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Puerto Rico and Section 936: A Costly Dependence

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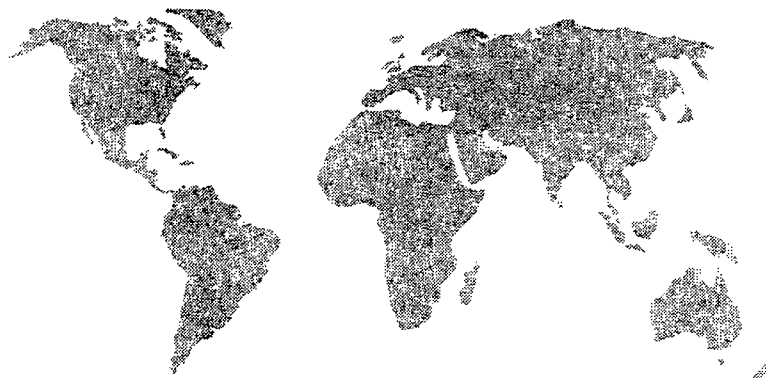
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Tax Policy Forum



Puerto Rico and Section 936: A Costly Dependence

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I. Introduction

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

At the outset, this approach—as expressed first in section 262 of the Revenue Act of 1921, and ultimately in section 936 of the Internal Revenue Code—was successful. In Puerto Rico during the 1950s and 1960s, it spurred the island's industrialization, infrastructure development, and

the attendant growth in employment and gross national product (GNP). By the mid-1970s, however, the job-creation benefits of section 936 took a backseat to the tax planning that brought great financial gain to only a few U.S. companies, substantial cost to the U.S. Treasury, and a competitive disadvantage to "native" Puerto Rican enterprises.

This problem persists in large part because section 936 can have an immense impact on after-tax U.S. profits: possessions corporations receive full credit against U.S. taxes owed on the net income earned in a possession, regardless of whether that income is generated by the use of tangible property and labor within the pos-

session or is attributable to the use of intangible property transferred to the possession corporation. Companies have been quick to see the benefit in transferring intangible assets and their related income streams to their possessions-based operations. Therefore, to the extent that corporations are able to claim tax credits for income sourced in the possessions that has been generated by properties temporarily located there but for which no real investments have been made, the cost of section 936 to the U.S. Treasury has been wholly unrelated to the intended development benefits that underlay adoption of section 936 in the first instance.

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

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

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

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

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

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

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

maceuticals received \$2.17 in tax benefits from the U.S. Treasury.³

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

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calculated that the incentive scheme would bring losses of \$15 billion in potential tax revenues during 1993-97.⁷

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

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

- essentially operated as a costly tax benefit to a few corporations;

- resulted, through links with the Caribbean Basin Initiative, in substantial gains for possessions corporations with little corresponding boost in regional exports;
- created a tax-subsidy-oriented development strategy, which for the past 20 years has been a principal cause of stagnation in the Puerto Rican economy; and
- has generated, understandably, a powerful lobbying effort to perpetuate the 936 corporate financial benefits by delivering the message that the Puerto Rican economy would falter without the investment stimulus of 936.⁸

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

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

⁴*Id.*

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

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

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

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

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

II. The Legislative History of Section 936

A. Background

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

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

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

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

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

“Operation Bootstrap,”¹³ attracted a surge of U.S. corporations, particularly in labor-intensive industries. From 1948 to 1972, Puerto Rico’s real GNP grew at an average annual rate of 6 percent (compared to a rate of 3.7 percent for the United States).¹⁴ At the same time, the island’s economy shifted from its traditional agricultural base to manufacturing, where employment increased from 55,000 in 1950 to 142,000 in 1972.¹⁵ Indeed, the program was so successful that during the 1950s and 1960s, Puerto Rico was dubbed the “economic miracle” of the Caribbean.¹⁶

After this boom, however, the Puerto Rican economy stagnated. And while the section 936 lobby has attempted to maintain and disseminate the historical boom illusion, the annual rate of physical investment declined by nearly 30 percent between 1973 and 1978, from \$1.5 billion to \$1.1 billion.¹⁷ In the next five years, from 1978

to 1983, new physical investment fell another 35 percent, from \$1.1 billion to \$0.7 billion.¹⁸ Private investment in plant and equipment also fell steadily from 10.3 percent of GNP in 1973 to 4.6 percent in 1983.¹⁹

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

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

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

¹¹U.S. Department of the Treasury, “Sixth Report,” p. 5.

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

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

¹⁴U.S. Department of the Treasury, “Sixth Report,” pp. 17, 19.

¹⁵*Id.*, p. 17.

¹⁶*Id.*

¹⁷*Id.*, p. 24.

¹⁸*Id.*

¹⁹*Id.* p. 17.

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

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

Congress responded to the early criticisms by creating a new section 936 of the Internal Revenue Code in the Tax Reform Act of 1976.²³ Congress stated that it sought to

... assist the U.S. possessions in obtaining employment-producing investments by U.S. corporations, while at the same time encouraging those corporations to bring back to the United States the earnings from these investments to the extent they cannot be reinvested productively in the possession.²⁴

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

B. Combating Transfer Pricing Abuses

Before 1982, there were no explicit statutory guidelines on transfer pricing.²⁵ This statutory silence provided possessions corporations with tacit permission to minimize their tax liability by shifting the taxable income attributable to property transferred from U.S. affiliates. A U.S. pharmaceutical company, for example, might develop a patentable drug

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

in its U.S. laboratory and receive deductions on its U.S. federal income tax obligations for the research and development costs it incurred. The company would then transfer the patent to its wholly owned possessions corporation, which would produce the patented drug and would claim the resulting income as possession-source income. As a result, the corporate group would owe little or no income tax, either in the United States or in Puerto Rico, for producing this drug.²⁶

Congress and the Treasury have repeatedly reacted to this problem but have met with limited success. Congress enacted the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), which added a new section 936(h) to the Internal Revenue Code to ensure that a sufficient percentage of income generated by such

transferred intangibles would be allocated to the U.S. parent.²⁷ Section 936(h) was revised again in 1986 to coordinate with section 482 provisions, which address transfer pricing in general. And, as recently as January 1993, Congress once again revised the regulations when it issued new temporary section 482 regulations, which refer to section 936(h).

²⁰*Id.*, p. 7.

²¹*Id.*, p. 6.

²²*Id.*

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

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

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

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

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

C. Section 936 Eligibility and Links to Investment and Employment

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

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

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

III. The Mechanics of Section 936 and Related Legislation

A. The Section 936 Tax Credit

Section 936 grants to subsidiaries of U.S. corporations operating in the possessions a tax credit²⁹ equal to the U.S. federal income tax liability from such operations.³⁰ This credit is based on the taxable income derived from: (1) trade or business within the possession,³¹ (2) the sale or exchange of substantially all of the assets used by the subsidiary in this trade or business,³² and (3) "qualified possession source investment income, (QPSII)" (i.e., passive income resulting from in-

vestment in the possessions of the exempted profits).³³

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

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

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

Gross income received on the mainland by a possessions corporation is only considered possession-source income if it is derived from trade or business with unaffiliated parties.³⁹ If a U.S. corporation deposits payments into a

bank account on the mainland of a possessions corporation subsidiary as payment for goods manufactured by that subsidiary in Puerto Rico, the payment will not be considered possession-source income of the subsidiary.⁴⁰ The subsidiary must receive payment in Puerto Rico for goods and services in order for the payment to be considered possession-source income that qualifies for the section 936 tax credit.⁴¹

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

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

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

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

³⁰IRC section 936(a)(1) (1989).

³¹IRC section 936(a)(1)(A)(i).

³²IRC section 936(a)(1)(A)(ii).

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

³⁴IRC section 936(a)(2)(A).

³⁵IRC section 936(a)(2)(B).

³⁶IRC section 243(b)(1)(C).

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

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

³⁹IRC section 936(b).

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

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

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

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

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

B. Complementary Puerto Rican Tax Incentives

In addition to the tax credit provided under section 936, the Puerto Rican government has, since 1948, provided its own complementary tax incentives for

manufacturing and other specified business activities. Puerto Rico currently grants partial exemptions (of 90 percent) from income tax and other taxes to approved businesses for specified periods of time, usually from 10 to 25 years.⁵⁴ A business is generally eligible for an exemption if it is producing on a commercial scale in Puerto Rico a "designated service unit"⁵⁵ or a manufactured product not produced in Puerto Rico before January 1, 1947.⁵⁶

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

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

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

A tollgate tax of up to 10 percent may be imposed on earnings repatriated to the United States

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

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

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

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

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

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

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

⁴⁸IRC section 936(g).

⁴⁹IRC section 936(f)(1).

⁵⁰IRC section 936(f)(2)(A).

⁵¹IRC section 936(f)(2)(B).

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

⁵³IRC section 936(e)(2).

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

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

⁵⁶13 L.P.R.A. section 256a(d)(1).

⁵⁷13 L.P.R.A. section 256(b)(d).

⁵⁸13 L.P.R.A. section 256b(a).

Example No. 1

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

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

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

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

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

Example No. 1 illustrates how these rules operate.⁶⁰ It shows that if located in Puerto Rico, 90 percent of the income of the subsidiary of XYZ company would be exempt from local income taxes. The remaining 10 percent would be taxed at a rate of 45 percent. Also, the 0.075-percent surtax on sales and the tollgate tax on repatriated earnings would apply. Consequently, the tax would be \$2,250,000 (10 percent of the \$50,000,000 in income taxed at a rate of 45 percent) less \$21,250.⁶¹

This amounts to a total of \$7.11 million owed to the government of Puerto Rico on income of \$50 million, compared to an estimated

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

C. The TEFRA Amendments to Section 936

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

gress to stem transfer pricing abuse.

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

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

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

⁵⁹ 13 L.P.R.A. section 256c(b).

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

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

⁶² IRC section 936(h)(5).

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

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

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

25-Percent Value Added

Test: The possessions corporation must show that it incurred production costs⁶⁷ with respect to the product that are not less than 25 percent of the difference of (1) gross receipts from sales or other disposition of the product to unrelated parties by the possessions corporation or its affiliates less (2) direct costs of materials purchased by the possessions corporation or its affiliates from unrelated parties in connection with the manufacture of that product.⁶⁸

65-Percent Labor Test: Alternatively, the possessions corporation must show that it incurred at least 65 percent of the total direct labor costs⁶⁹ of the possessions corporation and its affiliates in producing the product or service during the tax year. The 65 percent refers to compensation for labor services performed in the possession.⁷⁰

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

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

1. The Cost-Sharing Option

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

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

Sales to Unrelated Persons
of Possession Product

Total Sales of Products
in 3-digit SIC Code
 $\times$

110% of Worldwide Product-
Area Research

=

Cost-Sharing Payment

A possessions corporation may credit its payments under cost-sharing arrangements with unrelated persons against its share of the cost of product area research paid or accrued by the affiliated

group. On the other hand, amounts paid to, or on behalf of, related persons and amounts paid under any sharing agreements with related persons may not be credited against the possessions corporation's cost-sharing payment for the tax year.⁷⁵

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

⁶⁵IRC section 936(h)(5)(C).

⁶⁶IRC section 936(h)(5).

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

⁶⁸IRC section 936(h)(5)(B).

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

⁷⁰IRC section 936(h)(5)(B).

⁷¹IRC section 936(h)(5)(C)(i)(I).

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

⁷³IRC section 936(h)(5)(C).

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

⁷⁵Treas. reg. section 1.936-6.

Example No. 2

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

Sales to Unrelated Persons of Possession Product	x	110% of Worldwide	=	Cost-Sharing
Total Sales of Products in 3-digit SIC Code		Product Area Research		Payment
\$2,000,000	x	\$550,000	=	\$68,750
\$16,000,000				

gibles) associated with the possession product.⁷⁶

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

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

Example No. 3

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

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

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

2. The 50/50 Profit-Split Method

If, for any product, the possessions corporation elects the profit-split method, it must also have manufactured that product in the possessions. In the case of Puerto Rico, this requirement is met if: (1) the product has been substan-

tially transformed by the possessions corporation in Puerto Rico; (2) the operations conducted by the possessions corporation in connection with the product are substantial in nature and generally are considered to constitute manufacture or production; or (3) the conversion costs incurred by the possessions corporation in Puerto Rico (including direct labor, factory burden, and testing of components) account for 20 percent or more of the total cost of goods sold by the possessions corporation. In this context, packaging, labeling, and minor assembly operations are not deemed to constitute the manufacture or production of product.⁸⁰

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

⁷⁶IRC section 936(h) distinguishes between these forms of intangible property. "Manufacturing intangibles" refers to any patent, invention, formula, process, design, or know-how. "Marketing intangibles" includes any intangible property defined in IRC section 936(h)(3)(B), if it is used in marketing a product. Therefore, a determination must be made under the cost-sharing option as to what portion of the final sales price of the possession product constitutes a return to manufacturing intangibles (and is therefore tax-exempt income to the possessions corporation) and what portion is a return to marketing intangibles (and is therefore taxable income to the affiliates that perform the marketing). Regulations under IRC section 482 are applied to make this determination.

⁷⁷IRC section 936(h)(5)(c)(i)(I).

⁷⁸Treas. reg. section 1.936-6.

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

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

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

Example No. 4

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

Sales

1. Total sales by XYZ to unrelated persons (100 x \$10)	\$1,000
2. Total deemed sales by A to unrelated persons (100 x \$10)	<u>1,000</u>
3. Total gross receipts	\$2,000

Total Costs

4. Total expenses ¹	\$1,200
--------------------------------	---------

Combined Taxable Income and Allocation of Income Attributable to the 200 Units of S

5. Combined taxable income (line 3 minus line 4)	\$ 800
6. Share of combined taxable income apportioned to XYZ (50% of line 5)	400
7. Share of combined taxable income apportioned to A (line 5 minus line 6)	400

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

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

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

IV. The Economic Impact of Section 936 on Puerto Rico

A. The Broad Economic Trends

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

Since the mid-1970s, however, the section 936 tax incentives have proved to be both ineffective and inefficient as a vehicle for sustained economic growth. Consistent with this conclusion are three telling concerns. First, both em-

ployment and new physical investment in Puerto Rico have stagnated. Second, the composition of section 936 production has declined in labor intensity and has become increasingly capital-intensive. Third, the total cost of the tax credit to the U.S. Treasury has increased substantially. Collectively, these trends indicate that the limited benefit of the incentive to the Puerto Rican employee is increasingly unjustifiable in relation to the tax revenues foregone by the deficit-plagued U.S. Treasury.

Manufacturing employment in Puerto Rico virtually stagnated during 1970-86, and total non-government employment remained steady or declined throughout 1974-83.⁸⁴ The island is currently experiencing very high unemployment (18.1 percent), low labor-force participation (45.7 percent), and a high rate of migration to the mainland in search of jobs.⁸⁵ Similarly, during the past two decades, aggregate physical investment in Puerto Rico has remained stagnant. The annual rate of investment declined sharply during the 1970s and early 1980s, and total fixed annual investment is only

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

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

⁸⁴*Id.*

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

now approaching the levels of the early 1970s.⁸⁶

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

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

In light of stagnant employment and investment on the island and the declining labor intensity of section 936 industries, the concern, therefore, is the increasing cost-ineffectiveness of section 936. In 1989, the average revenue

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

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

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

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

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

⁸⁶*Id.*, pp. 25-26.

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

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

⁸⁹*Id.*

⁹⁰*Id.*, p. 6.

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

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

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

V. Section 936 and the Caribbean Basin Initiative

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

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

The 1986 act imposes a number of requirements regarding when earnings of section 936 firms will qualify for investment in a CBI country or possession. The first requirement is that investments can only be made in qualified Caribbean Basin countries as designated under the Caribbean Economic Recovery Act of 1983.⁹⁸ Twenty-three countries have thus far qualified and are so designated.⁹⁹ To be eligible for these tax-exempt investments, CBI-qualified countries are required to enter into a Tax Information Exchange Agreement (TIEA) with the United States.¹⁰⁰ The purpose of the TIEA is to allow the United States and CBI governments to share tax and other information that could lead to the arrest of drug traffickers, tax evaders, and other criminals.¹⁰¹

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

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

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

A section 936 company cannot receive a tax exemption if it invests funds directly in an otherwise-qualified CBI project. Instead, the section 936 company must invest through a "qualified financial institution."¹⁰⁵ The Government Development Bank for

Puerto Rico and the Puerto Rico Economic Development Bank are both defined as qualified financial institutions. Other than those two, a financial institution in Puerto Rico may qualify if it is: (1) a "banking, financing, or similar business" that is "organized under the laws of the Commonwealth of Puerto Rico or is the Puerto Rican branch" of such a business and is an eligible depository institution for investments from section 936

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

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

⁹⁵IRC section 936(d)(2).

