Puerto Rican Transfers and Section 936

by Lorraine Eden

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In the United States, tax incentives to foreign direct investment in U.S. possessions, such as Puerto Rico, have been around for a long time. These incentives have been under close scrutiny by the U.S. Congress since the mid-1980s, and came under direct attack in the 1993 budget negotiations. Although the incentives were curtailed, they still exist and are likely to continue to be controversial. Treatment of U.S. possessions is also among the most complicated parts of the U.S. Internal Revenue Code. A brief analysis is, therefore, an appropriate part of this ongoing debate.

A table of legislative changes dealing with the tax treatment of possessions corporations is provided in Table 1 below.

The Early History of the Possessions Exemption[1]

The 1921 Revenue Act exempted from U.S. taxation the foreign-source income of U.S. multinationals (MNEs) that received at least 80 percent of their income from U.S. possessions, if at least 50 percent of the income came from an active business or trade. Dividends paid to the U.S. parent were taxable on repatriation, while liquidated distributions were tax free. The purpose behind the exemption was threefold:

(1) to help U.S. multinationals compete with other foreign firms doing business in the Philippines, then a U.S. possession;

(2) to give U.S. investments in U.S. possessions the same tax deferral treatment received by American investments in foreign countries; and

(3) to encourage economic development and growth in U.S. possessions.

Internal Revenue Code (IRC) section 351 provided an additional tax incentive, on top of this exemption, because U.S. MNEs could transfer intangible assets to their possessions corporations, as contributions to capital, without recognizing U.S. taxable income at the time of the transfer.

While U.S. multinationals took some advantage of these incentives to locate part of their operations in U.S. possessions, the big shift in outbound transfers did not start until the 1950s.

Operation Bootstrap

In 1948, the Puerto Rican (P.R.) government set up Operation Bootstrap to encourage economic

[1]*See* Cole (1987), Coopers & Lybrand (1989: 41-46), Triplett (1990: 1-2) and Wright (1993: 14-17).

Table 1
Tax Treatment of U.S. Possessions Corporations

Date	Description of Legislation
1921	Revenue Act exempts foreign-source income of U.S. MNEs that receive at least 80 percent of their income from U.S. possessions, if at least 50 percent of the income comes from an active business or trade. Dividends paid to the U.S. parent are taxable on repatriation, while liquidated distributions are tax-free.
1928	Sec. 351 allows U.S. MNEs to transfer intangible assets to their possessions corporations as contributions to capital without recognizing U.S. taxable income at the time of the transfer.
1976	Sec. 936 converts the foreign tax exemption to a foreign tax credit for "qualified possession source investment income (QPSII)," defined as income from FDI in an active business or trade.
1976	Sec. 367 denies tax-free status to transfers to foreign corporations not involving a sale or a license where a tax avoidance motive was evident. Such transfers must be treated as contributions to capital and levied with a toll charge.
1982	Sec. 936(h) raises the percentage of active business income necessary to qualify as a possessions corporation from 50 to 65 percent of gross income. All intangible income earned by a possessions corporation must be allocated to the U.S. parent (the Dole rule), unless one of two safe harbors is chosen: a 50-50 profit split or cost sharing.
1984	Sec. 367(d) requires annual arm's length payments for intangibles transferred abroad to be included in the U.S. parent's income whether received or not.
1986	Sec. 936(h) is changed to require possessions corporations using the cost-sharing method to pay an arm's length royalty for the use of the parent's intangibles.
1986	S. 1231(e) requires that payments commensurate with income earned by the user of the intangibles be made to the developer of the intangibles.
1993	Sec. 936 is tightened by reducing the income tax credit for cost sharing or profit splits.
1993	Sec. 482 temporary regulations require possessions corporations using the cost-sharing safe harbor to make annual payments to their U.S. parents commensurate with the income earned by the affiliates from the use of the intangible.

development in the U.S. possession. Under the 1948 P.R. Industrial Incentives Act, the government provided tax holidays for profits earned by new foreign businesses setting up on the island. The tax holiday was expanded under the 1963 Industrial Incentive Act so that qualifying corporations received a 10- to 25-year, 100-percent holiday from P.R. corporate income, property, and local taxes.

