Taxes, Industrial Incentives and Political Status Options

Tax Related Industrial Incentive Impact of Political Status Options for Puerto Rico

Eric G. Negrín Rivera

Introduction

This paper will analyze the tax-related industrial incentive possibilities for Puerto Rico under each of the three status options: Commonwealth, Independence and Statehood. These possibilities will be significantly affected by the Omnibus Budget Reconciliation Act of 1993, signed into law by President Clinton on August 11, 1993. Provisions of such legislation most likely to affect the subject of our analysis are discussed below, albeit their actual impact is difficult to forecast with complete specificity.

Until 1993, tax incentives available to U.S. investors in Puerto Rico under Section 936 of the U.S. Internal Revenue Code were generally regarded as more attractive than tax incentives available for U.S. investments in states of the Union or in foreign countries. In the case of foreign country tax rules, the incentive differential for U.S. investors vis-a-vis Section 936 was deemed to be of little or no significance with respect to income from the active conduct of business. This differential was countered by the foreign jurisdictions’ capacity (unavailable in Puerto Rico under Commonwealth status) to enter into tax sparing agreements with industrialized countries other than the United States.

In the case of U.S. investments in states of the Union, the tax differential vis-a-vis Section 936 had decreased over the last decade, but was still considerable. As a result of the 1993 Budget Reconciliation Act, federal tax treatment of active income from foreign countries may well become more advantageous for U.S. investors in several manufacturing categories especially the “high-tech” ones than the now sharply reduced tax benefit of Section 936. These foreign country provisions apply in Puerto Rico under Commonwealth status as they would under Independence status, although under Independence the possibility of a tax treaty with the United States could vest some of these provisions with a fixity they lack under Commonwealth.

Statehood's tax disadvantage vis-a-vis Independence and Commonwealth, though perhaps lessened by the 1993 Budget Reconciliation Act, is likely to remain substantial for U.S. investors. Third country investors and locally owned corporations would also become subject to the impact of full federal corporate taxation under Statehood; a situation disadvantageous vis-a-vis Commonwealth and, in the case of third country investors, even more so vis-a-vis Independence.

Tax Consequences of Commonwealth

Background

U.S. tax exemption provisions pertaining to Puerto Rico-originated industrial profits have existed in various forms since 1921. Such provisions, usually applicable to all other U.S. possessions, were originally intended to eliminate disadvantages faced by U.S. corporations operating in the Philippines against their British competitors, which were allowed deferred taxation on foreign income until it was remitted back home. A few years after World War II, the government of Puerto Rico decided to embark on an industrialization program that offered U.S. investors, on top of the already available federal tax exemption, a combination of local incentives such as low rents, low-interest loans, and above all, little or no local income taxes. This program survives as the cornerstone of the island's development model under Commonwealth status.

Until 1976, profits of U.S.-owned manufacturing firms in Puerto Rico were tax exempt at the federal level through Section 931 of the U.S. Internal Revenue Code, under which dividends paid by the exempt companies to their U.S. parents were taxable to the latter but liquidation distributions were not. In 1976, Congress replaced Section 931 with a newly created Section 936. Section 936 provided a full credit against U.S. tax on Puerto Rico-source income (rather than exempting such income, as section 931 did) while granting affiliates a full deduction for dividends received from the latter.
Congress has recently curtailed Section 936 incentive in such a manner as to make most participating companies only partially tax exempt. Pursuant to the Omnibus Budget Reconciliation Act of 1993, for tax years beginning after December 31, 1993 Section 936 taxpayers must elect one of two alternative methods for capping the 100 percent credit they enjoyed heretofore on their manufacturing income. The first method, known as the "economic-activity limitation," limits the company's credit to the sum of a percentage of wages, depreciation, and taxes.

The second method, known as the "percentage limitation," limits Section 936 credit to an applicable percentage of the credit that was allowable for tax years beginning prior to 1994. Under a transition rule providing a 5-year phase in, the resulting "income-based credit" shall fall to 60 percent of the present full credit in 1994; 55 percent in 1995; 50 percent in 1996; 45 percent in 1997; and 40 percent in 1998 and thereafter.