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

⁹⁷13 L.P.R.A. section 256a(2)(j)(A).

⁹⁸IRC section 936(d)(4).

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

¹⁰⁰IRC section 936(d)(4)(B).

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

¹⁰²IRC section 936(d)(4)(A)(i).

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

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

¹⁰⁵IRC section 936(d)(4)(A).

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

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

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

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

Other evidence, however, suggests that the CBI program has been unsuccessful. The Latin American and Caribbean Economic Commission reported an

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

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

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

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

Recent data suggest a continuation of these trends. In 1990, U.S. imports from CBI countries were approximately \$1.4 billion less than in 1983.¹¹⁹ This constitutes a 2.1-percent annual rate of reduction in the amount of imports and a 16-percent gross decline.¹²⁰

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

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

¹⁰⁷IRC section 936(d)(4)(A)(ii).

¹⁰⁸IRC section 936(d)(4)(C)(iii).

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

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

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

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

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

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

¹¹⁵*Id.*, p. 8.

¹¹⁶*Id.*, p. 1.

¹¹⁷*Id.*

¹¹⁸*Id.*

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

¹²⁰*Id.*

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

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

VI. Further Reforms Affecting Section 936

A. Effects of Section 482 Regulations on Section 936

Section 482 of the Treasury regulations provides most of the guidelines concerning the proper allocation of income in a transfer pricing transaction. On July 1, 1994, final regulations were issued under section 482 that contain provisions that alter the manner in which transfer prices for intangible property will be reviewed by the IRS and that specifically coordinate with the transfer pricing requirements of section 936. The final section 482 regulations provide for greater taxpayer flexibility, at the cost of more stringent documentation requirements.¹²³ The IRS an-

ticipates that this will diminish the number of disputes between the IRS and taxpayers. Some practitioners contend, however, that the policy, in its move toward greater flexibility, imposes an unmanageable administrative burden on the IRS.

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

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

provisions that treat the 936 corporation as the owner of this property.

One reviewer of the tax changes makes the following claim:

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

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

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

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

¹²²*Id.*

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

¹²⁴Reg. section 1.482-1(e)(2).

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

¹²⁶*Id.*

Example No. 5

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

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

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

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

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

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

B. Further Limitations on the Section 936 Tax Credit

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

Under the new legislation, the section 936 credit will be calcu-

lated in a manner consistent to that used prior to December 31, 1993.¹²⁸ However, the amount of the credit will then be limited in one of two ways,¹²⁹ with the choice of method left to the taxpayer. The first, the percentage limitation, limits the credit by a statutorily defined percentage (that decreases in future years) of the section 936 credit allowable under present law. The second alternative, the economic activity limitation, links the limitation on the credit to a composite of factors that serve as proxy for the firm's level of economic activity in the possessions. All affiliated¹³⁰ possessions corporations are required to choose the same credit-limitation alternative.¹³¹

1. The Percentage Limitation

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

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

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

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

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

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

¹³² IRC section 936(a)(4)(B)(ii).

Example No. 6

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

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

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

Qualified Compensation

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

Depreciation Deductions

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

Possession Income Taxes

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

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

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

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

Total Economic Activity Limitation

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

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

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

2. The Economic Activity Limitation

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

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

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

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

¹³³IRC section 936(a)(4)(A).

tax that, under general circumstances, would be owed.

a. Qualified Compensation

The first component of the economic activity limitation is 60 percent of qualified compensation. Qualified compensation is the sum of:¹³⁴ (1) the aggregate amount of the possessions corporation's qualified possessions wages for the tax year¹³⁵ and (2) allocable employee fringe benefit expenses for the tax year.¹³⁶ Qualified possessions wages are defined as wages paid or incurred by the possessions corporation during the tax year to any employee for services performed in a possession.¹³⁷ However, such services must be performed while the principal place of employment of the employee is within that possession.

b. Depreciation Deductions

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

- (1) 15 percent of the depreciation deductions allowable to short-life qualified tangible property;
- (2) 40 percent of the depreciation deductions allowable to medium-life qualified tangible property; and
- (3) 65 percent of the depreciation deductions allowable to long-life qualified tangible property.¹³⁹

c. Possession Income Taxes

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

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

d. Election To Treat Affiliated Corporations as One Corporation

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

e. Analysis of the Economic Activity Limitation

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

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

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

by the Treasury secretary. The bill does not include as qualified possession wages amounts paid to employees who are assigned by the employer to perform services for another person, unless the principal trade or business of the employer is to make employees available for temporary periods to other persons in exchange for compensation.

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

¹³⁷IRC section 936(i)(1)(A).

¹³⁸IRC section 936(a)(4)(A)(ii).

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

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

¹⁴¹IRC section 936(i)(3)(A)(ii).

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

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

¹³⁴IRC section 936(a)(4)(A)(i).

¹³⁵Wages for this purpose include those defined under the Federal Unemployment Tax Act (FUTA). In computing the credit limitation for a tax year, the cumulative amount of wages for each employee may not exceed 85 percent of the maximum earnings subject to tax under the Old Age Survivors and Disability Insurance (OASDI) portion of social security (currently \$57,600). Rules for making appropriate adjustments to this limit for part-time employees and employees whose principal place of employment is not within a possession for the entire tax year are to be made

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

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

VII. Conclusion

History should have taught us the following lessons:

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

Section 482 and the TEFRA Amendments. Both the TEFRA amendments and the IRS's track record in enforcing section 482 indicate that almost nothing can be done to stop intangible income

transfers in either a useful development time frame (482 cases take more than 10 years to resolve), or in any but the most egregious of violations.

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

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

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

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

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

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

(5) Development officials in the possessions should see ownership changes in the assets base in two steps. Initially, properties that

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

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

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

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

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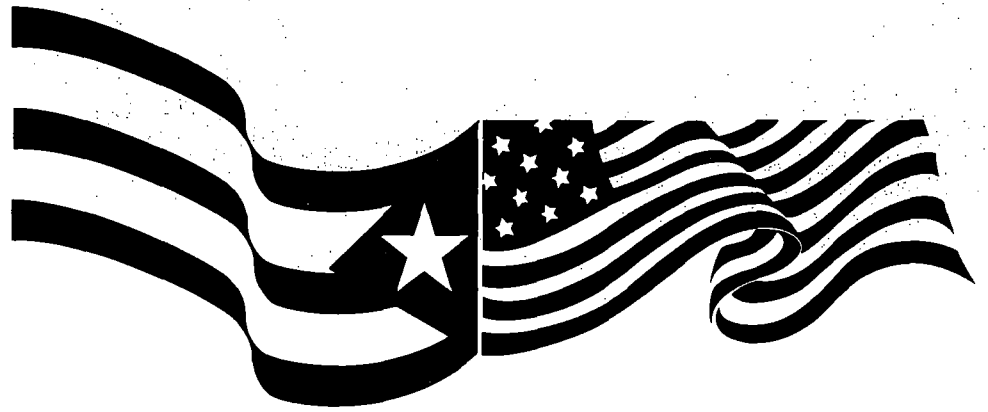
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Puerto Rican Statehood
[report]

70 PAGES



Puerto Rican Statehood

A Precondition to Sound Economic Growth

*J. Tomas Hexner
Glenn Jenkins
Helen F Ladd
K. Russell LaMotte*

Supplemental Sheet:

**Committee on Ways and Means
Subcommittee on Human Resources
Hearing on Welfare Reform
February 2, 1995**

**Witness: Miriam J. Ramirez de Ferrer MD
President, Puerto Ricans in Civic Action**

*P.O. Box 3225
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Summary of statement :

WE PROPOSE THAT CONGRESS:

1. Gradually extend the federal tax system to Puerto Rico over a 5 year period, while during the same time, phase in all federal programs, in order to shift some of the burden of operating our great Nation to the United States citizens in Puerto Rico.
2. Phase out the cover- overs of Federal custom duties, fees, and excise taxes and the Possessions Tax Credit over a five (5) year period.
3. Establish economic incentives such as President Reagan's Enterprise zones to help reduce unemployment in all affected areas. (Empowerment zones.)

President Reagan's state's rights conservative agenda got its start in a model block-grant program to Puerto Rico; let's complete the Reagan revolution with full application of the provisions of the Contract with America in Puerto Rico.

Stay During Feb 1-4 : Washington Hotel

Miriam J. Ramírez de Ferrer MD
President, Puerto Ricans in Civic Action



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Statement: Contract With America
Hearings on Welfare Reform
February 2, 1995

Mr. Chairman, Honorable members of this Committee, friends:

I want to thank you for giving me the opportunity to appear before you to express our views regarding the impact of the Contract with America on Puerto Rico.

As a physician, I have devoted my medical career to give medical services to the needy in Puerto Rico as an Ob-Gyn for the Health Department. The great majority of my patients are poor people, whose incomes fall below the poverty line, and whose means of support come from welfare programs. These 26 years have given me the opportunity to feel first hand the needs of the people who will be affected by the proposals in the Contract with America.

• **But, you are right ! The American Welfare system is broken.**

Puerto Rico endures the same sad story as every other state. It is sad that \$14.6 billion dollars in federal funding and tax credits have not markedly changed the quality of life for those it intended to.

Federal programs have created a welfare culture in major United States cities. These have held hostage generations of families in a web of overlapping federal handouts which promote dependency, illegitimacy, unemployment and anti-ethical values.

The hopes of many are with this new Congress. We encourage you to practice radical surgery to stop the billion dollar hemorrhage of federal funds throughout the Nation. State and territorial governments are hammered by the myriad of bureaucratic rules for over 300 federal assistance programs. What a waste ! It would be vastly more efficient to consolidate these into five or seven block-grants with clear guidelines.

Remember the conservative revolution of the Reagan years, with the President's "state's rights agenda" ? This Congress should learn from the block grant that replaced the Food Stamp Program. It was the outcome of the Reagan conservative agenda.

Miriam J. Ramirez de Ferrer MD
President, Puerto Ricans in Civic Action



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The block-grant did not work because it was the only assistance program. Partial welfare reform, without the extension of all other programs, failed to give Puerto Rico the edge to produce the shining results of President Reagan's vision of empowering local government. We endorse block grants, but with clear federal guidelines

In order to eradicate the conditions which trap welfare recipients in a state of cultural and economic poverty, we urge Congress to establish clear guidelines to expand the JOBS programs, and to limit cash benefits to a specific number of years. We support the creation of empowerment or enterprise zones to help our major cities generate more jobs.

We support a complete restructuring of the American Welfare system. Put in place a system that promotes work, education, self sufficiency and family values in all the Nation, including Puerto Rico. Include the 3.6 million United States citizens in Puerto Rico, because we suffer doubly under the ill-focused federal assistance programs that are underfinanced.

- **The Federal "Safety Net "for United States citizens in Puerto Rico is incomplete.**

Unequal federal funding limits the benefits of former President Reagan's "Safety Net" for United States citizens, as more than 200,000 senior Americans in Puerto Rico live in substandard conditions. Congress established the Supplemental Security Income program (SSI) in 1972 to guarantee a minimum level of income to needy aged, blind, and disabled persons, which should include all U.S. citizens, and exclude aliens without established legal residence.

However Congress did not expand SSI to Puerto Rico, since the program is funded from the general US Treasury Fund and we do not pay full Federal Taxes. In contrast, we qualify for all other Social Security entitlements, as we have been paying Social Security contributions.

We urge Congress to rectify this unequal treatment, and to finance the extension of the Supplemental Security Income by extending the Federal Income Tax to Puerto Rico, and phasing out the archaic practice of "cover overs" of Federal custom duties and excise taxes to the Puerto Rico Treasury.

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- **We are ready to assume equal responsibilities.**

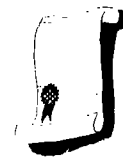
The United States citizens in Puerto Rico are ready to assume increased responsibilities. We already contribute **\$2.2 billion** in Social Security taxes. We should not be treated different than the residents in any other states. In addition to unequal treatment under the Supplemental Security Income, the United States citizens in Puerto Rico are treated unequally in the Medicaid, Medicare, Aid to Families with Dependent Children and Food Stamp programs.

We want equal treatment through the Contract Proposal Welfare Reform, re-focusing our goals on self - sufficiency, work fare and family values.

WE PROPOSE THAT CONGRESS:

1. Gradually extend the federal tax system to Puerto Rico over a 5 year period, while during the same time, phase in all federal programs, in order to shift some of the burden of operating our great Nation to the United States citizens in Puerto Rico.
2. Phase out the cover- overs of Federal custom duties, fees, and excise taxes and the Possessions Tax Credit over a five (5) year period.
3. Establish economic incentives such as President Reagan's Enterprise zones to help reduce unemployment in all affected areas. (Empowerment zones.)

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**THE UNITED STATES WILL BENEFIT FROM THE POSITIVE EFFECTS OF
EXTENDING THE FEDERAL INCOME TAX SYSTEM TO PUERTO RICO.**

1. It will help to balance the budget:

With the proposal for a Balanced Budget Amendment, the U.S. taxpayer will find some relief when we share the fiscal burdens through our contributions. As it stands presently, there is no relief in sight for the US taxpayer, but with the Contract with America, all U.S. citizens can help carry the load and realize the benefits of a sound fiscal future.

According to the Congressional Budget Office, extending the federal tax code to Puerto Rico would result in more than **\$2 billion** in annual federal revenues. Additionally, the complete phase out of Section 936 tax credit would produce an additional **\$2 billion**, according to the latest tax expenditure estimates of the Joint Committee on Taxation. This would result in a total of approximately **\$4 billion** annually.

The next table shows the amount of federal revenues that will be collected in Puerto Rico in the years 1999 and 2000, after the extension of the federal tax system:

	1999	2000
Total change in Federal revenues from Puerto Rico sources (millions)	\$2,251	\$2,244
New excise taxes	\$395	\$414
Custom duties	103	171
Rum excise tax	265	268
Individual income tax	809	846
Tax on Puerto Rico Corporations	519	545

(Source: Congressional Budget Office, April 1990)

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2. Working families in Puerto Rico, who earn mostly wages would pay lower federal income taxes than their current local tax burden.

The Puerto Rico taxpayer pays more state income tax than their fellow citizens in most of the other States of the Union. We are not equally treated in the U.S. Budget, so the government of Puerto Rico must levy high local income taxes in order to give services to the people.

Since federal income tax has not been extended to Puerto Rico, the middle class will not benefit from those changes to the tax return proposed by the Contract with America. The extension of the federal income tax system will allow our working families to enjoy the benefits of higher tax credits for children, personal exemptions, and lower tax rates. The Contract's capital gains tax cut would also help spur investments and the economy in the island.

It would also allow Congress to extend the Family Reinforcement Act provisions in the Contract with America to Puerto Rico.

3. Thousands of high income individuals who now escape taxes legally through tax loopholes in the local tax system would have to pay federal income taxes.

For example, interest on mortgage backed securities, known as Ginnie Maes, and interest on U.S. Treasury bonds are exempted from local income tax, but not federal income tax. Investors in Puerto Rico earned about \$100 million in interest income on these instruments, and nearly \$1 billion in manufacturing and tourist enterprises which receive partial tax exemption under local income tax laws.

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4. United States taxpayers will be pleased to know that all who benefit from the United States budget, will have to pay their share. "If you play, you pay."

5. Puerto Rico's "burden sharing" will restore the dignity of the United States citizens in Puerto Rico.

6. It would bring justice to the hard working families who live on wages which are subject to withholding source and who carry the burden of paying for the Puerto Rico budget.

The burden will be shared by all, as the Internal Revenue Service extends its enforcement power and uncovers the extensive underground economy in Puerto Rico. As loyal American citizens, people will recognize the importance of filing returns. (Read: Federal liability)

7. Both the Governor of Puerto Rico, Dr. Pedro Rossello and the Resident Commissioner, Carlos Romero Barcelo Esq., have publicly endorsed this concept. (See newspaper clipping)

President Reagan's state's rights conservative agenda got its start in a model block-grant program to Puerto Rico; let's complete the Reagan revolution with full application of the provisions of the Contract with America in Puerto Rico.

NATION & WORLD

Rosselló: 936 isn't a sacred concept

Governor backs 2-year term for island's delegate

By **ROBERT FRIEDMAN**
STAR Washington Bureau

WASHINGTON — Gov. Rosselló said Saturday he would not oppose the elimination of Section 936 if the federal gov-

ernment comes up with another program "to provide economic and social justice" for the island.