The Operation Bootstrap tax incentives induced many U.S. multinationals to set up foreign affiliates (called possessions corporations) in Puerto Rico in the 1950s. A U.S. parent company could transfer the ownership of technology developed in the United States to a possessions corporation; the affiliate would manufacture products using this technology in Puerto Rico for sale to the parent; and the parent would then market the final product in the United States. Since possession income was exempt from U.S. taxation, as long as profits were kept on the island, no taxes were payable to either government for the period of the tax holiday. Once the holiday expired, the parent could liquidate the corporation and bring the capital home tax-free.

A numerical example of these tax breaks, based on a hypothetical U.S. multinational (USCORP) and its P.R. affiliate (PRCORP) is provided in Box 1. USCORP develops and transfers an intangible to PRCORP. PRCORP manufactures a product, using its own materials and labor, and sells all the output to USCORP for an arm's length sale price in the United States. Prior to 1976, PRCORP's profits would not have been taxed by either government. Between 1976-82, the U.S. tax exemption was converted to a tax credit and the P.R. government added a withholding tax. The tax break remained 100 percent for retained profits or liquidations; dividends faced the full U.S. tax-and-credit program.

The U.S. Treasury Protests

The U.S. Treasury was not happy with this situation, even though tax-free transfer of intangibles was legal under section 351, because of income tax loss implications. Under section 482, the commissioner of Internal Revenue could allocate income among related parties so as to prevent tax evasion or to clearly reflect the income.

Individual section 482 audits started piling up across the United States in the mid-1960s. Partly as a result of these audits and the lack of a common IRS policy for dealing with them, the U.S. Treasury developed the 1968 transfer pricing regulations. Several cases involving transfer pricing audits of U.S. MNEs with P.R. income in the 1970s also went to the tax courts.[2]

[2]The best-known of these Puerto Rican transfer pricing cases are *Eli Lilly and Company v. Commissioner*, 84 T.C. 996 (1985), and *G.D. Searle and Company v. Commissioner*, 88 T.C. 252 (1987).

Box 1
The Pre-1982 Possessions Tax Credit

Income and Expenses of PRCORP, a Possessions Corporation	
Direct Material Costs	45.00
Direct and Indirect Labor Costs	5.00
Total Manufacturing Cost (= material + labor costs)	50.00
Manufacturer's Markup (30 percent of mfg. cost)	15.00
Price Sold to Parent Firm	65.00
Income and Expenses of USCORP, the U.S. Parent	
Price Paid to Possessions Corporation	65.00
Worldwide R&D Costs	10.00
Distribution Costs	20.00
Distributor's Markup (5 percent of final price)	5.00
Final Selling Price	100.00

Section 936 (Pre-1982)

Profits earned by PRCORP are not taxed by the Puerto Rican government if retained. If profit is remitted to USCORP, must pay P.R. tax of 10%. Tax is 10% x (PRCORP's markup) = 10% x 15 = 1.50.

USCORP profits are taxable at U.S. rate of 46% (we hold this rate constant throughout the example for simplicity).

Before 1976, if PRCORP's profits were retained offshore, or if PRCORP was liquidated when profits were returned, no additional U.S. tax was due, so USCORP's total tax is 46% x 5 = 2.30.

After 1976, if PRCORP remits dividends, they are brought into USCORP's consolidated income but the parent receives a full dividend-received deduction. USCORP pays U.S. tax of 46% x (5 + 15) - 1.50 = 7.70.

The U.S. tax break is 100 percent for profits retained offshore or only returned when PRCORP is liquidated. The tax break is worth 46% x 15 = 6.90.

The Treasury was concerned with two issues: (1) the separation of income and expenses, and (2) the appropriate valuation of intangibles. With respect to the first issue, U.S. law allowed American MNEs to develop intangibles, write off current R&D expenses against the U.S. tax, and then transfer the ownership of the intangibles tax-free to P.R. affiliates, where the subsequent income earned with the intangibles would not be taxed by either government. Thus, the expenses were declared in the United States and the income in Puerto Rico. With respect to the second issue, the ownership of very profitable intangibles was being transferred offshore, with inadequate compensation to the U.S. developer of the intangibles, so huge profits were going untaxed.

