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A Credit for All Reasons: The Ambivalent Role of Section 936

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A CREDIT FOR ALL REASONS: THE AMBIVALENT ROLE OF SECTION 936

ANN J. DAVIDSON*

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I. INTRODUCTION

This article evaluates Section 936 of the Internal Revenue Code from the perspective of the infrastructure development which has taken place in Puerto Rico over the past forty years. Section 936, the possessions tax credit, is specifically directed at encouraging investment in Puerto Rico.¹ The statute allows a tax sparing credit for the full amount of U.S. tax liability on possessions source income regardless of the amount of tax paid in Puerto Rico.² In addition, the statute provides for tax-free dividends returned to

1. I.R.C. § 936 (1986).

2. S. REP. No. 313, 99th Cong., 2d Sess. 380 (1986).

the mainland. The favorable tax situation for Puerto Rico has fostered the growth of high technology industries there.

Amendments to the statute in 1982 were aimed at curbing the abuses of some of the high technology industries investing in Puerto Rico.³ Treasury informed Congress that improper allocation of intangible income between related parties combined with the possessions tax credit was a problem with the statute. In order not to "throw out the baby with the bath water,"⁴ Congress left the credit in tact, but added requirements concerning the transfer of intangibles.

Section 936 survived the Tax Reform Act of 1986, but not without threats that it should be replaced by a wage credit. Once again, the cost of the statute and abuses by high technology industries were at the heart of the problems with the statute. As part of its lobbying efforts to keep the statute, the government of Puerto Rico proposed a twin plant project. The twin plant project encourages companies with operations in Puerto Rico to establish manufacturing operations in "qualified Caribbean Basin Initiative countries."⁵

Since its enactment in 1976, Section 936 has been controversial. Although some view the statute as Puerto Rico's lifeline, others view it as costly and a giveaway to the drug companies and other high technology industries investing in Puerto Rico. The first part of this article looks at the effect of the United States' inconsistent policy towards Puerto Rico and reviews U.S. laws and constraints on the economic development of Puerto Rico over the past eighty years. The second part of this article critically reviews Treasury's analysis of the possessions tax credit and suggestions to replace the possessions tax credit with a wage credit. The article concludes that Section 936 is necessary in order for Puerto Rico to be competitive with similarly situated economies and concludes that the United States must define its role *vis-à-vis* the development of Puerto Rico's economy before it can determine the role of Section 936.

3. 26 U.S.C. § 936(h) (1982).

4. 128 CONG. REC. S8802 (daily ed. July 21, 1982)(statement of Sen. Kennedy).

5. I.R.C. § 936(d)(4) (1986).

II. PUERTO RICO'S POLITICAL AND ECONOMIC FOUNDATION

Puerto Rico is an island located in the Greater Antilles Group. Puerto Rico is 100 miles wide and thirty miles long. The topography of the island is varied. The interior region is mountainous, while some of the coastal areas are deserts. Puerto Rico is surrounded by the Atlantic Ocean to the north and east, the Caribbean Sea to the south, and the Mona Passage which separates the island from Hispaniola to the east.⁶

A. *Puerto Rico as a Spanish Colony*

Puerto Rico was "discovered" by Christopher Columbus in 1493 and remained a Spanish colony until 1898. The Spanish hoped to find gold in Puerto Rico, but their dreams were never realized. In the early nineteenth century, the economy of the island focused on small farms.⁷ As early as the nineteenth century, the economic policy which dominated Puerto Rico emphasized the production of export products such as sugar, coffee, tobacco, and cattle, and the importation of most of its food supply.⁸

Throughout the 1800s, Puerto Rico was involved in a prolonged struggle to gain greater measures of self-control from Spain. The Charter of Autonomy granted by Spain in 1897 gave Puerto Rico home rule. This grant of political power by Spain was the first of many Puerto Rico would receive in return for its strategic defense position. The Charter was directed at Cuba to head off United States support of Cuban rebels. However, because Cuba and Puerto Rico were part of the same Spanish Antilles group, Puerto Rico received the Charter at the same time it was granted to Cuba.⁹

Although the governor of Puerto Rico was appointed by Spain, under the Charter of Autonomy, the insular parliament was partially elected. The insular parliament was empowered to legislate on local matters, to regulate tariffs, and with the approval of the Spanish Cortes, to negotiate commercial treaties. Spanish sovereignty, though, was preserved by a veto clause over local laws.¹⁰

6. See generally R. PICO, *THE GEOGRAPHY OF PUERTO RICO* (1974).

7. See generally K. WAGENHEIM, *THE PUERTO RICANS: A DOCUMENTARY HISTORY* (1973).

8. See generally H. PERLOFF, *PUERTO RICO'S ECONOMIC FUTURE* 15 (1950).

9. See generally R. CARR, *PUERTO RICO: A COLONIAL EXPERIMENT* (1984).

10. COMPTROLLER GENERAL, *PUERTO RICO'S POLITICAL FUTURE: A DIVISIVE ISSUE WITH*

B. Puerto Rico: 1900-1940

1. Political Structure

Ironically, the same war which allowed Puerto Rico self-government, also put Puerto Rico under United States control. In 1898 Spain ceded Puerto Rico to the United States under the Treaty of Paris, and Puerto Rico lost its gains towards autonomous rule.¹¹ The United States began its occupation of Puerto Rico on July 25, 1898, and continued its military occupation until 1900.

Congress passed the Foraker Act, Puerto Rico's first Organic Act, on April 12, 1900.¹² This Act abolished the military government in Puerto Rico and established a civilian government. In doing so it set forth the foundation for Puerto Rico's relationship with the United States.¹³

The purpose of the Foraker Act was "temporarily to provide revenues and a civil government for Porto Rico [sic] and for other purposes."¹⁴ The Act provided for executive, legislative, and judicial branches in Puerto Rico.¹⁵ Under the Foraker Act the chief executive was a "Governor of Porto Rico [sic]" appointed by the President of the United States.¹⁶ In addition, the President appointed an executive council consisting of eleven members, six of whom were Puerto Rican, with administrative authority.¹⁷

All local legislative activities were vested in a legislative assembly which consisted of two houses.¹⁸ The legislative authority extended "to all matters of a legislative character not locally inapplicable" with the proviso that Congress reserved the power to annul the local laws.¹⁹

The general provisions of the Foraker Act were that the laws and ordinances of Puerto Rico under Spanish rule were to con-

MANY DIMENSIONS, REP. NO. GGD-81-48 (Mar. 2, 1981)[hereinafter COMPTROLLER GENERAL].

11. Treaty of Paris, Dec. 10, 1898, United States-Spain, art. II, 30 Stat. 1754, T.S. No. 343.

12. Foraker Act, ch. 191, 31 Stat. 77 (1900) (a provision similar to §1 of the Act is codified at 48 U.S.C. § 731 (1987)).

13. COMPTROLLER GENERAL, *supra* note 10, at 10.

14. Foraker Act, ch. 191, 31 Stat. 77 (1900).

15. *Id.*

16. *Id.* § 17.

17. *Id.* §§ 18-26.

18. *Id.* § 27.

19. *Id.* §§ 31-32.

tinue.²⁰ U.S. currency would be the official legal tender.²¹ Moreover, statutory laws of the United States not locally inapplicable would have the same force and effect in Puerto Rico as in the United States, except for the internal revenue laws.²²

The Foraker Act provided a motley assortment of rights, privileges and obligations. The Foraker Act provided that although not citizens, Puerto Rican residents came under the protection of the United States.²³ The Act provided for a resident commissioner elected by Puerto Ricans who was to serve as the official representative to the United States. The commissioner, though, was not a voting representative.²⁴ However, the Act also provided that Puerto Rico would not pay any federal taxes to the United States. Thus the accusation of taxation without representation could not be made.²⁵

From an economic perspective the two most significant parts of the legislation involved shipping laws and tariffs. The Foraker Act provided that all shipping between the United States and Puerto Rico was subject to U.S. coastal shipping laws.²⁶ In addition, the Foraker Act provided that any tariffs, customs or duties on articles brought into Puerto Rico from third countries, or duties and taxes on articles brought into the United States from Puerto Rico were to go to the Puerto Rican Treasury.²⁷

The initial debate over Puerto Rico's economic ties with the United States focussed on a tariff provided by the Foraker Act. The Foraker Act provided for a tariff of fifteen percent between the United States and Puerto Rico on all articles of merchandise coming into Puerto Rico from the United States and vice versa. This tariff was to last until a system of local taxation could be established in Puerto Rico or until the first day of March, 1902.²⁸ The duties collected under this tariff system were not to be placed into the general fund of the U.S. Treasury, but were to be placed in a separate fund for the benefit of Puerto Rico and, when a civil-

20. *Id.* § 8.

21. *Id.* § 11.

22. *Id.* § 14.

23. *Id.* § 7.

24. *Id.* § 39.

25. R. CARR, *supra* note 9, at 37.

26. The Foraker Act, *supra* note 13, § 9.

27. Proclamation No. 8, 32 Stat. 1983 (1901)(in accord with this provision, President McKinley issued a proclamation on July 25, 1901).

28. *Id.*

ian government was established in Puerto Rico, were to go directly to the Puerto Rican Treasury.²⁹

The "sugar trust," a group of large American sugar corporations, lobbied for the tariff between the mainland and Puerto Rico.³⁰ Some believed the temporary imposition of the tariff was nothing more than political manipulation to allow the sugar trust to buy large land holdings at reduced prices.³¹ The belief was that the tariff would depress the sugar prices, forcing small farmers to sell out.

In the debate over the imposition of the tariff, the issue of how the United States should treat its dependencies was raised. On one hand the argument for the imposition of the tariff was supported by the view that

[N]ations have always acted and should govern themselves at all times upon principles entirely different from those which actuate individuals In looking at the question of any foreign territory the only question that should enter into consideration by us is one question: Is it best for the United States? The weal or woe, the misery or happiness, the poverty or prosperity of the foreigner or those to be annexed is not involved.³²

On the other hand, the argument for free trade was supported by the view that what is best for the territories is best for the United States. Under this view, linkages between mainland United States and Puerto Rico promote the economic well-being of both the United States and the territory.³³

29. *Id.*

30. 33 CONG. REC. 2278 (1900).

