Recent Changes in the Possessions Corporation System of Taxation: Their Efficacy and Their Relationship to Puerto Rico’s Economic Development

George C. Rockas

Follow this and additional works at: http://scholarship.law.cornell.edu/cilj

Part of the Law Commons

Recommended Citation
Available at: http://scholarship.law.cornell.edu/cilj/vol16/iss2/4
RECENT CHANGES IN THE POSSESSIONS CORPORATION SYSTEM OF TAXATION:
THEIR EFFICACY AND THEIR RELATIONSHIP TO PUERTO RICO'S ECONOMIC DEVELOPMENT

Section 936\(^1\) of the Internal Revenue Code deals with the possessions corporation\(^2\) system of taxation. Under this system, domestic corporations that operate in United States possessions\(^3\) and that meet certain requirements receive substantial tax benefits. In passing section 936 and its predecessor,\(^4\) Congress hoped to promote business and to encourage investment activity within United States possessions.\(^5\) The Tax Equity and Fiscal Responsibility Act of 1982

---

2. The term "possessions corporation" refers to a corporation organized under the laws of a state of the United States that qualifies for the benefits of section 936. Frequently, large corporations operating in the United States own most, if not all, of a possessions corporation's stock. This relationship will be referred to throughout this Note as a parent-subsidiary relationship. Subsidiary status, however, is not a prerequisite to becoming a possessions corporation.
5. See Tax Reform Act of 1976, Pub. L. No. 94-455, §§ 1051(b)-1051(c), 90 Stat. 1525, 1643. The Senate Finance Committee report dealing with the Tax Reform Act stated: The special exemption provided (under sec. 931) in conjunction with investment incentive programs established by possessions of the United States, especially the Commonwealth of Puerto Rico, has been used as an inducement to U.S. corporate investment in active trades and businesses in Puerto Rico and the possessions. . . . The committee after studying the problem concluded that it is inappropriate to disturb the existing relationship between the possessions investment incentives and the U.S. tax laws because of the important role it is believed they play in keeping investment in the possessions competitive with investment in neighboring countries.

(TEFRA) amended section 936 and related code sections dealing with possessions corporations in two ways. First, the Act provided concrete rules for allocating income derived from intangibles that parent companies transfer to their possessions corporation subsidiaries. Second, it required that possessions corporations derive sixty-five percent of their gross income from active business operations within a possession, rather than the fifty percent previously required. The effect that these changes will have on operations in possessions, particularly in Puerto Rico, is a matter of controversy.

There were two reasons for the section 936 amendments. Congress perceived that parent corporations abused section 936 by transferring income-producing intangibles to their Puerto Rican subsidiaries solely to take advantage of the section 936 tax credit. Moreover, it believed that the amendments would increase tax revenues and would thereby help to reduce a burgeoning federal deficit.

This Note evaluates the impact of the TEFRA amendments on the possessions corporation system of taxation. First, the Note discusses the mechanics of section 936 and its predecessor and examines Puerto Rico's tax treatment of possessions corporations. Second, it discusses the 1982 changes and reviews the motivating factors behind them. Third, it analyzes the relationship between Puerto Rico's economic development and the possessions corporation system. Fourth, the Note examines the efficacy of the TEFRA changes. This examination reveals that modification of the possessions corporation system was not in the best interests of either the United States

8. An intangible is "[p]roperty that is a 'right' rather than a physical object." BLACK'S LAW DICTIONARY 726 (rev. 5th ed. 1979). For the purposes of this Note, relevant intangibles include patents, trademarks, trade secrets, and formulas.
10. Most possessions corporations do business in Puerto Rico rather than in other possessions because Puerto Rico provides tax exemptions from all or most of its income taxes for a specific number of years. Thus, most possessions corporations find Puerto Rico more attractive than other United States possessions. See Benjamin, Tax Aspects of Operating a Possessions Corporation in Puerto Rico, 2 INT'L TAX J. 197 (1975-76).
11. See infra notes 141-57 and accompanying text.
12. See infra notes 158-69 and accompanying text.
or Puerto Rico. The Note therefore concludes that Congress should have left section 936 unchanged.

I

HISTORY OF THE POSSESSIONS CORPORATION SYSTEM OF TAXATION

A full evaluation of the recent amendments to section 936 requires an understanding of the evolution and pre-TEFRA technical requirements of section 936. One must master section 936 and its predecessor as well as Puerto Rico's tax treatment of possessions corporations. This section reviews these areas.

A. SECTION 936'S PREDECESSOR

Section 936 is best understood in light of the advantages and technical requirements of its predecessor, section 931.\textsuperscript{13} To qualify as a possessions corporation under that section, a corporation had to meet two gross income tests: (1) eighty percent or more of its gross income had to be from sources within a United States possession and (2) fifty percent or more of the corporation's gross income had to be from the active conduct of a trade or business within a United States possession.\textsuperscript{14} Moreover, a corporation had to meet both of these tests for the three-year period ending with the close of the taxable year in question.\textsuperscript{15} If the corporation did not conduct business within the possession or did not exist throughout this three-year period, it had to meet both tests for the period in which it actually did conduct business within a possession.\textsuperscript{16} If a corporation met the

\begin{itemize}
  \item \textsuperscript{13} I.R.C. § 931 (1964 & Supp. IV 1966), prior to amendment by I.R.C. § 936 (1976).
  \item \textsuperscript{14} I.R.C. §§ 931(a)(1)-931(a)(2) (1964), prior to amendment by I.R.C. § 936(a)(2) (1976). To come within the purview of section 931, a corporation had to meet two operational requirements. First, at least 80% of the corporation's gross income had to derive from sources within a possession. For purposes of this test, the income could derive from more than one possession. Furthermore, gross income meant gross receipts less cost of goods sold or, in the case of services such as assembly or packaging, gross income equaled total revenues. \textit{See} Rev. Rul. 74-374, 1974-2 C.B. 212-13. Second, at least 50% of the corporation's gross income had to derive from the active conduct of a trade or business within a single possession. The purpose of the 50% requirement was to insure that possessions corporations achieved significant economic penetration of a possession. Moreover, the purpose of the active trade or business requirement was to insure that passive holding companies did not derive possessions corporation status. \textit{See generally} Hudson, \textit{Tax Exempt Corporations In Puerto Rico - An Overlooked Opportunity?}, 31 U. FLA. L. Rev. 42, 45-48 (1978-79).
  \item \textsuperscript{15} I.R.C. §§ 931(a)(1)-931(a)(2) (1964), prior to amendment by I.R.C. § 936(a)(2) (1976).
  \item \textsuperscript{16} The current version of section 931's so-called three-year rule states:
    \begin{itemize}
      \item \textbf{GENERAL RULE.--}In the case of individual citizens of the United States, gross income means only gross income from sources within the United States if the conditions of both paragraph (1) and paragraph (2) are satisfied:
    \end{itemize}
\end{itemize}
two requirements, its foreign source and possession source income

(1) **3-YEAR PERIOD.**—If 80 percent or more of the gross income of such citizen (computed without the benefit of this section) for the 3-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession of the United States; and

(2) **TRADE OR BUSINESS.**—If 50 percent or more of his gross income (computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States either on his own account or as an employee or agent of another.

I.R.C. § 931(a)(1) (1982). The pre-1976 version of the three-year rule is similar to the current version. Moreover, section 936 has a three-year rule virtually identical to that of the current version of section 931. (The only significant difference is that section 936's rule applies to domestic corporations rather than to individuals.) I.R.C. §§ 936(a)(2)(A) - 936(a)(2)(B) (1982).

Revenue Ruling 69-481 clarifies the operation of the three-year rule. Rev. Rul. 69-481, 1969-2 C.B. 156. In that ruling, an individual taxpayer requested advice as to whether he satisfied the three-year rule for the taxable year ended December 31, 1966 and thus qualified for tax benefits under the pre-1976 version of section 931(a). In commenting on that rule, the Service stated:

For the purpose of determining the applicable period under section 931(a) of the Code in the case of an individual who is employed in a United States possession and in the United States intermittently during the 3-year period immediately preceding the close of the taxable year, the expressions "such part of such period immediately preceding the close of such taxable year as may be applicable" and "such period or such part thereof" mean the portion of the 3-year period immediately preceding the close of the taxable year in which the individual was employed in a possession of the United States, and not the full 3-year period.

The individual must base his computation for the determination as to whether his income meets the percentage requirements of section 931(a) of the Code upon his total income from all sources for those intervals constituting the applicable period.

Id. at 157.

Because the language of section 936's three-year rule is virtually identical to that of the pre-1976 version of section 931, Revenue Ruling 69-481 serves as a useful guide to interpreting section 936's three-year rule. Moreover, two other revenue rulings help clarify the meaning of this rule. First, in the context of a pre-section 936 possessions corporation, Revenue Ruling 74-422 held that "[f]or purposes of determining whether the gross income requirements of section 931(a) of this Code are met, the three-year period begins on the day a domestic corporation commences business operations in Puerto Rico." Rev. Rul. 74-422, 1974-2 C.B. 213. Second, Revenue Ruling 65-260 held that the three-year period referred to in the pre-1976 version of section 931(a) "means a period of 36 months immediately preceding the close of the taxable year." Rev. Rul. 65-260, 1965-2 C.B. 243.

Using the three revenue rulings as a guide, the following example illustrates the mechanics of the three-year rule in the context of a section 936 corporation. Assume that a United States corporation establishes a subsidiary on January 2, 1978 and on January 2, 1979 it establishes operations in Puerto Rico. The corporation seeks to obtain the benefits of section 936 for the taxable year ending December 31, 1980. The corporation's relevant financial data for the period from January 1978 to December 1979 are as follows:
was exempt from United States income tax.\textsuperscript{17}

Despite the existence of the tax exemption, possessions corporations seldom repatriated earnings,\textsuperscript{18} for three reasons. First, parent companies could not claim a dividends received deduction for any earnings paid to them by possessions corporations. Instead, parent companies had to pay a full tax on dividends.\textsuperscript{19} Second, all income earned by possessions corporations from foreign source investments was exempt from United States taxes.\textsuperscript{20} As a result, many possessions corporations accumulated profits in Puerto Rico and then invested the earnings outside the United States.\textsuperscript{21} Finally, a parent company could obtain a possessions corporation's retained earnings

<table>
<thead>
<tr>
<th>Location of Operations and Time Period</th>
<th>Source and Amount of Income</th>
<th>Total Income, All Sources</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States 1978</td>
<td>United States $10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Puerto Rico 1979</td>
<td>Puerto Rico $50,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Puerto Rico 1980</td>
<td>Puerto Rico $90,000</td>
<td>$90,000</td>
</tr>
</tbody>
</table>

Under Revenue Ruling 74-422, the three-year period begins on January 2, 1979, the day the subsidiary commences operations in Puerto Rico. Even though the period from January 2, 1979 to December 31, 1980 does not constitute three years, the possessions corporation can nonetheless seek section 936 benefits. Revenue Ruling 69-481 supports this conclusion. Under that ruling, the Service applied the “for such part of such period immediately preceding the close of such taxable year as may be applicable” language of section 931(a)(1) and held that the taxpayer qualified for section 931 benefits despite its carrying on operations in a possession for less than thirty-six months. According to the rationale of ruling 69-481, the taxpayer corporation in the example also meets both income tests and thus qualifies for section 936 benefits.