In the P.R. cases that went to court, the Internal Revenue Service (IRS) argued that the affiliates were basically contract manufacturers, performing no more than routine functions, and should be allowed only a small markup over manufacturing costs. In addition, the IRS argued that transfers of intangibles to these affiliates were invalid because they would not have occurred in arm's length relationships between unrelated parties. The tax courts generally disagreed with the IRS's view on both issues.

The Eli Lilly Case

The issues can clearly be seen in the *Eli Lilly and Company v. Commissioner* case.[3] Eli Lilly, a U.S. pharmaceutical MNE, owned an extremely profitable patent on the drug Darvon, the largest-selling prescription drug in the United States at the time. The parent firm developed the drug and deducted the R&D costs from its income. Then, under section 351, the parent transferred ownership of the patent, tax-free, to Lilly's P.R. affiliate, Lilly P.R. Subsequent income from Darvon thus was declared, and minimally taxed, in Puerto Rico. The IRS argued that the income from the Darvon intangibles belonged to the U.S. parent, despite the tax-free transfer under section 351. Eli Lilly argued that it had transferred the manufacturing intangibles to its affiliate, and had been paid for them in the form of paid-up capital in the affiliate.

The Tax Court held that the transfer of the Darvon intangibles to Lilly P.R. was legitimate and the subsidiary was the owner of the manufacturing intangibles. Even so, the IRS had the right to allocate income among related parties so as to clearly reflect their income. The court allocated a percent of the parent's worldwide R&D costs to the possessions corporation, and then used a profit split methodology to divide the remaining profits between the two parties.[4]

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[3]*See* Coopers & Lybrand (1989: 42-44), Hellawell and Pugh (1987: 171-77) and U.S. Treasury (1988: 28-29).

[4]The Tax Court based its profit split on what was reasonable in the circumstances. The court allowed Lilly P.R.: (1) profits equal to 100 percent of its manufacturing costs, plus (2) the location savings from being in low-cost Puerto Rico, plus (3) 55 percent of the profits from the manufacturing intangibles. The subsidiary ended up with more than half the total profits (Hellawell and Pugh 1987: 178).

The Court of Appeal rejected the R&D allocation, on the ground that Lilly P.R. owned the manufacturing intangibles, but affirmed the profit split methodology.

Congress Adds Section 936: 1976 and 1982

Concern over these apparent tax losses led the U.S. government, in the Tax Reform Act of 1976, to tighten this generous tax treatment. Congress added IRC section 936, which converted the foreign tax exemption to a foreign tax credit for "qualified possession source investment income" (QPSII), defined as income from foreign direct investment (FDI) in an active business or trade. The Senate Finance Committee Report accompanying the 1976 act stated that the purpose of section 936 was to encourage employment-producing investments by U.S. MNEs in Puerto Rico. The P.R. government also reduced the tax holiday from 100 to 90 percent for new investments, and added a 10-percent "toll charge" on repatriations of 10 percent (Cole 1987: 17).

The question of how many jobs the possessions tax credit has created and at what cost has been an important part of the ongoing controversy surrounding section 936 ever since its passage. In 1982, a U.S. Treasury report concluded that the tax loss to the U.S. government per job in a possessions corporation was $22,000, whereas the average compensation per job paid by possessions corporations was only $14,210 (Turro 1993b: 1417).

This controversy, and the IRS's lack of success in the courts, stimulated the U.S. Congress to add section 936(h) as part of the 1982 Tax Equity and Fiscal Responsibility Act (TEFRA).[5] TEFRA raised the active business income requirement for possessions status under section 936 from 50 to 65 percent of gross income. Also, all intangible income earned by a possessions corporation was allocated to the U.S. parent under the so-called "Dole rule." Thus, possessions corporations were to be effectively treated as contract manufacturers, which the IRS wanted. Two escape clauses, or "safe harbors," from the Dole rule were permitted through which a U.S. MNE could continue to earn tax-free intangible income: cost sharing and profit split. To use one of these two methods, all members of the MNE family involved in the same product line or services had to make an irrevocable election to do so.

The first safe harbor was based on cost sharing. The subsidiary was given ownership of the manufacturing intangibles and the parent was given ownership of the marketing intangibles.[6] The subsidiary had to make an R&D cost sharing payment to the parent. The payment, based on a specified formula, forced the P.R. affiliate to pay a share of the parent's worldwide R&D costs.[7] Any manufacturing intangibles were then the property of the possessions corporation. Finally, section 482 was used to determine the transfer price for the products manufactured by the possessions corporation and sold to the U.S. parent.