**Prospective Outlook under Commonwealth**

The history of Section 936 is, thus, one of periodic cutbacks in the value of its tax benefit. Puerto Rico, in fact, may in the intermediate future experience further congressional curtailments to the remnants of this provision. After the recent amendments to the Section 936 credit, it is even doubtful that the island will attract any significant new investments under it. High technology companies will probably do better under the foreign source income rules, while labor intensive companies are no longer attracted in large numbers for reasons unrelated to tax considerations.

Nonetheless, companies operating in Puerto Rico under Commonwealth status have the option of being treated like foreign operations for U.S. tax purposes. Tax incentives under Commonwealth, therefore, would remain at least as advantageous at present as those under Independence from the point of view of U.S. investors. In contrast with the situation under Independence, however, the permanence of foreign-source income incentives cannot be guaranteed under Commonwealth through a tax treaty with the United States; a disadvantage which the unstable experience of Section 936 demonstrates to be of considerable weight. Since Puerto Rico is treated more favorably than foreign countries on the outlay side of the U.S. budget, future cutbacks in the applicability to the island of advantageous revenue provisions tailored to international tax norms cannot be ruled out.

**Tax Consequences of Independence**

**Fundamental Scenario**

Under independence, Section 936 would probably cease to apply to Puerto Rico. Yet, regardless of the transition period granted by the United States, eventual elimination of Section 936 need not imply a reduction in tax-related incentives for investment on the Island. In fact, the relative immunity of the post-independence tax scenario to congressional modifications, coupled with the improved prospect for tax-related attraction of third country investments, would probably constitute a more advantageous tax regime for Puerto Rico.

Thus, income from manufacturing activity in Puerto Rico was not deemed to be subject to substantially greater tax advantages than similar activity in low-tax foreign countries. Although dividends received by a U.S. parent from a Section 936 company were not taxable while dividends from a foreign affiliate were, the ability to defer this latter liability until repatriation represented for many corporations an advantage comparable to total exemption. Many multinationals have simply kept their foreign profits reinvested abroad for long periods, after which the real tax liability due upon repatriation is reduced to a fraction of its original value. Also, U.S. companies have carried excess foreign tax credits from operations in high-tax locations that can be used to offset the U.S. tax on dividends from low-tax foreign countries. A U.S. parent with sufficient excess credits would currently be attracted to Puerto Rico only because of its local tax incentives, since the excess credits would in any event cancel any federal liability on dividends received.

Economic studies examining the likely outcome of an elimination of Section 936 in Puerto Rico have usually argued that firms would react by reincorporating as foreign subsidiaries.
Third Country Tax Sparing

The following scenario applies to comparable investments from foreign nations other than the United States. Independence would empower the island to enter into tax sparing treaties, i.e., treaties providing for total tax exemption at the investor’s home country, just as Section 936 did, with industrialized countries such as Japan, Canada, Germany, France, the United Kingdom, or others that customarily adopt tax sparing provisions in their tax treaties with developing nations. Other European nations like, Sweden or the Netherlands also include tax sparing provisions in their treaties with developing countries.

Under Commonwealth status, Puerto Rico lacks legal authority to enter into such treaties. Since the Island is not ordinarily subject to the internal revenue jurisdiction of the United States, tax treaties between the United States and third nations for the avoidance of double income taxation do not apply to income derived in Puerto Rico either. Hence, foreign companies in the Island may find themselves with no legal guarantee against double taxation (i.e., both in the Island and in the home country).

Policy Options

As pertains to the attraction of both U.S. and third country investments, the foregoing discussion makes evident that one major tax-related option available to an independent Puerto Rico would be simply to remain a low-tax jurisdiction in the fashion of other Caribbean and international “tax havens.” While federal tax provisions applicable to U.S. subsidiaries in low-tax foreign countries have provided incentives comparable to those of Section 936, the substantial changes approved under the 1993 Budget Reconciliation Act will probably make Section 936 less attractive on an overall basis, particularly for the hard hit “high-tech” sector, than the less affected provisions. Non-U.S. foreign investors, moreover, could start enjoying the currently unavailable advantage of home country tax sparing.