31. Supplementing the Foraker Act was a limitation upon the corporate ownership of land. 31 Stat. 716 (1900). The limitation of 500 acres was an outgrowth of the free trade bill for Puerto Rico. Some attribute the 500 acre limit to sugar production lobbyists who did not want new competition. Others view the limitation as a U.S. moral obligation to prevent large trusts from acquiring Puerto Rico's best lands. See Note, *Puerto Rican Land Reform: The History of an Instructive Experiment*, 73 YALE L.J. 334, 335 (1963) (authored by Keith S. Rosenn). Regardless of the reason for the statute, it was ignored until the 1940's. *Puerto Rico v. Rubert Hermanos, Inc.*, 309 U.S. 543 (1940).

32. See *supra* note 30.

33. CONG. REC. 2272-73 (1900) (daily ed.). Rep. James R. Williams (D-Ill.) described the benefits that could be developed without a tariff and the harm that would result if the temporary tariff were imposed.

Free trade with Puerto Rico would cause large sums of money to be invested in that island, breathe new life into their paralyzed industries, build up new ones, increase the opportunities of the laboring people, enable them to earn their own food and clothing, pay their own taxes, buy their own books, build their own schoolhouses, and become well-to-do citizens. This is just what the people of

Regardless of the motivation for the temporary tariff, the Supreme Court decided that the imposition of the tariff under the Foraker Act was constitutional. In *Downes v. Bidwell*, an American firm sought to recover duties paid under protest on a shipment of oranges brought from Puerto Rico to New York in November 1900, after the passage of the Foraker Act.³⁴ The Court held the duties were not prohibited by the Constitution even though the Constitution declares "all Duties, Imposts, and Excises shall be uniform throughout the United States."³⁵ In the case of unincorporated territories the issue which arises is not whether the Constitution applies but whether the provision is applicable.³⁶

The Court found that Puerto Rico is a "territory appurtenant and belonging to the United States, but not a part of the United States within the revenue clauses of the Constitution." Thus, duties imposed upon imports from Puerto Rico under the Foraker Act were held to be constitutional.³⁷

In addition, the Court found Puerto Rico to be an unincorporated territory of the United States. Its citizens came under the

Puerto Rico want. We must not lose sight of the fact that the people of the United States would be benefited by the course I have suggested. We can benefit Puerto Rico and at the same time benefit our own people.

Every pound of sugar, tobacco and coffee imported from Puerto Rico into the United States will be paid for with our flour, meal, meat, clothing, machinery, and other American products and the balance of trade is sure to be in our favor. If such an arrangement should result in reducing the price of sugar in this country, the benefit would go to the consumer. So we can surely afford to be just to the people of Puerto Rico when it is so greatly to our interest to do so

Mr. Chairman, Puerto Rico needs free trade now, the best market she can get for her products. As I have stated, free trade with Puerto Rico would at once carry large investments to that island in the sugar and tobacco business, increase the volume of money there, increase business of all kinds and would immediately increase the value of lands in the island. This would enable the landowners, who are heavily mortgaged, as the evidence shows, to renew their loans and save their land. But sir, if you delay free trade to Puerto Rico for two years, or even one year, the value of these lands will continue low, they will not be able to extend their loans, they will lose their lands under mortgage, the sugar trust will have the opportunity to go in and buy them up at low prices; then the Republicans, I suppose, will be ready to admit sugar from that island free

I want to say to the gentlemen on the other side, who are so anxious to protect the American people against the pauper labor of that little island, in God's name, give it just laws, good government, and you will have no pauper labor there in a few years to contend against Drive it out of the island as well as the rest of the United States.

34. *Downes v. Bidwell*, 182 U.S. 244 (1901).

35. U.S. CONST. art. I, § 8.

36. *Downes*, 182 U.S. at 287 (White, J., concurring).

37. *Id.*

protection of the United States, but were not U.S. citizens. Under the principles of the Constitution, they were entitled to certain natural rights of life, liberty, and property, but they were not entitled to certain remedial rights, such as suffrage.³⁸

In 1917 Puerto Ricans were granted U.S. citizenship by a new Organic Act, the Jones Act.³⁹ The bill, which also gave Puerto Rico self-government, was approved by the U.S. Senate on February 20, 1917, and was signed into law by President Wilson on March 2, 1917. Many viewed this granting of citizenship (when the U.S. was involved in World War I) as a measure to secure the Caribbean.⁴⁰ The Jones Act gave Puerto Rico the right to tax income arising from sources within Puerto Rico.⁴¹

This new Organic Act, the Jones Act, included a bill of rights and authorized a popularly elected nineteen-member Senate as a coequal companion to the thirty-nine member House.⁴² Most of the members of the Executive Council were to be appointed by the Governor, rather than by the President.⁴³ Puerto Rican Supreme Court Justices, the Governor, and several council members, however, continued to be appointed by the President.⁴⁴

Though it granted more self-governing powers, the Congress retained the right to nullify any local law.⁴⁵ Additionally, the Governor could refer legislation to the President for final disposition.⁴⁶ Citizenship, however, was a passive citizenship that denied Puerto Ricans representation in Congress. The Puerto Rican Resident Commissioner was elected by Puerto Ricans, but did not have a vote in Congress.⁴⁷ One commentator described the Jones Act as making clear "that the domestic constitution of Puerto Rico represented not the will of Puerto Ricans but the will of Congress."⁴⁸

38. *Id.* at 282-83.

39. The Jones Act, ch. 145, 39 Stat. 951 (1917).

40. 53 CONG. REC. 7474 (1916).

41. The Jones Act, *supra* note 39.

42. *Id.*

43. *Id.*

44. *Id.*

45. *Id.*

46. *Id.*

47. *Id.*

48. R. CARR, *supra* note 9, at 53.

2. Puerto Rico's Economy as a U.S. Possession

During the first thirty years of Puerto Rico's possession status with the United States, absentee landlords developed the sugar industry.⁴⁹ One commentator views these years as a positive development in Puerto Rico's history. From this perspective, even though Puerto Rico suffered the consequences of land monopoly, absentee ownership, and a large class of seasonally employed field workers, the influx of funds created new industries.⁵⁰

Other commentators have viewed both these years and the years of the 1930's as a devastating time for the Puerto Rican economy.⁵¹ Under this analysis, the economic position of Puerto Rico was dominated by U.S. corporations. The sugar industry, as well as the tobacco, manufacturing and fruit growing industries, banks, railroads, public utilities, steamship lines, and many lesser businesses, were partially or completely dominated by outside capital. Approximately sixty percent of the sugar crop was grown by American and other absentee companies, and the sugar cane was grown on all fertile farm land. The effect of this land concentration was disastrous to the agricultural economy.⁵²

Instead of the small farming economy of the 1800's, the economy of the early 1900's focused on large land holdings with absentee investors receiving the dividends. The "joker in the deck" was that even though there were profits, and statistically, the economy appeared to be productive, all of the profits were being exported out of Puerto Rico to the absentee landlords.⁵³ The small farmer was forced off his land to become a day laborer. In addition, the large land tracts devoted to sugar production, rather than food crops, forced the island consumer to import food from the United States, or from other markets with a tariff imposed on it.⁵⁴

By the time the Depression hit, Puerto Rico had thirty-six percent unemployment, compared with seventeen percent in 1899, and the wages plummeted to such a degree that a laborer needed to spend 104 days working to buy imported foods that once cost

49. H. PERLOFF, *supra* note 8.

50. *Id.* at 25-26.

51. See generally K. WAGENHEIM, *supra* note 7.

52. See *supra* note 30; H. PERLOFF, *supra* note 8, at 34.

53. B.W. DIFFIE & J.W. DIFFIE, PORTO RICO [sic]: A BROKER PLEDGE 201 (1931).

54. See also H. PERLOFF, *supra* note 8; Cf. B.W. DIFFIE & J.W. DIFFIE, *supra* note 53, at 22 (arguing that by the time the United States acquired Puerto Rico, there was already a growing dependence on imported food. See generally K. WAGENHEIM, *supra* note 7, at 5.

him seventy days of work.⁵⁵

"If the condition of the masses of the Island people in the period before 1928 could be described as 'deplorable,' then the situation of the Puerto Rican people in the next thirteen years can only be described as bordering on the 'critical.'"⁵⁶ Beginning in the mid-1930's, the New Deal Programs were expanded to Puerto Rico. Although \$1 million per month was spent in Puerto Rico,⁵⁷ the programs "consisted of little more than filling empty stomachs and mitigating suffering"⁵⁸ and did not tackle the structural problems of Puerto Rico's underdeveloped economy.⁵⁹

C. *Puerto Rico Under Operation Bootstrap*

1. Phase I: 1940-1948

Operation Bootstrap, which began in 1940, was the Puerto Rican government's two-stage program to improve the island's economic condition. The first stage lasted from 1941 until 1948 and has been described as a "socialist experiment."⁶⁰ One component of this first stage was a redistribution of the land held by the large sugar corporations. The Land Law of 1941 and the Land Authority created by it provided for the enforcement of a 500-acre land holding provision. The 500-acre land holding provision had been law since 1900, but had never been enforced.⁶¹ Under the Operation Bootstrap program, the large corporations' lands were redistributed in a manner designed to answer the need for land reform while retaining large-scale operations efficiency in the sugar industry. Specifically, the sugar operations profits were to be distributed proportionately between management and the field workers.⁶²

Another aspect of this first phase of development under Operation Bootstrap was government ownership and operation of key industries such as cement, glass, paperboard and shoes.⁶³ In addi-

55. B.W. DIFFIE & J.W. DIFFIE, *supra* note 53, at 213.

56. H. PERLOFF, *supra* note 8, at 30.

57. R. CARR, *supra* note 9, at 61.

58. H. PERLOFF, *supra* note 8, at 32.

59. R. CARR, *supra* note 9, at 61.

60. See generally K. WAGENHEIM, *supra* note 7.

61. See *supra* notes 30 & 50.

62. Note, *supra* note 31.

63. U.S. DEP'T OF THE TREASURY, FOURTH ANNUAL REPORT OF THE OPERATION AND EFFECT OF THE POSSESSIONS CORPORATION SYSTEM OF TAXATION 23 (1983) [hereinafter *FOURTH TREASURY REPORT*].