17. A tax exemption differs substantially from a foreign tax credit. A section 931 exemption applies to all income of a possessions corporation, regardless of whether the corporation actually incurred a foreign or possessions income tax. I.R.C. § 931 (1964 & Supp. IV 1966), prior to amendment by Tax Reform Act of 1976, Pub. L. No. 94-455, § 1051, 90 Stat. 1525, 1643. In contrast, a foreign tax credit shields a United States corporation's earnings from income tax only to the extent the corporation pays tax to a foreign government. See generally I.R.C. § 901 (1982). In this way, a corporation doing business abroad avoids double taxation.

18. For purposes of this Note, repatriation of earnings is a process in which possessions corporations pay their profits to American investors either by dividend or liquidation payments.


20. Under section 931, if a possessions corporation realized at least 80% of its gross income from within one or more possessions and if 50% or more of its gross income was from active business operations rather than passive investments, the corporation's foreign source income escaped federal taxation. See supra notes 13-17 and accompanying text.

21. Often, for example, possessions corporations reinvested these excess funds in the “Eurodollar” market either directly or through Guamanian banks. See TREASURY DEPARTMENT, SECOND ANNUAL REPORT ON THE OPERATION AND EFFECT OF THE POSSESSIONS CORPORATION SYSTEM OF TAXATION 18-19 (1979) [hereinafter cited as TREAS. DEPT SECOND ANN. REP.].
tax-free by liquidating completely the possessions corporation. Liquidation was, however, a harsh price to pay to repatriate earnings. Thus, liquidation usually occurred only when a possessions corporation's exemption from Puerto Rican taxes expired, or when its need to repatriate the funds exceeded the benefits derived from the continuation of section 931 status.

B. SECTION 936 AND RELATED CODE SECTIONS

During 1973 and 1974, Congress examined the efficacy of the possessions corporation system of taxation. Congress, however, enacted no reforms until 1976. In that year, Congress perceived two substantial problems with section 931 and related code sections. Its first concern was that allowing the foreign source income of possessions corporations to escape taxation lacked justification. Congress believed that neither the Puerto Rican economy nor the United States Treasury benefited from these investments. The investments represented a revenue loss as well as an uneconomic use of a possessions corporation's retained earnings.

The second problem that Congress wanted to rectify concerned the procedure by which a parent company decided whether to include a possessions corporation subsidiary in its consolidated federal income tax return under section 1501. If a possessions corpo-

22. See generally I.R.C. § 332 (1976). Under this section, a section 931 corporation could elect to be liquidated into its parent tax-free.

23. Puerto Rican tax law affords possessions corporations income tax exemptions for a period of years, the length of which is dependent upon the type and location of the industry on the Island. See P.R. LAWS ANN. tit. 13, §§ 255a-255b (1982). Once the exemption expires, parent companies frequently find that operating a possessions corporation is no longer advantageous. When this occurred in the pre-section 936 period, parent corporations liquidated possessions corporations and obtained their earnings tax-free. I.R.C. § 332 (1976); P.R. LAWS ANN. tit. 13, § 255e (1982).


25. H.R. REP. No. 658, 94th Cong., 2d Sess. 258, reprinted in 1976 U.S. CODE CONG. & AD. NEWS 3149, 3153-54; TREAS. DEP'T SECOND ANN. REP., supra note 21, at 21. I.R.C. § 1501 (1982) provides that “[a]n affiliated group of corporations shall . . . have the privilege of making a consolidated return with respect to the income tax imposed . . . for the taxable year in lieu of separate returns.” I.R.C. § 1504(a) defines an “affiliated group” as:

one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if:

(1) Stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of each of the includible corporations (except the common parent corporation) is owned directly by one or more of the other includible corporations; and

(2) The common parent owns directly stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each
ration and any subsidiaries of the parent met the tests prescribed under section 1504, the subsidiaries were includible in the parent's consolidated return. All corporations includible in the return constituted an "affiliated group," a taxable entity for federal income tax purposes.

Prior to 1977, section 1504's definition of "includible corporation" excluded "[c]orporations entitled to the benefits of section 931, by reason of receiving a large percentage of their income from sources within possessions of the United States." This definition, however, evoked great controversy. The Service argued that section 1504 barred parents from including any possessions corporations in a consolidated return. Parent companies argued that the question of includibility turned on whether the possessions corporation derived any benefits under section 931. Under this theory, a possessions corporation derived section 931 benefits when it made a profit during the taxable year and received no section 931 benefits when it sustained a loss. If a possessions corporation received section 931 benefits, the corporation was not includible in the parent company's consolidated return under section 1504. Instead, according to the parent companies, the possessions corporation had to file a separate return. But if the possessions corporation received no section 931 benefits, the parent companies reasoned, it was includible in the parent company's return.

The Tax Court settled the controversy in favor of the parent companies. Section 1504 therefore bestowed substantial benefits on both parent companies and possessions corporations: in those years in which the possessions corporations lost money, the parent could treat them as includible corporations and deduct the losses, and in those years in which the possessions corporations made a profit, the parents could treat them as non-includible corporations and receive the benefit of the section 931 exemption. Congress

---

26. See supra note 25.
27. Id.
29. See Burke Concrete Accessories, Inc. v. Comm'r, 56 T.C. 588 (1971).
30. Id.
31. Id.
32. Id.
33. Id.
34. Id.
35. Id.
looked unfavorably upon this practice and realized the need to redefine what constituted an "includible" possessions corporation under section 1504.

Responding to these problems, Congress passed the Tax Reform Act of 1976, which overhauled the entire possessions corporation system of taxation. Congress amended section 931 to apply only to individuals and created section 936 to deal specifically with possessions corporations. Under section 936, possessions corporations must meet the same "80-50" income tests that were applicable under section 931. But, unlike its predecessor, section 936 does not exempt possessions corporations' earnings from United States income tax. Instead, the United States taxes possessions corporations on their world-wide income. Possessions corporations, however, can claim a credit equal to that portion of their tax liability attributable to the earnings derived from possessions-source operating profits and from certain investment income. By making this

---

37. Id.
40. See supra note 14 and accompanying text. Of course, when applying the 80-50 gross income tests, possessions corporations must ascertain the source of their income. Because most section 936 corporations derive their income from the sale of products that they manufacture in Puerto Rico, the most important source rules deal with the sale or exchange of personal property. Sections 861 through 863 of the Internal Revenue Code cover this subject. I.R.C. §§ 861-863 (1982). Under these code sections, the source of income from the sale or exchange of personal property is generally where title passes to the purchaser. Thus, if a possessions corporation sells the goods that it manufactures in Puerto Rico to its United States parent corporation and if title to the goods passes in Puerto Rico, the income earned by the possessions corporation on such sales will be Puerto Rican source income.
43. I.R.C. § 936(a)(1)(1976). For purposes of this Note, world-wide income is defined as all income earned by a possessions corporation regardless of where the earning process took place.
44. Id. The section 936 credit, however, does not apply to "gross income actually received by a possessions corporation within the United States, whether or not that income is derived from sources within or without the United States." H.R. REP. No. 658, 94th Cong., 2d Sess. 258, reprinted in 1976 U.S. CODE CONG. & AD. NEWS 3149, 3154.

The concept of possessions source investment income is best understood in light of H.R. REP. No. 658's explanation of section 936. That report states: 

[qual]ified possession source investment income includes only income from sources within a possession in which the possessions corporation actively conducts a trade or business (whether or not such business produces taxable income that taxable year). Furthermore, the taxpayer must establish to the satisfaction of the Secretary that the funds invested were obtained from the active conduct of a trade or business within that same possession and were actually invested in assets in that possession. Funds placed with an intermediary (such as a bank located in the possession) are to be treated as invested in that possession only if it can be shown that the intermediary did not re-invest the funds outside the pos-
change, Congress satisfied its desire to tax income earned by possessions corporations outside of a possession, since, under section 936, such income is not eligible for a tax credit.\textsuperscript{45}

In passing the Tax Reform Act of 1976, Congress also addressed the includibility of a possessions corporation’s profits and losses in a parent’s consolidated income tax return. It amended section 1504’s definition of includible corporation so as to exclude specifically from an “affiliated group” any section 936 corporation.\textsuperscript{46} Moreover, Congress provided that a corporation, to be eligible for the section 936 credit, must elect possessions corporation status.\textsuperscript{47} The corporation cannot revoke the election without the consent of the Secretary.\textsuperscript{48} Thus, possessions corporations cannot make possessions corporation status for a particular taxable year dependent upon their profits and losses. As a result, parent companies no longer derive substantial advantages by electing consolidated reporting in loss years and by electing to exclude income or to take a credit in profit years.

The Tax Reform Act of 1976 made two other significant changes in the possessions corporation system. First, it amended the section 246(a) rule that disallowed parent corporations from taking a dividends received deduction for dividends paid to them by possessions corporations.\textsuperscript{49} Under the amended provision, the maximum

---

\textsuperscript{45} The section 931 exemption extended to all possessions corporation earnings except gross income actually received by a possessions corporation within the United States. As a result, section 931 corporations often invested earnings derived from active business operations in either possessions or foreign countries rather than in the United States. In this way, possessions corporations avoided paying United States taxes. Congress viewed this practice as an abuse of the tax system: However, investing the business earnings of these possession corporations outside of the possession where the business is being conducted does not contribute significantly to the economy of that possession either by creating new jobs or by providing capital to others to build new plants and equipment. Accordingly, while the committee believes it is appropriate to continue to exempt trade or business income derived in a possession and investment income earned in that possession, your committee does not believe it is appropriate to provide a tax exemption for income from investments outside of the possession.

\textsuperscript{46} I.R.C. § 1504(b)(4) (1976).

\textsuperscript{47} Id. § 936(a)(1).

\textsuperscript{48} Id. § 936(c)(2)(A) (After 10 years, consent is not necessary. I.R.C. § 936(c)(2)(B)(1976)).

\textsuperscript{49} See supra note 19 and accompanying text.
allowable deduction is one hundred percent.\textsuperscript{50} This change encourages possessions corporations to repatriate accumulated earnings that they cannot reinvest profitably in a possession. Moreover, by allowing a one hundred percent dividends received deduction, Congress eliminated the practice of liquidating possessions corporations solely to obtain retained earnings tax-free. Second, the Act directed the Treasury Department to submit to Congress an annual report analyzing the revenue, investment, and employment effects of section 936 on the United States and its possessions.\textsuperscript{51} These reports came to play a major role in the passage of the 1982 amendments to the possessions corporation system.\textsuperscript{52}

Despite the broad scope of the 1976 changes, Congress failed to rectify a number of pressing problems that had plagued the possessions corporation system. The most important of these was the allocation of income derived from intangibles transferred from a parent company to a possessions corporation. The rules governing such transfers were unclear and were the source of controversy and litigation.\textsuperscript{53} Congress waited six years before resolving this problem.\textsuperscript{54}

C. PUERTO RICO'S TAX TREATMENT OF POSSESSIONS CORPORATIONS

To some extent, the success or failure of the possessions corporation system is dependent upon the tax incentives that the Puerto Rican Government provides to American corporations.\textsuperscript{55} If the Puerto Rican Government decided not to provide incentives, the advantages United States corporations would derive from operating in Puerto Rico would be reduced significantly. At present, the Puerto Rican tax system provides substantial tax inducements to

\textsuperscript{50} See I.R.C. § 243(a) (1976).