An independent Puerto Rico could also seek to attract manufacturing investment by offering, in addition to a low tax option, the alternative of paying higher local taxes while also qualifying for government subsidies. This arrangement may facilitate profitability levels comparable to those prevailing even under the pre-1994 version of Section 936.

Under this second alternative, Puerto Rico could impose relatively higher rates of direct corporate tax and/or dividend withholding tax at aggregate rates intended to replicate those which the IRC would levy on profits received by U.S. parent companies from their Puerto Rico sources. The Dividend Withholding Tax, which maintains the deferral advantage, also yields a foreign tax credit under IRC sections 901 et seq. The Island’s government, in turn, could use these new revenues to provide participating companies with financing or capitalization at below-market rates of return. It could also provide other direct or indirect subsidies on pre-determined company costs, such as plant and equipment, labor, energy, transportation, insurance, pollution control, technology acquisition or development, locally provided services or components. These subsidies, if amounting in the aggregate to the entire sum of new local tax revenues (i.e., beyond those already collected under the prior low tax option), could be targeted in such way as to make participating companies retain after-tax earnings resembling the income amount that would have been exempt had full federal tax exemption continued to apply.

Unlike the deferral principle, the foreign tax credit is a standard concept in U.S. tax treaties with other nations. This could make the program just described relatively immune to unilateral U.S. curtailment than the low tax option. Such a program would have to meet U.S. legal and regulatory provisions designed to prevent companies from claiming U.S. foreign tax credits in certain situations or from introducing to the U.S. market, penalty-free, products that have been subject to subsidies by foreign governments. These provisions, arising from Section 901(i) of the U.S. Internal Revenue Code and from the countervailing duty standards in the U.S. Tariff Act, require that Puerto Rico’s subsidies be uniformly available to industrial taxpayers in general and that...
they not be determined by reference to the tax base or tax liability of each taxpayer. To the extent that Puerto Rico's subsidy program covered, for instance, pre-established percentages of certain categories of company costs, regardless of the tax base or tax liability of each participating company, it would be acceptable for some industries to benefit more from the program than others.

Because of the "general availability" requirements just described, any such program should be made applicable not only to the multinational sector but also to locally owned manufacturing companies. The latter are currently entitled under Puerto Rico's Industrial Incentives Act to the same exemption grants that Section 936 companies enjoy. The locally owned sector is small when compared to the Section 936 sector, and its inclusion in any such program would be unlikely to cause a major impact. Nevertheless, the experience of countries such as Singapore and Ireland suggests that a subsidy strategy focusing on financial, technological and marketing criteria may foster the strengthening of linkages between foreign-owned manufacturers and the local economy, while also facilitating the technological upgrading of local entrepreneurs and workers. Thus, in addition to serving as a promotional tool for the multinational sector, such an incentive orientation could have important consequences for Puerto Rico's evolution into a truly autonomous and self-sustaining economy.

Tax Consequences of Statehood

Fundamental Scenario

Because of the uniformity clause in the U.S. Constitution, under Statehood Puerto Rico would become subject to the same federal tax provisions applicable to all other states. These provisions include the federal corporate tax system. As of 1993, the maximum statutory rate of this provision applicable to income categories currently exempt under Section will be 35 percent.

The U.S. Congress would probably offer some kind of transition from pre-statehood to the full introduction of federal corporate taxes. It is less clear, however, whether such a transition would occur before or after the island's actual incorporation as a state. Constitutional concerns were posed during the Congressional negotiation process over the Energy and Natural Resources Committee version of the bill S.712, with respect to a five-year phase-out for Section 936 occurring after Statehood comes into effect. Such concerns led the Senate Finance Committee to amend S.712 in order to postpone the advent of Statehood until phase-out had been completed.

Regardless of any transition method eventually enacted, Statehood would signify in its final form, the full applicability of federal taxes not just to U.S.-owned corporations, but also to companies owned by Puerto Rico or third country residents. The island could no longer count on economically significant tax-related incentives to attract multinational manufacturing investment or promote locally-owned ventures.