tion to opening factories, the Puerto Rican government bought utilities, developed a bank and a central planning agency, and in general took a socialist style approach to the social and economic problems of Puerto Rico.⁶⁴

Interestingly, the start-up funds for this initial program came about as a result of the tariff provisions in the Foraker Act. The Puerto Rican rum industry prospered as a result of World War II because the production of alcohol on the mainland was needed for the war effort. Therefore, Puerto Rican rum, manufactured since 1936, became popular due to its availability. Besides supplying profits for the Puerto Rican distillers, the Puerto Rican tax revenues increased due to the excise taxes on the rum.⁶⁵ Under the laws defining Puerto Rico's relationship with the United States, excise taxes on goods manufactured in Puerto Rico were remitted to the Puerto Rican Treasury rather than to the U.S. Treasury.⁶⁶ Thus, the budget of the Puerto Rican government, which before 1940 had been \$22 million, increased to \$150 million.⁶⁷

However, the factories did not create enough jobs, and there was a shortage of the trained technicians essential to industrial development. In addition, this "socialist" style economy frightened away new investment capital as a result of the excise taxes on the increased rum sales.⁶⁸ In 1946 the Tariff Commission of the United States, reporting on the economy of Puerto Rico, found that by the mid-1940's most Puerto Ricans still lacked "the means to feed themselves properly, clothe themselves adequately, house themselves decently, or provide an elementary education for their children or a minimum of security for their own old age."⁶⁹ The report traced Puerto Rico's inability to find adequate remedies for its economic problems to the low ratio of resources and productive capacity in relation to the size of the population.⁷⁰

64. The bank and planning agency still exist. The bank is the Government Development Bank. The planning board is named the Economic Development Administration and is popularly known as Fomento.

65. 26 U.S.C. § 7652 (1982).

66. See *supra* text accompanying note 27.

67. E. HANSON, *TRANSFORMATION: THE STORY OF MODERN PUERTO RICO* 198 (1955).

68. K. WAGENHEIM, *supra* note 7, at 244.

69. UNITED STATES TARIFF COMMISSION, *THE ECONOMY OF PUERTO RICO* 2 (1946).

70. *Id.*

2. Phase II: 1948-1970

Under the second phase of Operation Bootstrap, Puerto Rico experienced rapid economic growth from 1948 until the early 1970's.⁷¹ Puerto Rico utilized its unique relationship with the United States to attract private investment from the mainland. These private investments created an increase in export shipments, as well as a rise in real per capita income. The development of private industry increased Puerto Rican taxing capacity and provided funds for needed infrastructure and human resource development, which supported increased development. However, the recurring unemployment problem prevailed.⁷²

The effect of the second stage of Operation Bootstrap was to combine tariff-free access to the mainland markets, common currency, citizenship and law, a relatively flexible minimum wage system, and an industrial incentive policy that centered on a tax exemption program.⁷³ This last factor was the combined result of an exemption from local taxes and a fluke in federal law that exempted mainland U.S. companies doing business in Puerto Rico from federal taxation.

(a) *Section 931, the Federal Tax Incentive.* Section 931, the main federal component of Operation Bootstrap was enacted as Section 262 of the Revenue Act of 1921.⁷⁴ Section 931 remained substantially unchanged until the 1976 Tax Reform Act.⁷⁵ The provision was enacted to help U.S. businessmen in the Philippines. Unlike most other countries, the United States has always taxed its citizens on worldwide income. Although the Revenue Act of 1918 permitted citizens of the United States to take a credit in the amount of income, war-profits, and excess-profits taxes paid to any foreign country or to any possession of the United States for income derived from local sources, it was believed that Americans doing business abroad were discriminated against. If the local tax rate was less than the United States' tax rate, Americans were lia-

71. U.S. DEP'T OF THE TREASURY, FIFTH ANNUAL REPORT ON THE OPERATION AND EFFECT OF THE POSSESSIONS CORPORATION SYSTEM OF TAXATION 18 (1985) [hereinafter FIFTH TREASURY REPORT].

72. *Id.*

73. UNITED STATES-PUERTO RICO COMMISSION ON THE STATUS OF PUERTO RICO, STATUS OF PUERTO RICO 55-56 (1966) [hereinafter STATUS OF PUERTO RICO].

74. Revenue Act of 1921, ch. 136, 42 Stat. 227, 271.

75. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1051, 90 Stat. 1520, 1645 (codified at 26 U.S.C. § 936 (1982)).

ble for the difference. The non-American doing business in the Philippines only paid the Philippine tax. Although the American doing business in the Philippines only had to pay one tax because he received credit for the foreign tax, the tax was at a higher tax rate than the Philippine tax paid by citizens of other countries.⁷⁶

The argument used to support the possessions' exemption was that U.S. citizens doing business in an American possession should not be placed in the same position as U.S. citizens residing in foreign countries because the Philippines (or any possession) was not a foreign country. The Philippine government argued that if American investors in the Philippines were required to pay taxes on their income in the Philippines equal to the amount imposed on American citizens in the United States, there would be no inducement for further investment in the possession.

Section 262 of the Revenue Act of 1921 provided that if eighty percent of the income of citizens or domestic corporations was derived from sources within a U.S. possession and fifty percent of that income was derived from the active conduct of a trade or business, any income from sources outside the United States (both possession and foreign source income) was exempt from U.S. taxation.⁷⁷ Liquidation was tax free.⁷⁸ However, any dividends returned to the United States were taxed.⁷⁹

(b) *Puerto Rican Tax Incentives.*⁸⁰ To take advantage of Sec-

76. H.R. REP. NO. 350, 67th Cong., 1st Sess. 1 (1921).

77. Revenue Act of 1921, ch. 136, 42 Stat. 227, 271.

78. Act of August 16, 1954, ch. 736, 68A Stat. 102 (codified at 26 U.S.C. § 332 (1982)).

79. I.R.C. § 246 (1982) (prior to amendment by Tax Reform Act of 1976, Pub. L. No. 94-455, § 1051(f)(3), 90 Stat. 1520, 1646).

80. The current Puerto Rico tax incentives are part of the Puerto Rico Industrial Incentive Act of 1978, P.R. LAWS ANN. tit. 13, §§ 255-255m (Supp. 1982).

The current Industrial Incentive Tax Act was enacted in 1978. The current incentive program provides ninety percent exemption from income and property tax in the first five years of a firm's operation and a gradually decreasing rate of exemption for the next twenty years.

The Act contains provisions to encourage labor intensive industries and to assist small firms. For an exempted manufacturing business whose industrial development income in any year is less than \$500,000, the first \$100,000 of the income is totally exempted. In addition, an exempted business engaged in manufacturing may deduct five percent of its total production payroll up to an amount not to exceed fifty percent of its industrial development income. For this purpose, the production payroll is related to wages directly related to the exempted economic activity. Other provisions in the Act provide benefits for businesses enjoying tax exemption under the prior acts.

In addition, the current law allows nonlocal manufacturing enterprises several choices in dealing with repatriation of accumulated earnings. Firms can withdraw their earnings from Puerto Rico at any time and incur a tollgate charge of ten percent.

tion 931, Puerto Rico enacted the Industrial Tax Exemption Act in 1948. That Act provided qualified firms with an exemption from income, property and municipal taxes. To qualify for the exemption, a manufacturing firm had to produce either an item not produced on a commercial scale in Puerto Rico prior to 1947 or certain specified items, such as wearing apparel or processed food items. The exemption was to be phased out by 1962.⁸¹

However, in 1954 the Industrial Tax Exemption Act was amended and expanded to promote long-term industrial development. The 1954 amendment provided that certain businesses were exempt from income tax upon industrial development income for ten years.

A 1963 version of the Act continued the exemption program for firms establishing industrial manufacturing businesses in Puerto Rico. Instead of general exemptions related to specific types of industry, the 1963 Act provided varying lengths of exemptions (from ten to thirty years), depending on the location of the new business in various economic development and employment need zones. In addition, the 1963 Act provided for elective partial exemptions which correspondingly extended the length of the exemption. The exemptions focus on the manufacture of products that were not previously manufactured in Puerto Rico at the time of the Industrial Incentive Act of 1948 and to certain other products designated in the Act.⁸²

Thus, the 1948 through 1963 versions of the Act were gradually liberalized. While the 1948 Act strictly limited the exemption to new industries and for a limited time period, the 1954 Act added ten years of exemption for new industries to establish themselves in Puerto Rico and take advantage of the exemption program. In 1960 a section was added that allowed an existing industrial unit to expand and, through permission of the Governor of Puerto Rico, be allowed a new full industrial exemption.⁸³ The 1963 Act was more liberal in application than the prior acts. Firms establishing businesses in specific underdeveloped economic zones received exemptions of up to thirty years. The exemption period was doubled if the business elected to take only a partial exemp-

81. Industrial Tax Exemption Act of 1948, P.R. LAWS ANN. tit. 13, §§ 221-238 (1978).

82. Puerto Rico Industrial Incentive Act of 1963, P.R. LAWS ANN. tit. 13, §§ 252-252j (1978).

83. P.R. LAWS ANN. tit. 13, § 242h(5) (1978).

tion.⁸⁴ In addition, the exemption period effectively was extended by the provision that allowed a business to postpone the start of its tax-exemption period up to four years from the beginning of its operations date.⁸⁵

A concurrent Puerto Rican tax provision in effect at the time of Operation Bootstrap was the tollgate tax. The tollgate tax was a tax on dividends distributed by an exempt corporation to its parent corporation outside Puerto Rico.⁸⁶ The tollgate tax was imposed only if the parent corporation would claim a foreign tax credit on the amount of the tax.⁸⁷ Thus, the statute attempted to raise revenue without increasing the parent corporation's overall tax burden.

However, the pre-1976 tollgate statute was rarely used for Section 931 corporations. Before 1976, a U.S. parent corporation was fully taxed on dividends received from possessions corporations under Sections 246(a)(B) and 901(d)(1). In order to avoid any federal or local taxes on income, the majority of possessions corporations waited until their tax-exempt status had expired in order to repatriate their retained earnings through liquidation free of local and federal taxes.⁸⁸ Although the accrual of retained earnings was a potential source of funds for the socio-economic growth of the Island, the corporations did not hold their funds in Puerto Rico, but invested in markets outside Puerto Rico.⁸⁹

(c) *Economic Growth and Industrialization.* From 1948 through the early 1970's, Puerto Rico's real GNP increased at a higher rate than that of the U.S. mainland. Puerto Rico's economic growth during this period was an "economic miracle."⁹⁰ The U.S. Government's 1966 report on the status of Puerto Rico provides a description of the growth and transformation of the Puerto Rican economy in the eighteen years following the 1948 Incentives Act. In those eighteen years, Puerto Rico's annual gross national product increased from \$651 million to \$2,757 million. The increase in

84. *Id.* § 252k.