\textsuperscript{52} See infra note 162 and accompanying text.

\textsuperscript{53} At present, the Service is involved in litigating two section 936 cases which deal with the allocation of income derived from transferred intangibles. Eli Lilly Co. and Subsidiaries v. Comm'r, No. 76-5113 (T.C. filed June 1976); Searle Co. and Subsidiaries v. Comm'r, No. 79-12836 (T.C. Filed June 1979).


\textsuperscript{55} In 1900, Congress granted Puerto Rico exclusive taxing jurisdiction over the Puerto Rican source income of its residents. Organic Act of 1900, Pub. L. No. 56-191, § 14, 31 Stat. 77, 80. See also Puerto Rican Federal Relations Act, Pub. L. No. 64-446, 39 Stat. 319 (1950). Thus, Puerto Rico taxes Puerto Rican corporations on their world-wide income and it taxes non-Puerto Rican corporations, such as possessions corporations, only on the income they earn as a result of operating on the Island.
possessions corporations.\textsuperscript{56} If Puerto Rico were to eliminate these inducements, parent companies would probably be less inclined to establish operations there, despite the benefits of section 936.

Traditionally, Puerto Rico has employed two taxing devices that have affected significantly the possessions corporation system. The first of these devices is the industrial tax exemption.\textsuperscript{57} The exemption policy is traceable to the Industrial Tax Exemption Act of 1948.\textsuperscript{58} This Act exempted qualified firms from income, property, and municipal taxation in the hope that the exemptions would induce American firms to move to Puerto Rico.\textsuperscript{59} Puerto Rico subsequently has passed several different versions of the industrial tax exemption, all based on this same goal.\textsuperscript{60} Today's version of the industrial exemption is the Industrial Incentive Act of 1978.\textsuperscript{61} This exemption, like its predecessors, allows possessions corporations to pay significantly reduced income\textsuperscript{62} and property\textsuperscript{63} taxes.

The second taxing device employed by the Puerto Rican Government is the "tollgate" or withholding tax.\textsuperscript{64} This tax works as follows: when a possessions corporation pays a dividend to its United States parent, it must remit a specified percentage of the amount of the dividend to the Puerto Rico Department of the Treasury.\textsuperscript{65} Under current rules, the tollgate tax must exceed ten percent of the dividend.\textsuperscript{66} The exact rate depends upon how long the possessions corporation has invested the distributed funds in Puerto Rico and how long the possessions corporation has invested the funds in certain forced investments.\textsuperscript{67}

\textsuperscript{56} See infra notes 57-67 and accompanying text. For a detailed discussion of Puerto Rico's tax treatment of possessions corporations, see TREAS. DEP'T FOURTH REP., supra note 4, at 23-31.

\textsuperscript{57} P.R. LAWS ANN. tit. 13, § 255a(c)-255a(d) (1982) (defining those businesses eligible for the industrial tax exemption).

\textsuperscript{58} Industrial Tax Exemption Act of 1948, 1948 P.R. Laws, Act No. 184, ch. 35.

\textsuperscript{59} Id.


\textsuperscript{62} See P.R. LAWS ANN. tit. 13, § 255b(a)(1982).

\textsuperscript{63} Id. § 266b(h) (delineating tax exemption rules applicable to property used for industrial development).

\textsuperscript{64} See id. § 255c.

\textsuperscript{65} Id. § 255c(b).

\textsuperscript{66} Id.

\textsuperscript{67} Id.
II
RECENT CHANGES IN THE POSSESSIONS CORPORATION SYSTEM OF TAXATION

The Tax Equity and Fiscal Responsibility Act of 1982\(^6\) modified the possessions corporation system in two ways. First, it established rules for the allocation of income derived from intangibles that have been transferred from a parent to a subsidiary operating in Puerto Rico.\(^6\) Second, the Act imposed more stringent limits upon the amount of passive investment that possessions corporations can earn.\(^7\) Congress believed that these changes not only would curb abuses in the possessions corporation system but also would raise additional tax revenues.\(^7\)

A. ESTABLISHMENT OF RULES FOR THE ALLOCATION OF INCOME DERIVED FROM TRANSFERRED INTANGIBLES

A traditional concern of the Internal Revenue Service has been the "shifting" of income-producing assets\(^7\) between related organizations.\(^7\) This activity, if unregulated, allows parent corporations to minimize income taxes by transferring such assets to a subsidiary. Under section 482 of the Internal Revenue Code, the Service can prevent this type of tax avoidance.\(^7\) That section authorizes the Internal Revenue Service to "distribute, apportion or allocate" gross income between or among related corporations, trades, or businesses "to prevent evasion of taxes or clearly to reflect the income" of any of these organizations.\(^7\)

Over the years, the transfer of income-producing intangibles from parent companies to section 936 corporations has given rise to significant allocation problems.\(^6\) These transfers were usually tax-

---


\(^7\) Id.


\(^7\) For purposes of this Note, income-producing assets are any assets that help a business earn income or that actually produce income. Examples includes stocks, bonds, factories and intangibles such as patents, formulas and copyrights.

\(^7\) See generally TREAS. DEP’T SECOND ANN. REP., supra note 21, at 10-11.


\(^7\) I.R.C. § 482(1976).

free under section 351.\textsuperscript{77} In a typical situation, section 936 corporations used the intangibles to manufacture products and to market them directly to mainland wholesalers. They then priced the products to recover both their manufacturing costs and the parent firm's research and development costs.\textsuperscript{78} Theoretically, the procedure resulted in a two-fold tax benefit: (1) section 936 corporations could claim a credit equal to the income attributable to the products and (2) the parent companies could deduct the cost of research and development from their taxable United States income. The Service, however, questioned this procedure and attempted to reallocate the income under section 482.\textsuperscript{79} This issue is currently before the Tax Court.\textsuperscript{80}

In 1982, Congress attempted to raise additional revenue by focusing upon the practice of transferring intangibles, an activity which was seen by many as an abuse of the tax system.\textsuperscript{81} The legislative history of TEFRA emphasizes Congress's concern for the disparity between the average tax expenditure per employee and the average wage per employee of section 936 corporations.\textsuperscript{82} Congress

\textsuperscript{77}. I.R.C. § 351 (1976). Section 351 permits United States corporations that own 80% or more of a United States subsidiary to transfer appreciated property, including intangibles, to the subsidiary solely in exchange for the subsidiary's stock or securities without recognition of gain. The Code treats the transfers as tax free on the premise that the subsidiary will eventually be taxed on income produced by the transferred property. See Treas. Dept Fourth Rep., supra note 4, at 15. This rationale, however, does not apply when transfers are made to possessions corporations because their income is tax-exempt. Consequently, the Service challenged this practice. See infra notes 79-80 and accompanying text.


\textsuperscript{79}. See Internal Revenue Service Technical Advice Memorandum 8040019 (July 7, 1979), 189 IRS Letter Rulings, Part II (CCH Oct. 1980).

In the memorandum, a parent corporation made a section 351 transfer of intangibles to its possessions corporation subsidiary. The Service took the position that the transfer lacked substance and that tax avoidance motivated the parent. As a result, it refused to treat the tangible as "belonging" to the possession. Instead, it applied section 482 and reallocated all the income produced by the intangibles to the parent. This action reduced the amount of income possessions corporations could shield from United States tax. See Treas. Dept. Fourth Rep., supra note 4, at 19.

\textsuperscript{80}. Although the new rules clarify the allocation procedure, they do not resolve outstanding allocation disputes between the Internal Revenue Service and taxpayers. As a result, a number of suits dealing with this issue are in litigation. See supra note 53.


focused on the pharmaceutical industry, which had derived windfall tax benefits from the transfer of intangibles. In 1978, for example, the average tax expenditure per employee in that industry exceeded $43,000, while the average wage per employee was only about $13,000. Congress questioned the efficacy of such a system, given that the drug industry accounted for approximately fifty percent of the tax expenditures under section 936 but provided in return only fifteen percent of Puerto Rico's manufacturing jobs and only about three percent of Puerto Rico's total jobs. Senator Robert Dole, Senate Finance Committee Chairman, commented on these statistics:

The Government loses over $500 million to provide only 3 percent of Puerto Rico's employment. This is not a good bargain for us or even a worthwhile deal for Puerto Rico, although it is a tremendous deal for the drug industry. Moreover, according to the Treasury Department, intangible-intensive industries, like the drug industry, do very little to encourage the development of related industries in Puerto Rico, because their customers and suppliers are not in Puerto Rico.

There was thus a strong need for Congress to make clear rules governing the transfer of intangibles to possessions corporations. The Senate originally urged that all income from transferred intangibles be allocated to United States shareholders. The Puerto Rican Government, however, bitterly opposed this drastic measure. Congress eventually adopted a compromise position.

For a discussion of the "tax expenditure per employee" concept, see infra note 145 and accompanying text.


84. Id. at 48. In contrast, in 1978 the average tax expenditure per employee of all section 936 manufacturing corporations was $12,667, while the average compensation per employee was $10,697. Id. The 1978 averages are important because they are the ones Congress used when examining the possessions corporation system and when promulgating TEFRA.

In February 1983, six months after TEFRA's passage, the Treasury Department released its fourth annual report. That report shows that the tax benefits section 936 corporations received as a result of operating in Puerto Rico increased substantially between 1978 and 1980. In 1980, the average tax expenditure per employee in the pharmaceutical industry was $58,743 while the average compensation per employee was $15,644. TREAS. DEP'T FOURTH REP., supra note 4, at 112. The average 1980 tax expenditure per employee of all section 936 manufacturing corporations was $17,186, while average compensation per employee was $11,915. Id.

85. Id.


88. For the original Senate version of the section 936 amendments, see 128 CONG. REC. S8604 (daily ed. July 19, 1982).

89. See, e.g., supra note 82; Letter from Carlos Romero-Barceló, Governor of Puerto Rico, to Senator Daniel P. Moynihan concerning the proposed amendments to section 936, reprinted in 128 CONG. REC. S8802 (daily ed. July 21, 1982).
The Tax Equity and Fiscal Responsibility Act of 1982 provided two options which allow corporations to treat income attributable to manufacturing intangibles as income eligible for the section 936 credit. Under the first option, parent corporations can transfer these types of intangibles to a section 936 subsidiary provided the subsidiary (1) shares, through a cost-sharing payment, in the annual research and development costs of the parent and other affiliates.

90. For purposes of the rule changes, the term "manufacturing intangible" includes patents, inventions, formulas, processes, designs, patterns and know how. The term, however, does not include marketing intangibles such as trademarks, trade names and brand names. Moreover, the manufacturing intangibles covered by the cost sharing option "must be related to the products produced or services rendered" by the possessions corporation. H.R. Rep. No. 760, 97th Cong., 2d Sess. 506, reprinted in 1982 U.S. CODE CONG. & AD. NEWS 781, 1283-84.