Rate of Return Impact of Federal Taxation

Table I estimates the possible increase in federal burden that manufacturing companies currently subject to Section 936 would experience under Statehood. Using 1989 data, the table presents a set of comparisons based on firms' return on assets for that year vis-a-vis possible post-statehood scenarios. Such comparisons are made for the entire Section 936 manufacturing sector as well as for each separate industrial category listed in the U.S. Treasury Department's published balance sheets.

The table provides two "pre-statehood" return on assets scenarios. The "100 percent credit" scenario presents the return on assets ratio estimated for Section 936 companies under actual 1989 statistics. The "40 percent credit" scenario provides (where applicable) the corresponding ratio that would have resulted had the same companies been subjected in that year to income-based limitation as it will become effective by 1998.

Two post-statehood scenarios are presented, showing estimated return on assets ratios based on a 35 percent federal tax rate. The first scenario assumes that under Statehood Puerto Rico would collect the same amount of taxes that it did prior to Statehood, and takes into account the deduction of these Puerto Rican taxes
from U.S. taxable income. The second scenario assumes that no Puerto Rico taxes are collected under Statehood from former Section 936 companies.

Finally, the possible range of percentage point reductions in return on assets ratios resulting from these two post-statehood scenarios is shown vis-a-vis the two pre-statehood scenarios. Under the first post-statehood scenario “with PR tax,” the
For industrial categories where the 40 percent limitation is inapplicable, the post-statehood ratios are only compared against the 100 percent credit to determine Statehood’s estimated impact. For the rest of the industrial categories, including Section 936 manufacturing sector as a whole, the impact of Statehood would be somewhere within the ranges shown in the table. In most instances, the lower bound of each range (e.g., 5.2 in the “with PR tax” Statehood effect for “manufacturing/total”), would probably be further from reality than the upper bound (e.g., 14.6 for the same case). A number of companies in those industrial categories would face lower effective tax rates under the economic-activity limitation and, more important, the effects of the 1993 amendments could be minimized or eliminated by companies reorganizing themselves as foreign subsidiaries.

As shown earlier, federal tax rules for U.S. subsidiaries in foreign countries were considered to yield incentives comparable to those of Section 936 prior to the 1993 Budget Reconciliation Act. Puerto Rico’s capacity to use these foreign country rules for attracting U.S. investment under commonwealth or independence remains substantially unimpaired. Consequently, the upper ranges in Table I may still provide a reasonable idea of Statehood’s tax-related impact on firms’ profitability.

Conclusion

The foregoing analysis has depicted the probable tradeoffs for Puerto Rico under the Commonwealth, Independence and Statehood status options from the standpoint of tax-related industrial incentives. No attempt was made to determine the relative weight of such tradeoffs within a wider context of aggregate economic return on assets ratio for the entire Section 936 manufacturing sector would decrease by 5.2 percentage points vis-a-vis the “40 percent credit” scenario, and by 14.6 percentage points vis-B-vis the “100 percent credit” scenario. Under the “no PR tax” scenario, the reduction would be of 3.3 percentage points vis-B-vis the 40 percent credit and 12.6 percentage vis-B-vis the 100 percent credit.

advantages and disadvantages under each status option.

Industrial tax incentives have played a key role in Puerto Rico’s economic development for more than four decades. Such key role, however, may be interpreted as indicative of the limitations rather than the benefits of Commonwealth status. As a state, it may be argued, the island could become vested with stability and familiarity within the U.S. federal framework, thus eliminating the need for tax concessions or other premiums required under today’s hardly permanent status. The net value of federal tax exemption, moreover, could be more than offset by heightened federal transfer programs to which Puerto Rico could be entitled as a state. It may be argued that whatever tax or other benefits the United States has granted to a politically subordinate Puerto Rico are only a glimpse of what the bargaining power of congressional representation and presidential vote could gain for the islanders.

Independence, in turn, could signify an eventual phase-out of net federal transfer programs currently applicable to Puerto Rico. Yet the benefit of such transfers, and of whatever economic advantage may additionally stem from the Island’s subsidiary relationship to the United States, might be more than compensated by the commercial and entrepreneurial options that political sovereignty would make available. Cheaper imports, greater and more varied access to international export, capital and credit markets, and the capacity to adapt locally applicable rules and incentives to the specific needs of the Island’s economy, could be the formula for Puerto Rico’s break away from its slow growth in the last two decades.