85. *Id.* § 252l.

86. *Id.* § 3144 (amended by Act No. 96 of June 1, 1976).

87. *Id.* at 252b(a)(3) (amended by Act No. 95 of June 1, 1976).

88. U.S. DEP'T OF THE TREASURY, THIRD ANNUAL REPORT ON THE OPERATION AND EFFECT OF THE POSSESSIONS CORPORATION SYSTEM OF TAXATION 13 (1980) [hereinafter *THIRD TREASURY REPORT*].

89. See Madera, *Reflections on Section 936, the Tollgate Tax in Puerto Rico, and the Industrial Incentives Act of 1978*, P.R. BUS. REV. at 43 (1984).

90. *FOURTH TREASURY REPORT*, *supra* note 63, at 33.

per capita personal income was from \$376 to \$900 in constant 1965 dollars. The labor force rose from 663,000 to 769,000, and employment grew from 589,000 to 680,000. In spite of the miraculous economic growth, the chronic unemployment problem remained. The report states that "the employment rate remained substantially unchanged."⁹¹

Under Operation Bootstrap, Puerto Rico's declining agrarian economy was transformed into an expanding industrial structure.⁹² Between 1948 and 1965, agricultural employment declined from 36.3% to 17.5% of total employment, while employment in construction, trade, and other service activities increased. Manufacturing outside the home needlework industry more than doubled.⁹³ During this period, a total of 1,027 new manufacturing plants located on the Island. Net income from manufacturing increased from \$58 million to \$449 million, or from ten percent to twenty percent of the product value.⁹⁴ Even though unemployment remained level through the early 1970's, wages increased.⁹⁵ Average factory wages increased from \$0.42 per hour in 1950 to \$0.94 per hour in 1960 to \$3.11 per hour in 1977.⁹⁶

The economic growth spurred advances in health, education and the development of Puerto Rico's infrastructure. In terms of infrastructure, the highway system in Puerto Rico grew from 2,394 kilometers in 1940, to 3,559 in 1950, to 4,700 in 1960, to 5,294 in 1965.⁹⁷ The telephone system grew from 17,404 telephones in Puerto Rico in 1940, to 194,707 in 1965.⁹⁸ Electric power is provided through the government-owned Water Resources Authority. In 1940 only 28.8% of dwellings in Puerto Rico had electricity. By 1964, ninety-four percent of dwellings had electricity.⁹⁹

In terms of health, Puerto Rico made astonishing progress in the first twenty-five years of Operation Bootstrap. A person born

91. STATUS OF PUERTO RICO, *supra* note 73, at 54.

92. *Id.*

93. The home needlework industry was virtually wiped out of the Puerto Rican economy with the introduction of the minimum wage. *See infra* note 178.

94. STATUS OF PUERTO RICO, *supra* note 73, at 54.

95. *See infra* notes 178-83 and accompanying text (discussion on the effect of the imposition of the minimum wage on Puerto Rican wages).

96. 1 U.S. DEP'T OF COMMERCE, ECONOMIC STUDY OF PUERTO RICO 219 (1979) [hereinafter KREPS REPORT].

97. STATUS OF PUERTO RICO, *supra* note 73, at 183.

98. *Id.* at 184.

99. *Id.* at 168.

in Puerto Rico in 1910 had a life expectancy of 38.2 years. In 1940 life expectancy at birth was 46.0 years. By 1965, life expectancy at birth was 69.9 years, the same as on the U.S. mainland.¹⁰⁰ Infant mortality dropped from 113.4 per 1,000 live births in 1940 to 42.3 in 1965.¹⁰¹ The number of persons per physician on the island decreased from 3,763 in 1940 to 954 in 1965.¹⁰²

Education improved tremendously. University and college enrollment increased from 12,000 in 1950 to 152,000 in 1983.¹⁰³ The median number of years of school completed by Puerto Rican adults over the age of twenty-five rose from 3.7 years in 1950 to 4.6 years in 1960.¹⁰⁴

From a political perspective, Puerto Rico progressed under the early stages of Operation Bootstrap. In 1947, Congress authorized Puerto Rico to select its own governor, who in turn appointed the executive officials.¹⁰⁵ The most significant federal legislation concerning Puerto Rico was Public Law 600.¹⁰⁶ Public Law 600 provided for the organization of a constitutional¹⁰⁷ government by the people of Puerto Rico. This Act was adopted as a "compact" allowing the people of Puerto Rico to organize a government pursuant to a constitution of their own adoption.¹⁰⁸

Specific provision was made for an Island-wide referendum in which the Puerto Rican people were given the opportunity to accept or to reject this legislative proposal.¹⁰⁹ A provision was also made in the bill for Congress' ratification of any proposed constitution before it became effective.¹¹⁰

(d) *Puerto Rico: 1971-1976.* The Puerto Rican economy, which had grown very rapidly in the 1950's and 1960's under Operation Bootstrap, displayed very slow growth in the years between 1973 and 1977. This deceleration was brought about by the oil crisis and

100. *Id.* at 163 (life expectancy in the United States in 1910 was 50.0 years, while in 1940 it was 62.9 years).

101. *Id.*

102. *Id.* at 165.

103. Note, *Puerto Rico*, P.R. BUS. REV. 3 (May 1984).

104. STATUS OF PUERTO RICO, *supra* note 73, at 161.

105. Act of Aug. 5, 1947, ch. 490, § 1, 61 Stat. 770.

106. Act of July 3, 1950, ch. 446, 64 Stat. 319.

107. *Id.*

108. *Id.*

109. *Id.*

110. The Constitution provides that Puerto Rico is a commonwealth, a free associated state.

ensuing worldwide recession. These circumstances almost doubled the unemployment.¹¹¹ Puerto Rico's economy is closely tied to the U.S. mainland, because of the commonwealth relationship and the U.S. tax foundation of Operation Bootstrap. These ties subject the Puerto Rican economy to U.S. production shifts.¹¹²

By 1975, the severity of the recession in Puerto Rico was evidenced in Puerto Rico's Gross National Product (GNP) and Gross Domestic Product (GDP). According to the Kreps Report, the GNP contracted \$69 million and the GDP dropped \$96 million in constant 1954 dollars. The changes were two percent and 2.5% of their respective levels. These relative amplitudes on contraction were very similar to the cutbacks in gross products experienced in the United States, but the Puerto Rican declines were slightly less severe, and the 1976 rebound was not as strong as in the United States.¹¹³

In the 1960's and early 1970's, manufacturing employment continued to grow rapidly along with total employment. The labor force grew more normally as immigration from the mainland slowed and participation rates leveled off at about forty-five percent. By the early 1970's the unemployment rate dropped to the ten to eleven percent range.¹¹⁴

In 1975, however, employment dropped sharply and the unemployment rate went up. In 1977, the unemployment rate was twenty-three percent and the labor participation rate was only forty-two percent. This low labor participation rate sharply contrasted to the sixty-two percent labor participation rate on the mainland.¹¹⁵

(e) *Enactment of Section 936.* In 1973 and 1974, the House Ways and Means Committee held hearings on tax reform, including the repeal of the tax-free liquidation rules for possessions corporations and retention of the deferral rules on undistributed earnings of foreign subsidiaries.¹¹⁶ These hearings sparked an interest in the revision of Section 931 and led to the enactment of Section 936 in 1976.

111. KREPS REPORT, *supra* note 96, at 3.

112. *Id.* at 4. See *infra* notes 186-89.

113. KREPS REPORT, *supra* note 96, at 62.

114. *Id.* at 63.

115. *Id.* at 75.

116. Bissell, *The Changing Structure of the United States-Puerto Rican Tax Relationship*, 8 GA. J. INT'L AND COMP. L. 897, 901 (1978).

The Puerto Rico government convinced Congress not to disturb the existing relationship between the possession investment incentives and the U.S. tax laws. Congress reasoned that the possessions would find it difficult to attract investments by U.S. corporations unless Puerto Rican tax incentives were not nullified by U.S. laws. Congress decided that certain requirements upon the possessions, such as minimum wage laws and the use of U.S. flagships for transporting goods between the mainland and the possession, substantially increased labor, transportation and other costs of establishing business operations in the possessions, made it difficult for Puerto Rico to attract U.S. corporations.¹¹⁷

When Congress enacted Section 936, it affirmed the policy that the taxation of Puerto Rico investment income was to be treated differently, and more favorably, than the taxation of income from foreign countries. Section 936 was different than Section 931 in a number of ways. First, the new statute provided a credit rather than an exemption for the taxation of possessions income. Second, dividends could be remitted tax-free to the mainland. Third, the new statute was enacted specifically for the benefit of Puerto Rico and was to be closely watched by the U.S. Treasury Department through their annual reports. Specifically, Congress concluded that:

(possessions) corporations are generally to be taxed on worldwide income in a manner similar to that applicable to any other U.S. corporation, but (the full) foreign tax credit is to be given for the business and qualified investment income from possessions regardless of whether or not any tax is in fact paid to the government of the possession. The effect of this revised treatment will be to exempt from tax the income from business activities and qualified investments in the possessions, to allow a dividends received deduction for dividends from a possessions corporation to its U.S. parent corporation, and to tax currently all other foreign source income of possessions corporations (with allowance for the usual foreign tax credit) The committee believes that this revised treatment will assist the U.S. possession in obtaining employment-producing investments by U.S. corporations while at the same time encouraging those corporations to bring back to the United States the earnings from these investments to the extent they cannot be reinvested productively in the possessions.¹¹⁸