"If it is demonstrated that another mechanism could improve life for the people, then I would be totally in favor of it," the governor said.

He said that his past support of the island's tax-sparing program was never based on the well-being of the 936 corporations, but on the economic and social benefits that island residents derived from it.

"I'm not defending 936, but the people. Section 936 is not a sacred concept," Rosselló said.

The governor made his remarks during a news conference at a hotel here on the opening day of the four-day National Governors Association meeting.

He said extending empowerment zones to Puerto Rico could be one way to replace Section 936. Under that concept, special tax breaks are given to businesses operating in targeted areas. However,

only states are currently eligible for that program.

"The main thing is that the incentives be there to improve the lot of the people," said the governor.

Those incentives, he said, should not be based on whether Puerto Rico is a state or a territory, but on "economic and social needs."

The governor also said he backed a proposal to change the term of the is-

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LOCAL NEWS

From Page 12

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land's resident commissioner from four years to two.

He said the proposal, made in a bill filed by Rep. Elton Gallegly, R-Calif., was "consistent with our position that as American citizens we be treated equally."

It is "reasonable," he said, for Puerto Rico's representative in Congress to serve just two years, "as any other representative."

Rosselló said he also supported changing the resident commissioner title to delegate.

He agreed that a two-year term could open the possibility of voters electing a resident commissioner of a

different party than the sitting governor.

"So what?" he said. "That's what happened nationally. That's democracy."

Rosselló said he would not testify Tuesday at a House hearing on the proposal, but would submit his position in writing.

Although he has been listed as a witness, he insisted he was not officially invited to testify before the Native American and Insular Affairs Subcommittee chaired by Gallegly.

The hearing is supposed to take up Gallegly's Omnibus Territorial Act, which contains the resident commissioner changes, and the effects of the Republican party's Contract With America on the territories.

Rosselló said he had "no problem" with the concept of a balanced

budget, a principle part of the contract. But the governor raised concerns that the budget would be balanced mostly by cutting programs "that will affect the well-being of people."

The House already has passed a bill calling for a balanced budget amendment and the Senate is expected to act on it soon.

Three-quarters of the states would have to approve the amendment before it becomes part of the Constitution.

In a recent study, the U.S. Treasury Department estimated that a balanced budget amendment would mean Puerto Rico would lose more than \$4 billion annually in federal funds, starting in the year 2002, when the amendment would go into effect.

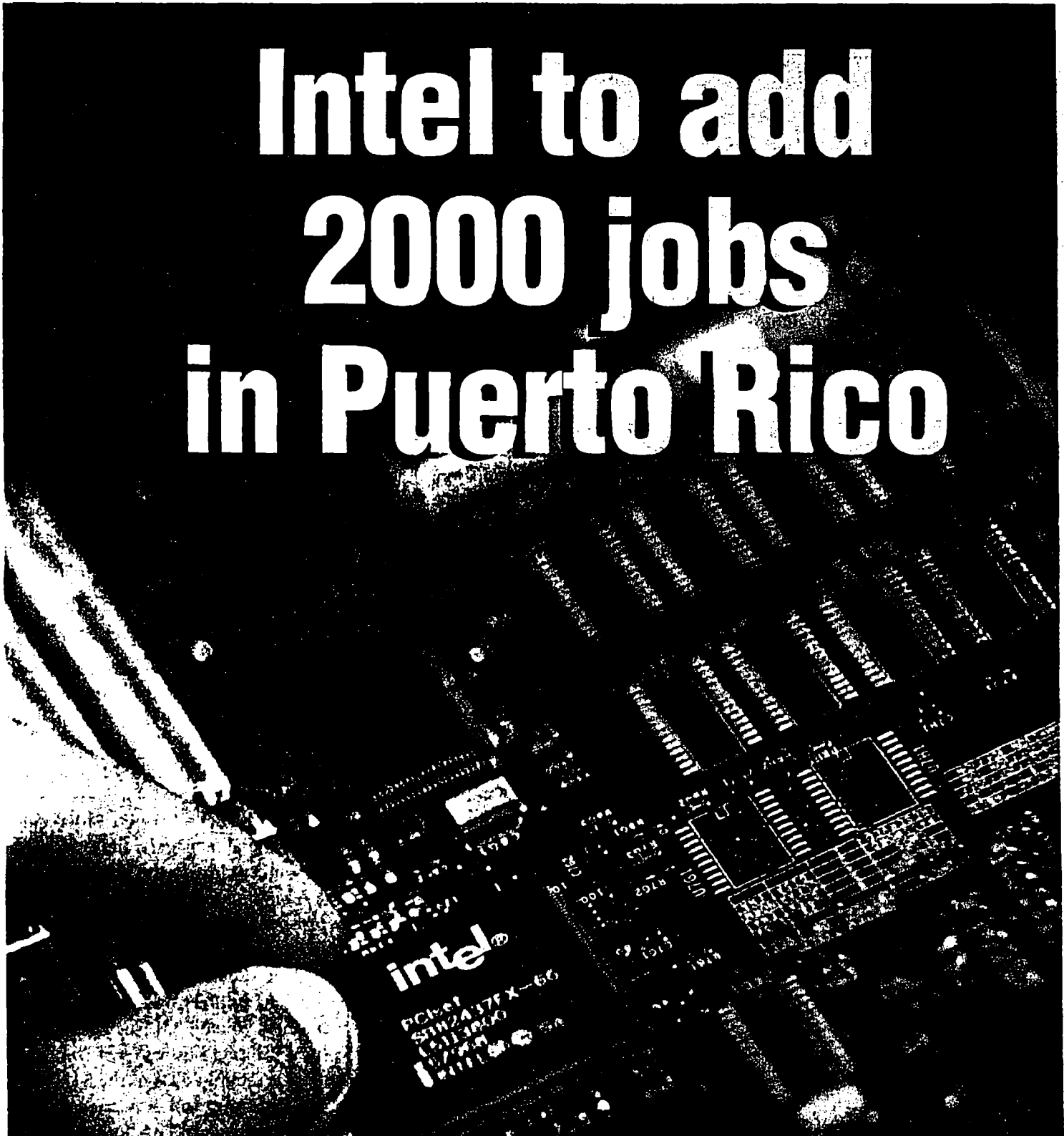
BEAN BUSINESS

NS INC.

THURSDAY, MAY 18, 1995

WEEKLY \$2.00

Intel to add 2000 jobs in Puerto Rico



Expansion makes local unit the
c m, any's single biggest in the
world and fourth-largest

Mitchell International expands in P.R.

Automotive-oriented software to standardize repair claims for motor-vehicle crash clients, body shops and insurers

BY FRANCES RYAN

California-based Mitchell International (MI), a leading provider of automotive-oriented computer technology and software products for the collision repair and property insurance industries, is ready to establish a permanent presence in Puerto Rico, CARIBBEAN BUSINESS learned.

A broad look at the system presages more accurate repair claims, probable reduction in fraud and kited repair costs against both insurers and car owners.

MI's potential market in Puerto Rico is estimated at \$298 million gross revenues annually. The island has approximately 2,000 auto-body repair shops, 27 insurance companies, and satellite businesses that work directly with the industry.

CARIBBEAN BUSINESS calculations indicate Mitchell's first year revenues could exceed \$3 million. One of the company's challenging goals is to recruit 600 to 800 body shops and all relevant insurance companies working in a paperless environment within the next two to three years.

After a trial period on the island of little over a year, "our business has increased 60%. We have seen a tremendous need for quality information and we want to provide it," said Hillel Katzowicz, vice president for Mitchell International. Mitchell's official announcement to establish a regional presence in Puerto Rico will

be made at a reception tonight (Thursday) at the Radisson Normandie Hotel in San Juan.

A limited portion of the local repair industry reportedly has been working with Mitchell, estimating products well over 20 years, using the company's stateside manuals, whose figures do not coincide with Puerto Rico's inflated costs due to freight and taxes.

The lack of local information regarding body repairs, parts and services has made it "guesswork"; for insurance adjusters who use stateside figures as bases to calculate repair estimates for thousands of claims processed every year. Mitchell aims to alleviate that situation with a database of local figures for parts and repair services.

DATABASE COVERS ALL MAKES

"This truly has been a cooperative effort. We receive tremendous support from all of the suppliers," Katzowicz said. "This database will cover all makes and models of motor vehicles. It will be much easier for insurers and repairers to arrive at accurate estimates, instead of the need to convert from U.S. pricing."

Mitchell's local pricing suppliers include Bella International, Vortex Motors, EER Parts & Service Inc, Triangle Dealers, Autos Vega, Motorambar, Suzuki del Caribe, Toyota de Puerto Rico, Losada Auto and Trebol Motors. ■

New generic-drugs plant opens in Humacao

Danbury comes on line after waiting two years for FDA OK; will make anti-depressant, relaxer and antibiotic products

LIDA ESTELA RUJAÑO

Danbury Pharmacal Puerto Rico Inc. will open facilities in Humacao next week, two years after purchasing its property and with Blanca Melendez, one of the few women in the top drawer of the island's pharmaceutical companies, as general manager.

The Florham Park, New Jersey-based, generic drug manufacturer purchased two buildings of 56,000 and 6,000 square feet in Humacao Industrial Park in 1992 from another company and first extensively remodeled the larger building. The other building is scheduled to be remodeled soon.

The company withheld production until it received U.S. Food and Drug Administration certification for three major products and made its first shipment last April. The approved products are Nortriptyline, an anti-

depressant, and Minocycline, an antibiotic, both in capsule form, and Cyclobenzaprine, muscle relaxer tablets. The company is awaiting approval for other products, "but this is a slow process," Melendez said.

The parent company's \$12 million-\$15 million investment has 70 employees and a \$3 million annual payroll, and the general manager predicted she will have 125 employees working in three shifts by 1997-98, and may exceed projections, Melendez said.

Danbury Pharmacal is a subsidiary of Schein Pharmaceutical Inc. It is not a 936 company but plans to file for Section 936 of the U.S. Internal Revenue Code tax benefits, Melendez said. The parent company also has plants in Carmel, New York; Phoenix, Arizona; and Danbury, Connecticut, with 1,644 employees in all, Melendez said.

The parent Schein Pharmaceutical Inc. dates to 1932

when Henry Schein opened a drugstore in Queens, New York. From the 1940s through the 1950s, it evolved into a distribution company selling by catalog medical, dental and surgical products. In 1970, Henry Schein bought into Danbury Pharmacal, Inc., a newly created company, to manufacture generic tablets and capsules.

Ten years ago Jay Schein, Henry's son, and Martin Sperber, who is now chief executive officer, reorganized the company into two entities: Henry Schein Inc. and Schein Pharmaceutical Inc. which in 1986 purchased Steris Laboratories, Inc., makers of sterile products. Two years later, Schein built manufacturing facilities in Phoenix, Arizona and Carmel, New York.

In 1992 the company produced its first trademark product, Infed, an injectable, on the market. The following year it opened a distribution center in Brewster, New York and relocated corporate headquarters to Florham Park, New Jersey. Last year, it made a strategic alliance with Miles, Inc., a division of Bayer Ag and also acquired rights to market Ethical Holdings products. ■

Olympic lands \$11 million Defense contract

San Juan Star — Tuesday, June 6, 1995

KEN HEMLOCK
STAR Staff

Guaynabo-based apparel manufacturer Olympic Mills Corp. has been awarded an \$11 million contract to produce undershirts for U.S. military use, the U.S.

Defense Logistics Agency announced. The contract is part of Olympic's effort to secure business for an Humacao plant now starting up and expected to employ as many as 800 people next year, Francisco Carvajal, company president.

Olympic is negotiating additional contracts with U.S. defense agencies and clients for the Humacao plant, which now employs about 50 people.

The contract includes an option to renew the \$11 million contract, which calls for delivery of 682,000 white and 3.2 million undershirts by October 1996, the Logistics Agency said.

News of the defense contract comes as Puerto Rico companies and the Economic Development Administration (Fomento) boost efforts to maintain the island's share of military contracts amid cuts in U.S. defense spending.

So far, Puerto Rico seems to have suffered smaller cuts than other jurisdictions, said Pedro Acevedo, director of Fomento's procurement technical assistance center.

Preliminary estimates show defense contracts to Puerto Rico of \$25,000 or more totalled \$220 million in the U.S. fiscal year ended Oct. 1, 1994. That's down from \$248 million one year earlier, an 11 percent decline.

The fiscal 1994 contracts included \$104 million from the Defense Logistics Agency, down from \$172 million the previous year; \$65 million from the Navy, down from \$78 million; \$17 million from the

Army, up from \$16 million; \$15 million from the Corps of Engineers, up from \$6 million, and \$5 million from other defense divisions, up from \$4 million one year earlier, the preliminary data indicate.

Acevedo said Fomento's defense contract marketing efforts include increased contracts with U.S. defense purchase centers and greater technical assistance to contractors here, especially for preparing bids and installing computer hookups.

The U.S. Defense Department — like private buyers — increasingly seeks on-line communication with contractors as part of an effort to keep inventory levels low and place orders as needed.

Carvajal said Olympic plans a fully-integrated operation in Humacao that will make cloth, dye it and then cut, sew and package garments.

But dying operations cannot yet take place at the Humacao site because the Aqueduct and Sewer Authority lacks the

capacity to treat water emissions from that dying operation.

Olympic is building a \$2 million water treatment plant at the plant and should complete the project later this year. Until then, it must import dyed cloth from the states, limiting job growth at the factory, said Carvajal.

Founded in 1949, Olympic Mills makes textiles and apparel, including Grana-brand underwear. It is one of several subsidiaries of Olympic Holding Corp., which employs about 1,000 people in Puerto Rico with plants in Guaynabo, Cidra, Yabucoa and Humacao. The holding company also operates a twin plant in the Dominican Republic.

Earlier this year, Olympic obtained a contract from Disney Consumer Products International Inc. to manufacture and market Disney clothing in Puerto Rico and the Dominican Republic.

Sears brings 'super appliance' outlet to P.R.

Homelife furniture outlet three times regular department size;
Galeria Paseos plan brings island's first super appliance store

By FRANCES RYAN

Sears will open late this fall its first free-standing furniture and appliance stores, the Homelife furniture outlet being the second of its kind in the entire Sears chain, in a two-level location at Galeria Paseos, as anticipated by CARIBBEAN BUSINESS.

The furniture concept conforms to Sears' new stateside strategy of "Homelife" furniture stores, said Ed Cameron, president of Sears of Puerto Rico. The appliance/electronic store will operate under the Sears Brand Central logo, and which Cameron claimed will be the island's first "super appliance" store.

"The only difference in the Homelife preparation is that we'll have a version tailor-made for the

Puerto Rican market," Cameron said. He estimated approximately 60% of its inventory will be supplied by local manufacturers and sources. Homelife is in line with continuing Sears expansion and remodeling efforts around the island, he explained. Galeria Paseos is near Los Paseos Urbanization in Rio Piedras.

The furniture store will occupy 30,000 square feet, nearly three times more floor area than the average Sears in-store furniture department. It will

make available more space at Sears for projected expansion of other popular departments, such as women's, men's and children's apparel, cosmetics and jewelry.

The two-level location will be connected by a glass elevator and escalators. Individual entrances will be identified with Sears Brand Central and Homelife signs.

Cameron said plans call for remodeling of all Sears stores, beginning with Plaza Las Americas in January. Three other Sears stores will be in line for remodeling in 1996. ■

Circuit City considers P.R. market

Preliminary talks held to open several stores; effort
coincides with Sears' expansion plan in same category

By FRANCES RYAN

CARIBBEAN BUSINESS learned that stateside electronic-store chain Circuit City is considering Puerto Rico's market as part of its expansion plans. Paul Rakov, of Circuit City's public relations office, said in a phone conversation. "We're constantly looking and evaluating new market opportunities but no decisions have been made about Puerto Rico."

Real estate executives from Circuit City have visited the island several times to evaluate potential sites, especially in the Guaynabo area, according to

a local industry source who requested anonymity. "So far, we don't have plans to open stores on the island and efforts are being concentrated on the opening of 65 new stores we have planned for this year in the States," Rakov said.

Nonetheless, several leading shopping center executives from Puerto Rico who recently attended the annual conference of the International Council on Shopping Centers held in Las Vegas confirmed preliminary talks with Circuit City executives who have expressed their interest in opening several stores on the island. The company is looking at stores with size averaging 3,000 square feet to

4,000 square feet to carry a comprehensive inventory of electronic appliances, designed to compete directly with Radio Shack and similar stores.