For their part, supporters of the Commonwealth highlight the risks and of the other
two status options. To world investors, who are usually averse to rapidly changing scenarios, Commonwealth represents the historic pillar upon which any important strategic change in the island's economy, or even in its political status, should gradually be built.

A tax view of Puerto Rico’s status dilemma is thus very limited view, even from a purely economic standpoint. Economic analysis, in fact, will always sacrifice accuracy to the extent it remains too "pure." Economic life can never be dissected from the wider social, political, and even psychological realities affecting a society in the first place.

With these caveats, our focus on tax aspects reveals Commonwealth and Independence to be more beneficial for Puerto Rico than Statehood. Independence, in the long run, offers greater stability and versatility than Commonwealth, with no apparent disadvantage in its immediate impact when compared with the now curtailed attributes of the Commonwealth. The continued deepening and evolution of this type of assessment, should definitely play a role in any future status decision made for Puerto Rico.

*Consultant in legal and tax related areas.*
### Table 1

Return on Assets Ratios for Seccion 936 Companies

<table>
<thead>
<tr>
<th>Industrial Category</th>
<th>Pre-Statehood Ratio</th>
<th>Post-Statehood Ratio</th>
<th>Statehood Effect</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>40% credit</td>
<td>100% credit</td>
<td>with PR tax</td>
</tr>
<tr>
<td>Manufacturing Total</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>40% credit</td>
<td>32.3</td>
<td>41.7</td>
<td>21.1</td>
</tr>
<tr>
<td>100% credit</td>
<td>28.6</td>
<td>37.1</td>
<td>24.1</td>
</tr>
<tr>
<td>Food &amp; Kindred Products</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Textile Mill Products</td>
<td>n/a</td>
<td>16.2</td>
<td>10.5</td>
</tr>
<tr>
<td>Apparel &amp; Other Textile Products</td>
<td>n/a</td>
<td>21.6</td>
<td>14.0</td>
</tr>
<tr>
<td>Paper &amp; Allied Products</td>
<td>n/a</td>
<td>11.9</td>
<td>7.7</td>
</tr>
<tr>
<td>Printing &amp; Publishing</td>
<td>n/a</td>
<td>48.3</td>
<td>31.4</td>
</tr>
<tr>
<td>Chemicals &amp; Allied Total</td>
<td>37.2</td>
<td>47.1</td>
<td>30.6</td>
</tr>
<tr>
<td>Chemicals &amp; Allied Drugs</td>
<td>34.9</td>
<td>44.4</td>
<td>28.9</td>
</tr>
<tr>
<td>Petroleum &amp; Coal Products</td>
<td>13.7</td>
<td>17.9</td>
<td>11.6</td>
</tr>
<tr>
<td>Rubber &amp; Miscellaneous Plastic Products</td>
<td>n/a</td>
<td>21.4</td>
<td>13.9</td>
</tr>
<tr>
<td>Leather &amp; Leather Products</td>
<td>n/a</td>
<td>23.1</td>
<td>15.0</td>
</tr>
<tr>
<td>Stone, Clay &amp; Glass Products</td>
<td>n/a</td>
<td>23.8</td>
<td>15.4</td>
</tr>
<tr>
<td>Fabricated Metal Products</td>
<td>n/a</td>
<td>23.4</td>
<td>15.2</td>
</tr>
<tr>
<td>Machinery Except Electrical</td>
<td>148.2</td>
<td>189.7</td>
<td>123.3</td>
</tr>
<tr>
<td>Electrical &amp; Electronic Equipment</td>
<td>36.8</td>
<td>47.3</td>
<td>30.7</td>
</tr>
<tr>
<td>Transportation Equipment</td>
<td>n/a</td>
<td>41.2</td>
<td>26.8</td>
</tr>
<tr>
<td>Instruments &amp; Related Products</td>
<td>37.8</td>
<td>48.3</td>
<td>31.4</td>
</tr>
<tr>
<td>Miscellaneous Manufacturing</td>
<td>n/a</td>
<td>30.4</td>
<td>19.7</td>
</tr>
</tbody>
</table>