[i]he cost sharing payment will be equal in amount to a fraction of the current year's worldwide direct and indirect product area research expenditures. The fraction would generally equal the ratio of third party sales of products produced or services rendered, in whole or in part, in the possession to third party sales of all products produced or services rendered by the [section 936 corporation] and its affiliates (U.S. and foreign) in the same product area.
H.R. Rep. No. 760, 97th Cong. 2d Sess. 506, reprinted in 1982 U.S. CODE CONG. & AD. News 781, 1283-84. A product area is a group of related products as defined by "reference to the three-digit classification of the Standard Industrial Classification Code." I.R.C. § 936(h)(5)(C)(i)(I)(e) (1982). The United States government developed the Standard Industrial Classification Code in order to classify more efficiently industry activities and to facilitate the collection, analysis and presentation of industry data. The Code classifies various industries and products through a two-digit, three-digit and four-digit classification system. It assigns each major industry a two-digit classification number. The Code then divides each major industry into product groups classified by a three-digit number. Each three-digit classification is further broken down into even more specific product groups which are given four-digit classification numbers. U.S. OFFICE OF MANAGEMENT AND BUDGET, STANDARD INDUSTRIAL CLASSIFICATION MANUAL 9-13, 116-17 (1972). Under this system, for example, the Code assigns to all industries producing chemicals and allied products the same two-digit numbers. "Drugs" is one three-digit classification group within the chemicals and allied products industry. The drugs group consists of biological products, medicinal chemicals, botanical products and pharmaceutical preparations. The Code assigns each of these products a specific four-digit number. Id. at 116-17.

After determining the relevant three-digit product area, possessions corporations can reduce their cost sharing payments to the following formula:

\[
\frac{\text{Total product area research expenditures}}{\text{Total product area sales by possessions corporations to third parties}} \times \frac{\text{Total product area sales by possessions corporations and United States and foreign affiliates to third parties}}{\text{Total product area sales by possessions corporations to third parties}}
\]

and (2) has a "significant business presence" in Puerto Rico.\textsuperscript{92} If a section 936 corporation satisfies these conditions, it can claim the full income derived from the manufacturing intangibles and the full tax credit.\textsuperscript{93} But when a possessions corporation manufactures a product and uses a transferred intangible in the production process, it must follow pricing guidelines established in section 482 regulations if it sells the product to an affiliate.\textsuperscript{94} Cost sharing payments received by a parent company from a possessions corporation are not includible in the parent's gross income.\textsuperscript{95} Instead, they reduce the parent's deductions for research and development.\textsuperscript{96}

Under the second option, a parent corporation and its possessions corporation subsidiary can split equally their combined taxable income resulting from partial or complete production of products in Puerto Rico.\textsuperscript{97} Fifty percent of this income is allocable to the possessions corporation and fifty percent is allocable to the parent company.\textsuperscript{98} To qualify for profit sharing, a possessions corporation must

\textsuperscript{92} To qualify "to elect cost sharing for a product or type of service, [a possessions corporation] must have and maintain a significant business presence in the possession with respect to that product or type of service. . . . [These requirements are met] if (1) more than 25 percent of the value added by the [parent company, possessions corporation and other affiliates] to the product is added by the [possessions corporation] in a possession or (2) at least 65 percent of the direct labor costs of the [parent company, possessions corporation and other affiliates] for the product or service (or in connection with the purchase and sale of goods not produced by the affiliated group) are incurred by the island affiliate and are compensation for services rendered in the possession. . . . [The] test is intended to require real and significant business activity in the possessions." H.R. REP. No. 760, 97th Cong., 2d Sess. 507, reprinted in 1982 U.S. CODE CONG. & AD. NEWS 781, 1284-85; I.R.C. § 936(h)(5)(B)(ii) (1982).


\textsuperscript{98} I.R.C. § 936(h)(5)(C)(ii) (1982). H.R. REP. No. 760 contains a concise explanation of the effect and mechanics of electing the 50/50 profit split option:

If an election is made, the island affiliate will be entitled to 50 percent of the combined taxable income from the sale of products produced or services rendered in a possession by the island affiliate and sold to third parties or foreign affiliates by the island affiliate or a mainland affiliate. The remainder of the combined taxable income for a product will be allocated to the mainland affiliates. This latter amount may exceed the island affiliate's share of the income from the product if the amount of proportionate product area research expenditures, determined under cost sharing, is in excess of the amount allocable to the combined taxable income absent application of the cost-sharing formula. For example, if combined taxable income is $100 without taking into account
satisfy the same significant business presence test required under the cost-sharing option.\textsuperscript{99} Moreover, it must manufacture or produce the product in the possession within the meaning of section 954,\textsuperscript{100} the controlled foreign corporation provision.\textsuperscript{101} To elect the option, a possessions corporation must satisfy one additional requirement: it must make its election by the due date of its first post-1982 tax return.\textsuperscript{102} If the products or services within the product area covered by the election do not meet the significant business presence test, the possessions corporation may not claim a section 936 credit for income attributable to these products or services.

Congress hoped that these options would eliminate many of the abuses it perceived to be associated with the possessions corporation system of taxation, and that they would raise additional tax revenue. It hoped that the new rules would not, however, dissuade corporations from establishing operations in Puerto Rico. Controversy exists as to whether the new rules will serve these goals.

B. INCREASING THE ACTIVE TRADE OR BUSINESS REQUIREMENT

Before the 1982 changes, possessions corporations could earn up to fifty percent of their total income from passive investments such as bank deposits, stocks, and bonds.\textsuperscript{103} This led Section 936 corporations to accumulate liquid investments.\textsuperscript{104} Moreover, the large amount of money held in Puerto Rican banks did not always provide new capital for Puerto Rican businesses.\textsuperscript{105} On many occasions, the banks invested these funds overseas.\textsuperscript{106}


\textsuperscript{100} I.R.C. § 954(d)(1)(A) (1982).


\textsuperscript{102} I.R.C. § 936(h)(5)(F)(i) (1982). This requirement also applies to the cost-sharing option.


\textsuperscript{104} Position Paper, supra note 82, at S8803.

\textsuperscript{105} Id.

\textsuperscript{106} Id. at S8803-04.
Congress questioned the extent to which these practices actually furthered Puerto Rican economic development. To cope with these perceived abuses, Congress raised, from fifty to sixty-five, the percentage of a corporation's gross income that must be derived from an active trade or business. Congress hoped to increase thereby the capital investments of businesses in Puerto Rico.

III

SECTION 936'S RELATIONSHIP TO PUERTO RICO'S ECONOMIC DEVELOPMENT

The purpose of section 936 is to enhance both employment and industrial opportunities in Puerto Rico. The position of the Treasury Department of Puerto Rico reflects this view:

Section 936 has played an extremely important part in the Puerto Rico industrial development program. Puerto Rico has advanced since 1940 from a poverty-stricken island heavily dependent on low-wage sugar production to a modern, semi-industrialized economy. Much of the credit for this successful record goes to the Island's program to attract mainland private industry to Puerto Rico through Puerto Rico's Industrial Incentive Acts, which build upon Federal tax benefits provided to qualifying U.S. corporations locating in Puerto Rico. These Federal tax benefits, provided under section 936 of the Internal Revenue Code, have been essential to the rapid growth in United States private investment which has been the backbone of the Island's development.

To evaluate the possessions corporation system, one must review trends in employment, education, and industry in Puerto Rico over the last decade.

Important indicators of the success of section 936 are the number and quality of jobs in Puerto Rico. Today, Puerto Rico needs more jobs, including "primary" jobs. There are several reasons for this employment problem. First, Puerto Rico no longer

108. I.R.C. §§ 936(a)(2)(B)-936(a)(2)(C) (1982). The 65% requirement will be phased in over three taxable years. In the 1983 taxable year, the required percentage was 55, and in 1984 it is 60. In the 1985 taxable year, the required percentage will finally reach 65.
110. The unemployment rate during the summer of 1982 reached 23.6%. Id. at S8796.
111. Michael Piore, a labor economist, describes "primary" jobs in Puerto Rico as follows:

[The primary market offers jobs which possess the following traits: high wages, good working conditions, employment stability and job security, equity and due process in the administration of work rules, and chances for advancement. The secondary sector has jobs that are decidedly less attractive, compared with those in the primary sector. They tend to involve low wages, poor working conditions, considerable variability in employment, harsh and often arbitrary discipline, and little opportunity to advance. The poor are confined to the secon-
serves industry as a source of low cost labor. As a result of increased wage demands by labor in recent years, many traditional, labor-intensive industries have left the Island and have moved to developing countries where labor is cheaper. Second, the expectations of Puerto Ricans have risen as their Island has undergone economic development: residents want jobs that are better than those that were held by preceding generations. The growing demand for "primary" jobs is a by-product of the increasing educational level of the labor force. School enrollment has increased significantly since 1950. In that year, 49.3 percent of the school age population (6 to 18 years) attended some educational institution. By 1977, this figure had increased to 79 percent. Moreover, the amount of public funds expended on education has increased substantially, resulting in a dramatically improved quality of education. These qualitative improvements are affecting the composition of the work force. Not only is the ratio of skilled to unskilled workers increasing over time, but the Puerto Rican technicians and managers are displacing their American counterparts. Finally, the availability of

---

114. In the Puerto Rican apparel industry, for example, real wages (wages adjusted for price inflation) increased 260% between 1955 and 1980. TREAS. DEP’T FOURTH REP., supra note 4, at 43. Two specific factors account for the increase. First, because of the growth in investment and the increase in education and on-the-job training in the 1950s and 1960s, Puerto Rican labor has become more productive. Id. Second, and more important, between 1940 and 1981 the United States phased in its minimum wage laws in Puerto Rico. Id. The hourly wage rate in many Puerto Rican industries, such as apparel, food products, and leather products, was near or at the legal minimum. Id. at 45-46. The Treasury Department suggested that "[t]his clustering of workers at or near the minimum, combined with the fact that the minimum wage increased more than average actual wages in many Puerto Rican industries between 1973 and 1977, indicates that changes in the minimum wage in Puerto Rico have tended to increase Puerto Rican wages." Id. at 47.

115. TREAS. DEP’T THIRD ANN. REP., supra note 83, at 28-30. These countries include Korea, Hong Kong, Indonesia, the Dominican Republic, and the Philippines. Research Paper One, supra note 113, at 13.


117. Id. at 1, 5, 26-28.


119. Id.

120. Id.

121. C. SANTIAGO, supra note 118, at 18. In 1954-55, for example, Puerto Rico expended $75.40 per student. By 1972-73, this figure had increased to $450.00 per student.

122. Id.

123. Id.
food stamps and other transfer payments eliminates an unemployed worker's need to take any job.\textsuperscript{124} Instead, a worker can wait until the job he wants becomes available.\textsuperscript{125} These three factors indicate that the quality as well as the quantity of jobs must be considered in attempting to solve Puerto Rico's employment problem.