Circuit City's interest in Puerto Rico coincides with Sears' expansion efforts, which include the opening of a new Sears Brand Central at Galeria Paseos to be a super electronics retail store. Also the announcement of Sears launching of its stateside concept Homelife store, also at Galeria Paseos, coincides with Home Depot's interest in the island market and strong marketing efforts from Kmart to expand in the home accessories and light home furniture division. Opening such specialty stores allow retailers to get closer to other residential areas which are in much need of such products. In Sears' case, it allows it to use its strong name brand recognition factor to get closer to other markets away from the traditional shopping center. ■

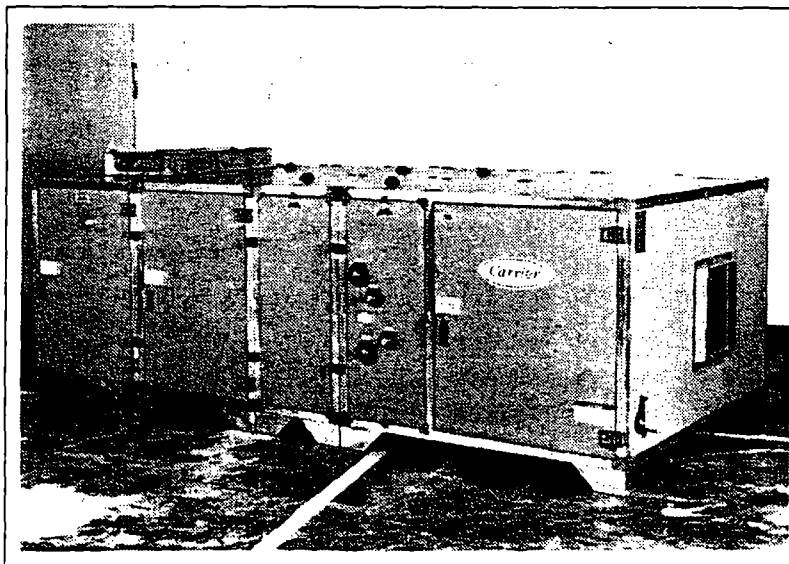
Carrier plant opens in Bayamon

First assembly factory by air-conditioning giant outside U.S. mainland primarily to target local market

By MERIEMIL RODRIGUEZ

In its first move offshore, Carrier Corp. — the stateside air-conditioning and refrigeration products manufacturer and distributor — selected Puerto Rico for a plant to assemble an air-handling unit called AirQPlus, CARIBBEAN BUSINESS learned.

The Hato Tejas, Bayamon plant — called Air Caribe — will be supplying its units to commercial, industrial and hospital users in Puerto Rico, the rest of the Caribbean and some Latin American countries, said engineer Gianna Solis, commercial equipment sales manager for Carrier of Puerto Rico in Cataño. The local plant is being used as a test case by Carrier — whose parent company is United Technology of Connecticut. If successful, the company plans to open similar plants in other offshore locations, Solis said.



AirQPlus, Carrier Corp.'s air-handling units, will be assembled in Puerto Rico for the regional and Latin American markets.

Air Caribe will create 18 direct jobs the first year and 30 in 1996, Solis said. The plant opened in May, but still hiring, and the air-handling units will be introduced officially June 19. However, it already has an impressive roster of local clients, including the Caribe Hilton and Westin Rio Mar hotels, Banco Popular, Dupont Pharmaceuticals, and USSC Ponce, she said.

"Puerto Rico was selected for this operation because of the island's vast experience as a manufacturing center," the mechanical engineer said.

The parts used in the Puerto Rico assembly line will come from company plants in the U.S. mainland and Italy. The unit meets the new air quality standards set by the Society of Heating Refrigeration and Air-Conditioning Engineers (ASHRAE 62). Engineer Rafael Muñoz is the manager of Air Caribe.

Carrier has been in Puerto Rico for more than 60 years and, in 1990, purchased nine local Arc Supply stores that distribute air-conditioning and refrigeration equipment. The local operation, which is directed by Sergio Colombo, responds to Carrier Latin America, based in Miami ■

De la Cruz reports 30.3% growth in 1994

Agency marks 10th anniversary adding new accounts; capitalized billings reached \$47 million last year

BY ANGELIS ALVARADO

De la Cruz & Associates ended 1994 with a whopping 30.3% growth last year and capitalized billings hitting the \$47 million mark, an ideal way to enter the agency's 10th anniversary year in 1995.

Rene de la Cruz teamed up with Alberto Goachet in 1985 to form De la Cruz & Goachet. "We wanted to create a different agency — one that understands the clients' needs and problems, providing the best results in problem solution," he says.

When Goachet departed in 1989, De la Cruz & Associates was already an important voice in the business with close to \$20 million in capitalized billings.

Clients and market needs require the expansion of services — Key Communications is the public relations arm of DLC, headed by Salvador Hasbun Martinez, a "cooker of solutions using the right mix of ingredients," as he describes himself.

Joey Jimenez is senior vice president of the client services team, which operates under the motto: "Strategic thinking makes for better creativity," Jimenez says he believes it can be done.

Drawing from his experience in a variety of accounts, Jimenez and his team help clients choose a successful path by acquiring in-depth knowledge of their business, the market, and the consumer.

Teresa Guerrero, DLC media director, says that for those who think there's nothing creative in

media management, the team proves them wrong. "Creative media placement means looking for the best way to get a product noticed while being cost-effective," Guerrero said.



Rene de la Cruz

Market Investigators, a DLC affiliate, is a sophisticated state-of-the-art technological center which offers credible results for clients. The team, under Myrna de Jesus, helps clarify the role that marketing and advertising should play in a client's quest for success.

DLC Caribbean is the company segment that addresses business in an area which is bustling with activity. With regional trade blocs and a globalized economy, markets become more demanding and complex. De la Cruz understands these markets and knows how to face the many changes organizations experience. "The experience I've gained dealing with the marketing and advertising needs of many businesses is one of the many things I put at the disposal of our clients," De la Cruz said. ■

Toyota of P.R. celebrates first year

Local Toyota executives support lobbying efforts in international trade dispute; Toyota positioned to be among top three this year

FRANCES RYAN

Toyota of Puerto Rico celebrates today its first anniversary after purchase of the make's franchise by the parent company from Gomez Hermanos Inc., the pioneer and long-time Toyota distributor on the island. Toyota of Puerto Rico also retained exclusive distribution of Lexus on the island.

The company has instituted a "Triple-S" campaign (Sales, Spare parts and Service) to strengthen its dealers in a long-haul effort to regain the No. 1 spot in island sales, held for years by Gomez Hermanos.

Three years ago, Mitsubishi Motors took the lead and has held it, aided by its distributorship of the Korean Hyundai for the low-end market where approximately 60% of unit sales are made. Toyota claims a sales increase this year, with the well-received redesign of the Toyota Tercel as a contributing factor.

Sales for 1994 show Mitsubishi at 18,971 units,

Hyundai at 16,022, and Toyota third at 15,738.

"We're here to stay and take care of our customers," said Hector Rivera, an executive of Toyota Puerto Rico. Referring to threatened U.S. tariff increases on selected Japanese luxury models, he added, "We're supporting stateside lobbying efforts to deal with the possibility of trade tariff increases proposed by the Clinton administration. We'll do everything in our power to continue bringing the products our customers have become accustomed to."

Even though local Japanese distributors' sales would be minimally affected if trade tariffs are increased, all of them reportedly vow to continue taking care of local customers "because each one is just as important to us as the thousands of customers in the U.S. who could be affected by such sanctions," Rivera said.

He said Toyota has no desire to add to the controversy, but rather to play a key role in its solution. The company is making efforts toward that objec-

tive and is standing apart from other manufacturers, particularly in connection with its efforts to buy from American parts suppliers.

Toyota, as a key player in the situation, includes its six manufacturing plants in the U.S., which represent an investment of more than \$5.5 billion and an annual payroll of more than \$900 million for nearly 18,000 employees. The company estimates more than 75,000 people are employed throughout more than 1,430 Toyota U.S. dealerships.

In addition, Toyota's Avalon luxury model car, the only six-passenger car built by a Japanese company, is manufactured in the U.S. to supply Taiwan, Europe and Japan markets. The parent Toyota company announced Toyota dealers in Japan will be selling U.S.-built Chevy Cavaliers starting in January 1996.

On the other side of the fence, most Mitsubishi luxury Diamante models are built in Australia, so industry sources say it's unlikely the measure would apply to them since it is aimed mainly at Japanese domestic manufacturers. Mazda in the States has shifted manufacture of some of its luxury models to stateside manufacturing plants to be closer to the market place. CARIBBEAN BUSINESS sources said all of them are dealing with aggressive inventory measures to avoid being caught in the transition. ■

New Scotch N Sirloin to open next year

Former owner of Condado steak house to open out of San Juan;
\$700,000 investment in new restaurant to seat 200 people

By FRANCES RYAN

Harry Sweeney, longtime restaurateur and owner of Dar Tiffany in Isla Verde, will revive the original Scotch N Sirloin restaurant concept he first developed in October 1969 at Condado's La Rada Hotel. The restaurant closed the day Hurricane Hugo hit the island, just two weeks short of its 20th anniversary.

Sweeney told CARIBBEAN BUSINESS he's in the process of identifying an appropriate site for the restaurant, which will be located outside of the San Juan metropolitan area. The restaurant site should be about 6,000 square feet to 7,000 square feet in size with a seating capacity of about 200 people. Plans call for opening the first of next year, Sweeney said. The initial investment to open the new Scotch N Sirloin is estimated to be more than \$700,000.

The original Scotch N Sirloin restaurant menu primarily featured steak and seafood, with such popular entrees as prime rib, sirloin steak and New York strip steak. Each day there was fresh fish, including crab, lobster and other seafood entrees. Frequent Scotch N Sirloin patrons enjoyed a popular and extensive

salad bar.

"The success of the restaurant was phenomenal. Since we closed, people have continuously asked me when the Scotch N Sirloin will be back; now is the time," Sweeney said. During February's high season the restaurant served more than 16,000 dinners.

Dar Tiffany, an Isla Verde landmark, also will undergo several changes. "We're going to redefine our concept a bit, moving more into the seafood end of the business and offering more ways of doing it," Sweeney said. Dar Tiffany's jazz on weekends and "steak for two" promotion on Wednesday already yielded positive results.

Sweeney is feeling competition from new restaurants in the area, such as Ruth's Chris Steak House at the Sand's Hotel & Casino Resort, and the proliferation of upscale franchise restaurants.

However, he isn't standing still and plans to refocus his business to take on the competition. Dar Tiffany's patrons will continue to enjoy a welcoming ambience to meet friends, chat and enjoy a good meal. Dar Tiffany is 5,000 square feet in size and has a seating capacity of 150 people. ■

Kimberly-Clark breaks new ground in P.R.

Will expand aggressively in industrial-products market here and in Caribbean; entering potential \$150 million industry

by FRANCES RYAN

Kimberly-Clark, better known for its consumer products, is aggressively expanding its business in the industrial supplies area in Puerto Rico, CARIBBEAN BUSINESS learned. Kimberly-Clark Puerto Rico Industrial Sales Division, a wholly owned subsidiary, has especially targeted industrial rippers, service products and workwear.

Market development efforts in Puerto Rico began last September and have already yielded positive results, said Carlos Jimenez, KCPR's business development coordinator. In some product categories, KC's products have shown a 400% increase in sales during that period. Nonetheless, there is still plenty of room for growth, and the positive experience we've gained here in Puerto Rico will be put to good use in developing other regional markets further and opening new ones throughout the Caribbean," Jimenez added.

Jimenez said KCPR's sales goal for the industrial division will result from a combination of factors including quality products, an established support network to ensure customer satisfaction, continued company efforts in the research and development area, and an innovative distribution effort.

KCPR's industrial division oversees distribution of its products in the Dominican Republic, St. Thomas, Aruba, Curacao and St. Martin. New country mar-

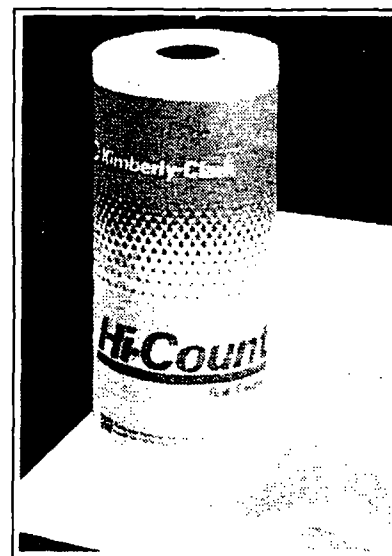
kets expected to open during the next few months are Trinidad and Jamaica. "After that, we will concentrate on providing local support, strengthening customer service efforts, and maintaining the high service standards we've always striven for," Jimenez said. Other Caribbean markets slated to open this fall are St. Kitts and Antigua.

Expansion efforts both locally and regionally will require an increase in personnel of more than 50%, said Jaime Esteras, KCPR's sales representative who was also present during the interview.

Industry sources estimate Puerto Rico's business potential in the above-mentioned categories of industrial supplies exceeds \$150 million. Other industry leaders with a strong presence in the local market are Scott Paper and Georgia Pacific products. "However, KCPR is the only company with an established

wholly owned subsidiary on the island that provides all of the three product categories under one roof. Some competitors concentrate on one or two categories, but we can meet customers' needs in all three categories," Esteras said.

Currently, KCPR concentrates its distribution efforts on the following industries: food service, 39%; manufacturing, 26%; building maintenance, 24%; health care, 5%, and hotels and transportation, 3% each. Such distribution may vary in the future

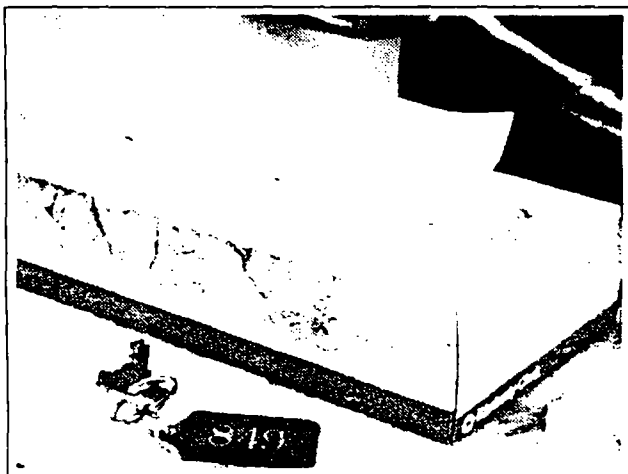


according to existing market potential and development of new products. Kimberly Clark currently carries 50 products, most of which are available to local customers; new ones are expected to be introduced as the local market is developed. Esteras pointed out that Kim-

berly-Clark's Research & Development Division spends more than \$250 million every year on new product development.

A market with vast potential for growth in the category of service products is the hotel industry, in which KCPR's roster of clients includes El San Juan Hotel & Casino, the recently inaugurated Marriott Hotel, El Conquistador, the local Hilton hotels, and the Excelsior, among others. Chief among those products are the Kleenex product line of facial tissue and practical dispensers, Surpass and Delsey bathroom tissue products, and Kimberly's own tissue and towel dispensers.

With strict Occupational Safety & Health Administration regulations in place, KCPR's disposable workwear has become a must for many employees within the manufacturing sector. "Our extensive product line in this area starts with our patented fabric manufacturing process for the disposable workwear uniforms we sell. In addition, we pay special attention to the education process in dealing with clients to help them choose the appropriate product that will help them remain in compliance in the workplace," Esteras said ■



Holiday Inns slated for Bayamon, Caguas

BY TERRY CHEVAKO

H.I. Development Corp., which owns the Puerto Rico Holiday Inn and Days Inn hotels, will build Holiday Inns in Caguas and Bayamon, the first hotel for each of those municipalities. The projects will add almost 300 rooms to the island's roster, generating nearly 400 new direct jobs.

Jack Tomlinson, who scouts and negotiates real-estate deals for H.I. Development, said the two projects are being developed in tandem. He said the

designs for each hotel should be completed within three months, and the approval process will be finalized shortly thereafter.

Tomlinson said the financing package is almost in place, but preferred not to give any details. He said the ground-breaking for both properties should occur within five or six months, and the construction process will take 12 to 18 months.