117. H.R. REP. No. 658, 94th Cong., 1st Sess. 254-55 (1974).

118. SEN. REP. No. 938, 94th Cong., 2d Sess. 278-79 (1976).

Although not officially part of the statute, there was an understanding in the House and Senate Committee Reports to the 1976 Act that the U.S. Treasury would furnish Congress with an annual report analyzing the revenue effects of possessions corporations, as well as the effects of Section 936 on investment and employment in Puerto Rico and other possessions.¹¹⁹ The reports were to begin with a report for calendar year 1976 and were to be submitted to Congress annually within eighteen months following the close of each calendar year. As of December 1987, five reports had been submitted, the most recent in July 1985.¹²⁰

3. Present Day Puerto Rico

The economy of Puerto Rico expanded at a fairly rapid rate from 1976 until 1980, but slowed down between 1981 and 1983.¹²¹ International trade agreements which limited textile and apparel exports to the United States from low wage countries, a weak dollar which enhanced the tourist industry, and economic recovery in the United States all helped the economy.¹²² The unemployment problem, though, did not disappear. From 1977 through 1983, the unemployment rate was in the high teens or low twenties.¹²³ This figure would have been higher but for increased migration to the mainland.¹²⁴

Between 1970 and 1980, the industry composition of manufacturing in Puerto Rico changed dramatically. Chemicals became the largest industry. The chemical industry grew from 11.4% to 37.3% of the total income originating in Puerto Rican manufacturing. Income originating in machinery and metal products increased its share of the total income in manufacturing by about fifty percent, or from 19.4 to 28.3% of the total income in Puerto Rican manufacturing. Income from the apparel and food products industries declined in their share of total manufacturing income in the years 1970-1980.¹²⁵ Employment declined substantially in traditional la-

119. H.R. REP. NO. 658, 94th Cong., 1st Sess. 259 (1974). See also S. REP. NO. 438, 94th Cong., 2d Sess. 282 (1976).

120. The first four reports were submitted June 1978, June 1979, June 1980, and Feb. 1983.

121. FIFTH TREASURY REPORT, *supra* note 71, at 23.

122. Note, *supra* note 103, at 5.

123. FIFTH TREASURY REPORT, *supra* note 71, at 23.

124. *Id.* at 21.

125. *Id.* at 30.

bor intensive industries and increased in high technology industries.

Some argue that the shift in the composition of the Puerto Rican manufacturing sector and increases in the income and capital stock of Puerto Rican manufacturing industries have produced less than proportionate increases in manufacturing payroll and employment. The Treasury Reports measured the share of payroll costs in total "value added" and found only 16.2% of the value added of all industries with expanding employment went to payroll, while a 37.4% share of the payroll in value added went to industries with declining employment in Puerto Rico. In effect, even though profits increase with high technology industries, a much smaller percentage is going towards workers' salaries.¹²⁶ One conclusion might be that this situation is no different than that of Puerto Rico at the beginning of this century. Then, the "joker in the deck" was that the enormous profits from the sugar industry were bypassing the Island and going directly to the mainland investors.

III. THE "COST" OF SECTION 936

The U.S. Treasury Department, in its annual reports, used a tax benefit analysis of Section 936 and found the statute to be costly. The tax benefit analysis estimates the cost of Section 936 employment on a per job basis using the federal tax benefits received by the possessions corporations.

A. The Tax Benefits Concept

Treasury estimated the federal tax benefits of possessions corporations in manufacturing by applying the effective U.S. tax rate to the qualified possession source income reported by each Section 936 manufacturing company on its U.S. income tax return, and then subtracting income and tollgate taxes paid to Puerto Rico.¹²⁷ Possessions corporations outside of the manufacturing sector were presumed to pay income taxes to Puerto Rico at a rate at least equal to the effective U.S. corporate rate, and thus presumed not to give rise to any federal tax benefit.¹²⁸

126. FOURTH TREASURY REPORT, *supra* note 63, at 52.

127. FIFTH TREASURY REPORT, *supra* note 71, at 46.

128. *Id.*

Treasury computed tax benefits on a per-employee basis.¹²⁹ According to the most recent report (Fifth Treasury Report), the tax benefit per manufacturing employee averaged \$20,656, or 146.8% of the average employee compensation.¹³⁰ The federal tax benefits per employee varied from one industry to another. In the pharmaceutical industry, the average federal tax benefits amounted to \$69,200 per employee, or more than three times the average compensation of the comparatively well-paid Puerto Rican pharmaceutical employee.¹³¹ For labor intensive industries, such as the apparel industry, the average tax benefit per employee was only \$3,030, a third of the average wage.¹³²

The pharmaceutical industry accounted for fifty percent of the total federal tax benefits, compared to fifteen percent of the total employment.¹³³ The apparel industries, however, accounted for only 2.5% of the total federal tax benefits but provided seventeen percent of the manufacturing employment.¹³⁴

According to the Treasury Department's reports, a direct relationship exists between a company's tax expenditure per employee and its total compensation per employee. "This reflects a tendency of the high-profit industries to employ more highly skilled workers and/or a willingness to pay those workers more than they would have been paid by other Puerto Rico employers."¹³⁵ For instance, the chemical industry, provides twenty percent of the total jobs in Section 936 manufacturing firms and paid twenty-six percent of the total employee compensation.¹³⁶

The industries in which tax expenditure per employee were the highest (pharmaceuticals, electrical, and electronic equipment, scientific instruments, and non-electrical machinery) tended to be the same industries in which total employment has been growing during the past decade. Conversely, industries in which tax expenditure per employee were the lowest (tobacco products, textiles, apparel, leather products) tended to be those whose employment was declining.¹³⁷

129. *Id.* at 49.

130. *Id.*

131. *Id.* at 48.

132. *Id.*

133. *Id.* at 51.

134. *Id.*

135. THIRD TREASURY REPORT, *supra* note 88, at 51.

136. *Id.* at 51.

137. *Id.*

At the top of the ranking are 14 companies for which the U.S. tax benefits represented \$100,000 or more per employee in Puerto Rico. At the low end are the companies which incurred losses and thus derived no immediate tax benefit from Section 936. The top 14 possessions corporations accounted for 29 percent of the tax benefits but provided only 5 percent of the employment of the 324 manufacturing companies. The top 38 possessions corporations, those for which tax savings per employer equalled or exceeded \$50,000 in 1982, collectively accounted for 55 percent of the tax benefits and 13 percent of employment tax benefits.¹³⁸

B. Proposals to Change Section 936

In spite of the Treasury Department's negative reports on Section 936, the Tax Reform Act of 1986 retained the possessions tax credit.¹³⁹ The Joint Committee on Taxation explained that "Congress believed that the credit and complementary local tax incentives had promoted economic growth in Puerto Rico."¹⁴⁰ The retention, though, was not without debate. Both the Treasury Department and the President suggested to Congress that the possessions tax credit be replaced by a wage credit.

1. Treasury's Proposal

The November 1984 Treasury Department Report to the President (Treasury's Proposal), proposed the repeal of Section 936.¹⁴¹ Treasury did "not believe that there should be a permanent tax subsidy for operations in the possessions."¹⁴² However, in order to smooth the transition from a system that provided a credit for taxes on income earned in the possessions to a system which does not recognize possessions corporations to be any different from foreign corporations, the Treasury proposed a wage credit which was to be phased out after several years. Under Treasury's Proposal, the amount of the wage credit was a fixed dollar amount per hour worked. The credit would be available for all persons employed in

138. FIFTH TREASURY REPORT, *supra* note 71, at 51.

139. I.R.C. § 936 (1986).

140. Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99th Cong.; Pub. L. 99-514) 1002 (Comm. Print 1987).

141. U.S. DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH, 327 (1984) [hereinafter TREASURY'S PROPOSAL].

142. *Id.* at 328.

the possessions by a manufacturing firm. The deduction for wages would be reduced by the amount of the credit.¹⁴³

Under Treasury's Proposal the "wage credit would replace the existing credit for taxable years beginning on or after January 1, 1987. It would be sixty percent of the minimum wage for a six year period, 1987 through 1992, and then would be phased out in equal installments over the next six years."¹⁴⁴

The proposal was to simplify the law and provide a more direct, cost-effective incentive to create jobs in the possessions. Treasury noted that since the tax benefits received by some current Section 936 corporations would be substantially reduced under a wage credit, corporations in the electronics and pharmaceutical industries might decide to restructure or even close their operations in the possessions. The proposal, however, concludes that the wage credit should attract more labor intensive industries to the possessions.¹⁴⁵

2. The President's Proposal

President Reagan submitted his tax simplification proposals (The President's Proposal) to Congress in May, 1985.¹⁴⁶ The President's Proposal also replaces the possessions tax credit with a wage credit. Under The President's Proposal, though, the possessions tax credit would be:

. . . repealed and replaced by a permanent wage credit. A U.S. corporation could elect a wage credit equal to 60 percent of wages, up to the Federal minimum wage amount, paid to persons employed in the possessions by an establishment engaged in manufacturing, plus 20 percent of such wages paid above the Federal minimum wage amount, subject to an overall cap per employee of four times the Federal minimum wage amount. Corporations electing the wage credit would be required to reduce their otherwise allowable deduction for wages paid by the amount of the wage credit claimed. At the present annual minimum wage amount of \$6,968, and with a 33 percent corporate tax the maximum net credit would be \$5,602 per employee (67

143. *Id.* at 328-29.

144. *Id.* at 329.

145. *Id.*

146. U.S. DEP'T OF THE TREASURY, THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY ch. 12.05 (1985) [hereinafter THE PRESIDENT'S PROPOSAL].

percent of the maximum gross credit of \$8,362).¹⁴⁷

Under The President's Proposal:

the wage credit could be used to offset the U.S. tax on any income, without regard to whether such income may have arisen from sources in a possession. The credit would not be refundable, but could be carried forward for 15 years.

Corporations electing the wage credit would not be entitled to claim a foreign tax credit for taxes paid to the possessions, but they would be allowed a deduction for such taxes, regardless of whether they otherwise claim a credit for taxes paid to other countries.¹⁴⁸

Dividends paid by corporations electing the wage credit would be subject to the general rules with respect to dividends-received deductions for dividends from a U.S. corporation.¹⁴⁹ Similar to the findings in the annual Treasury reports and Treasury's Proposal, the President's Proposal found the existing credit to be costly and inefficient.