Section 936 has increased the number and improved the quality of jobs in Puerto Rico. A brief review of Puerto Rico's recent industrial and employment history illustrates that fact. In recent years, traditional, labor-intensive industries, such as textile, apparel, leather, and tobacco industries, have either reduced or ceased their operations in Puerto Rico and established facilities in developing countries where wages are lower.\textsuperscript{126} As a result, thousands of Puerto Rican workers have lost jobs. In contrast, technology-oriented industries have moved to Puerto Rico and have created many jobs.\textsuperscript{127} At present, these industries provide 39.4 percent of Puerto Rico's manufacturing jobs and serve as one of its most important sources of new employment.\textsuperscript{128} High technology industries expanded employment by thirty-seven percent between 1976 and 1981.\textsuperscript{129} During that period, employment in the electronics industry

\begin{footnotesize}
\begin{enumerate}
\item[124.] See generally Treas. Dep't Fourth Rep., supra note 4, at 48 (listing the amounts of federal grants-in-aid and taxes transferred to Puerto Rico by the United States Government for selected years during the 1968-1981 period).
\item[125.] Research Paper One, supra note 113, at 5. See also Treas. Dep't Third Ann. Rep., supra note 83, at 28.
\item[126.] Between 1968 and 1978, the number of industries engaged in manufacturing tobacco products, textile products, apparel products, and leather products decreased 31\%, 42\%, 87\%, and 36\%, respectively. Research Paper One, supra note 113, at 10 (citing Commonwealth of Puerto Rico, Department of Labor and Human Resources, Census of Manufacturing Industries of Puerto Rico (1968-1978)). Moreover, in 1975, The Tobin Committee stated that "[t]he shifting structure of industry reflects partly the shifting real comparative advantage of Puerto Rico. As the Puerto Rican labor force has become better trained and more productive, it has become too valuable a resource to use in these [labor-intensive] industries." The Committee to Study Puerto Rico's Finances, Report to the Governor 21 (1975).
\item[127.] In the ten years between 1968 and 1978, for example, the number of establishments engaged in manufacturing chemicals and allied products, drugs, electrical machinery and professional and scientific instruments increased 65\%, 42\%, 31\%, and 57\%, respectively. Moreover, in that same period employment increased 255\%, 579\%, 77\%, and 228\%, respectively. Research Paper One, supra note 113, at 10-11 (citing Commonwealth of Puerto Rico, Department of Labor and Human Resources, Census of Manufacturing Industries of Puerto Rico (1968-1978)). See also Treas. Dept. Fourth Rep., supra note 4, at 53 (listing the distribution of employment in Puerto Rican manufacturing industries between 1968 and 1981).
\item[128.] Position Paper, supra note 82, at S8797.
\item[129.] Id.
\end{enumerate}
\end{footnotesize}
increased by fifty-six percent, to 20,800 employees.\textsuperscript{130} During the
decade from 1968 to 1978, jobs created in high technology industries
have offset about one-half the jobs lost through diminution of tradi-
tional industrial activity on the Island.\textsuperscript{131} The establishment and
expansion of these industries is in large part due to the benefits con-
ferred by section 936.\textsuperscript{132}

Despite the significant contributions that high technology indus-
tries make to the Puerto Rican economy, the industries do not create
enough employment to replace jobs lost in traditional industry and
to provide the new jobs necessary to meet an expanding labor
force.\textsuperscript{133} Therefore, unemployment in Puerto Rico remains high.\textsuperscript{134}

One possible solution to this problem is to attract labor-inten-
sive industries back to Puerto Rico. This approach, however, is not
feasible for two reasons. First, most Puerto Ricans simply do not

\textsuperscript{130} \textit{Id.}

\textsuperscript{131} \textit{Research Paper One, supra} note 113, at 9-12, (citing \textit{COMMONWEALTH OF PUERTO
RICO, DEPARTMENT OF LABOR AND HUMAN RESOURCES, CENSUS OF MANUFACTURING
INDUSTRIES OF PUERTO RICO (1968-1978))}. The pharmaceutical industry, for example,
created approximately 8,335 additional jobs from 1968 to 1978. \textit{Id.}

\textsuperscript{132} Many major United States manufacturers operating in Puerto Rico have reported
significant tax savings under section 936. \textit{See Treas. Dep't Third Ann. Rep., supra
note 83, at 37. But for the existence of these tax savings, no significant reasons exist why
United States manufactures should continue to move to and expand their operations in
Puerto Rico. The position of the Puerto Rico Treasury Department reflects this view:

In creating jobs, Section 936 has been an important tool. While motivations
for investment are as varied and complex in Puerto Rico as they are on the main-
land, most informed observers of the Island's economic scene believe that tax
exemption is an extremely important reason for industrial investment in Puerto
Rico. The Island has few natural resources which can be profitably exploited by
industry. Most firms which have located on the Island ship their final products
to, and obtain their raw materials from, points on the mainland which are
between 900 and 1400 miles from the point of manufacture. 'Energy cost - espe-
cially for electricity - are also somewhat higher than on the mainland, due to the
almost exclusive reliance of the Puerto Rico Electric Power Authority on oil-
fueled power generation. It will be several years before alternative energy
sources will begin to change these unfavorable energy costs.

For these reasons, and because of the uncertainty that Puerto Rico's present
political status poses, investors considering locating in Puerto Rico generally
look for a post-tax rate of return higher than on the mainland before coming to
the Island, something which Section 936 has been able to provide.

\textsuperscript{133} \textit{Research Paper One, supra} note 113, at 12.

\textsuperscript{134} \textit{See supra} note 112 and accompanying text. The Treasury Department Fourth
Annual Report lists by year the Puerto Rican unemployment rate, total employment in
Puerto Rico, and the distribution of employment in selected sectors of the Puerto Rican
economy:
want to work in traditional manufacturing industries.\textsuperscript{135} As the level of education continues to increase, even fewer Puerto Ricans will be interested in these jobs.\textsuperscript{136} Second, to attract traditional industries back to Puerto Rico would be a difficult task. Tax considerations play little, if any, role in the decision of these industries to leave Puerto Rico. Many traditional industries leave Puerto Rico despite the tax advantages that accompany possessions corporations status.\textsuperscript{137} The major impetus behind the exodus of labor-intensive

\begin{table}
\centering
\begin{tabular}{|c|c|c|c|c|c|c|c|c|}
\hline
Year & Unemployment Rate & Total Employment & Total Government Employment & Total Non-Government Employment & Agriculture & Manufacturing & Wholesale Trade & Insurance, Real Estate \\
\hline
1950 & 12.9\% & 596 & 45 & 551 & 214 & 55 & 90 & 3 \\
1955 & 14.3 & 539 & 50 & 489 & 164 & 66 & 89 & n.a. \\
1965 & 11.7 & 617 & 82 & 535 & 107 & 106 & 109 & n.a. \\
1971 & 11.6 & 700 & 111 & 589 & 61 & 132 & 134 & 15 \\
1972 & 11.9 & 737 & 131 & 606 & 58 & 141 & 135 & 16 \\
1973 & 11.6 & 757 & 143 & 614 & 49 & 142 & 146 & 18 \\
1974 & 13.2 & 775 & 147 & 628 & 53 & 147 & 148 & 18 \\
1975 & 18.1 & 738 & 151 & 587 & 49 & 137 & 141 & 18 \\
1976 & 19.5 & 718 & 158 & 560 & 46 & 133 & 140 & 18 \\
1977 & 19.9 & 739 & 168 & 571 & 41 & 144 & 145 & 19 \\
1978 & 18.1 & 780 & 180 & 600 & 40 & 156 & 149 & 21 \\
1979 & 17.0 & 807 & 190 & 618 & 38 & 160 & 155 & 21 \\
1980 & 17.1 & 827 & 202 & 625 & 43 & 157 & 152 & 23 \\
\hline
Annual growth rate 1950-1960 & -1.0\% & 3.3\% & -1.3\% & -5.3\% & 3.9\% & 0.8\% & 7.2\% \\
Annual growth rate 1960-1970 & 2.4 & 5.5 & 1.9 & -5.8 & 5.0 & 2.8 & 8.0 \\
Annual growth rate 1970-1981 & 1.8 & 6.1 & 0.8 & -4.5 & 1.5 & 1.8 & 6.1 \\
\hline
\end{tabular}
\caption{employment data}
\end{table}

Treas. Dept Fourth Rep., supra note 4, at 37. As the table indicates, Puerto Rico's unemployment rate has traditionally been high. Moreover, the table also reflects that the rate of employment growth in recent years in the manufacturing sector has been small and in fact declined in 1980 and 1981.

\textsuperscript{135} See supra notes 112-25 and accompanying text.

\textsuperscript{136} See supra notes 117-23 and accompanying text.

\textsuperscript{137} The following table shows the substantial decline in the number of possessions corporations engaged in traditional manufacturing activities between 1973 and 1980.
industry from Puerto Rico is wage costs. The high wages demanded by Puerto Rican workers make many products produced by traditional industry noncompetitive in both United States and international markets. Products manufactured in developing countries, on the other hand, can be produced for substantially less cost because wages are lower. As a result, these products have a competitive advantage in international markets.

The future of Puerto Rico's industrial economy must be based on capital-intensive, high technology industry. Expansion of traditional industry is no longer a viable way to bolster the economy. Therefore, any attenuation of the incentives to attract high technology industries to, and to keep such industries in, Puerto Rico would lead to a decline in industrial growth and a loss of many jobs.

IV

THE EFFICACY OF THE RECENT CHANGES IN THE POSSESSIONS CORPORATION SYSTEM

Reviewing the section 936 amendments in light of their effect on Puerto Rico's economic development and their ability to curtail perceived abuses and to raise revenue makes it clear that Congress should not have modified the possessions corporation system of taxation. The TEFRA changes are harmful to the economic development of Puerto Rico, the perceived abuses are not pervasive, and the potential revenue gain is speculative and relatively insignificant.

<table>
<thead>
<tr>
<th>Manufacturing Industries</th>
<th>Number of Possessions Corporations 1973*</th>
<th>Number of Possessions Corporations 1980**</th>
<th>Percent Decrease (Increase)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food and Kindred Products</td>
<td>22</td>
<td>18</td>
<td>18.2</td>
</tr>
<tr>
<td>Stone, Clay and Glass Products</td>
<td>8</td>
<td>6</td>
<td>25.0</td>
</tr>
<tr>
<td>Textile Mill Products</td>
<td>16</td>
<td>9</td>
<td>43.8</td>
</tr>
<tr>
<td>Apparel</td>
<td>93</td>
<td>82</td>
<td>11.8</td>
</tr>
<tr>
<td>Rubber Products</td>
<td>14</td>
<td>8</td>
<td>42.9</td>
</tr>
<tr>
<td>Leather and Leather Products</td>
<td>19</td>
<td>13</td>
<td>31.6</td>
</tr>
</tbody>
</table>

** TREAS. DEP'T. FOURTH REP., supra note 4, at 48-49.

138. See supra note 126 and accompanying text.
139. Position Paper, supra note 82.
A. New Rules Governing the Transfer of Intangibles: A Harmful Approach to a Perceived Threat

By establishing concrete rules regarding income derived from transferred intangibles, TEFRA resolved the controversy between the Internal Revenue Service and Section 936 corporations.140 As a result, possessions corporations can better predict the tax consequences of operating in Puerto Rico. The overall efficacy of the rules, however, remains doubtful.