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The second safe harbor was a 50-50 profit split, on a product-by-product basis, of the combined taxable income of the U.S. parent and its P.R. affiliate. Since the owner of the intangible was entitled, under U.S. law, to the profit from the use of the intangible, the second safe harbor effectively split profits, after all costs were covered, between the marketing and manufacturing processes. The ease of this split, of course, depended on the ease of identifying which returns came from marketing and which from manufacturing, and on the assumption that they could be separated. In practice, more than 50 percent of the profit was allocated to the U.S. parent.

Box 2, which is based on the information in Box 1, provides a numerical example of the operation of section 936(h). Under the Dole rule, PRCORP is faced with full, annual U.S. taxation. In this example, the cost sharing and profit split safe harbors each generate only half the U.S. tax of the Dole rule. It is not surprising that U.S. MNEs have opted for the safe harbors to preserve at least part of their tax holiday.

Section 367 Provides the First Backstop

Section 351 has been an important component of the possessions corporation strategy for U.S. multinationals. Tax-free transfer of the ownership of U.S. intangibles, coupled with a P.R. tax holiday and reduced U.S taxation, made for a very generous package encouraging foreign direct investment in Puerto Rico. In 1976, at the same time that section 936 was added to the tax code, section 367 was added as a general rule, which denied tax-

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[5]In 1984, Congress, concerned that MNEs be prevented from declaring (tax-deductible) R&D costs at home while declaring the income from these intangibles in low-tax foreign locations, required U.S. multinationals to include a deemed royalty payment in their own income. *See* IRC section 367(d).

[6]Manufacturing intangibles are returns to technology development, both product and process, including patents and technical know-how used in manufacturing, whereas marketing intangibles are associated with franchises, trademarks, distribution networks, brand names, corporate reputation, and so on.

[7]The cost sharing formula was "Sales of Possessions Products to Unrelated Persons" (S^P) divided by "Total Sales to Unrelated Persons of All Products in Same SIC Code" (S) and multiplied by "Worldwide Produce Area Research Costs of the Affiliated Group" (R), or $S^P/S \times R$. *See* Granwell and Hirsh (1986: 1042).

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Box 2
The 1982 Revisions to the Section 936 Possessions Tax Credit

1982 Section 936(h): The Dole Rule

All of PRCORP's manufacturing intangibles (i.e. PRCORP's markup of 30% over manufacturing cost) are allocated to USCORP, but a profit margin is allowed to PRCORP as a contract manufacturer. (This is already included in PRCORP's manufacturing cost.) The Dole rule is equivalent to eliminating the U.S. tax holiday for PRCORP. Thus, USCORP pays 46% x (PRCORP markup + USCORP markup) = 46% (5 + 15) = 9.20 in U.S. tax. The U.S. tax break is zero compared to the pre-1982 situation.

1982 Section 936(h), Election 1: Cost Sharing

PRCORP pays a portion of USCORP's worldwide R&D costs.

Between 1982 and 1986, this portion was not formalized in law. If PRCORP's share is 50%, 50% of R&D cost is disallowed as an expense of USCORP and allocated to PRCORP. USCORP's new profit is 5 + (50% x USCORP R&D costs) = 5 + 5 = 10. In this example, 5/15 or 33.3% of PRCORP's profits are allocated back to USCORP.

U.S. tax paid by USCORP is 46% x 10 = 4.60. This tax, as a percent of the Dole rule tax, is 4.60/9.20 = 50%.

In 1986, section 936(h) is revised: PRCORP must pay an arm's length royalty to USCORP for manufacturing intangibles if USCORP elects the cost sharing method. New section 1231(e), also introduced in 1986, requires the royalty to be commensurate with the income earned using the intangibles. The arm's length return is not determined as it is specific to the facts and circumstances, but can have the effect of the Dole rule; i.e., allocating all intangibles to USCORP.

1982 Section 936(h), Election 2: Profit Split

Total MNE Profit = PRCORP's markup + USCORP's markup = 15 + 5 = 20. Profits allocated to USCORP = 50% x 20 = 10.