. . . The average tax benefit per employee for all section 936 corporations was more than \$22,000 in 1982, more than 50 percent more than the average wage of possessions corporations' employees of \$14,210. Fourteen corporations received tax benefits in excess of \$100,000 per employee. Those fourteen companies accounted for 4 percent of the section 936 corporations for which employment data was available and derived 29 percent of the combined tax benefits.¹⁵⁰

The President's Proposal concluded that the income based possessions tax credit did not serve as a direct incentive to increase employment. According to the proposal, the reason for the permanent wage credit was the recognition of the United States' special obligation toward the "goal of encouraging increased employment and economic growth, in the possessions"¹⁵¹ and "economic health of the Caribbean region."¹⁵²

The President's Proposal recognized that:

147. *Id.* at 309.

148. *Id.* at 309-10.

149. *Id.* at 310.

150. *Id.* at 308.

151. *Id.* at 311.

152. *Id.*

the proposed wage credit may be less attractive than the existing Section 936 for certain corporations, primarily those in industries such as pharmaceuticals and electronics which have lower than average employment levels and higher intangible income. Accordingly, immediate repeal of the existing credit could cause undesirable short-term economic dislocation in the possessions.¹⁵³

C. Analysis of Cost

On closer inspection it is questionable whether a wage credit would be more effective in increasing employment in Puerto Rico or whether total repeal of a possessions tax credit would be less costly to the U.S. Treasury. Congress enacted Section 936 to provide an increase in employment in a cost-effective manner.¹⁵⁴ According to the Treasury Department, U.S. tax liabilities were reduced by \$1,679 million in tax year 1982 by the possessions corporation system.¹⁵⁵ The reduction in federal tax liabilities under Section 936 was estimated by applying to possessions corporations in manufacturing the same U.S. tax rules which applied to corporations operating within the United States in 1982, and then subtracting income and tollgate taxes paid to Puerto Rico.¹⁵⁶

1. Flaws in Treasury's Calculations

An absolute loss of \$1,697 million in tax revenues for one year is significant. However, Treasury's cost analysis is premised on the assumption that without the possessions credit, possessions corporations would not take advantage of other tax saving devices and that the elimination of Section 936 would not adversely affect Puerto Rico's economy. Even the Treasury Department, though, questions whether the elimination of the possessions corporation exemption would result in a gain to the U.S. Treasury of the tax benefits provided to corporations as a result of Section 936, because of the alternatives available to possessions corporations if Section 936 were repealed.¹⁵⁷

153. *Id.* at 313.

154. H.R. REP. NO. 658, 94th Cong., 1st Sess. 255 (1975); H. CONF. REP. NO. 760, 97th Cong., 2d Sess. 505 (1982).

155. FIFTH TREASURY REPORT, *supra* note 71, at 46.

156. *Id.*

157. *Id.* at 59-61.

As a result of Section 936, Puerto Rico is able to be, on tax grounds, a more attractive location than the United States for plant and equipment and other operating assets. However, from a tax planning perspective, the tax advantages of a Puerto Rican location for physical assets may not be significantly better than those available in a low-tax developing country. If Section 936 were repealed, a possessions corporation could elect to remain in Puerto Rico as a Puerto Rican-chartered corporation, or it could move to a foreign country, and continue to obtain the benefit of a 100% U.S. tax exemption if the corporation "deferred taxes" by not repatriating earnings until liquidation.

In a study of effective corporate tax rates for Fortune 500 companies, Tax Analysts concludes that "the recapture or turn-around of deferred taxes will occur only for those companies that have enjoyed little or no growth during the past several years."¹⁵⁸ For example, the U.S. federal income tax could be avoided altogether if the U.S. parent had excess foreign tax credits which could be used to offset federal tax on dividends of foreign affiliates.¹⁵⁹

It is difficult to determine whether the repeal of Section 936 would decrease tax avoidance as a result of the transfer of intangibles. Prior to the Tax Equity and Fiscal Responsibility Act (TEFRA) amendments, many U.S. parent corporations transferred intangibles tax-free to possessions corporations which, in turn, claimed as part of their income the return attributable to the intangibles. The TEFRA amendments,¹⁶⁰ though, provided a method to allocate income from intangibles between the parent and possessions affiliate in order to "lessen the abuse caused by taxpayers claiming tax-free income generated by intangibles developed outside of Puerto Rico."¹⁶¹

Moreover, intercompany transfer pricing problems are not unique to possessions corporations. Section 1231 of the Tax Reform Act of 1986 extends the "commensurate with income attributable to the intangible" standard to foreign affiliates, as well as possessions affiliates.¹⁶² The Internal Revenue Service has also recognized that the abuse extends beyond possessions corporations and recently litigated a Section 482 case involving the transfer of

158. TAX ANALYSTS, *EFFECTIVE CORPORATE TAX RATES* 1985 4 (1986).

159. *Id.*

160. See 26 U.S.C. § 936(h).

161. H. CONF. REP. NO. 760, 97th Cong., 2d Sess. 505 (1982).

162. I.R.C. § 482 (1986).

an intangible to a foreign, low tax jurisdiction.¹⁶³

Although certain industries locating in the possessions are able to take advantage of the possessions tax credit, their overall effective tax rates are not as high as other industries. For example, in 1985 the effective corporate tax rate for pharmaceutical companies was 28.25% for their U.S. tax on their U.S. income and was 30.52% on their worldwide income. (The possessions tax credit constituted a 9.18% reduction in the U.S. corporate rate.)¹⁶⁴ During 1985, the effective U.S. corporate tax rate on U.S. income for the insurance industry was 19.41%. The effective rate on worldwide income for the insurance industry was 19.72%.¹⁶⁵ The banking industry, mutual, national, and state paid U.S. corporate rates of 7.78%, 15.39%, and 16.49%, respectively, on U.S. income and paid worldwide rates of 7.78%, 21.75%, and 19.58%, respectively.¹⁶⁶ The mining industry as a whole paid an effective corporate tax rate of 8.13% on U.S. income and an effective worldwide rate of 8.84%.¹⁶⁷ The natural gas transmission industry paid a U.S. rate of 4.70% on U.S. income and a worldwide rate of 9.43%.¹⁶⁸

Tax Analysts studied the effective tax rates to determine the impact of the Tax Reform Act of 1986. The study used the effective corporate tax rates from 1985 and then applied the post tax reform rules. In spite of the loss of the special life insurance deduction and the changes in reserves for both the insurance and banking industries, the insurance and banking industries post tax reform effective rates remained lower than those of the pharmaceutical industry even though the pharmaceutical industry retained the possessions tax credit.¹⁶⁹ Moreover, the effective corporate tax rate study contains the caveat that "to the extent corporations' existing operations are adversely affected by tax reform, steps will be taken to ameliorate the impact of tax reform by restructuring."¹⁷⁰

163. *Bausch and Lomb v. Internal Revenue Service*, No. 3394-86 (U.S.T.C., filed Feb. 1986).

164. TAX ANALYSTS, *supra* note 158, at 4.

165. *Id.* at 117.

166. *Id.* at 31, 33, and 43.

167. *Id.* at 157.

168. *Id.* at 163.

169. TAX ANALYSTS, *QUANTIFYING THE IMPACT OF THE TAX REFORM ACT OF 1986 ON EFFECTIVE CORPORATE TAX RATES* 3, 5, 9 and 16 (1986).

170. *Id.* at Introduction.

2. Economic Dislocation

Another flaw in Treasury's analysis of the "cost" of Section 936 is that it does not sufficiently address the economic dislocation that would result with the repeal or the replacement of the possessions tax credit with its concomitant cost to the federal government. A recent report by the General Accounting Office concludes that, although extending the U.S. income tax to Puerto Rico would increase federal revenues in the short run (the savings would result mainly from the elimination of Section 936), increased social costs due to economic dislocation and reduced revenues for the same reasons could negate that gain.¹⁷¹

From the perspective of an employer, the proposals to develop labor intensive industries *vis-à-vis* a wage credit provide no greater incentives than those already in place through the possessions tax credit. Thus, there is no reason to believe more labor intensive industries would locate in Puerto Rico as a result of a credit, such as the proposed wage credits.

For example, under the President's Proposal, the wage credit would have been equal to sixty percent of wages paid above the federal minimum wage amount, subject to the overall wage cap per employee of four times the minimum wage amount.¹⁷² A corporation which elects the wage credit must reduce its deduction for wages by the amount of the wage credit that is claimed.¹⁷³ The President's Proposal used the minimum wage rate of \$6,968 and a proposed corporate tax rate of thirty-three percent¹⁷⁴ to arrive at the maximum net credit per employee of \$5,602 on employee wages of \$27,872 or higher.¹⁷⁵

The average wages for an employee in apparel manufacturing is \$8,954. The proposed wage credit per apparel employee is \$3,067.¹⁷⁶ Thus, for apparel workers the amount of the credit re-

171. General Accounting Office, *Welfare and Taxes: Extending Benefits and Taxes to Puerto Rico, Virgin Islands, Guam and American Samoa* 2-5 (1987) (TAX NOTES Microfiche 87-5939).

172. PRESIDENT'S PROPOSAL, *supra* note 146, at 312.

173. *Id.*

174. The Internal Revenue Code of 1986 fixed the top corporate rate at thirty-four percent. See I.R.C. § 11 (1986).

175. Sixty percent of annual minimum wage of \$6,968 = \$4,180.80. $3 \times 6,968 = 20,904$. Twenty percent of \$20,904 = \$4,180.80. Total credit = \$8,362 (Sixty percent of \$6,968 plus twenty percent of \$20,904). Thirty-three percent corporate tax rate. Sixty-seven percent \times \$8,362 = maximum of \$5,602. PRESIDENT'S PROPOSAL, *supra* note 146, at 309.

