 936(a)(4)(B)(ii).

Example No. 6

XYZ is a possessions corporation that elects to use the economic-activity limitation. XYZ does not choose the profit-split method for computing its income from intangibles. Wage and fringe benefit expenses for XYZ total $180,000 ($150,000 in qualified possession wages and $30,000 in employee health, accident, and life insurance plans). XYZ's depreciation deductions amount to $50,000 for short-life tangible property, $30,000 for medium-life tangible property, and $20,000 for long-life tangibles. XYZ has $1,000,000 of taxable income for the year.[1] Nine hundred thousand of this is income from active business operations. Of the remaining $100,000, $50,000 is QPSII and $50,000 is other taxable income. Sixty thousand dollars is paid in possession income taxes.

Under the laws in effect through the end of 1993 (assuming no deduction for possession income taxes), the section 936 credit amounts to $332,500 (35% of $950,000 in total income less other taxable income). U.S. tax liability equals $17,500 (35% of $50,000 in other taxable income).

The revised section 936 law does not change the credit attributable to QPSII. Thus, $17,500 (35% of $50,000 in QPSII) of the present law credit is not subject to the economic activity limitation. The remainder, $315,000 is, however, subject to the limitation.

Qualified Compensation

Qualified possession wages amount to $150,000. Potentially, $25,000 in fringe benefit expenses ($150,000/$180,000 x $30,000) could have been included in the credit limitation base. The 15% limitation on fringe benefits applies, however, limiting the allocable amount to $22,500 (15% of $150,000). Total qualified compensation thus amounts to $172,500 ($150,000 + $22,500), 60 percent of which is $103,500.

Depreciation Deductions

The depreciation component of the credit limitation is the sum of (1) 15% of the $50,000 depreciation allowance on short-life property, (2) 40% of the $30,000 depreciation allowance on medium-life property, and (3) 65% of the $20,000 depreciation allowance on long-life property, for a total of $32,500.

Possession Income Taxes

None of the $60,000 of possession income taxes (a 6% effective rate) is disqualified from the credit limitation base by virtue of the maximum 9% effective tax rate provision. However, only the portion of the $60,000 that is allocated to nonsheltered income may be included in the credit limitation base. This portion is a function of the ratio of the increase in tax as a result of the compensation and depreciation limitations, and the tax that would be paid in the absence of the section 936 tax credit.

In the absence of the compensation and depreciation limitations, XYZ's U.S. tax liability would be $17,500. With the limitations, it would amount to $350,000 (35% of $1,000,000) less (1) $136,000 ($103,500 + $32,500), the active business section of the 936 credit and (2) the QPSII credit of $17,500. That is, $196,500. Hence, the increase in tax liability is $179,000 ($196,500 - $17,500).

With no section 936 credit, the U.S. income tax liability would amount to $350,000 (35% of $1,000,000).

The amount of possession income taxes which may be included in the credit limitation base is therefore $30,686 [($179,000/$350,000) x $60,000].

Total Economic Activity Limitation

The total limitation on the active business credit is therefore $166,686 (that is, $103,500 for compensation, plus $32,500 for depreciation, plus $30,686 for possession income taxes) compared to $315,000 under the regulations before revision. The full credit of $17,500 on QPSII is also granted. The corporation's net U.S. tax liability is therefore $165,814 ($350,000 - $166,688 - $17,500).

[1]Taxable income is computed in accordance with the pre-December 31, 1993 rules for determining the taxable income of a possessions corporation.

portion of the taxes so deductible is the portion that is allocable to the corporation's taxable income, the U.S. tax on which is not offset by the section 936 credit as a result of the limitation.

The operation of the percentage limitation is shown in Example No. 5. As the example shows, the limitation clearly reduces the section 936 credit over time. However, a firm's choice to use this alternative will be a function of the magnitude of its potential credit in relation to the credit available under the economic activity limitation. This, of course, will be determined by the firm's capacity to claim credit from the expansion of new labor-intensive activities, as well as activities that purport to be so.

2. The Economic Activity Limitation

The sum of three proxy measures for economic activity in the possessions serves as an upper limit for the tax credit allowed to a possessions corporation for a tax year. The credit against U.S. tax on the possessions corporation's business income may not exceed the sum of the following components:[133]

- 60 percent of qualified compensation;
- the applicable percentages of depreciation deductions on qualified tangible property claimed for regular tax purposes by the corporation; and
- a portion of the possession income taxes incurred during a given year, if the corporation does not elect the profit-split method to allocate income from intangibles.