U.S. tax paid by USCORP is 46% x 10 = 4.60. This tax, as a percent of the Dole rule tax, is 50%.

free status to transfers to foreign corporations not involving a sale or a license where a tax-avoidance motive was evident. Section 367 required such transfers to be treated as contributions to capital and levied with a toll charge. Section 367, however, did not apply to intangibles transfers to possessions corporations because they were considered to be American, not foreign, affiliates.

Given the concern in the early 1980s with intangible income, Congress added section 367(d) in 1984. Section 367(d) ensured that if intangible property was transferred abroad, the transferor was treated as receiving an imputed royalty over the life of the intangible. The U.S. developer and transferor of the intangible were required to include arm's length payments, treated as being received annually over the life of the intangible, in its income whether received or not.

In 1986, section 936(h) was revised to require possessions corporations to make arm's length royalty payments to their parents. Given the choice between a reasonably certain profit split and an uncertain valuation of the arm's length royalty charge, most pharmaceutical MNEs, especially those with valuable drug patents, shifted from the cost sharing to the profit split method. The 1986 Tax Reform Act also added the commensurate-with-income standard to the section 482 legislation.

Effectively, by 1986, the United States had plugged the intangibles loophole through which U.S. MNEs with foreign affiliates had historically been able to avoid U.S. income tax (Boidman 1988: 44:10).[8] Any MNE transferring intangible assets abroad is now treated as receiving an imputed royalty payment over the life of the intangible and the royalty is counted as the transferor's U.S.-source income, regardless of the method of transfer or the type of intangible property.

Who Benefits From 936?

Even with the 1982 tax changes, section 936 still sheltered income earned in Puerto Rico from U.S. tax, in effect keeping Puerto Rico as a U.S. tax haven. Firms that shifted manufacturing operations to Puerto Rico paid lower labor costs, had duty-free access to U.S. markets for their products, and made minimal tax payments to either government. Robert Cole (1987: 17) estimated the effective tax rate on possessions corporations to be less than 5 percent

[8]A debate similar to the U.S. debate over intangibles has not occured in Canada because Canadian law is quite different from U.S. law in this area. In the Canadian Income Tax Act, under sections 69 and 85, tax-free transfers of assets from a Canadian parent to its affiliates can be made only when the affiliate is also in Canada. In such a case, intercorporate transfers of assets do not affect the Canadian government's ability to tax the MNE's worldwide income. When the affiliate is a foreign company, on the other hand, transfers of assets, both tangible and intangible, are subject to a toll charge under section 69 at the time of transfer. The toll charge values the rights to the assets according to the arm's length standard. Thus, if Northern Telecom transfers technology to its U.S. subsidiary, Revenue Canada checks to see that the price charged reflects fair market value, and, if not, Revenue Canada revalues the transfer. In the United States, until section 367(d) was passed in 1984, there was no equivalent broad-based rule that required transfers to foreign affiliates to be made at fair market value.

Table 2
The Top Ten 936 Multinationals

Company	Industry	Number of Employees in P.R. Possessions Corporations
Baxter Intl.	Pharmaceuticals	5,547
Sara Lee	Underwear, hosiery	5,037
General Electric	Electric components	3,555
H.J. Heinz	Processed tuna	3,550
Johnson & Johnson	Health care	3,354
Westinghouse Electric	Electric components	3,281
Abbott Laboratories	Pharmaceuticals	2,633
Bristol-Myers Squibb	Pharmaceuticals	2,163
Warner-Lambert	Pharmaceuticals	1,649
United States Surgical	Surgical/medical	1,594
Average of top ten 936 multinationals		3,236

Source: Based on data in "A Hurricane Heads for Puerto Rico," *Business Week*, p. 52, 54 (June 14, 1993)

on retained earnings and less than 12 percent on remitted dividends.

The 1982 IRS study of transfer pricing adjustments involving section 482 found that P.R. adjustments totaled $508 million, or 11 percent of total adjustments for all countries. Of the P.R. audits, pricing adjustments were 83 percent of the total, followed by expense allocations (7.7 percent) and net income allocations (5 percent). By 1991, there were about $13 billion in tax-exempt investments under section 936, implying a potential tax loss to the U.S. Treasury of about $3 billion (Richardson 1992: 171-172).

The top 10 U.S. companies manufacturing in Puerto Rico under section 936 are listed in Table 2. Four of the 10 are pharmaceuticals. While pharmaceutical MNEs received more than half the tax credits, they provided only 18 percent of the jobs created under section 936.