I. Perceived Abuses of Section 936 as They Relate to Tax Expenditures

Tax expenditure per employee was an important indicator used by Congress to assess the possessions corporation system.141 Industries that rely heavily on intangible transfers generally have a very high tax expenditure per employee ratio.142 In its examination of the intangible transfer problem, Congress adopted the view that high tax expenditures per employee ratios constitute an abuse of the tax system.143 Congress wanted to reduce these ratios through the passage of TEFRA.144 By dramatically reducing the tax expenditures arising from intangible-intensive industries, however, Congress hurt Puerto Rico's economy.

A high tax expenditure per employee ratio indicates that a particular industry is profitable; a low tax expenditure ratio indicates the converse.145 Highly profitable growth industries that necessarily create large section 936 tax expenditures, such as those involved in

140. See Internal Revenue Service Technical Advice Memorandum 8040019 (July 7, 1979), 189 IRS LETTER RULINGS, Part II (CCH Oct. 1980). See also Eli Lilly Co. and Subsidiaries v. Comm'r, No. 76-5113 (T.C. filed June 1976); Searle Co. and Subsidiaries v. Comm'r, No. 79-12836 (T.C. filed June 1979). These cases deal with income allocation questions in situations where a parent company transferred income-producing intangibles to a possessions corporation.
141. See supra notes 82-87 and accompanying text.
142. TREAS. DEP'T THIRD ANN. REP., supra note 83, at 48-49.
143. See supra notes 82-87 and accompanying text.
144. Id.
145. Tax expenditure per employee simply equals the total tax expenditure attributable to a given company divided by the total number of workers the company employs. The greater the income of a possessions corporation the more money the United States Treasury loses in the form of section 936 credits. See TREAS. DEP'T THIRD ANN. REP., supra note 83, at 48. These credits represent tax expenditures. Thus, the tax expenditure per employee ratio is a function of profitability. If, for example, possessions corporation A has five employees, a fifty percent tax rate and a net income of one thousand dollars, the tax expenditure attributable to A equals five hundred dollars ($1000 × .5) and the tax expenditure per employee equals one hundred dollars ($500 ÷ 5). If possessions corporation B has the same tax rate and the same number of employees as A but has a profit of only five hundred dollars, the tax expenditure attributable to B equals two hundred fifty dollars ($500 × .5) and the tax expenditure per employee equals fifty dollars ($250 ÷ 5).
high technology,¹⁴⁶ are the type of industries that should be encouraged to move to Puerto Rico.¹⁴⁷ The Island's continued economic development depends upon these enterprises. They are the industries that have moved to Puerto Rico in the greatest numbers over recent years,¹⁴⁸ have created the most employment,¹⁴⁹ and have paid the highest wages.¹⁵⁰ But section 936 modifications, by curtailing the tax benefits, make Puerto Rico less attractive to these industries. The income allocation rules, for example, have reduced the profitability of high technology industries operating there because significant amounts of income are no longer shielded from United States income tax.¹⁵¹ In addition, the diminution of section 936 benefits creates a problem in connection with the attraction of new possessions corporations to Puerto Rico. Those benefits that remain may not constitute a significant enough inducement for new employment-generating investment in Puerto Rico.¹⁵²

The net effect of these factors is that the new rules threaten the Island's economic development and thus are not in Puerto Rico's

¹⁴⁶. The high technology industries are the most profitable manufacturing industries in Puerto Rico. In 1981, for example, the chemical industry produced 37.3% of Puerto Rico's total net manufacturing income while the machinery and metal products industry, the producer of electrical and electronic equipment, earned 28.3% of this total. TREAS. DEP’T FOURTH REP., supra note 4, at 51. In contrast, the more traditional apparel industry contributed only 8% of Puerto Rico's total 1981 net manufacturing income. Id.

¹⁴⁷. See supra notes 112-32 and accompanying text.

¹⁴⁸. See supra notes 126-32 and accompanying text.

¹⁴⁹. Id.

¹⁵⁰. For example, in 1978, the average hourly wage paid in the drug industry was $4.32. In contrast, the average hourly wages paid in the tobacco, textile and apparel industries were all under $3.00. COMMONWEALTH OF PUERTO RICO, DEPARTMENT OF LABOR AND HUMAN RESOURCES, CENSUS OF MANUFACTURING INDUSTRIES OF PUERTO RICO (1978). See generally TREAS. DEP’T THIRD ANN. REP., supra note 83, at 48.


¹⁵². The Treasury Department has recognized that allocating income from transferred intangibles to possessions corporations induces investment in Puerto Rico. It has stated that "[i]f the income attributable to the intangibles is treated as earned by the 936 corporation, rather than the parent, the effect of the transfer will be to increase the pool of tax exempt Puerto Rican income earned by the 936 corporation and thus augment the incentive for investing in Puerto Rico." Treas. Dep’t Fourth Rep., supra note 4, at 5.

Evidence exists that Technical Advice Memorandum 8040019 and the current litigation concerning the application of section 482 to intangible income may have discouraged United States investment in Puerto Rico. See supra notes 79-80 and accompanying text. After fiscal year 1980, substantially fewer investors made contractual agreements with the Puerto Rican Economic Development Administration. Specifically, in fiscal year 1981, investors entered into 20.9% fewer contracts than in fiscal 1980, while in 1982, investors entered into 15.3% fewer contracts than in fiscal 1980. Treas. Dep’t Fourth Rep., supra note 4, at 20. One probable reason for this decline was the uncertain tax consequences accompanying intangible transfers and the possibility of not being able to shield large amounts of possessions corporation income from United States taxation.
best interests.\(^{153}\) This threat is very untimely given Puerto Rico's exorbitant unemployment rate\(^{154}\) and the declining rate of real investment on the Island.\(^{155}\)

By passing legislation which reduced the tax benefits afforded intangible-intensive possessions corporations, Congress implicitly embraced the misguided view that all such enterprises had abused the tax system. Admittedly, some high technology industries reaped

---

153. Congress adopted the TEFRA rule changes despite the Treasury Department view that Puerto Rico probably derives significant benefits from intangible transfers. On this subject, it stated:

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

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

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

Treas. Dep't Fourth Rep., supra note 4, at 67-68. (While this statement appears in the Treasury Department Fourth Annual Report published in February 1983, it is unlikely that the Treasury Department's view of the effect of intangible transfers on Puerto Rico's economy changed significantly between the August 1982 passage of TEFRA and the publication date.)

154. See supra notes 112 & 134 and accompanying text.

155. Over the last decade, the amount of real investment in Puerto Rico has declined significantly. For a chart summarizing real investment in Puerto Rico for the last 20 years, see Treas. Dep't Fourth Rep., supra note 4, at 41. The TEFRA rule changes occurred when private, non-residential, fixed investment in Puerto Rico was far below the peak year of 1973. Because TEFRA takes away existing benefits, it should not only dissuade United States parent corporations from forming section 936 corporations or expanding their already existing Puerto Rican operations, but also reduce even further the annual level of real investment in Puerto Rico. Without an adequate growth in capital expenditures, Puerto Rico will not prosper.
huge profits at the expense of United States taxpayers through the transfer of intangibles. The TEFRA amendments, however, penalize all possessions corporations, the majority of which did not enjoy such high profits.

156. The pharmaceutical industry illustrates this point. In 1978, for example, the industry paid an average salary of $13,000 per employee while the tax savings per employee equaled approximately $43,000. The average tax expenditure per employee among all possessions corporations, on the other hand, equaled $12,667 and the average employee compensation among all possession corporations equaled $10,697. These figures indicate that the pharmaceutical industry, among others, made profits from section 936 status that were far in excess of the norm. See supra note 84 and accompanying text. See also TREAS. DEP’T FOURTH REP., supra note 4, at 112 (listing net income, tax expenditure, and tax expenditure per employee figures for all industries operating in Puerto Rico as possessions corporations); infra note 157.

157. The Treasury Department Fourth Annual Report contains a list of average employee compensation, tax expenditures, and tax expenditures per employee for 1980:

<table>
<thead>
<tr>
<th>Qualified Possession Corporations</th>
<th>Tax Benefits</th>
<th>Tax Benefits</th>
<th>Average Employee Compensation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Corporations</td>
<td>Net Income ($000)</td>
<td>Amount ($000)</td>
<td>Percent of Total</td>
</tr>
<tr>
<td>All Manufacturing Industries</td>
<td>282</td>
<td>2,234,383</td>
<td>961,693</td>
</tr>
<tr>
<td>Food and kindred products</td>
<td>10</td>
<td>85,983</td>
<td>33,174</td>
</tr>
<tr>
<td>Textile mill products</td>
<td>6</td>
<td>5,594</td>
<td>2,687</td>
</tr>
<tr>
<td>Apparel</td>
<td>52</td>
<td>70,906</td>
<td>32,809</td>
</tr>
<tr>
<td>Men’s and boys’</td>
<td>14</td>
<td>29,233</td>
<td>13,346</td>
</tr>
<tr>
<td>Women’s and children’s</td>
<td>32</td>
<td>37,655</td>
<td>17,707</td>
</tr>
<tr>
<td>Hats, caps, etc.</td>
<td>3</td>
<td>2,212</td>
<td>939</td>
</tr>
<tr>
<td>All other</td>
<td>3</td>
<td>1,828</td>
<td>817</td>
</tr>
<tr>
<td>Chemicals</td>
<td>52</td>
<td>1,234,178</td>
<td>523,260</td>
</tr>
<tr>
<td>Industrial chemicals, plastics</td>
<td>7</td>
<td>105,705</td>
<td>44,471</td>
</tr>
<tr>
<td>Pharmaceuticals</td>
<td>34</td>
<td>1,092,059</td>
<td>462,664</td>
</tr>
<tr>
<td>Soaps, cleaners, etc.</td>
<td>4</td>
<td>31,300</td>
<td>13,828</td>
</tr>
<tr>
<td>All other</td>
<td>7</td>
<td>5,114</td>
<td>2,297</td>
</tr>
<tr>
<td>Rubber and plastics</td>
<td>6</td>
<td>12,276</td>
<td>6,830</td>
</tr>
<tr>
<td>Leather</td>
<td>8</td>
<td>10,957</td>
<td>4,777</td>
</tr>
<tr>
<td>Footwear</td>
<td>5</td>
<td>8,189</td>
<td>3,674</td>
</tr>
<tr>
<td>All other</td>
<td>3</td>
<td>2,408</td>
<td>1,103</td>
</tr>
<tr>
<td>Stone, clay, and glass</td>
<td>3</td>
<td>1,580</td>
<td>621</td>
</tr>
<tr>
<td>Fabricated metal products</td>
<td>17</td>
<td>27,033</td>
<td>12,584</td>
</tr>
<tr>
<td>Metal cans and containers</td>
<td>5</td>
<td>6,040</td>
<td>2,800</td>
</tr>
<tr>
<td>Cutlery, hand tools, screws, bolts</td>
<td>3</td>
<td>9,270</td>
<td>4,236</td>
</tr>
<tr>
<td>All other</td>
<td>9</td>
<td>11,722</td>
<td>5,548</td>
</tr>
<tr>
<td>Machinery, except electrical equipment</td>
<td>5</td>
<td>29,998</td>
<td>12,207</td>
</tr>
<tr>
<td>Electrical and electronic equipment</td>
<td>74</td>
<td>411,569</td>
<td>185,959</td>
</tr>
<tr>
<td>Radio, TV, communication</td>
<td>7</td>
<td>58,245</td>
<td>26,112</td>
</tr>
<tr>
<td>Electronic components</td>
<td>19</td>
<td>69,438</td>
<td>31,067</td>
</tr>
<tr>
<td>All other</td>
<td>48</td>
<td>285,888</td>
<td>128,763</td>
</tr>
<tr>
<td>Transportation equipment</td>
<td>5</td>
<td>13,568</td>
<td>6,116</td>
</tr>
<tr>
<td>Instruments and related products</td>
<td>23</td>
<td>77,246</td>
<td>33,376</td>
</tr>
<tr>
<td>Scientific instruments</td>
<td>6</td>
<td>6,109</td>
<td>3,153</td>
</tr>
<tr>
<td>All other</td>
<td>17</td>
<td>71,137</td>
<td>30,223</td>
</tr>
<tr>
<td>All other manufacturing</td>
<td>21</td>
<td>250,755</td>
<td>106,293</td>
</tr>
</tbody>
</table>

* Less than 0.5%.
abuse the possessions corporation system by transferring large amounts of intangibles to their Puerto Rican subsidiaries, the new legislation reduces the already reasonable tax benefits they derive from operation in Puerto Rico. As a result, the new rules create undeserved hardships for these enterprises.