The Caguas Holiday Inn will use three to four acres of a 10-acre lot leased from the municipality

of Caguas for an undisclosed sum. The Bayamon Holiday Inn will be built on four-acre lot. The Caguas hotel will be about 120 rooms, while the Bayamon hotel will have about 150 rooms. Rack rates for both hotels are expected to be under \$100

Tarquin Callen, president of H.I. Development said the hotels will act as commercial hotels during the week and will cater to the leisure crowd on weekends. Callen said he expects to generate a great deal of business from weddings and other special activities held by residents of the two municipalities. ■

Tuesday, June 6, 1995

Old Isla Verde Holiday Inn could house Ritz-Carlton

By SAM DIMEO
Of The STAR Staff

A deal to build a \$100 million, 400-room hotel on the site of the old Holiday Inn in Isla Verde could be completed within two months, a source close to the negotiations said Monday.

The source, speaking on the condition of anonymity, said Florida developer John Anderson was moving to secure financing for the project, which would be managed by the Atlanta-based The Ritz-Carlton Hotel Co.

Anderson, who owns Rahn Properties in Fort Lauderdale, Fla., would use incentives offered under the Puerto Rico Tourism Development Act, with 60 percent of the financing guaranteed, not loaned, through the Tourism Guarantee Fund and 40 percent put up in equity, the source said.

Puerto Rico Tourism Company officials could not be reached for comment.

The former Holiday Inn, currently a dilapidated three-story structure behind Sam's Diner in Isla Verde, was operated successfully after its opening in the early 1960s and changed hands several times before shutting its doors for a final time in 1979.

"They are going to bring down whatever is left of the structure," the source said, adding that the government believed the Ritz-Carlton name would help improve the Isla Verde tourist area much as the opening of the 525-room San Juan Marriott Hotel and

Please see RITZ, Page B-20

Yauco Plaza gets approval for expansion

Shopping-center owners to construct \$10 million worth of retail space, creating 800 jobs; Kmart to be anchor

By FRANCES RYAN

Yauco Plaza got approval from the Puerto Rico Planning Board, after three years of consideration, for the expansion of the shopping center in the city of Yauco, CARIBBEAN BUSINESS learned.

The \$10 million expansion will add 205,025 square feet of new retail space. Financing for the project will be provided by the banking sector, Planning Board documents indicate. Yauco Plaza is now 234,000 square feet in size.

The space will be allocated for mixed retail use, including a department store, supermarket, four small shops, four accessory buildings for services, and a drugstore. The complex will have 1,200

parking spaces as required by the board. Prospective tenants include a 117,000-square-foot Kmart store, a 40,500-square-foot Pueblo Supermarket, and a new Walgreens drugstore to occupy about 15,525 square feet. At this point, all prospective tenants have submitted their letters of intent to develop their respective operations at that site as soon as it becomes available.

The project, with direct access to the existing Yauco Plaza I, will be located on Road 128 at the intersection with PR 2 in Yauco's Susua ward. The project's site is 19.98 *cuerdas* (19.38 acres) in size. The Puerto Rico Highway Authority has required that project owners develop their own access entrance to and from

the new facility. An additional traffic light will be installed to avoid traffic bottlenecks in the area.

The new facility is expected to create 250 direct jobs and another 150 indirect jobs during the construction phase and about 800 permanent direct jobs. The total of municipal and construction taxes, or *patentes*, expected from the new operation will generate approximately \$500,000 every year toward Yauco.

The firm of Mariano Romaguera &

Associates conducted a commercial viability study in the area with results showing that the project will not have a negative impact to the existing retail activity in the Yauco area. The analysis also revealed that the existing demand for retail sales in the area is 286,000 square feet of space, which exceeds the proposed new retail space, leaving another 28,000 square feet of retail still available for the new marketing and retail sales opportunities. ■

\$50 million investment program in Mayaguez

Sultan of the West readies for 21st century with improvements, new law school heads pack of major and minor renewal projects

MERIE MIL RODRIGUEZ

Mayaguez is investing close to \$50 million in capital improvement projects designed to awaken economic activity and renovation, CARIBBEAN BUSINESS learned.

Led by 37-year old Mayor Jose Guillermo Rodriguez, a first-term incumbent but

with 15 years experience in

municipal affairs, the program

includes more than a score

of projects. They extend

to parks improvements

and replacement of

bridges in rural

areas, and some

already are complete

nearing completion.

Major projects include

a law school and two

paseos, pedestrian malls and

renovations of Plaza Colon, De

Diego Park, and the Plaza del

Mercado, plus a \$1.6 million building for "incu-

cubator" manufacturing projects, and remodeling of

the Mayaguez sports coliseum.

Most of the projects will be financed with funds

borrowed from the Government Development Bank

of Puerto Rico and the federal Farmers Home

Administration, said Reynaldo Torres, director of

the municipal Department of Conservation, Beautification and Urban Development.

The private law school, named for statesman Eugenio Maria de Hostos, will anchor development of two paseos, which will cost \$5 million to \$7 million, said Torres, whose department was established

less than a year ago to accelerate municipal projects. The law school now occupies

temporary quarters, but will

move into an old public

school building provided

by the municipality with

\$1 million toward reno-

vation. The balance of

renovation presumably

will be supported by

private funding.

The school, whose

dean is attorney and for-

mer Catholic University

Law School professor Carlos

Rivera, should become a comple-

ment to the University of Puerto Rico

Mayaguez campus. Banco Bilbao Vizcaya of Puerto

Rico extended a \$500,000 loan to the law school for

operational expenses and equipment, and is provid-

ing some student financing, according to assistant

dean Rolando Emanuelli Jimenez.

The Paseo Eudaldo Baez-Garcia, named for a for-

mer Mayaguez legislator and deputy mayor now

"Businesses

in the paseos and other areas will be receiving technical information and orientation so they too can renovate, paint and update marketing and merchandising. The mayor wants to arouse Mayaguez from its slumber."

—REYNALDO TORRES

DIRECTOR, MUNICIPAL DEPARTMENT OF CONSERVATION,
BEAUTIFICATION AND URBAN DEVELOPMENT

deceased, extends north to south and will be built in two phases. The bid request for the first phase, from Nenaditch Street to Borinquen Avenue, is out. The paseo will have bicycle and pedestrian lanes, and was designed by CMA Architects. It has both commercial and residential structures.

The second paseo, named for Georgina Morales, founder of Mayaguez' first department store, will be a pedestrian mall including street vendors and kiosks. Both paseos will converge in the law-school area that also will have a large fountain. The design is by Architect Carlos Juan Ralat and bid requests will be issued in about two months, Torres said.

"Businesses in the paseos and other areas will be receiving technical information and orientation so they too can renovate, paint and update marketing and merchandising," he said. "The mayor wants to arouse Mayaguez from its slumber."

Bid requests also are out for a \$200,000 renovation of Plaza Colon, and a \$100,000 face-lift for De Diego Park, designed by Architect Jorge Rigau. The \$1.8 million remodeling of the landmark Mayaguez Plaza del Mercado — produce market — will be finished in November. The renovation includes central air conditioning, and a second floor to be occupied by small businesses and a bank branch. The architect is Efren Badia and Lopez Construction is the builder.

The municipality recently completed a \$1.6 million industrial building for incubator manufacturing projects and is remodeling the Civil Defense building at a cost of \$500,000. The project will be done by Grafe Construction and the first cornerstone ceremony will be May 26, Torres said. ■

Navieras to invest \$7 million in new crane

Privatized carrier issues request for proposals to construct;
Edward O'Donnell named to new post of commercial director

By PABLO J. TRINIDAD

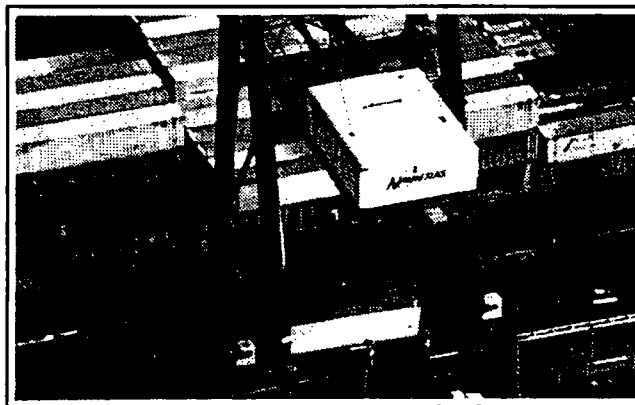
NPR Inc., the new owner and operator of the recently privatized maritime shipping line

Navieras, has issued a request for proposals for companies interested in designing and building a new crane in Puerto Nuevo Port Zone with an estimated cost of \$7 million.

The company, which was until recently a government corporation, also expects to grant a \$1 million contract this week for rehabilitation work on its cranes at the Port of San Juan.

Navieras' request for proposals is part of the company's \$50 million capital investment program to upgrade its operations over the next couple of years. The program calls for replacing Navieras' three aging cranes in Puerto Nuevo at a cost of about \$7 million each with new equipment that will allow the carrier to handle more and bigger containers in less time, said Ronald M. Katims, president of NPR Inc.

"We want cranes that are higher, wider and faster," Katims said, "which will allow our ships to spend less time in port and improve our container loading and unloading efficiency."



Navieras' new cranes in the Puerto Nuevo Port Zone will be faster and capable of handling larger containers.

Two stateside companies (the names of which were not revealed) are bidding on the \$1 million contract to rehabilitate Navieras' three giant container-handling cranes in the Puerto Nuevo Port Zone. The rehabilitation work will be done in stages over about three months.

In a related development, Navieras recently appointed Edward W. O'Donnell, a veteran shipping industry executive, to serve as the company's executive vice president and commercial director. O'Donnell's main task will be to develop a strategy to win back clients and return the carrier to profitability. Under the ownership of the Commonwealth government, Navieras lost about

\$100 million in revenues over the past couple of years as it went through the privatization process.

In his newly created position of commercial director, O'Donnell plans to integrate previously separate functions such as marketing, advertising, pricing, market research, and public relations into one effort. He has already established a bonus system based on profitability rather than on business volume for company employees.

"We need to earn money so that we can re-invest in facilities and such equipment as cranes and ships, which are needed for the long term." ■

More mining companies looking at P.R.

Cominco, Newmont show interest in copper, gold & silver;
government stands to get millions of dollars in revenues

By PABLO J. TRINIDAD

Three mining companies, including Canada's Cominco Ltd. and Newmont Mining Corp. of Denver, are interested in mining copper, gold and silver deposits in Puerto Rico.

As reported by CARIBBEAN BUSINESS on April 20, Southern Gold Resources and its affiliate USMX Inc. of Lakewood, Colo. are conducting an environmental impact statement with the goal of obtaining a land lease to mine the Cala Abajo copper and gold deposits located between the municipalities of Adjuntas and Utuado.

In addition, CARIBBEAN BUSINESS found that Spokane, Wash.-based Cominco American Inc. (a subsidiary of Cominco Ltd. of Vancouver) and Newmont Mining Corp. are also interested in exploring copper, gold and silver deposits on the island.

Early last year, Cominco America concluded exploration work for gold and copper deposits in the Barranquitas area, said George Cole, vice president for exploration at Cominco America. He said the company abandoned the project because test drilling results indicated that gold yields were not high enough for exploitation.

Cominco is in the process of letting its Barranquitas exploration concession terminate. Cole said the company, however, remains interested in other mining opportunities on the island.

There are 11 confirmed deposits of copper, gold and silver ore in Puerto Rico. Most of them are concentrated in the west central highlands, including the municipalities of Lares, Utuado, Jayuya, Adjuntas, Barranquitas and Caguas.

Newmont is said to be interested in the Yanama gold and copper ore deposits located in the municipality of Lares. The Yanama and Elecho gold and copper sites east of the town of Lares are regarded as the most eco-

and Piedra Hueca sites.

Pedro Gelabert, secretary of the Puerto Rico Department of Natural & Environmental Resources, said the Commonwealth government is evaluating the possibility of joining mining companies as a partner in developing mineral projects on the island. He said his department could not endorse Southern Gold's plan for the Cala Abajo project until the environmental impact statement and economic feasibility studies are completed.

Last week, Gelabert held a press conference to announce Southern Gold Resources' proposed plans for the Cala Abajo project.

The Cala Abajo site has the potential to yield about 378,661 tons of copper with an estimated gross value of \$757 million, and 597,000 ounces of gold with a

"Government support is very important. Puerto Rico's support for mining has a history of ups and downs."

— GEORGE COLE
VICE PRESIDENT FOR EXPLORATION AT COMINCO AMERICA

gross value of \$238 million, according to studies conducted by USMX.

The study estimated the net value of the Cala Abajo copper and gold deposits at nearly \$600 million. The Commonwealth government, which owns mineral rights on the island, stands to receive about two-thirds, or nearly \$400 million, of the revenues from the 18-year project. Gelabert said that 20% of government's revenue from royalties must go toward investments in environmental areas.

"Mining operations are very profitable and generate a lot of money for both governments and private investors," Cole said. "But government support is very important. Puerto Rico's support for mining has a history of ups and downs."

Puerto Rico was a significant source of gold during early Spanish colonial rule, when slave labor was abundant and environmental laws were nonexistent. In recent years, however, plans to exploit Puerto Rico's copper and gold deposits have been controversial because of concern over the potentially bad impact on the environment. The island has a large limestone and cement industry, as well as granite and marble quarries producing construction materials. ■

Closed Denver Chemical sold to Block Drug

By LIDA ESITLA RUANO

Denver Chemical Puerto Rico Inc., a division of Carter-Wallace Inc., which closed its Humacao operations last December, has been sold with the help of the Economic Development Administration to Block Drug Company, a New Jersey pharmaceutical company. Block has two plants adjacent to Denver Chemical in Humacao.

Fomento has assumed a new role as broker. Fomento Administrator Jaime Morgan Stubbe told CARIBBEAN BUSINESS: "We are matching operations that are on the verge of closing with investors

or companies that see potential in these operations.

Denver Chemical was established in Puerto Rico in 1973 to manufacture dental cushions and liquid medicine. Later it branched into other products.

It closed last December with 53 employees. Its main product was Organidin for treatment of bronchial asthma and emphysema. The product was pulled from the market in June 1994 by the Federal Drug Administration (FDA) which questioned its effectiveness. The drug represented \$50 million in annual sales for parent company Carter-Wallace.

Carter-Wallace announced last fall that it would reduce by 16% its workforce worldwide. ■

CellularOne doubles its market presence

Launches expansion in Puerto Rico with investment of more than \$4.6 million; to increase staff by 18

By FRANCES RYAN
CARIBBEAN BUSINESS
Reporter

CellularOne, a leading force in the telecommunications industry, plans to more than double its field presence during 1995, Heidi Souffront, public affairs and communications vice president for the company, told CARIBBEAN BUSINESS. Its retail-sales program features the combination of an extended sales base, a reach-out sales approach for potential and existing customers, and a continued commitment to firm up customer service.

In less than two years, CellularOne invested more than \$1.8 million to create a dynamic point-of-sales infrastructure that includes six sales-and-service centers, three minibooths and three mobile units.

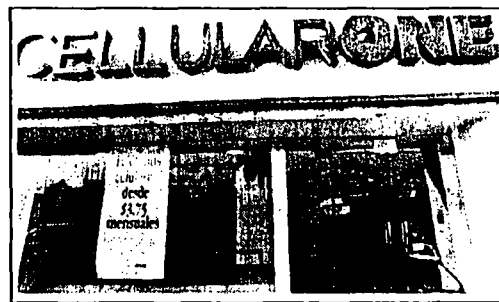
During 1995, plans call for opening two service centers, in Fajardo and St. Croix, with an initial average investment of \$300,000 each. A new mobile unit will be assigned to the Fajardo area, and additional minibooths

will be opened in every new Wal-Mart Stores Inc. and Sam's Wholesale Club Division sites on the island.

CellularOne minibooths, typically 150 square feet in size, next are scheduled to open at Wal-Mart's new Humacao store and in the Fajardo area, at a cost of \$35,000 each. Total investment in retail-sales infrastructure could amount to more than \$4.6 million by the end of 1995.

The sales force to oversee operations at these locations is expected to increase 18%, from 123 to 150, before the end of the year. "Our retail-sales force is divided into three categories: the store sales associates working at the service centers and minibooths; the direct-sales force who travel in the field, reaching out to customers at home and at their workplace; and the corporate-sales associates, in charge of corporate accounts," Souffront said.

"During 1995, we also plan to continue to penetrate the market. Industry statistics show there's still plenty room for growth. We just introduced our One Plan that offers a



convenient payment plan to acquire a cellular phone. And beginning in March, we'll begin the marketing and advertising efforts of our new paging systems," Souffront said.