176. Sixty percent of \$6,968 = \$4,180. \$8,954 - \$6,968 = \$1,986. Twenty percent of

mains more or less the same under the possessions tax credit or under the proposed wage credit. Using the wage rate from the Fifth Treasury Report, labor intensive industries using the possessions tax credit receive \$3,030 per employee in tax benefits;¹⁷⁷ under the proposed wage credit the benefit would only be increased by a little over one percent to \$3,067. It is not realistic to conclude that this enticement would sufficiently draw labor intensive firms to Puerto Rico. Moreover, as a result of the Tax Reform Act of 1986, the U.S. corporate tax rate was reduced from forty-six percent to thirty-four percent. The reduction makes investment on the mainland considerably more attractive, and offsets other incentives to draw industry to Puerto Rico.¹⁷⁸

Another dimension to the argument that a wage credit will increase the number of workers employed by a possessions corporation, is that the wage credit focuses on the lower range of the wage scale. Corporations employing minimum wage workers get a credit of sixty percent of the wages they pay. However, corporations employing workers in the upper range of the scale receive a diminished credit, and there is no incentive to employ workers that make more than \$27,872 annually. Because the wage credit would be less attractive than the income based possessions tax credit for certain corporations, such as pharmaceuticals and electronics, repeal of Section 936 and replacement by the wage credit "could cause undesirable short-term economic dislocation in the possessions."¹⁷⁹

The economic dislocation, whether short-term or long-term, would be costly to the U.S. Treasury. Federal payments to Puerto Rico have been a significant part of total funds entering the Island and would probably increase due to the dislocation of the high technology corporations.¹⁸⁰ For example, net federal payments equalled 23.6% of income from productive activity in 1983. This figure takes into account the termination of the public service jobs programs and, to a lesser extent, the statutory ceiling imposed on federal nutritional assistance to Puerto Rico.¹⁸¹

\$1,986 = \$398. Total credit = \$4,578. Sixty-seven percent = \$3,067.

177. FIFTH TREASURY REPORT, *supra* note 71, at 48.

178. I.R.C. § 11 (1986).

179. PRESIDENT'S PROPOSAL, *supra* note 146, at 313.

180. See V.S. CLARK, PORTO RICO [sic] AND ITS PROBLEMS 410, 413 (1930); FIFTH TREASURY REPORT, *supra* note 71, at 23.

181. FIFTH TREASURY REPORT, *supra* note 71, at 5.

The net migration of residents of Puerto Rico to the mainland would probably increase. In 1983, the number of persons migrating to the mainland from Puerto Rico was over 44,000.¹⁸² Any economic dislocation will only increase those figures and increase costs to the U.S. Treasury. Not only is there the potential for increased migration, but because unemployment will focus on more skilled jobs, a "brain drain" could take place.

In addition, proposals to substitute the possessions tax credit with a wage credit or to repeal the possessions credit altogether do not take into account the multiplier component of Section 936 industries. "High employment multipliers indicate that the industry has a substantial impact on employment in other industries through its extensive linkages in the Puerto Rican economy."¹⁸³ Thus, in addition, to those employees directly being affected by the elimination of the credit, a ripple effect would occur, increasing unemployment proportionately. A study by Robert R. Nathan Associates, Inc. estimates that for 1984 direct employment for Section 936 corporations amounted to 94,433 direct jobs and an additional 154,270 indirect jobs.¹⁸⁴

Mere speculation that the possessions tax credit will be replaced or repealed demonstrates the adverse consequences such an action would have on the Puerto Rican economy. A recent survey of existing Section 936 firms attempted to determine the effect of uncertainty at the time of the TEFRA amendments in 1982, and the proposals to replace the possessions tax credit with a wage credit in 1985 on investment in Puerto Rico. The survey found that thirty-nine percent of the companies with plants in Puerto Rico delayed future investment in Puerto Rico in 1982 as a result of uncertainty over the future of Section 936 at that time. The delayed projects were estimated to be worth \$150 million with concomitant job projections of close to 2,000 employees. In 1985, the delayed investments amounted to around \$120 million and the temporary job loss was expected to be around 2,000.¹⁸⁵

182. *Id.* at 21.

183. Robert R. Nathan Associates, *Section 936 and Economic Development in Puerto Rico* (prepared for the Puerto Rico USA Foundation) 36 (August 1987) (TAX NOTES Microfiche No. 87-5513).

184. *Id.* at 38.

185. *Id.* at 22.

IV. PUERTO RICO NEEDS FEDERAL INCENTIVES TO CONTINUE THE DEVELOPMENT OF ITS INFRASTRUCTURE

A. U.S. Requirements

U.S. requirements have shaped Puerto Rico's dependent economy and ability to attract new industry. The inclusion within the U.S. tariff borders, as well as the sharing of U.S. currency, stimulated trade between Puerto Rico and the mainland United States. The omission of duties on Puerto Rican exports to the mainland United States gave Puerto Rico an advantage over outside competitors¹⁸⁶ and strengthened her ties with the United States. At the same time, though, Puerto Rico's close ties to the United States have hindered her competitive position.

1. Customs

Puerto Rico is part of the same customs system as the United States, and it maintains the same duties on imports from foreign countries as does the rest of the United States. "The result is to eliminate foreign countries as a potential source of supply for many types of products, and at the same time increase their cost to Porto Rico [sic] because of no independent control over tariffs."¹⁸⁷

2. Shipping

In addition, U.S. shipping laws¹⁸⁸ have influenced Puerto Rico's competitive position. Since their enactment, these shipping laws have required that goods moving between the United States and Puerto Rico be carried on American ships. The economic significance is that Puerto Rican imports and exports traditionally carry higher shipping rates than if Puerto Rico were free to utilize the cheaper carriers of other countries.¹⁸⁹ The shipping requirement influences the development of the Puerto Rican economy in at least four ways:¹⁹⁰

(1) it increases the cost of Puerto Rican imports by the extent to which rates charged by American ships are higher than those

186. V.S. CLARK, *supra* note 180, at 410.

187. *Id.*

188. The Jones Act, 46 U.S.C. § 877 (1982).

189. V.S. CLARK, *supra* note 180, at 411.

190. See V.S. CLARK, *supra* note 180, at 410-11.

charged by ships of other countries;

(2) the shipping requirement offsets the advantage which tariff free access to the U.S. mainland gives Puerto Rico in selling to the mainland;

(3) Puerto Rico would have been able to build up greater trading links with foreign countries if it had been free to use foreign shipping; and

(4) if the port of entry for foreign goods could have been Puerto Rico rather than the United States, the Puerto Rican Treasury would have collected the import duties on those goods. Due to the foreign shipping requirement, foreign goods transported on foreign ships enter Puerto Rico through U.S. ports and are re-exported to Puerto Rico on U.S. ships.

3. Limited Ability to Negotiate Tax Treaties¹⁹¹

Puerto Rico is limited in the promotion of foreign investment because it is not able to be a party to any double taxation agreements. Since the Jones Act, Puerto Rico has had its own system of taxation. As a result, Puerto Rico is not a party to any U.S. double taxation agreements. Unlike developing countries, Puerto Rico cannot promote investment through tax holidays because the incentives are lost through double taxation or limited by a foreign tax credit system for taxes actually paid.

In 1986, Puerto Rico attempted to negotiate a "tax sparing" treaty with Japan to promote Japanese investment. Under the terms of the proposed treaty, Japan would have given a foreign tax credit to Japanese firms investing in Puerto Rico for the Puerto Rican taxes which would have been paid but for Puerto Rico's incentives. The proposed treaty would have been directly between Puerto Rico and Japan. The U.S. State Department took a year to determine that it would not authorize Puerto Rico to proceed with negotiations on the grounds that it violated U.S. policy. Under Puerto Rico's commonwealth status, Puerto Rico needs the permission of the United States before it enters into negotiations leading

191. For a discussion of Puerto Rico's ability to be a party to tax treaties, see Davidson, *Tax Sparing: A Question of Treasury Policy or Puerto Rico Politics*, 35 TAX NOTES 731 (1987). The Constitution of Puerto Rico provides that Puerto Rico, in its commonwealth status, is free of superior authority in the management of its own local affairs, but is linked to the United States and hence is a part of the political system in a matter compatible with its federal structure.

to international agreements.

B. Loss of Competitive Advantages

The U.S. Treasury found that when Puerto Rico introduced its tax exemption program in 1948, a number of factors made Puerto Rico a highly competitive location for U.S. firms. Through the 1960's, labor cost was low relative to the U.S. mainland and the worker's high productivity contributed to Puerto Rico's competitive position. Puerto Rico had the advantage that it was inside the U.S. tariff wall and offered a more stable political and economic environment than countries in Latin America and the Far East.¹⁹² A number of factors contributed to the decline in investment in labor intensive industries in Puerto Rico.

1. Increased Cost of Labor

The U.S. Treasury Department concluded that high wages were the most significant factor in reducing Puerto Rico's competitive advantage in attracting investment. The average hourly wages of production workers in manufacturing industries in Puerto Rico rose much more rapidly than U.S. wages between 1955 and 1971, and rose slightly faster than U.S. wages in most industries after 1971.¹⁹³

One reason for the rise in manufacturing wages was the blanket imposition of the minimum wage on Puerto Rico in the late 1930's.¹⁹⁴ The imposition of the minimum wage threatened the entire economy of the Island at the time. For example, the hand needlework industry, which, at its peak in 1936, had become Puerto Rico's second largest industry, was almost extinguished by the imposition of the minimum wage because the higher wages made it impossible for Puerto Rico to compete with the low wage countries of the Far East.¹⁹⁵

The Fair Labor Standards Act which imposed the minimum wage was amended in 1940 to remedy the disastrous situation.¹⁹⁶

192. FIFTH TREASURY REPORT, *supra* note 71, at 23.

193. *Id.* at 29.

194. FOURTH TREASURY REPORT, *supra* note 63, at 43. See Fair Labor Standards Act, ch. 676, 52 Stat. 10610 (1938) (codified at 29 U.S.C. §§ 205-206 (1982)).

195. 86 CONG. REC. 5363 (1940).