U.S. tax liability, therefore, is computed by subtracting the sum of the above three components from the amount of precredit U.S.

[133]IRC section 936(a)(4)(A).

tax that, under general circumstances, would be owed.

a. Qualified Compensation

The first component of the economic activity limitation is 60 percent of qualified compensation. Qualified compensation is the sum of:[134] (1) the aggregate amount of the possessions corporation's qualified possessions wages for the tax year[135] and (2) allocable employee fringe benefit expenses for the tax year.[136] Qualified possessions wages are defined as wages paid or incurred by the possessions corporation during the tax year to any employee for services performed in a possession.[137] However, such services must be performed while the principal place of employment of the employee is within that possession.

b. Depreciation Deductions

The second component is the sum of the following applicable percentages of allowable depreciation deductions:[138]

(1) 15 percent of the depreciation deductions allowable to short-life qualified tangible property;

(2) 40 percent of the depreciation deductions allowable to medium-life qualified tangible property; and

(3) 65 percent of the depreciation deductions allowable to long-life qualified tangible property.[139]

c. Possession Income Taxes

The final component of the economic activity limitation is a portion of the income taxes paid or incurred to a possession by corporations that do not elect the profit-split method.[140] Possession income taxes paid in excess of a 9-percent effective rate of tax are not included.[141] Moreover, only the portion of taxes that satisfies this effective rate requirement and that is allocable to nonsheltered income is included.[142]

The operation of the economic activity limitation is shown in Example No. 6.

d. Election To Treat Affiliated Corporations as One Corporation

For purposes of computing the economic activity limitation, an affiliated group of corporations may elect to treat all affiliated possessions corporations as one corporation. For a group so electing, the available consolidated credit amount is to be allocated among the possessions corporations of the group under rules prescribed by the Treasury secretary. Any election to consolidate applies to the tax year for which such election is made and to all succeeding tax years unless revoked with the consent of the Treasury secretary.

e. Analysis of the Economic Activity Limitation

In concept, over the course of five years, section 936 credits will be effectively linked to growth in employment wages and tangible investment. From a practical standpoint, however, the policy is less promising.

The correlation between tax avoidance and development strategies based on complex tax incentive schemes is well established. Indeed, the compounding negative results of repeated efforts by Congress to patch the loopholes of section 936 verify this correlation.

The revisions to section 936 made by the Omnibus Budget Reconciliation Act of 1993 significantly increase administrative

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[134]IRC section 936(a)(4)(A)(i).

[135]Wages for this purpose include those defined under the Federal Unemployment Tax Act (FUTA). In computing the credit limitation for a tax year, the cumulative amount of wages for each employee may not exceed 85 percent of the maximum earnings subject to tax under the Old Age Survivors and Disability Insurance (OASDI) portion of social security (currently $57,600). Rules for making appropriate adjustments to this limit for part-time employees and employees whose principal place of employment is not within a possession for the entire tax year are to be made by the Treasury secretary. The bill does not include as qualified possession wages amounts paid to employees who are assigned by the employer to perform services for another person, unless the principal trade or business of the employer is to make employees available for temporary periods to other persons in exchange for compensation.

[136]Fringe benefits may include: (1) employer contributions under a stock bonus, pension, profit sharing, or annuity plan; (2) employer-provided coverage under any accident or health plan for employees; and (3) the cost of life or disability insurance provided to employees. Fringe benefit expenses do not include any amount that is treated as wages. Allocable employee fringe benefit expenses are equal to a fraction of the aggregate amount that is consistent with the conditions listed above. The numerator of this fraction is the aggregate amount of the possessions corporation's qualified possessions wages (as defined above). The denominator is the aggregate amount of compensation (wages and benefits) paid or incurred during the tax year. Fringe benefit expenses may not, however, exceed 15 percent of the aggregate amount of qualified possession wages for that year.

[137]IRC section 936(i)(1)(A).

[138]IRC section 936(a)(4)(A)(ii).

[139]The terms of IRC section 168 apply to the definition and classification of depreciable tangible property.

[140]Possessions corporations that utilize the profit-split method may deduct a portion of their possession income taxes paid or accrued during the tax year. This portion is the part of U.S. taxable income, the U.S. tax on which is not offset by the revised section 936 credit.

[141]IRC section 936(i)(3)(A)(ii).

[142]The portion of possession income taxes allocated to nonsheltered income is determined by computing the ratio of two hypothetical U.S. tax amounts that are computed under the assumption that no credit or deduction is allowed for possession income taxes. This ratio is then multiplied by the taxable income of the corporation as computed under the assumptions that no credit or deduction is allowed for possession income taxes and that all other deductions are allowed as under present law.