As the largest operation in the Caribbean, Puerto Rico is CellularOne's most important market. It serves as a springboard for the recent entrance into the St. Thomas and St. Croix markets. Industry statistics show that while penetration level is still much lower than in the States, the island's cellular-phone market is growing 60% faster.

In Puerto Rico, some of the characteristics that lead to higher average revenue per subscriber include urban traffic congestion, climate, portables, and safety consciousness. ■

Valnet Medical plant will open on island

Santa Isabel surgical equipment operation represents \$1 million investment, creation of 45 jobs in 2 years

By LIDA ESTELA RUANO
CARIBBEAN BUSINESS
Associate Editor

A new local plant to manufacture plastic surgical equipment, which will represent a \$1 million investment and the creation of 45 jobs within two years, will be established in Santa Isabel by brothers Antonio and Jorge Calaf in a 22,000-square foot Puerto Rico Industrial Development Company building.

Antonio Calaf said the company, which expects to start operations in July with 20 employees, will be the first of its kind in Puerto Rico because it will offer integrated services. What makes it unique is that they will make all kinds of plastic products, ordered by clients, either made completely by them or in cooperation with

an injection molding plant. In the beginning, they will be dealing with plastic products that will not hold liquids.

Calaf, who has 20 years of experience in the health-service industry, said their plant, called Valnet Medical Corp., an acronym for Value Added Network, will evolve in two stages. For the first two years, they will be making the plastic products.

Afterwards, they will take advantage of the \$45 million U.S. medical devices market. The great majority of these companies in the U.S. are small and medium-size with fewer than 100 employees. Most of them, Calaf said, identify their forte, marketing, innovation or manufacturing, and either subcontract or take on a strategic alliance partner for the others. Valnet would

like to supply that necessity, by either being the partner or the subcontractor.

"This is very important for Puerto Rico because we would be bringing new products to be made here. Puerto Rico will also put in added value," Calaf said. Although this is being done a great deal in the U.S., especially in the electronics industry, it is just beginning in the medical devices sector. Most medical devices programs are being revised continually so it makes sense for a company to subcontract a product it might be making for only two years.

Calaf, an industrial engineer with a master's degree in administration, was manager for the Baxter Healthcare plants in Maricao and Aguada for three and a half years. Then he was promoted to chief of the quality control division for all the Baxter plants on the island. During the past six years, he worked at Nova Pharmaceutical Corp. His brother, Jorge, is a certified public accountant with a master's degree in computers. At this point, they are going through all the permits and financing processes. ■

Arby's to open 25 stores

\$13 million investment to add 875 direct jobs, first in San Juan area, later in other towns

By FRANCES RYAN
CARIBBEAN BUSINESS
Reporter

Florida-based Arby's Inc. plans to open 25 restaurants on the island over a six-year period. Tim Johnson, Arby's general manager for Latin America, told CARIBBEAN BUSINESS.

Open in Puerto Rico since July 1988, Arby's is the leading quick-service roast beef company with about 2,700 restaurants in 15 countries, including Canada, Latin America, the Middle East, and Asia.

It is estimated that each Arby's requires a startup investment of about \$500,000, or a minimum initial investment of \$13 million to open the 25 projected restaurants in Puerto Rico. Arby's, usually found in food courts, also has free-standing operations that can cost up to \$1 million, including real estate. Each store

will help create 35 to 40 new job opportunities, or a total of 875 jobs when all stores are open.

Arby's master franchisee for Puerto Rico recently changed hands. Island restaurants now are operating under the National Restaurant Corp. name, a local operation that reports to Far Investment Group, which has headquarters in Brentwood, Tenn. Laran Ferdowsi, of Far Investment, is now responsible for the Arby's franchise on the island.

Ferdowsi has been on the island with Johnson to handle details related to the expansion plan, which is scheduled to begin next month with the opening of a store at the Isla Verde food court. Locations under negotiation include one on the third level of Plaza Las Americas and a restaurant in Guaynabo, possibly in the San Patricio area.

The company first will concentrate on opening San Juan metropolitan area stores and then move on to



the rest of the island. Other major cities being evaluated for Arby's restaurants include Mayaguez, Cayey, Caguas, Bayamon, San German, San Sebastian, San Juan, Carolina, and Fajardo.

Arby's has been in business since 1964.

BUSINESS

s and's retail sales up 2.2% over '94 for April

KAVIRA NEGGERS

Star Staff

Puerto Rico retail sales increased by 2.2 percent in April compared to the same month in 1994, totaling \$897.6 million, according to figures released Friday by the Commerce Development Administration.

However, overall sales from January to April showed a slight drop of 0.8 percent, compared to the same period in 1994. Retail sales for the trimester were

\$27.6 million less than the \$3.51 billion reported for the 1994 comparable period.

From March to April retail sales were also down 0.3 percent. March sales totaled \$900.3 million.

The figures are based on an establishment survey of 18 different types of merchandise.

Of the 18 categories, only 8 registered increases in sales in April. Sectors showing the strongest growth were paint, wallpaper, and windows, which increased 58 percent; restaurants sales, 18.1 per-

cent; and jewelry, 6.9 percent.

However, furniture stores took a 19.7 percent dive in April with sales amounting to \$29.8 million, from the \$37.1 million in 1994. Variety stores' sales were down 11.7 percent from \$10.1 million in April 1994 to \$8.9 million.

April to April sales of women's apparel showed a 14.5 percent reduction from \$16.9 to \$14.4 million.

"Retailers are beginning to face the fact that sales aren't that good and that the market is essentially saturated," said

a veteran retail consultant who was not identified.

Commerce Development Administrator Juan Woodroffe was away on trip on Friday and not available for comment. However, he issued a news release highlighting only those categories that showed increases.

Meanwhile, the Arecibo, Fajardo, Guayama, and Mayaguez regions showed sales increases for the first four month period of this year compared to 1994.

Chase seals \$600 million Island Finance purchase

Largest P.R. acquisition package ever

By AGNES J. MONTANO
Of The STAR Staff

Chase Manhattan Bank closed a \$600 million financing package Wednesday for the purchase of Island Finance Corp., by Des Moines-based Norwest Financial Corp., the largest financing of an acquisition to date in Puerto Rico.

The deal beats the \$200 million syndicated loan granted to Cellular One by Citibank in May to finance operations in Puerto Rico, repurchase stock, make local investments and refinance debt.

Chase acted as advisor and sole manager for the financing which consists of a \$500 million bridge loan in Puerto Rico to be refinanced through a syndicated commercial paper facility on the mainland. Another \$100 million in loans will be syndicated in the local market.

Chase is in the process of selecting the financial institutions which will form the syndicate, said bank vice president Beth Alvarez.

"We are inviting institutions not only in Puerto Rico but also in the U.S. to

participate in the syndicate," said Alvarez.

Island Finance, Puerto Rico's largest small loan company, was sold by ITT Corp. in December as part of ITT Corp's divestiture of its subsidiary, ITT Financial Corp. The Puerto Rico company dominates the island's small loan market with a \$1 billion portfolio.

Roberto Dávila, managing director of Chase Puerto Rico, said the loan was the product of Chase's "leadership in acquisition financing, loan syndications and capital markets."

This is the second such loan granted by Chase for a Puerto Rico acquisition. In 1993, a syndicate formed by Chase and Scotiabank de Puerto Rico provided Venezuelan billionaire brothers Gustavo and Ricardo Cisneros \$130 million out of the \$420 million financing package used to buy the island's leading supermarket chain, Pueblo International.

Island Finance has nearly 2,000 employees, 52 branches in Puerto Rico, and 30 in different locations in the Caribbean and Central America.

Thursday, June 1, 1995



Photo special to the STAR by ELIZA LENZA

Secretary of State Baltasar Corrada del Río talks with United Kingdom honorary consul in Puerto Rico, Ian Court and U.K. trade officer Juliana Greco at Friday's ceremonies inaugurating an expanded U.K. commercial office in San Juan.

Saturday, June 3, 1995

U.K opens new trade office in San Juan

By **DOREEN HEMLOCK**

Of The STAR Staff

The United Kingdom formally expanded its trade office in San Juan on Friday, reflecting dramatic increases in commerce and London's interest in Puerto Rico as a business partner.

The expansion follows a doubling of U.K.-Puerto Rico trade to nearly

\$700 million last year, proposals by a British firm to buy seven island shopping malls and growing involvement by U.K. firms in infrastructure projects here, including the Urban Train and water systems.

Puerto Rico now ranks as England's top market in the Caribbean, its third largest in Latin America after Brazil and Mexico, and its 49th largest worldwide, up from 55th last

year, British data show.

"It's remarkable that Puerto Rico is the largest Caribbean market, when you consider that the United Kingdom has traditional ties in the West Indies to Jamaica, Trinidad and other countries," said Alistair Hunter, the U.K.'s consul in New York, who visited San Juan for the ribbon-

Please see U.K., Page B26

P.R. spending near \$4 million on lobbying efforts in D.C.

Benefits said very generous, like best hotels, restaurants

By **ROBERT FRIEDMAN**

STAR Washington Bureau

WASHINGTON — The Puerto Rico government is spending closer to \$4 million on lobbying efforts here than the \$2 million previously reported by La Fortaleza, the STAR has learned.

Alvaro Cifuentes, chief of staff for Gov. Rosselló, had estimated earlier this week that the lobbying and consulting costs for the governor's office totaled about \$2 million. He acknowledged that there may be other contracts with commonwealth agencies of which he was unaware.

"I could be \$300,000 to \$400,000 off, either way," Cifuentes had said.

But further information obtained by the STAR puts the cost considerably higher. The payments add up to between \$3.7 million and \$4.3 million. Fees were unavailable for some outside lobbyists hired by commonwealth agencies other than the Governor's Office.

The latest figures show the probable yearly earnings of 16 of the 17 lobbyists and consultants used by the commonwealth government:

Law firms — Verner, Liipfert, Bernhard, MacPherson and Hand, \$1.3 million; Long, Aldridge and Norman, \$400,000; McDermott, Will & Emory, \$240,000; Harris and Associates, \$90,000. The public relations firm Robinson, Lake, Sawyer & Miller, \$240,000 (its predecessor, Fleishman-Hillard, Inc. was billing the island \$720,000 a year) and the Luntz Research Companies pollsters, \$175,000.

From Page 2

Lobbyists

stay at the best hotels and eat at the most expensive restaurants and the government picks up the tab," said a Puerto Rican official here who preferred not to be identified.

Costs of P.R. lobby efforts near \$4 million

Rosselló chief of staff had estimated lobbying and consulting costs for the governor's office at \$2 million less. **Page 2**

Other lobbyists should get the following yearly fees: former congressman Robert García, \$120,000; former congressman Vin Weber, \$80,000; former Puerto Rico Federal Affairs Administration head Luis Guinot, \$100,000; Tonio Bourgos, \$80,000; Liz Robbins, \$120,000; David Gerkin, \$100,000; Don Devine, \$80,000; Michael Whouley, \$180,000; Bob White, \$120,000; Mark Goodin, \$90,000.

No data was available on Greenburg and Traurig, a firm that gets commissions from bond sales. Also, several island agencies have separate contracts with lobbyists here. Among them are the Transportation Department — for the Tren Urbano project — the Education Department and the Puerto Rico Industrial Development Company.

Transportation Secretary Carlos Pesquera said his agency will spend at least \$270,000 and as high as \$800,000 this year on lobbying and public relations efforts to try to get federal funding for the light rail system.

Other agencies use consultants here for a single issue. For instance, the Government Development Bank used the high-powered law and lobbying firm of Aken Gump Strauss Hauer & Feld to help in the sale of Navieras. It could not be learned how much the firm received for its services.

In addition, lobbyists are said to have generous expense accounts.

"When these people come down to Puerto Rico they

Please see LOBBYISTS, Page 4

"You're talking closer to \$4 million than \$2 million" in lobbying costs to the island, the official said.

Some 30 states have offices in Washington to look out for the state's interests. Unlike PRFAA, however, the staffs are comparatively small and the hiring of outside lobbyists appears to be a rarity.

California, the largest state, for

instance, has a staff of eight. PRFAA employs 45 people.

The big difference, of course, is that besides two senators, California has 52 representatives, while Puerto Rico has no voting representation in Congress.

"When you have no votes in Congress, you have to spend money on lobbyists," said Cifuentes.

\$2 m on earmarked for P R lobby effort

By RICHARD T. FRIEDMAN
Washington Bureau

WASHINGTON — Puerto Rico is spending some \$2 million a year on lobbyists and consultants in 17 different firms to try to prevent the loss of "hundreds of millions of dollars" in federal funds under the new Republican rule in Congress, La Fortaleza Chief of Staff Lívior Cifuentes said Tuesday.

"We felt that in these changing conservative times, everything is up for grabs," Cifuentes said. "We have hundreds of millions of dollars in jeopardy. If you put it in that context, you can see that spending the \$2 million is worthwhile."

While most of the 26 lobbyists and consultants from the 17 firms have been hired by the Puerto Rico Federal Affairs Administration here, others have contracts principally with commonwealth agencies, but also are called on to do work for the administration, Cifuentes said.

José Roberto Martínez, who headed PRFFA 1989-1993 during the Hernández Colón administration, said hiring all those

firms for lobbying and consulting work was "excessive."

"I would be the first to admit that some of these firms are needed," said Martínez, who now represents the Popular Democratic Party here. "But I think 17 firms are too many."

Martínez noted that during the 1989-1991 plebiscite hearings, seven lobbying firms were working for PRFAA, whose staff had been reduced from 24 to 14 in the four years he was there "because we couldn't afford more people." He said PRFAA spent about \$700,000 annually for lobbyists during his years as administrator.

PRFAA currently employs 45 people. The agency was expanded both in budget and personnel when it began to supervise the stateside Puerto Rico offices during the Rosselló administration.

"Lobbyists are important for two principal reasons," Martínez said. "They give you access, a foot in the door, and information that cannot be readily obtained."

Puerto Rico needs information and access now, more than ever before, according to Cifuentes.

The Rosselló administration, he said, has had the most active Washington agenda of any Puerto Rico government, but has no voting representation in Congress. Therefore, he said, the island has hired top-flight consultants and lobbyists to defend its interests.

Cifuentes said many of the firms and individuals on the island payroll were chosen because they consider Puerto Rico among their top priorities.

"We're not necessarily going after those who have a lot of clients," he said. "Things are moving too fast in Washington and we want to be able to get someone on the phone who will immediately look at the issue for Puerto Rico. In fact, we want to anticipate the issues, get to them, and the people involved, before they come out."

Here is a rundown of the leading lobbyists and consultants for the island, the earnings of some of them and what they do:

■ Verner, Liipfert, Bernhard, McPherson and Hand. The law firm, mostly associated with the Democratic Party, does all the legal work for the Puerto

Rico government here. They are the main Section 936 consultants and also work on many other island-related issues. Verner, Liipfert reportedly made \$1 million in the first year of its contract. Firm attorneys John Merrigan, Gary Klein and Jim Miller do most of the work on Puerto Rico issues.

■ Vin Weber, a former Minnesota congressman whose main value is his closeness to House Speaker Newt Gingrich. Weber's contract allows him to make up to \$80,000 a year.

■ Don Devine, a veteran Republican who headed the Office of Personnel Management in the Reagan administration and who serves as an adviser to Senate Majority Leader Robert Dole. He is the leading candidate for the Republican presidential nomination. Devine earned \$80,000 last year.

■ David Gerkin, a Democrat who worked last year on health care and this year on welfare issues for the island, gets paid \$8,500 a month. "I generally focus on meat and potatoes, I bring home the bacon" for the island, Gerkin said in a

Please see LOBBYISTS, Page 6

From Page 3

Lobbyists

short interview. A tennis partner of J. Bennett Johnston, the former chairman of the Senate Natural Resources Committee, Gerkin lobbied for the statehooders during the 1989-91 plebiscite hearings.

■ Robert García, the former congressman from the Bronx, a Democrat, who is paid \$10,000 a month to work mostly on issues related to stateside Puerto Ricans and with the Congressional Hispanic Caucus.

■ Greenberg and Traurig, a Miami-New York-D.C. firm that, among other things, acts as bond counsels for the Government Development Bank. Its connections are mostly Democratic.

■ Tonio Bourgos, a veteran New York Democrat and one-time senior staffer for former Gov. Mario Cuomo. He advises on mostly New York Hispanic affairs.

■ Liz Robbins, a lobbying pro who helps Puerto Rico in Congress, she receives \$10,000 a month. Her connections are mostly Democratic.

■ Luis Guinot, former PRFAA head in the Ferré administration and ambassador to Costa Rica in the Bush

administration, has been hired for his strong Republican connections.