A 1992 General Accounting Office (GAO) report concluded that, in 1987, drug companies with manufacturing operations in Puerto Rico received an average tax benefit worth $70,788 for each job paying $26,471 (see 6 *Tax Notes Int'l* 519 (March 1, 1993)). Thus, each dollar in wages paid to P.R. workers cost the U.S. Treasury $2.67 in forgone tax revenue.

For a handful of the pharmaceutical firms, the section 936 credit stood not just as a break, but as a bonanza. The GAO study found that Pfizer Inc.'s tax savings amounted to about $156,400 per worker, or six times the average compensation at its P.R. operations. Merck and Co.'s tax savings amounted to $110,493 per employee, or more than four times the average compensation (Wartzman and Calmes 1993: A1).

The 1992-93 Attack on Section 936

Congress, in the summer of 1992, discussed cutting the tax credit for new investments in Puerto Rico to 85 percent, but there was strong opposition from MNEs already located there and from local government officials. During House Ways and Means Committee hearings on the proposed reduction in the section 936 credits, opinions differed. Rep. Phillip Crane (R-Ill.) protested the cuts, commenting that the credit "is critical to the viability of the Puerto Rican economy and has helped to create more than 150,000 jobs on the U.S. mainland" (Richardson 1992: 171). Despite the credit's impact on the Puerto Rican economy, other members justified trimming section 936 benefits. Rep. Donald Pease (D-Ohio) claimed that section 936 had been abused by pharmaceutical companies, which received 56 percent of all benefits. Others, including Reps. Fortney (Pete) Stark (D-Calif.) and Tim Roemer (D-Ind.), argued that the perks lured companies to move off the mainland, thereby exporting jobs and creating problems for other areas of the country (*see* 5 *Tax Notes Int'l* 171 (July 27, 1992)).

Early in his presidency, Bill Clinton singled out the pharmaceutical multinationals, promising to "break the stranglehold . . . the lobbyists have on our government" (Wartzman and Calmes 1993: A1). In November 1992, he promised: "to protect American consumers and bring down prescription drug prices, I will eliminate tax breaks for drug companies that raise their prices faster than Americans' incomes rise" (quoted in Turro 1993b: 1418).

Clinton's economic advisers called for a radical revision of the P.R. tax break. The administration devised a plan that it argued would encourage job creation in Puerto Rico while eliminating the large windfall to drug companies. The tax break "ought to be based on the wages that companies actually pay" (Wartzman and Calmes 1993: A1). The president sought to reduce the value of the tax credit by half ($7 billion) over five years and to replace it with a tax credit related to wages.

The Possessions Wage Credit Act of 1993, S. 362, was introduced by Sen. David Pryor (D-Ark.) on February 16, 1993. Pryor characterized section 936 as a "gigantic tax windfall for the pharmaceutical industry" (quoted in 6 *Tax Notes Int'l* 518 (March 1, 1993)). The bill called for phasing out section 936 over five years, and simultaneously phasing in a wage-based credit, effective January 1, 1993. The end result would be, by 1998, a 40-percent nonrefundable tax credit for the first $20,000 of qualified possessions wages, the same incentive available to enterprise zones in the United States. During the phase-in period, the bill would permit section 936 companies the lesser of 100 percent of the section 936 credit or 100 percent of qualified wages in 1993 and 1994, dropping in increments so that by 1998, section 936 companies would be entitled to only the 40-percent wage credit.

The Puerto Rican government was very concerned with the possible loss of section 936. With 11 percent of the economy's labor force employed by about 400 U.S. possessions corporations, $14 billion held by these firms in P.R. bank deposits, and a $34 billion economy at stake, the fears were real. Manufacturing accounted for 40 percent of the island's GDP; when taken together with the banking and finance industry servicing the section 936 possessions corporations, the dependence of Puerto Rico on section 936 was evident (*Business Week*, p. 52, 54 (June 14,1994)).

P.R. Governor Pedro Rosselló entered the debate with his own proposal. He argued that the proposed changes to section 936 would wreak havoc on the island's economy. Moreover, the governor argued, the North American Free Trade Agreement (NAFTA) would make Puerto Rico more dependent than ever on section 936 since "the advantage that Puerto Rico enjoys as a territory of the United States is no longer an exclusive advantage" (quoted in Rohter 1993: A1). Phasing out section 936 while phasing in NAFTA would have a "double whammy" effect on the island's economy.