2. **TEFRA Amendments to Section 936: Important Revenue Raising Devices?**

Budgetary considerations played an important role in Congress'

<table>
<thead>
<tr>
<th>Parent Company*</th>
<th>Industry</th>
<th>Net Revenue in Millions**</th>
<th>Research and Development Expense in Millions**</th>
<th>Research and Development as a Percent of Revenue</th>
<th>Patents Assigned***</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Marginal Industries</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Applied Magnetics Corp.</td>
<td>Computers &amp; Peripherals</td>
<td>73.913</td>
<td>3.431</td>
<td>4.6%</td>
<td>0</td>
</tr>
<tr>
<td>3. Bell and Howell, Inc.</td>
<td></td>
<td>701.488</td>
<td>35.489</td>
<td>5.1%</td>
<td>29</td>
</tr>
<tr>
<td>4. Dataproductions Corp.</td>
<td>Computers &amp; Peripherals</td>
<td>268.956</td>
<td>19.100</td>
<td>7.1%</td>
<td>4</td>
</tr>
<tr>
<td>5. Data Terminal Systems</td>
<td>Computers &amp; Peripherals</td>
<td>122.133</td>
<td>5.787</td>
<td>4.7%</td>
<td>0</td>
</tr>
<tr>
<td>6. Gould, Inc.</td>
<td>Electronics</td>
<td>1,846.100</td>
<td>95.900</td>
<td>5.2%</td>
<td>60</td>
</tr>
<tr>
<td>7. Motorola, Inc.</td>
<td>Electronics</td>
<td>3,335.868</td>
<td>229.00</td>
<td>6.9%</td>
<td>160</td>
</tr>
<tr>
<td>8. Perkin-Elmer Inc.</td>
<td>Scientific Instruments Electronics</td>
<td>1,115.830</td>
<td>83.476</td>
<td>7.5%</td>
<td>26</td>
</tr>
<tr>
<td>9. Pittway Corp.</td>
<td>Electronics</td>
<td>399.227</td>
<td>3.280</td>
<td>.82%</td>
<td>3</td>
</tr>
<tr>
<td>10. Ransburg</td>
<td>Industrial Equipment</td>
<td>144.570</td>
<td>9.127</td>
<td>2.1%</td>
<td>4</td>
</tr>
<tr>
<td>11. Storage Technology Corp.</td>
<td>Computers &amp; Peripherals</td>
<td>921.963</td>
<td>67.227</td>
<td>7.3%</td>
<td>4</td>
</tr>
<tr>
<td>12. Sun Electric Corp.</td>
<td>Electronics</td>
<td>177.405</td>
<td>5.471</td>
<td>3.1%</td>
<td>6</td>
</tr>
<tr>
<td>13. Westinghouse Electric Corp.</td>
<td>Electronics</td>
<td>9,367.500</td>
<td>230.000</td>
<td>2.5%</td>
<td>386</td>
</tr>
<tr>
<td><strong>Pharmaceutical Companies</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Abbott Laboratories, Inc.</td>
<td></td>
<td>2,342.524</td>
<td>113.655</td>
<td>4.9%</td>
<td>64</td>
</tr>
<tr>
<td>2. American Hospital Supply, Inc.</td>
<td></td>
<td>2,870.100</td>
<td>52.400</td>
<td>1.8%</td>
<td>34</td>
</tr>
<tr>
<td>3. Eli Lilly &amp; Co., Inc.</td>
<td></td>
<td>2,773.205</td>
<td>234.809</td>
<td>8.5%</td>
<td>112</td>
</tr>
<tr>
<td>4. Johnson &amp; Johnson, Inc.</td>
<td></td>
<td>5,399.000</td>
<td>282.900</td>
<td>5.2%</td>
<td>21</td>
</tr>
<tr>
<td>5. Merck &amp; Co., Inc.</td>
<td></td>
<td>2,929.455</td>
<td>274.168</td>
<td>9.36%</td>
<td>160</td>
</tr>
<tr>
<td>6. Pfizer, Inc.</td>
<td></td>
<td>3,249.700</td>
<td>176.900</td>
<td>5.4%</td>
<td>91</td>
</tr>
<tr>
<td>7. Schering-Plough, Inc.</td>
<td></td>
<td>1,808.800</td>
<td>109.100</td>
<td>6.0%</td>
<td>28</td>
</tr>
<tr>
<td>8. Upjohn Co., Inc.</td>
<td></td>
<td>1,898.334</td>
<td>171.606</td>
<td>9.0%</td>
<td>336</td>
</tr>
<tr>
<td>9. Warner-Lambert, Inc.</td>
<td></td>
<td>3,379.952</td>
<td>114.789</td>
<td>3.4%</td>
<td>37</td>
</tr>
</tbody>
</table>

* Each of these companies has possessions corporation subsidiaries operating in Puerto Rico.

** See the 1981 annual reports of the companies in question.

*** This column contains the number of patents assigned to the various companies during 1981. See U.S. DEPT. OF COMMERCE, UNITED STATES PATENT AND TRADEMARK OFFICE INDEX OF PATENTS, 1981, PART I (1982).

As the table indicates, marginal industries are not as intangible-intensive as the pharmaceutical industry. However, the marginal industries are nonetheless heavily reliant on intangibles. They spend money on research and development and they frequently patent their discoveries. Under the old rules, some parent companies dealing in high technology
decision to pass new tax rules for possessions corporations. During 1982, Congress searched for ways to reduce a burgeoning federal deficit. Given the perceived abuses associated with the transfer of intangibles to these corporations, the rules governing such transfers were a likely target of reform.

During the legislative process, Congress emphasized the amount of money the United States lost through intangible transfers. This suggests that Congress perceived the new rules to be revenue-raising devices. But by relying on the tax expenditure figures in the Treasury Department reports, Congress implicitly assumed that products, such as electrical equipment and instruments, transferred intangibles to their Puerto Rican subsidiaries in an attempt to receive the tax benefits that accompany this practice. See supra notes 107-11 and accompanying text. The Service, however, frequently challenged this practice just as it challenged the intangible transfers made by pharmaceutical companies. On this subject, the 1981 annual report of Westinghouse Electric Corporation states:

The federal income tax returns of the Corporation and its wholly owned subsidiaries are settled through December 31, 1973. For 1974 and 1975 the Internal Revenue Service has proposed income tax deficiencies of approximately $14.5 million related to reallocations to the parent company of a portion of the income of certain domestic subsidiaries operating in Puerto Rico under tax incentive grants. The Corporation has filed a protest against such proposed adjustments with the office of the Regional Director of Appeals of the IRS. If similar reallocations were made for subsequent years, substantial additional taxes would be assessed for the years 1976 through 1981. Tax counsel for the Corporation has advised that the proposed reallocations are not appropriate under the law. Accordingly, the Corporation will vigorously contest the proposed reallocations for 1974 and 1975 and any similar reallocations for later years. Management believes that adequate provisions for taxes, including tax deficiencies applicable to the ultimate resolution of the reallocation issues, have been made through December 31, 1981.


The new rules regulating intangible transfers apply to marginal industries as well as to those industries that derive excessive benefits under section 936. For those marginal possessions corporations that did receive intangibles from their parents in the pre-TEFRA period and that did obtain tax savings as a result of the transfers, the already reasonable benefits that they derive from operating in Puerto Rico will decrease under the new rules. Moreover, as a result of the new rules, possessions corporations that did not participate in or benefit from intangible transfers in the pre-TEFRA period no longer have the option to engage in this activity tax-free under section 936. The parent companies of these possessions corporations thus lost a potential source of tax savings. TEFRA unfortunately penalizes all industries in an effort to curb the large profits the pharmaceutical companies were deriving from Puerto Rican operations.


159. See infra note 168.

160. See supra notes 76-80 and accompanying text.

161. See infra note 168. See also supra note 158.

but for the section 936 credit, high technology, intangible-intensive industries would operate in the United States, would earn the same net income earned in Puerto Rico, and would pay a United States income tax equivalent to the tax expenditure that would arise from operating in Puerto Rico. In other words, Congress assumed that possessions corporations would not behave differently in the absence of section 936. This assumption of "no behavioral change" is erroneous. Commenting on the weakness of the "no behavioral change" analysis, Professor Boris Bittker stated:

To be fully informative, of course, the estimates [of revenue losses] would have to take account of the fact that tax concessions influence behavior; since the revenue "lost" by virtue of any tax provision depends in part on what the taxpayer would have done in its absence, its "cost" cannot be accurately measured by merely recomputing the tax liability on the return as filed. It might turn out that the revenue effects of tax incentive provisions, if they succeed in their objective of altering behavior, are especially difficult to estimate—although these are precisely the provisions that are most in need of cost effectiveness studies. . . . [O]ne must ask whether the "tax expenditure" label is appropriately applied to amounts computed on an assumption about economic behavior that will often be quite unrealistic.

By assuming no behavioral change, Congress failed to realize that a given investment may be highly profitable in one location, but unprofitable somewhere else. Thus, the tax expenditure estimates assigned to possessions corporations overstate the cost of section 936 to the United States. The amount of tax expenditures that will be


For fiscal year 1980, the reduction in U.S. Tax under the possessions corporation system of taxation is estimated at $1.195 million. In making this estimate, it is assumed that in the absence of section 936, the net income of all U.S. corporations in the aggregate would not change.

Id. The statement indicates that the Treasury Department has employed the "no behavioral change" assumption in calculating tax expenditures.