■ Long, Aldrich and Norman, a law firm hired for work with the Justice Department. Although most of its contacts are with Democrats, one member of the firm — Matt Towery — has ties to House Speaker Gingrich.

■ Robinson, Lake, Sawyer and Miller, recently hired to do the island's public relations work here, replacing Fleishman-Hillard, Inc.

■ Luntz Research Companies, the GOP polling firm, which also acted as pollsters for the Rosselló campaign in 1992. Since the firm takes no stateside polls on Puerto Rico, it is unclear why they are among the consultants.

■ Michael Whouley, a Democrat, and head of a Boston consulting firm, who is said to be very close to the Clinton administration.

■ Bob White, another Democratic Bostonian who does advance work on trips to the states by Rosselló administration members. White will also become involved in the opening in 60 days of a Puerto Rico office in Boston.

■ To further strengthen its Republican connections, PRFAA recently hired three lobbyists with strong GOP ties: Harris and Associates; McDermott, Will and Emory; and Mark Goodwin. Since they are relative newcomers no further information was available on them.



MWW/STRATEGIC COMMUNICATIONS, INC.

FEDERAL EXPENDITURES IN PUERTO RICO

As a commonwealth, Puerto Rico is not subject to federal taxes. The citizens of Puerto Rico do, however receive certain federal benefits. In fiscal year 1993, total federal expenditures for these benefits in the five territories amounted to \$10.3 billion. Puerto Rico received approximately \$9 billion of this total. In addition, the Section 936 possessions tax credit cost the U.S. Treasury approximately \$3.1 billion.

The United States General Accounting Office (GAO) recently released a report outlining the Federal Government's fiscal relations with the U.S. territories (GAO/T-GGD-95-71). To follow is a brief outline of current federal expenditures in Puerto Rico.

Federal Income Tax on Corporations

Corporations organized in the territories are generally treated as foreign corporations for U.S. tax purposes. Like foreign corporations, they are taxed on their U.S. earnings, but their territorial income is not subject to U.S. tax. U.S. corporations with subsidiaries in the territories can receive significant tax benefits through the possessions tax credit if their subsidiaries meet certain qualifications under section 936 of the Internal Revenue Code.

Internal Revenue Service (IRS) studies covering the 1980s showed that 99 percent of the credit was earned by corporations operating in Puerto Rico. In addition, the Department of the Treasury estimates that the credit caused the federal government to forego \$3.1 billion of tax revenues in 1993. Treasury predicts that, even with a cap on 936 that is to go into effect in 1994, with projected economic growth the annual cost will return to \$3.0 billion by 1999.

Federal Income Tax on Individuals

Under the Internal Revenue Code, individuals who are residents of a territory and who earn income only from sources within the territory are to pay income tax only to the territory. They owe no federal tax on this income.

Page 2

Federal Expenditures in Puerto Rico

Rules and Revenues for Other Taxes

In addition to local income taxes, some other forms of federal taxes do effect residents of Puerto Rico and the other territories. In Puerto Rico, payroll taxes and their revenues are retained by the U.S. government to fund Social Security and Medicare. Unemployment insurance taxes are also collected and the revenues are retained by the U.S. government. The IRS collected \$2,497.5 million in revenues from Puerto Rico in fiscal year 1993. Source: Internal Revenue Service Annual Report.

Merchandise shipped from the United States to Puerto Rico is exempt from any federal excise taxation. However, any merchandise manufactured in Puerto Rico and shipped into the United States for sale or consumption is subject to excise tax under section 7652 of the Internal Revenue Code. The tax revenue collected is, however, redistributed to the island. In fiscal year 1993, Puerto Rico received a total of \$197.5 million from section 7652 excise taxes. Source: Department of Treasury, Bureau of Alcohol, Tobacco, and Firearms and GAO computations.

Current Caps on Federal Social Programs

Aid to Families with Dependent Children (AFDC) is limited to a maximum federal matching rate of 75% subject to a cap of \$82 million. The 50 states and the District of Columbia receive open ended funding with a maximum federal funding rate of 83%.

Medicaid is limited to a maximum federal matching rate of 50% and is capped at \$79 million. The federal matching rate for the 50 states and the District of Columbia varies but is no more than 83%.

Medicare in Puerto Rico is administered along the same guidelines as in the states, except that hospital reimbursement rates under the special prospective payment system in Puerto Rico are lower than in the states. The federal expenditures in Puerto Rico in fiscal year 1993 were \$532.8 million.

SSI -- Puerto Rico does not receive SSI. Instead it operates an adult assistance programs -- aid to the aged, blind, or permanently disabled (AABD). The federal government provides a grant to Puerto Rico to meet a share of the program's cost subject to a cap. The current cap on the AABD program in Puerto Rico is \$82 million.

Puerto Rico's Nutrition Assistance Program, a variant to the U.S. food stamp program, is administered in the form of a block grant which provides its participants with monthly checks rather than food stamps. In fiscal year 1995, the Nutrition Assistance Block Grant was capped at \$1.1 billion. This funding level is approximately one quarter less than in the 48 contiguous states and the District of Columbia.

TABLE I

Table I shows the Treasury Department's estimates for FY 1993 through FY 1999 of the federal tax revenues foregone due to the possessions tax credit (936) in the U.S. territories. These are the most recent estimates available that span the period before and after the revision of the credit by the 1993 Budget Act. The estimates reflect a temporary decline in the revenue cost of the credit after FY 1993. By FY 1996, however, income among credit recipients is expected to make revenue costs rise again.

Dollars in billions

Fiscal Year	Tax Expenditures
1993	\$3.1
1994	2.9
1995	2.6
1996	2.7
1997	2.7
1998	2.8
1999	3.0

Source: U.S. Executive Office of the President, Budget of the United States Government, Fiscal Year 1995.

(Published February 1994)

TABLE II

Table II shows Federal expenditures in Puerto Rico, the U.S. Territories as a whole, and in the United States in FY 1993.

Dollars in Millions

	Puerto Rico	Territories Total	United States
Grants to local governments	\$3,132	\$3,580	\$195,201
Salaries and wages	619	1,133	166,189
Direct payments for individuals	4,484	4,768	650,953
Procurement	410	621	201,369
Other programs	153	182	46,500
Total	\$8,798	\$10,284	\$1,260,213

Source: Federal Expenditures by State for Fiscal Year 1993, Bureau of the Census, 1994.

REFORM OF SECTION 936 NECESSARY FOR CONTINUED ECONOMIC GROWTH IN PUERTO RICO

In evaluating Section 936, please consider the following points:

I. SECTION 936 HAS FAILED TO ACHIEVE ITS GOAL OF CREATING MANUFACTURING JOBS

The possessions tax credit, section 936 as it is called, has failed to achieve its goal of creating manufacturing jobs on the island. Although originally intended to help the citizens of Puerto Rico, it is now a tax loophole for large corporations, especially pharmaceutical manufacturers. These companies move their facilities to the island which leads layoffs on the Mainland U.S. Section 936 no longer helps the Puerto Rican people and is a drain on the U.S. Treasury, costing nearly \$3 billion annually. The manufacturing sector is the same number today as when 936 was created in 1970's (around 100,000 jobs).

II. PUERTO RICAN ECONOMY DOES NOT ADEQUATELY GROW

Despite the existence of 936 and the supposed benefits it brings to the island, the Puerto Rican economy does not enjoy steady economic growth. According to the U.S. Government Accounting Office's tax study on tax section 936, the presence of 936 companies has not significantly increased employment in Puerto Rico. In fact, GAO source figures report that unemployment in 1991 "stood at 16 percent." In 1979, the federal government established a task force to examine the Puerto Rican economy which concluded unemployment was way too high at around 17 percent. Today, the unemployment figure is still around the same figure yet 936 tax credits have increased by over 200 percent in the last 15 years.

III. SECTION 936 HAS NOT SIGNIFICANTLY INCREASED THE STANDARD OF LIVING IN PUERTO RICO

The 936 firms have not significantly increased the standard of living for Puerto Rico. According to the GAO study, "High income, not high employment and investment, is what the current section 936 tax credit rewards through tax exemption." Additionally, "the tax credits received can be high in relation to the cost of Puerto Rican resources employed, such as labor."

IV. TAX CREDITS ARE BASED ON THE PROFITS, NOT THE EXPENDITURES OF 936 COMPANIES

The tax credits are based on the profits of the 936 companies, not the wages the companies pay. What has resulted is a high profit, low employment industry of 936 companies. For instance, the pharmaceutical industry enjoys over 50 percent of the tax credits, yet only employs 15 percent of the 936 workers. The average worker earns approximately \$25,000 per year, but the average tax credit the company receives per year is over \$100,000 dollars.

The Reagan, Bush and Clinton administrations each proposed changing 936 to a wage/investment credit. In the FY93 Budget Reconciliation Act, the income credit was reduced to 60 percent and will be further gradually reduced to 40 percent over five years. If 936 is totally changed to a wage/ expenditure credit, the U.S. Treasury will save billions of dollars, and the Puerto Rican economy will enjoy a boom in investment.

V. A WAGE BASED CREDIT WILL MEAN MORE JOBS

Gradual reform of 936 is not necessary. Changing to a wage based tax credit immediately will mean more jobs for the people of Puerto Rico. Non-pharmaceutical 936 companies will benefit greatly from immediate reform and it is estimated that eliminating the phase out will reduce the deficit by an additional \$1.2 billion a year. Gradual reform will delay job creation. If 936 is changed to a wage/expenditure credit, it is estimated that 80 percent of the 936 companies will gain or not be impacted.

VI. PUERTO RICO SHOULD BE MADE A SUPER ENTERPRISE ZONE

In effect, Puerto Rico should be made a super enterprise zone. Enterprise zones, including reduced capital gains taxes, lower depreciation rates, and new investment tax credits, are an effective way of bringing back an economically depressed area. The people of Puerto Rico deserve the same opportunity that other economically depressed areas will receive.

VII. REFORMING 936 IMMEDIATELY WILL SAVE APPROXIMATELY \$3 BILLION

Reforming 936 immediately and sunseting the program will save the federal government approximately \$3 billion a year. Half of that money should be used to remove the cap on Puerto Rico's medicaid funding and funding of a super enterprise zone. The other half could go towards further deficit reduction.

VIII. 936 HAS LINED THE POCKETS OF PHARMACEUTICAL COMPANIES AND IS THE BEST SYMBOL OF SPECIAL INTEREST LOBBYING

The 936 program has lined the pockets of pharmaceutical companies without helping the Puerto Rican people. The 1993 GAO study has found that "one sector, pharmaceuticals, has accounted for 45 to 55 percent of all tax benefits received..." While textile, apparel, rubber and plastic products, leather and machinery have received a disproportionate level of tax benefits, thus growth in those areas has been significantly less than the pharmaceutical industry. Due to 936, several pharmaceutical companies each increased their corporate profits by over \$50-\$100 million a year. These companies spend millions every year in Washington to protect their special tax breaks.

If you have any questions on these points, please do not hesitate to contact our Washington representatives Jonathan Slade or Steve Crout at (202) 296-6222.

PUERTO RICO AND THE STATUS ISSUE

I. COMMONWEALTH STATUS ATTAINED IN 1952

Under the Constitution's "territorial clause," Congress has primary jurisdiction over the relationships between the federal government and territories, and the terms in which a territory becomes a state. In 1950, legislation was signed into law authorizing Puerto Rico to call a convention and draft its own constitution. After a series of legislative and electoral steps, Puerto Rico was proclaimed a commonwealth under its constitution in 1952, which was approved by Congress shortly thereafter. Thus, Puerto Rico was granted full local executive, legislative and judicial authority, ending U.S. administration over Puerto Rico's local affairs. In 1952, the Puerto Rican people approved of the commonwealth status by an overwhelming 75 percent in a referendum.

II. THREE POLITICAL PARTIES FORMED ON THE BASIS OF POLITICAL STATUS

The main political question before the people of Puerto Rico today is whether or not the island should remain a commonwealth, request admission as a state or become independent. Since status is the main issue, the Republican and Democratic parties are organized separately, and are not major factors in island politics. Three primary political parties on the island have developed based on the political status issue.

New Progressive Party: The New Progressive Party (NPP) is supportive of Puerto Rico Statehood. The party contends Statehood will allow residents to enjoy the full rights, benefits and responsibilities as the 50 states in the U.S. The Party also argues that Statehood will enable residents the right to vote for President in the U.S. and elect at least six Puerto Rican representatives and two senators to Congress.

Popular Democratic Party: The Popular Democratic Party (PDP) is supportive of maintaining Puerto Rico's commonwealth status. The Party contends that commonwealth guarantees a permanent union between Puerto Rico and the U.S. under the terms of the existing bilateral path, which cannot be altered except by mutual agreement. The party also argues that commonwealth guarantees U.S. citizenship, common currency and common defense with the U.S. The PDP is a strong defender of the 936-income-based tax credit which encourages U.S. plants to shift operations to the island.

Puerto Rico Independence Party: The Puerto Rico Independence Party supports the establishment of Puerto Rico as an independent nation. The party contends independence will guarantee Puerto Ricans the authority to exercise all political affairs as a sovereign nation. The party also argues that a treaty of cooperation with the U.S. will guarantee the continuation of acquired benefits including U.S. citizenship.

III. PUERTO RICO RESIDENTS DO NOT PAY FEDERAL TAXES AND THEREFORE ENJOY FEW FEDERAL BENEFITS

Despite their commitment to the United States in times of war, Puerto Ricans do not enjoy the full benefits of the United States citizenship. Overall, Puerto Rico ranks 48th among the 50 states and U.S. territories in federal funding per capita. If Puerto Rico were granted statehood, Puerto Ricans would pay federal taxes, and would thus be eligible for full federal benefits.

IV. MAJORITY OF VOTERS RECENTLY REJECTED COMMONWEALTH

The results of the plebiscite held in Puerto Rico on Sunday, November 14, 1993, demonstrate that a majority of the island's residents support a change in the island's political status - rejecting the current commonwealth status. A total of 46.2% of the people voted for statehood and 4.4% voted for independent -- over 50% of the people calling for a change in the island's current status. The support for the commonwealth decreased by over 15% from the last plebiscite held in 1967.

V. THE COMMONWEALTH PARTY (PDP) WON A PLURALITY OF THE PLEBISCITE VOTE BY DECEIVING THE VOTERS

The Commonwealth party only won the 1993 status referendum by promising the Puerto Rico voters an unattainable status. The so-called "Enhanced Commonwealth" proposes a new relationship with the U.S. which goes against all current legal and political trends. The false promises include the following:

1) A bilateral pact undermines Federal authority:

The commonwealth platform states that a bilateral pact can be established that will allow Puerto Rico equal power over all federal issues. Such a pact can never take place since a territory must remain under the jurisdiction of Congress unless it becomes a state. This view was recently confirmed by a federal court decision in which the bilateral pact of the Marianas Island was considered beneath Congressional power under the territorial clause;

- 2) Full Federal benefits without tax contributions:
The Commonwealth party campaigned on the promise that Puerto Rico would receive full federal benefits without additional taxation. This pledge goes against the nature of the Health Security Act under which Medicaid and Medicare are being reformed and in many instances curtailed;
- 3) Anti-NAFTA Agricultural Protection:
The enhanced commonwealth status proposed greater protection for Puerto Rican agricultural products. Protectionist trade measures are inconsistent with the President's Nafta agreement, the CBI and the new GATT agreement;
- 4) Pre-1986 Section 936:
The Commonwealth party campaigned for a return to the pre-1986 Section 936 tax exemption for U.S. corporations located in Puerto Rico. Here again, this pledge is contrary to the President's FY 1993 budget proposal to transform Section 936 to a wage based credit and the compromise reached in Congress during consideration of the Budget Reconciliation Act.

VI. PUBLIC SUPPORT FOR STATEHOOD IS CLEARLY GROWING

The last three plebiscite were held in 1967 and statehood was supported by 38 percent of the voters. On November 14, 1993, over 46 percent of the voters chose statehood. The 8 percent increase in support for statehood clearly shows where the trend is going. Since the first formal vote on the status issue was held in 1952, the percentage of voters opposing commonwealth has increased by over 25 percent (25 percent in 1952 to 50.6 percent in 1993). The polls indicate that young voters strongly support statehood. Based on four decades of plebiscites/referenda on the status issue, the voting trend in Puerto Rico is clearly towards statehood and a formal request for admission to the Union as the 51st State.

If you have any questions on these points, please do not hesitate to contact our Washington representatives Jonathan Slade and Steve Crout at (202) 296-6222.