Governor Rosselló proposed two alternatives to the administration's plan, either of which would have raised significantly less revenue for the U.S. government: a total compensation-based cap on the section 936 credit or a revised income-based incentive.[9] Roselló told the committee that, while the Clinton administration's proposal would bring in an estimated $7.2 billion over the 1994-98 period, his plan would raise about $2.8 billion in revenue.

> The section 482 temporary regulations now will force P.R. firms to make cost sharing payments commensurate with the income they earn using these intangibles.

The administration's proposals, somewhat diluted, passed the House in April 1993. However, continued lobbying by the P.R. community and the U.S. drug MNEs led to the proposals being further watered-down. Drug multinationals like Pfizer Inc. and Merck & Co. did not want a wage-based credit since their possessions corporations were capital intensive; labor-intensive MNEs such as Westinghouse Electric Corp. and General Electric Co. were prepared to settle for the wage credit (Wartzman and Calmes 1993: A4).

An additional concern, voiced by Sen. Patrick Moynihan (D-N.Y.), Chair of the Senate Finance Committee, was the upcoming nonbinding plebiscite on whether Puerto Rico should remain a U.S. possession, become a U.S. state, or go it alone. The fear was that dropping section 936 could push the islanders into demanding statehood, a status that would have generated substantial additional costs for the U.S. government (Krauss 1993).[10]

The Outcome: Take Your Pick

President Clinton eventually committed himself to a compromise backed by Moynihan and Sen. Bill Bradley of New Jersey (where many of the drug MNEs are located) that would restore more than $2.6 billion in tax breaks. The final tax bill, the Omnibus Budget Reconciliation Act (OBRA), was passed on August 6, 1993, with a much-watered-down version of the initial administration proposal. The reduction in the possessions tax credit is now expected to raise $3.8 billion over the 1994-98 period.

Under the final bill, taxpayers must make a choice between two types of limitations on the section 936 credit. The first option is an *income tax credit*, which amounts to a percentage limitation of the old 936(h) credit. Under this method, the current 100-percent income tax credit falls to 60 percent in 1994 and an additional 5 percent each year to 40 percent in 1998. Taxpayers may deduct a portion of the possessions taxes paid.

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[9]Under the first option, a section 936 company would receive a tax credit equal to the sum of: (1) the total compensation paid to its employees; (2) the total of the company's Puerto Rico income and withholding taxes paid on dividends, up to a 9-percent effective rate; (3) federal income taxes attributable to the company's QPSII; and (4) 10 percent of new capital investment in machinery, equipment, and plant. The second option would give an income-based credit to section 936 corporations to be phased-down to 90 percent of existing credit in 1994 and to 80 percent in subsequent years. The corporation would be entitled to the full section 936 credit for QPSII, subject to the current limitation at the time (Turro 1993c: 1079).

[10]In the referendum, Puerto Ricans voted to keep the status quo.

Box 3
The 1993 Revisions to the Section 936 Possessions Tax Credit

1993 Section 936(h) Option 1: Income Tax Credit

U.S. credit drops to 60 percent of the section 936 credit in 1994, falling to 40 percent in 1998.

Election 1: Cost Sharing Method

If USCORP has elected cost sharing, the tax credit in 1998 is 40% of (PRCORP's markup – PRCORP's share of USCORP's R&D costs) = 40% x (15 – 5) = 4. Assuming PRCORP's share is the same as in 1982 (i.e. pre-TRA '86), the effective tax break is 4/15 = 27%. USCORP must include in its income 60% of PRCORP's markup – PRCORP's share of R&D costs = 60% x 10 = 6.

USCORP's tax is 46% (5 + 6) = 5.06. This tax, as a percent of the Dole rule tax, is 5.06/9.20 = 55%.

Election 2: Profit Split Method

If USCORP has elected the profit split, the tax credit for PRCORP is 40% x (PRCORP markup – 50% (USCORP markup + PRCORP markup)) = 40% x (15 – 50% (5 + 15)) = 40% x 5 = 2. The effective tax break is 2/15 = 13%.