166. Id. at 20.

In the Fourth Annual Report, the Treasury Department realized that it had calculated improperly tax expenditures in prior Annual Reports. It believed that its tax expenditure calculations underestimated the cost of section 936. Treas. Dep't Fourth Rep., supra note 4, at 124. After careful analysis, however, it becomes clear that the Department had overestimated, rather than underestimated, section 936 tax expenditures.

On this subject, the Department stated:

In past Annual Reports on possessions corporations, the U.S. tax benefits under section 936 were estimated by applying the average effective U.S. corporate tax rate to the qualified possession income of 936 corporations (except those in non-manufacturing industries) and thus subtracting income and tollgate taxes paid to Puerto Rico. The Treasury used 40 percent as the effective U.S. tax rate for years
converted into a revenue gain by the United States Treasury under the new rules remains speculative.

Moreover, the amendments are expected to raise only an additional $428 million in 1984.\textsuperscript{167} This amount is insignificant when compared to the $98.3 billion in total additional revenue Congress wanted to raise through this and other measures\textsuperscript{168} and to the threat the changes pose to Puerto Rico's economic development.\textsuperscript{169}

3. Interpretive Problems

Implementing the new tax rules leads to two interpretive problems. First, allocating income under the profit sharing method will be extremely difficult. Situations in which a parent company transfers both marketing\textsuperscript{170} and manufacturing\textsuperscript{171} intangibles to a

---

\textsuperscript{167} See supra note 151.
\textsuperscript{169} Position Paper, supra note 82.
\textsuperscript{170} See supra note 90 and accompanying text.
possessions corporation illustrate this point. Under TEFRA, possessions corporations can only claim a return on manufacturing intangibles. In situations involving the transfer of both types of intangibles, the Service will be hard-pressed to determine the precise return derived from each. The possessions corporation naturally will argue that the bulk of its income arose from manufacturing intangibles. The Service, on the other hand, will assert that the bulk of the possessions corporation's income arose from marketing intangibles. Second, determining the costs of intangible development under the cost sharing method will also be difficult. The parent company will want to underestimate the cost of developing transferred manufacturing intangibles, because cost sharing payments reduce a parent's research and development deductions. By underestimating, the parent can reallocate the remaining costs to other development projects to gain the benefit of the tax deduction. The Service, on the other hand, will want to assign large cost figures to the transferred intangibles and thereby minimize the parent's research and development deductions. These interpretive problems most certainly will give rise to much litigation.

B. THE ACTIVE TRADE OR BUSINESS REQUIREMENT

Increasing the active trade or business requirement from fifty to sixty-five percent affects only those possessions corporations that presently derive less than sixty-five percent of their gross income from an active trade or business. Because most possessions corporations already meet this test, the new rule serves more of a cosmetic than a functional purpose. It does, however, reinforce Congress' intent that the possessions corporation system bolster Puerto Rico's

---

171. Id.
172. Id.
173. The possessions corporation will assert that most of its income derives from manufacturing intangibles because only income attributable to these kinds of intangibles come within the purview of the section 936 allocation amendments. Once within the purview of the amendments, some or all of this income is eligible for the section 936 credit and thus non-taxable. See supra note 90 and accompanying text.
174. The Service will want to assert this position because income from transferred marketing intangibles does not fall within the purview of the new rules. As a result, any income attributable to these intangibles is allocable to the parent and thus subject to United States taxation. Id.
175. See supra note 96 and accompanying text.

In 1980, the passive investment income of all section 936 manufacturing corporations was approximately 15% of their total gross income. TREAS. DEPT FOURTH REP., supra note 4, at 123. Not surprisingly, this figure rose after 1980 because of rising interest rates and increasing reinvestment of interest income. Id. at 123 n.8. However, given the rela-
capital structure rather than merely promote passive investment. Moreover, the new rule forces those corporations that do not derive at least sixty-five percent of their gross income from an active business within Puerto Rico to increase such activity or lose possessions corporation status. In this sense, the new rule promotes Puerto Rico's industrial development.

C. OTHER PROBLEMS WITH THE TEFRA AMENDMENTS

Two additional observations concerning the TEFRA amendments warrant close scrutiny. These observations, unlike the others previously articulated, do not deal specifically with either income allocation or active trade requirements. Rather, they deal with the general notion that any diminution in possessions corporation tax benefits conflicts with United States and Puerto Rican interests.

1. The Precursor Theory

The possessions corporation system of taxation has undergone gradual erosion over the last decade. The significant changes made to the system in the Tax Reform Act of 1976 and the Tax Equity and Fiscal Responsibility Act of 1982 illustrate this point. These changes represent a dangerous trend that cannot be ignored by corporations considering to elect possessions corporation status and to establish operations in Puerto Rico. They signal a possible emasculation or rescission of section 936.

The original Senate version of TEFRA raised the active trade or business requirement to ninety percent and allocated all income derived from transferred intangibles to possessions corporation shareholders. The Puerto Rican Government vigorously opposed these changes, claiming they would destroy Puerto Rico's industrial

178. See supra notes 103-09 and accompanying text. Passive investment does little to stimulate Puerto Rico's economic development. Id.


182. See original version of the Senate's section 936 amendments, reprinted in 128 CONG. REC. S8604 (daily ed. July 19, 1982).
development. Because of this fierce resistance and the intervention of the United States President on the side of Puerto Rico, the Senate eventually compromised its position. The incident, however, remains important because it reflects the vulnerability of the possessions corporation system. To some extent, this vulnerability stems from Puerto Rico's lack of representation in Congress. In addition, the incident suggests that Puerto Rico's ability to protect its economic interests might grow more difficult as Congress takes steps to meet its increasing revenue demands.

The passage of TEFRA, as well as the events surrounding it, impugns Congress' commitment to Puerto Rico's industrial development. Moreover, it warns industry that further changes in the possessions corporation system may be in the offing. Thus, all industries operating or planning to operate in Puerto Rico should re-evaluate their investment plans before taking any further action.

2. TEFRA's Relationship to the Caribbean Basin Initiative

The United States has shown great concern about political instability, economic depression, and the spread of communism in the Caribbean region. The Caribbean Basin Initiative announced by President Reagan in February 1982 illustrates this point. Under

---

184. See Letter from President of the United States Ronald Reagan to Dan Rostenkowski, Chairman of the House Ways and Means Committee (July 27, 1982), reprinted in [July-Sept.] TAX NOTES (Tax Analysis) 552 (August 9, 1982). The text of this letter states:

I am writing to express my concern over the abrupt cutback of tax incentives for U.S. corporations investing in Puerto Rico and other U.S. possessions which is contained in H.R. 4961, recently passed by the Senate. The tax incentives under section 936 of the Internal Revenue Code and the related Puerto Rican exemptions have made significant contributions to Puerto Rican economic development. Relying upon these incentives, many U.S. corporations have made long-term commitments to investment and employment on the island. In 1980, these corporations directly provided over 70,000 jobs in Puerto Rico.

I do recognize that the effect of the current system may be too generous in that some companies have enjoyed large tax benefits relative to the benefits derived by Puerto Rico. However, the Senate bill goes much further than is necessary. It would discourage investments in Puerto Rico which are fully consistent with the original objectives of the possession tax incentives and are vital to the economic development of the island. I urge you to make changes in the Senate bill which would limit abuses of section 936 without causing severe economic distress in Puerto Rico.

Id.
186. See Address Before the Permanent Council of the Organization of American States, 18 WEEKLY COMP. PRES. DOC. 217 (February 24, 1982). The Caribbean Basin Initiative has been carried out through two pieces of legislation. First, on September 10,
the Initiative, the current Administration proposes to spend hundreds of millions of dollars to aid the Caribbean nations. By providing the region with a firm economic foundation, the United States hopes to guard against political instability and communist encroachment.

There are many reasons for significant concern over the Caribbean. On this subject, Senator Charles Percy, Chairman of the Senate Foreign Relations Committee, stated:

The Caribbean Basin is a region of profound interest and concern to the United States. It is economically important to us. A good share of our trade, especially raw materials and petroleum, passes through the Caribbean. It is militarily important to us. It guards the access to the Panama Canal and to the Atlantic Ocean. If hostile bases were established in the region, we would have to engage in costly defense preparations quite different from what we have now. The Caribbean Basin is also politically important to the United States. The countries of the region are our neighbors. It is important to us and to them that we all pursue positive, mutually cooperative and beneficial relations in the region. No one gains from hostilities.

As Senator Percy observed, the Caribbean, in which Puerto Rico plays a vital role, possesses economic, strategic, and political importance for the United States. An economically strong Puerto Rico could strengthen United States efforts to blunt communist influence by proving that free enterprise can succeed in the region. TEFRA, however, reduces the incentives of United States corporations to establish subsidiaries in Puerto Rico and poses a threat to the Island's economic development. Thus, the effects of the recent section 936 amendments conflict with basic principles of the Caribbean Basin Initiative.

In addition, passage of TEFRA occurred at a time of height-


187. See Address Before the Permanent Council of the Organization of American States, 18 WEEKLY COMP. PRES. DOC. 217 (February 24, 1982).
188. Id.
190. See supra notes 145-54 and accompanying text.
ened political and social unrest in Puerto Rico.\textsuperscript{191} Much of this instability has stemmed from rampant unemployment.\textsuperscript{192} Increasing conflict between Puerto Ricans favoring statehood and those favoring independence from the United States also has contributed to the problem.\textsuperscript{193} Some commentators believe that these tensions could trigger a new wave of terrorist violence in Puerto Rico.\textsuperscript{194} TEFRA only exacerbates the political and social tensions within an already troubled area.

The above analysis suggests that the new possessions corporation rules deleteriously affect United States interests in the Caribbean. Because of the significant economic, strategic, and political importance of these interests, Congress erred by modifying the possessions corporation system. The changes not only impinge on Puerto Rico's industrial development\textsuperscript{195} at a time of internal instability, but also raise questions about United States resolve to help Caribbean nations develop economically. Any of the Caribbean nations could justifiably construe the section 936 amendments to be in contravention of the spirit of the Caribbean Basin Initiative.

CONCLUSION

The new rules dealing with the allocation of possessions corporation income derived from transferred intangibles are harmful to the economic development of Puerto Rico. Moreover, given the relatively few possessions corporations which historically abused their section 936 status, and the insignificant amount of revenue raised by the new rules, the income allocation provisions are unnecessary. Thus, Congress should not have made these changes in the possessions corporation system.

Congress also should not have amended the section 936 active trade or business requirement. In practice, this change has little effect on the possessions corporation system, as most possessions corporations already meet the sixty-five percent test. In theory, however, the new rule further erodes section 936, thereby warning United States corporations that Congress might continue to decrease possessions corporation benefits. The amendment therefore dissuades corporations from establishing operations in Puerto Rico.

\textsuperscript{193} \textit{See} Chaze, \textit{supra} note 191.
\textsuperscript{194} \textit{Id.} “It is despair and [a] sense of hopelessness that lead people to form Guerrilla armies and to riot in the street.” \textit{Id.} (quoting Governor Carlos Romero-Barceló).
\textsuperscript{195} \textit{See supra} notes 145-54 and accompanying text.
The section 936 amendments not only fail to deal adequately with the problems Congress sought to address, but they also deleteriously affect the economic interests of Puerto Rico. Congress should have left section 936 unchanged.

George C. Rockas