STATEHOOD HAS BEEN A LONG AND DIFFICULT PROCESS

Whether it involved a series of referendums or decades of petitioning Congress, many former U.S. territories endured an arduous process in becoming a state. In some cases, the statehood supporters in a given territory had to wait 40-50 years for admission to the Union.

In many of these states, the territorial business and political leaders opposed statehood due to taxes and other issues. More specifically, the sugar interests in Hawaii and fishing industry in Alaska each actively opposed statehood movements for many years.

Puerto Rico is the first U.S. territory to have dozens of major American corporations actively opposing the statehood movement. If Puerto Rico became the 51st state, these corporations would lose their special tax breaks from locating on the island.

In order to fully understand Puerto Rico's quest for statehood, we thought it would be useful to examine the statehood process and difficult struggles of other former U.S. territories.

- I. THE STATEHOOD PROCESS---Due to resentment generated from the colonial experience, American territories mobilized to become states. In most of these areas, the formal movement was initiated by the submission to Congress of various petitions demanding admission as a matter of right. Although these petitions were initially ignored by Congress, they reflected the cohesiveness of the territory as well as the desire to become a state. The creation of a state was accomplished by the election of delegates to a popular convention that would draft a constitution as the fundamental law of the state. Constitutional conventions were called in two ways: (1) direct popular initiatives or (2) by the passage of congressional enabling act. As a result, the states were ready to be admitted to the Union. The power to create new states is a power exclusively reserved to the people in those areas; however, Congress has the power to **admit** new states.
- II. JEFFERSONIAN GUIDELINES FOR STATEHOOD---There are three basic guidelines for statehood: (1) In order to consider statehood for any given area, a majority of eligible voters living in the proposed state must desire statehood; (2) Citizens of the aspiring state must embrace principles of democracy and self-government as characterized in the American form of government and the U.S. Constitution; and (3) The proposed new state must have enough population and resources to support a state government.
- III. THE TENNESSEE PLAN---Tennessee's quest for statehood is unique because Tennesseans themselves set in motion the events that brought about statehood in the early 1790s. A state legislature was voted upon and the first popular assembly convened on

August, 1794. In January of 1796, the delegates were called for a convention to draft a state constitution. When the state constitution was sent to Congress, it was well received by the House of Representatives. The Senate, on the other hand, was dominated by Federalists, and strongly opposed Tennessee's admission into the Union. The Senate rejected the motion for immediate admission as a state, and approved its own version of the bill. When the bill reached the House, they refused to pass the Senate bill. A conference committee was established, and on June 1, 1796, the conference committee reported that the Senate should recede to the House, and the territory admitted as "the state of Tennessee." The Tennessee Plan became the blueprint for several states to follow.

- IV. **ALASKA STATEHOOD**---In 1867, under the Treaty of Cession, the Alaskan lands were formally transferred to the United States. Prior to World War II, Congress passed the First Organic Act and the Second Organic Act which granted Alaska an elective territorial legislature, however, the Act imposed several severe limitations on the territory's legislative authority. Alaska's desire to achieve a high degree of self-government did not receive real attention until World War II. However, Alaska's remoteness to the United States contributed greatly to its difficult statehood struggle. The adoption of the Tennessee plan, which led to the election of a complete congressional delegation prior to congressional authorization, was a key to Alaska's success in becoming a state. Consequently, several referendums were held regarding the statehood issue. The results reflected growing support among Alaskans for statehood. On January 3, 1959, 91 years after the Alaska territory was transferred to the U.S., President Eisenhower formally admitted Alaska as the forty-ninth State of the Union.
- V. **HAWAII STATEHOOD**---In 1898, supporters of annexation won approval of the transfer of sovereignty over Hawaii to the U.S. In 1890, under the Organic Act, the people of Hawaii were granted U.S. citizenship and the authority to manage their own internal affairs, subject to the approval of Congress. Momentum began to build for statehood after World War I. In 1940, a plebiscite was held in Hawaii on the question of statehood. The people overwhelmingly voted in favor of statehood (67 percent). Despite the results of the 1940 plebiscite, the statehood movement in Hawaii was postponed by World War II. Finally, after a 14 year struggle, the Congress passed and the President signed into law legislation to admit Hawaii as the 50th State of the Union, provided the people of Hawaii approved in a plebiscite. The people in favor of statehood and Hawaii was admitted as the 50th State of the Union on August 21, 1959.
- VI. **NEW MEXICO STATEHOOD**---New Mexico's quest for statehood was the longest in the U.S., lasting 62 years. The biggest obstacle for statehood was the racial prejudice against the large Hispanic population of New Mexico. Between 1846 and 1912, many Congressional speeches and newspaper articles conveyed a strong prejudice towards the Spanish-speaking population of New Mexico. Although no official referendums for statehood were held, five proposals of state constitutions were submitted to the people

of New Mexico for ratification. The referendums reflected growing support among New Mexicans for statehood. The final constitutional vote was held in 1911 and 70 percent supported ratification while 30 percent opposed it. One year later, New Mexico was admitted as the 47th state.

- VII. **WISCONSIN STATEHOOD**---Wisconsin's struggle for statehood faced great opposition from the people, and the statehood platform was rejected four times before it finally rallied a majority. The people of Wisconsin had the opportunity to vote on the statehood issue on seven occasions. Between 1840 and 1846, in four different referendums, a majority of voters rejected proposals for statehood. Finally, in 1846, after an enabling act was approved by Congress, a referendum was taken which resulted in favor of statehood. Two years later, a state constitution was drafted and ratified, and Wisconsin was admitted as the thirtieth state.
- VIII. **OREGON STATEHOOD**---Oregon began to aspire for statehood immediately after it was organized as a territory. Between 1854 and 1857 four plebiscites were held to organize a State government. The referendums were defeated in the first three, and overwhelmingly passed on the fourth referendum. The Oregon experience is interesting because the results of the first three referendums were close. As a matter of fact, statehood proponents lost by 2 percent in the June 1855 and April 1856 referendums. The Oregon admission bill went through two sessions of the 35th Congress before it was approved. Finally on June 3, 1859, Oregon was admitted as the 33rd State of the Union.

Puerto Rico, like many other former U.S. territories, has faced significant obstacles in its quest for statehood.

If you have any questions on these points, please do not hesitate to contact our Washington representatives Jonathan Slade and Steve Crout at (202) 296-6222.

GENERAL FACTS ON THE COMMONWEALTH OF PUERTO RICO

- I. **U.S. TERRITORY**---Puerto Rico came under United States sovereignty by the Treaty of Paris, signed on December 10, 1898. The U.S. invaded Puerto Rico during the Spanish-American War.
- II. **U.S. CITIZENSHIP**---Puerto Ricans have been citizens since 1917. Citizenship was granted by an act of Congress and signed into law by President Wilson.
- III. **SELF-GOVERNING TERRITORY**---Under the Constitution, Congress has primary authority over Puerto Rico under the territorial clause.

In July 1950, the U.S. Congress enacted Public Law 600. It provided that existing laws which defined the political, economic and fiscal relationship between Puerto Rico and the United States should remain in full force. It also authorized Puerto Rico to draft and approve its own Constitution, which took effect on July 25, 1952. Puerto Rico's relationship with the U.S. is referred to as a commonwealth status.

- IV. **GOVERNMENTAL STRUCTURE**---The Government is comprised of an elected Governor and bicameral legislature. Elections are held every four years at the same time as the U.S. Presidential election. In 1992, the New Progressive Party (pro-statehood) won the Governorship and two-thirds of the seats in each legislative body.
- V. **U.S. REPRESENTATION**---The people of Puerto Rico do not vote in national elections. They are represented in Congress by a Resident Commissioner who has a voice in the House of Representatives but no vote. The election of the Resident Commissioner is held every four years along with regular elections. Although the political parties are formed based on the status issue, Puerto Rico voters elect delegates and send a delegation to the Democratic and Republican conventions every four years.
- VI. **LEGAL SYSTEM**---Legal protection is provided by the Constitution of Puerto Rico, with ultimate appeal to the U.S. Supreme Court. U.S. citizens living in Puerto Rico do not have automatic constitutional rights. Congress must grant Puerto Rico each constitutional right by legislation.
- VII. **GEOGRAPHY**---Puerto Rico measures 100 miles by 35 miles with an area of 3,434 square miles. Topography varies from coastal flatlands to mountainous central highlands.

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- VIII. **POPULATION**---Puerto Rico has 3.7 million U.S. citizens. Population density is slightly over 1,000 persons per square mile. This places Puerto Rico's population density as the seventh highest in the world. About 2.5 million Puerto Ricans also reside on the U.S. Mainland.
- IX. **ECONOMY**---In 1992, the Gross Domestic Product was \$33.6 billion. In fiscal year 1990, the Gross National Product was \$21.5 billion. Per capita personal income of \$5,721 is about 1/3 of the United States average and is ranked below all 50 states. Real per capita income has grown at an average annual rate of 4% during the past five years.
- X. **TRAVEL/TRADE**---There are no travel restrictions to other U.S. areas and no Customs duties or quotas on shipments between Puerto Rico and the U.S. Mainland. Products manufactured in Puerto Rico are "Made in the U.S.A."
- XI. **MILITARY SERVICE**---Puerto Rican-Americans have fought and died in each of this century's wars. For example, 20,000 Puerto Ricans served in Operation Desert Storm. The first U.S. soldier killed in Somalia was from Puerto Rico.

If you have any questions on these points, please do not hesitate to contact our Washington representatives Jonathan Slade and Steve Crout at (202) 296-6222.

PUERTO RICO STATEHOOD IS A PREREQUISITE FOR ECONOMIC DEVELOPMENT

In evaluating the benefits of Puerto Rican statehood, please consider the following points.

I. STATEHOOD WOULD BRING NEW PRIVATE SECTOR JOBS

The current unemployment rate in Puerto Rico ranges from 16-18 percent -- over triple the unemployment rate in the U.S. Clearly, Puerto Rico's economy is based out-dated and ineffective economic development strategies. Statehood, which as a general goal supports self-sufficiency, would provide the change needed to create new private sector jobs.

Commonwealth Today

Puerto Rico as a commonwealth today endures an extremely high unemployment rate of 16-18 percent, a low labor force participation rate of 45.7 percent, and a high one percent rate of migration to the mainland U.S. for better jobs.

The underlying problem is that the commonwealth economy is based on a model of government assistance and tax incentives to encourage investment. For example, the commonwealth economy has long depended on the section 936 tax code to bring jobs to the island. This tax incentive, however, exists solely upon the consent of Congress and offers no long-term investment security. In addition, the commonwealth economy is too dependent on the public sector for jobs. Puerto Rico has experienced a rapid growth rate in government employment over the past ten years. Currently, the Puerto Rican government accounts for one in four jobs, whereas the U.S. government accounts for one in six jobs.

It is widely recognized that sustained economic growth in the U.S. and throughout the world is stimulated by private sector response to the marketplace. Successful economic growth is not possible under the commonwealth system which relies too heavily on government assistance.

Statehood Tomorrow

If Puerto Rico were to achieve statehood, a new economic model would be implemented emphasizing long-term economic growth through consistency in tax treatment and modern private sector investment initiatives. In return, the government's role as principal employer would be reduced and private sector job growth would be increased.

For example, under statehood Puerto Ricans would pay federal taxes in return for full federal

funding of entitlement programs. Federal funding for entitlement programs would free current local tax revenues for investments in infrastructure and public works -- investments critical to enhancing private sector growth.

In addition, the imposition of federal taxes would create pressure to reduce the current tax burden on Puerto Ricans under the commonwealth system to a rate in line with that of the other 50 states. This pressure to reduce local taxes will result in the streamlining of the public sector. The result would be a smaller, more efficient public sector -- reducing the government's role as principal employer and increasing private sector job growth.

Statehood also brings permanent advantages that similar locations do not have. For example, statehood brings a permanent exemption from U.S. tariffs, use of the U.S. dollar and protection under the U.S. legal system.

Above all, statehood offers a familiar and consistent economic system that will increase investor confidence.

II. STATEHOOD WOULD BRING POSITIVE GOVERNMENT REFORM

Puerto Rico has had to increasingly depend on public corporations to provide basic services. Although such corporations were originally designed to be supported through fees, most are heavily subsidized today. The result is that public revenues are being spent on services that could be provided by the private sector. This drain on the general fund prohibits expenditures on other important public programs. Statehood would bring positive government reform that encourages economic stimulus.

Commonwealth Today

As a Commonwealth, Puerto Rico subsidizes 54 public corporations to provide general services. For example, the Commonwealth government has owned and managed the utility, telephone, hotel, sugar, shipping, insurance, maritime, banking, housing, sewage and a host of other industries.

These public corporations were originally designed to provide government functions with more efficiency than agencies of the Commonwealth government. Instead, these corporations have become heavily subsidized arms of the government that are inefficient and costly.

The services rendered by public corporations are better suited for the private sector which would create jobs and generate revenues for the general fund. Unfortunately, commonwealth dependence on government corporations fails to provide the economic infrastructure needed to stimulate the private sector.

Statehood Tomorrow

A move to Statehood would provide the stimulus needed to reform Puerto Rico's heavy dependence on government and public corporations to supply jobs. The imposition of federal taxes on Puerto Rican citizens and businesses will create pressure to reduce current commonwealth income taxes so that the overall tax base is on average to those states on the mainland. A reduction in commonwealth taxes will require a more efficient, downsized public sector. As a result, there will be a natural trend to privatize many of the services provided by public corporations.

Privatization of certain public sector services will help establish a viable infrastructure and create jobs. Many of the services provided by the public sector are more suitable for the private sector such as shipping and insurance. Overhaul of the public corporation sector will also provide additional tax revenues. In the private sector, these corporations would generate tax revenue, and eliminate tax exemptions utilized by public corporations.

In sum, the transition to Statehood will reduce an over-sized government sector and help establish a more efficient private sector that will create jobs and provide additional revenues.

III. STATEHOOD WOULD NOT COST THE U.S. TREASURY

A change in status to statehood would not be a drain on the U.S. Treasury. In fact, commonwealth currently costs the U.S. Treasury about \$4-5 billion annually. Under statehood, Puerto Ricans would pay federal taxes just as mainland citizens. The imposition of federal taxes would offset the cost of entitlement programs. In addition, the elimination of possessions tax credits such as Section 936 would save the American taxpayer billions. Simply put, statehood will not burden the U.S. Treasury and will help Puerto Rico become more self-sufficient.

Commonwealth Today

Commonwealth is currently a drain on the federal budget. As a commonwealth, Puerto Rico is not subject to federal taxes. The citizens of Puerto Rico do, however, receive certain federal benefits without paying taxes.

In addition, the commonwealth economy is built upon the 936 possessions tax which allows U.S. corporations to relocate to the island in return for huge federal tax breaks. This tax break for U.S. corporations costs the U.S. Treasury nearly \$3 billion annually.

Under commonwealth, Puerto Rico will simply continue to drain the federal budget and will never develop the infrastructure necessary to become a self-sufficient, growing economy.

Statehood Tomorrow

There are essentially four potential impacts of statehood on the federal budget. First, individuals and businesses in Puerto Rico will be required to pay federal taxes. Second, the federal government will provide full funding for entitlement programs such as health care and welfare. Third, tax breaks for U.S. corporations under Section 936 will be eliminated. Fourth, as it has done historically for new states, the federal government may choose to provide Puerto Rico some form of statehood grant to help smooth the transition to statehood.

A balanced, phase-in approach will relieve any burdens on the federal budget. For example, federal taxes should be phased-in consistent with the increase in funding for entitlement programs. Under such an approach, federal taxes will offset the cost of new entitlement programs and provide fiscal harmony during the transition period.

In addition, the Section 936 possession tax should be phased out. The Clinton economic team estimated that a five-year phase-out of Section 936 would save the U.S. taxpayer in excess of \$7 billion. A phase-out approach will provide the U.S. Treasury with significant revenues while protecting against possible short term disruptions in the economy.

Finally, as the collection of federal taxes increases to offset entitlement programs, and federal savings are realized from the gradual elimination of Section 936, federal revenues will be available for some form of a statehood grant to assist Puerto Rico in the transition period.

In summary, Puerto Rico will become a self-sufficient, vibrant economy and will not depend on annual federal handcuts.

If you have any questions on these points, please do not hesitate to contact our Washington representatives Jonathan Slade and Steve Crout at (202) 296-6222.

Source: J. Hexner, G. Jenkins, H. Ladd, K. LaMotte, "Puerto Rican Statehood a Precondition to Sound Economic Growth," (HEX, 1992).