In this case, USCORP's tax is 46% x (50% x (5 + 15) + 60% x 5) = 46% x 13 = 5.98. This tax, as a percent of the Dole rule tax, is 5.98/9.20 = 65%.

1993 Section 936(h) Option 2: Activity-Based Credit

Under this method, all of PRCORP's profit would be added to USCORP's income, but a nonrefundable tax credit equal to 60% of the wage bill plus certain percent of depreciation deductions plus a percent of the P.R. tax would be given. Puerto Rican taxes would be creditable under the cost sharing method, deductible under the profit split method.

USCORP would pay 46% (USCORP markup + PRCORP markup) – the tax credit = 46% x (5 + 15) – 60% x 5 = 9.20 – 3 = 6.20. This tax, as a percent of the Dole rule tax, is 6.20/9.20 = 67%.

The second option is a *nonrefundable activity-based credit* (Krauss 1993: 28; Turro 1993a: 435-436). The credit is the sum of 60 percent of qualified labor compensation plus a certain percentage (varying between 15 and 65 percent) of depreciation deductions for qualified tangible property plus a percentage of possession income taxes (if the profit split method is not used). If the profit split method is used, taxpayers may deduct a portion of the possessions taxes paid.

Box 3 provides a numerical example of the 1993 tax changes to section 936. Both the income tax credit and the activity-based credit raise more U.S. tax revenues than was generated under section 936(h); neither is as punitive as the Dole Rule. In this example, where labor costs are a small percent of PRCORP's manufacturing costs, the activity-based credit is less generous than the income tax credit. Based on this example, it looks likely that most multinationals, and certainly all the capital-intensive firms such as pharmaceuticals, will opt for the income tax credit.

Section 482 Provides an Additional Backstop

The opportunities for tax avoidance through possessions corporations were reduced as a result of the section 482 temporary regulations, which went into effect in April 1993. These regulations provide new methods for valuing intrafirm transfers of intangibles, in accordance with the commensurate-with-income principle adopted by the U.S. Congress in 1986.[11] One subsection of the new regulations deals with U.S. possessions corporations.[12] If a possessions corporation has made a cost sharing election under section 936, the regulations require that the payment be at least that computed for transfers of intangibles under section 482. Since the new regulations are designed to ensure that royalty payments are made for intangible transfers, and that such payments are commensurate with the income earned by the intangible, possessions corporations now must make annual payments to their U.S. parents commensurate with the income earned by the P.R. affiliates from the use of the intangible. Section 936(h) thus has been made subordinate to section 482.

Conclusions

Two issues have dominated Treasury concerns with possessions corporations: the separation of income and expenses, and the appropriate valuation of intangibles. As we have outlined in this paper, each of these concerns has been addressed in various ways since 1976.

The generous P.R. tax holidays and U.S. tax treatment are now a thing of the past. Since 1982, possessions corporations have had to pay either full tax (the Dole Rule) or adopt one of two safe harbors, meaning that somewhat less than half of annual profits of P.R. affiliates, on average, have been taxed in the United States. The 1993 budget debate again reduced this tax break. And lastly, the section

[11]The income received by the developer of an intangible must be commensurate with the income earned by the user of the intangible.

[12]Temp. Reg. section 1.482-1T(f)(3), "Special rules. Coordination with section 936" (482T93: 92).

482 temporary regulations now will force P.R. firms to make cost sharing payments commensurate with the income they earn using these intangibles.

Still, in 1993, U.S. MNEs with possessions corporations managed to escape with more of their tax breaks than one might have expected. OBRA 1993 is likely to raise less than half the revenue of President Clinton's first proposal. Moreover, the MNEs managed to preserve, at least in part, the very form of credit that Clinton's advisors had insisted was indefensible: a credit that rewards U.S. companies in Puerto Rico for the profits they earn rather than for the jobs they create. Clearly, one important factor was political: U.S. uncertainty over the P.R. referendum on its political status.

This is probably not the end of the assault on the possessions tax credit nor on the pharmaceutical multinationals. Senator Pryor, who introduced the bill to repeal section 936, has vowed to take the drug MNEs on again in 1994, saying: "The drug companies still have an extremely lucrative benefit not enjoyed by companies elsewhere" (quoted in Wartzman and Clames 1993: A4). ✦

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