The numerator of the above ratio is the U.S. tax liability of the possessions corporation that would arise under the bill by virtue of the economic activity limitation determined without any credit or deduction for possession income taxes. The denominator is the U.S. tax liability of the possessions corporation that would be imposed on the income (computed under existing section 936 rules) of the corporation without any credit or deduction for possession income taxes.

complexity and auditing. This, in turn, enhances the potential for tax avoidance by presenting new opportunities for tax manipulation of corporation expenses and transfers to maximize tax benefits under section 936. Payroll padding, for example, is certain to replace transfer pricing as a means of increasing the credit to 936 firms in the absence of substantive real growth in employment and investment.

In addition, since December 31, 1993, Puerto Rican firms, which pay a 42-percent income tax rate, are being forced into unfair competition with firms from the mainland. Mainland firms will benefit not only from Puerto Rican tax incentives but also from the tax credits that subsidize 60 percent of wages in section 936 firms and significant percentages of depreciation on tangible investment. Payroll and employment expansion under the revision will not be market-based and will be unsustainable in the absence of the tax credit. Accordingly, the tax credit will foster a dependence not just on the part of U.S. multinationals, but also by Puerto Rican workers, whose livelihoods will increasingly be directly dependent on revenues foregone by the U.S. Treasury.

VII. Conclusion

History should have taught us the following lessons:

Section 936. If a tax credit is offered based on the amount of possessions-source income a corporation generates, then methods will be found to transfer income streams from the mainland to the possession. The income streams most easily transferred will be those related to intangible assets. These assets represent little or no real investment to the possession.

Section 482 and the TEFRA Amendments. Both the TEFRA amendments and the IRS's track record in enforcing section 482 indicate that almost nothing can be done to stop intangible income transfers in either a useful development time frame (482 cases take more than 10 years to resolve), or in any but the most egregious of violations.

The Caribbean Basin Initiative. Reinvestment of section 936 profits flows readily into profit-maximizing and risk-minimizing, rather than development-maximizing, uses.

Under the current state of the law, if these lessons have been learned, the future holds the following for the possessions:

(1) If section 936 remains, nothing can or will be done to stop the diversion of income derived from intangibles to possessions corporations.

(2) Unless a possessions corporation determines that it will be unlikely to secure new intangible assets in the future (a proposition very unlikely in the pharmaceutical industry), the new percentage limitations on the section 936 credit will not be elected.

(3) Possessions corporations will have plans drawn up targeting pre-existing possessions-based labor-intensive businesses for mergers. Premium targets will have low risks but high balance-sheet (wage and tangible property) attributes. These targets will not necessarily be those best suited to the long-term economic development of the possession. Similar to the CBI, these plans will be investment plans to "buy and hold," not development plans to "buy and further develop" local industries.

(4) Very quickly after income starts to flow to a possessions intangible, the possessions corporation will implement its acquisition strategy. The possessions corporation will aggressively strive to maximize the elements of the three-factor economic activity limitation formula.

(5) Development officials in the possessions should see ownership changes in the assets base in two steps. Initially, properties that the possessions corporations had leased will be purchased, and delivery, cleaning, or security-type subcontractors will be absorbed as in-house departments. Secondly, because neither the Internal Revenue Code nor regulations have any requirements linking the wages paid or the tangible property owned by the possessions corporation to the income stream that actually generates the credit, a more wide-ranging absorption of possession-based assets and wage-paying businesses will be observed.

(6) The possessions economy will stagnate. Each target absorbed will dilute the pool of possessions-based entrepreneurial talent. Each business not absorbed will struggle at a competitive disadvantage against possessions-owned competitors. Section 936 will function as its mirror opposite. In the extreme instance, section 936 will subsidize the dismantling of the Puerto Rican entrepreneurial system and the local tax base it represents.

In summary, section 936 has ceased to be an efficient means of attaining employment-producing investments in Puerto Rico and other U.S. possessions. While the initial rationale for the credit was the creation of jobs and the stimulation of economic activity in the possessions, the outcome has been far different. Firms with intangible assets now take advantage of transfer pricing laws to maximize profits without making the investments that would create sustainable growth in Puerto Rico.

The fundamental questions then are: First, can the long record of disappointment be ended? Second, can the legislation provided in the 1993 budget transform section 936 into an instrument of public benefit, rather than of private profit? We conclude that the costs of section 936 will continue to outweigh its benefits.

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