196. Fair Labor Standards Act, ch. 432, 54 Stat. 615 (1940).

The 1940 amendments fixed wages for Puerto Rico by industry. Under the 1940 amendment, the wages were to be high enough to discourage the migration of businesses from the mainland, but low enough to attract industrial development to the Island.¹⁹⁷ However, the lower rates did not attract U.S. industries to any appreciable extent. By 1977, the average hourly wage in manufacturing in Puerto Rico was \$3.11 per hour compared to the minimum wage rate of \$2.30 per hour.¹⁹⁸

The Fair Labor Standards Act was amended in 1977, and higher statutory levels were established. As a result, almost all Puerto Rican workers were to receive the U.S. minimum wage.¹⁹⁹ Ironically, one of the arguments for the extension of the minimum wage to Puerto Rican workers in 1977 was that it was necessary in order to retain labor intensive industries in Puerto Rico. It was reasoned that increased productivity was the result of laborers' skills and training, available machinery and equipment, technology, management's administrative organization and efficiency and the employees' attitude towards their work. It was argued that "fair compensation is an indispensable element in developing proper motivation for work."²⁰⁰

In addition to the minimum wage, a number of other factors tied to Puerto Rico's relationship with the United States increased the real cost of labor in Puerto Rico. For instance, the expansion of federal income maintenance programs in Puerto Rico may have increased the cost of labor because such programs may reduce work incentives, and by inducing higher labor turnover rates, raise labor-training costs.²⁰¹

In addition, some have viewed the possessions tax credit itself as a cause of higher wages in Puerto Rico. The proposition set forth to support this theory is that some industry committees, authorized by the Fair Labor Standards Act have set Puerto Rican minimum wages at levels higher than in the absence of the favorable tax treatment.²⁰²

197. 86 CONG. REC. 5363 (1940).

198. KREPS REPORT, *supra* note 96, at 219.

199. Fair Labor Standards Act, Pub. L. No. 95-151, § 2(e), 91 Stat. 1246 (1977).

200. H.R. REP. No. 521, 95th Cong., 1st Sess., 56 (1977) (individual view of Resident Commissioner Baltasar Corrada).

201. FOURTH TREASURY REPORT, *supra* note 63, at 47.

202. STATUS OF PUERTO RICO, *supra* note 73, at 75.

2. Changes in the U.S. Taxation Laws

Changes in the United States' domestic taxation laws also affected the relative profitability of locating in Puerto Rico. Since 1962, Congress reduced the corporate tax rate,²⁰³ introduced investment tax credits and liberalized the period over which assets could be depreciated for federal tax purposes. As the result of these domestic taxation changes, the overall effective tax rate on income earned from physical capital decreased, and the attraction of tax exemption for physical investment in Puerto Rico decreased.²⁰⁴

3. Changes in the U.S. Tariff Schedule²⁰⁵

Changes in the U.S. tariff schedule in the 1960's reduced the locational advantage of Puerto Rico relative to foreign countries as the price advantage Puerto Rican products could enjoy in the U.S. market was cut. During the Kennedy Round of negotiations, tariffs fell by forty percent to fifty percent.²⁰⁶ As a result, U.S. imports of clothing from Puerto Rico fell from thirty percent of all U.S. imports in 1965 to nine percent in 1976. On the other hand, Hong Kong's percentage rose from fifteen to twenty-three, Korea's percentage from one to seventeen, and Taiwan's percentage from two to sixteen of U.S. imports of clothing for the same time period.²⁰⁷

C. Puerto Rico Needs the Possession Tax Credit to Compete with Other High Technology Economies

A wage credit, such as the one suggested in The President's Proposal, would not be sufficient to attract labor intensive industries back to Puerto Rico because the federal minimum wage, as well as other cost factors such as social security taxes that must be paid by employers and fringe benefits, have already driven many of the labor intensive industry companies out of Puerto Rico to low

203. As a result of the Tax Reform Act of 1986, the current top corporate rate is thirty-four percent. I.R.C. § 11 (1986). The relatively low rate has caused some countries to dub the United States as a "tax haven." See International Tax Institute Conference Papers, *Minimizing Taxes* - 1987, (June, 1987).

204. FIFTH TREASURY REPORT, *supra* note 71, at 29.

205. The Caribbean Basin Initiative specifically exempts textiles from tariff free access to the United States. See 19 U.S.C. § 2703(b)(1) (Supp. II 1985).

206. FIFTH TREASURY REPORT, *supra* note 71, at 30.

207. KREPS REPORT, *supra* note 96, at 108.

wage jurisdictions. Under the wage credit suggested by The President's Proposal, the hourly wage of an apparel worker in Puerto Rico would have been reduced from \$4.35 an hour to \$2.14 an hour, not including fringe benefits.²⁰⁸ This reduction does not begin to make Puerto Rico competitive with other locations for labor intensive industries, such as apparel manufacturing. Apparel workers make 35 cents per hour in Haiti; 65 cents per hour in Costa Rica; 82 cents per hour in the Dominican Republic; 83 cents per hour in Korea; \$1.25 per hour in Taiwan and \$1.62 per hour in Hong Kong.²⁰⁹ Other countries competing for labor intensive industries have a significant advantage over Puerto Rico.

It is unlikely that any wage credit will be sufficient to make Puerto Rican wages competitive with those from Haiti or Costa Rica for labor intensive industries. Those countries with which Puerto Rico competes are moving away from labor-intensive industries. Countries such as Korea and Taiwan realize they are not able to compete with low wage countries for labor intensive industries²¹⁰ and are providing incentives to attract high technology industries. Even though hourly wages for workers in manufacturing are only \$1.25 in Taiwan and 83 cents in Korea, these countries provide incentives that promote high technology industry. For example, under Korea's Foreign Capital Inducement Law, foreign-invested enterprises requiring high-technology or large capital investments receive tax privileges.²¹¹ The foreign corporation can exempt or reduce its taxes in proportion to the number of shares owned by foreign investors. The exemption from taxes is for any continuous five year period selected by the taxpayer within the first ten years after registration as a foreign-invested enterprise. The reduction in taxes allows an amount equivalent to 100% of the ordinary depreciation for fixed assets of the enterprise to be additionally deductible as

208. Average wage \$4.35/hr. Credit on minimum wage 60% of \$3.35/hr. = \$2.01. Credit on remaining \$1.00, 20% of \$1.00/hr. = \$.20. Credit = \$2.21. Net wage paid by employer = \$2.14.

209. All statistics are for 1986-87. Statistics from Haiti, Costa Rica and the Dominican Republic are based on conversations with embassy officials. Statistics from Korea, Taiwan and Hong Kong are from the U.S. Department of Labor, BUREAU OF LABOR STATISTICS (August, 1987).

210. *The 'four dragons' lose their fire*, BUS. WK., Mar. 28, 1983, at 64.

211. MINISTRY OF FINANCE OF KOREA, TAX BUREAU, KOREAN TAXATION 252 (1985). A May 1987 newsletter from Seihwa Accounting Corp. (Seoul, Korea) stated that the Korean Ministry of Finance announced changes in tax exemption opportunities for foreign investors. However, tax exemption changes would be available for foreign investment in 40 specific advanced technology business areas, even in cases where the foreign shareholder ratio is 100%.

special depreciation. In Taiwan, incentives similar to the Korean incentives are available that encourage a number of different types of investment, including those that are capital and technology intensive. Taiwan offers an additional deferral of taxes for high technology and capital intensive industries.²¹²

Section 936 has been successful in helping Puerto Rico compete with countries such as Korea and Taiwan in attracting high technology industry. In 1960, 3.4% of the Puerto Rican net manufacturing income was in the chemical area. By 1983, 36.8% of the net income from manufacturing was in the chemical industry.²¹³ Section 936 provided the tax incentives for this development. By 1981, high technology industries accounted for thirty-eight percent of the manufacturing employment in Puerto Rico.²¹⁴ By 1984, the share of manufacturing employment directly attributable to possessions corporations (which are mainly high technology firms) was sixty-one percent.²¹⁵

V. CONCLUSION

The current ambivalency over Section 936 neither increases federal revenue nor fully supports Puerto Rico's economic development as a high technology economy. Robert R. Nathan Associates, in a study prepared for the Puerto Rico U.S.A. Foundation, a coalition of Section 936 corporations, concludes that uncertainty over Section 936 has created an unstable tax environment. Thus, he concludes businesses cancel investments because of the long-term instability of the tax environment. The Tax Reform Act of 1986, though, is not unique to Puerto Rico in creating an unstable environment. For example the Act eliminated capital gains and investment tax credits, changed depreciable lives, and included treaty overrides.²¹⁶

The history of Puerto Rico's relationship with the United States demonstrates that it is Congress' lack of direction in defin-

212. Taiwan Statute for Encouragement of Investment, art. VII (amended Dec. 1984) (translated by Lee and Li).

213. FIFTH TREASURY REPORT, *supra* note 71, at 31.

214. FOURTH TREASURY REPORT, *supra* note 63, at 52.

215. *Id.* at 28.

216. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986). See §§ 302, 702, and 1241. For a discussion of treaty overrides, including the branch profits tax, see Forry & Karlin, 1986 Act: Overrides, Conflicts, and Interactions with U.S. Income Tax Treaties, 793 TAX NOTES (1987).

ing the mainland's obligation to its dependencies that is wreaking havoc with the Puerto Rican economy, not merely its ambivalence towards Section 936. Examples of indecisions which have scarred the Puerto Rican economy include:

1. the tariff imposed by the Foraker Act which allowed the U.S. sugar corporations to buy the sugar plantations and export the profits to the mainland;
2. the imposition of the minimum wage which skewed the economy so it was no longer able to compete with its natural rivals;
3. a tariff-free trade situation with the United States whose economic benefits are negated by U.S. shipping requirements; and
4. the denial by the State Department to allow Puerto Rico to negotiate tax treaties with Japan and other countries in order to extend investment incentives beyond Section 936.

The fundamental question which needs to be answered before the possessions tax credit can be tackled is the same one asked at the time Puerto Rico was ceded to the United States. "How should the United States treat her dependencies?" Once that question is answered, the decision can be made to analyze the possessions tax credit in terms of providing support for the Puerto Rican economy or in terms of the Treasury Department's concerns over lost tax liabilities.

Puerto Rico needs Section 936 in order to remain competitive with similarly situated economies. Without U.S. investment through Section 936, Puerto Rico is not able to use its investment incentives to attract foreign investment.

Even though it might be argued certain high technology firms are reaping tremendous tax benefits as a result of Section 936, this situation is different than that of "the joker in the deck" at the beginning of this century. As a result of favorable federal tax treatment, Puerto Rico has been transformed from a Caribbean poor-house to a high technology economy. Puerto Rico has profited by receiving a sophisticated infrastructure.

Unfortunately, a simple wage credit is not the solution to Puerto Rico's chronic unemployment problem. Perhaps, though, the sophisticated infrastructure as a result of Section 936 will provide the cushion for Puerto Rico to develop its own solutions to the unemployment problem.