U.S. Possessions Corporation Tax Credit, 1980

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The possessions tax credit of almost $1.6 billion was a relatively small portion of the more than $42 billion in credits claimed by all U.S. corporations for 1980. However, for the 589 corporations that claimed it, the credit was significant because it offset 100 percent of their U.S. tax liability on possession business income and qualified investment income. U.S. corporations conducting their business activities in Puerto Rico have claimed this tax credit since 1976, the first year for which a credit, rather than an income exclusion, was allowed.

Returns Claiming Possessions Tax Credit

Income Year	Number of Returns	Net Income (Billions)	Possessions Tax Credit (Billions)
1976	384	$1.5	$0.7
1977	519	1.8	0.8
1978	598	2.5	1.2
1979	597	3.1	1.4
1980	589	3.5	1.6

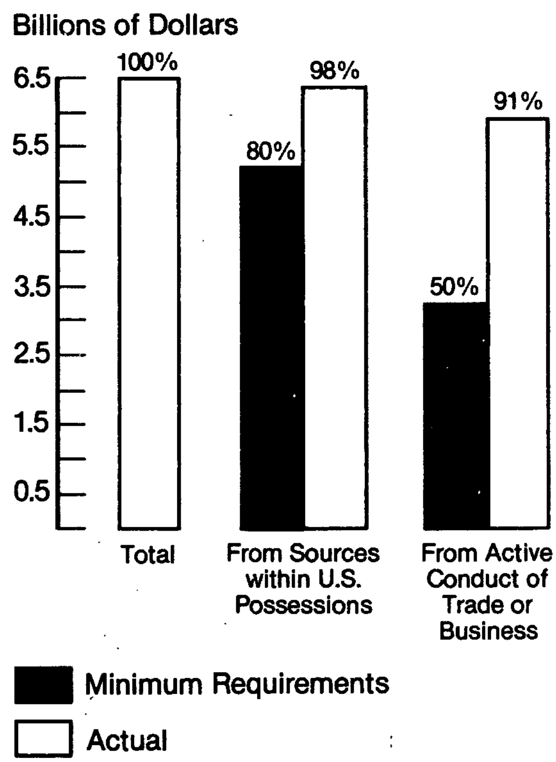
The amount of the possessions credit exceeded the Federal revenue loss attributable to the credit, since corporations which claimed the possessions credit could not claim the foreign tax credit for taxes paid with respect to possessions source income, as well as certain other Federal tax benefits which otherwise would have been available. The Treasury Department estimates that for 1980, the Federal revenue foregone as a result of the possessions tax credit was $1.2 billion, compared to a total possessions credit of $1.6 billion [1].

The 589 corporations claiming the credit for 1980 represented approximately 70 percent of the 820 corporations electing to be treated as possessions corporations. The remaining corporations were either inactive or reported a loss from their operations in a possession for 1980.

THE EVOLUTION OF THE POSSESSIONS TAX CREDIT

Although the credit presently benefits corporations deriving most of their income from the conduct of a trade or business in Puerto Rico or U.S. possessions (excluding the Virgin Islands), beneficial tax treatment of possessions income first began in 1921 to aid U.S. companies with subsidiaries operating in the Philippines (a possession of the United States from 1898 to 1945). Under the Revenue Act of 1921, corporations were exempt from U.S. taxation on all foreign, including possession, source income if at least 80 percent of their gross income was derived from sources within a U.S. possession, and at least 50 percent of their gross income was derived from the active conduct of a trade or business in a U.S. possession. Moreover, under certain conditions, these subsidiaries could be included in consolidated returns which included their U.S. parent corporation and other affiliates. These rules remained the basis for later provisions enacted in the Internal Revenue Code of 1954. Corporations which claimed the benefit of these provisions came to be known as "possessions corporations." Figure A shows that for 1980, possessions corporations greatly exceeded these gross income requirements.

Figure A
Possessions Corporation Gross Income, 1980



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Before 1976, the provisions for possessions corporations entitled their parent corporations to a unique form of domestic tax treatment. In profitable years, the possessions income was excluded from taxation, while in loss years, the corporate parents were allowed to offset their profits with the subsidiaries' losses by joining the subsidiary in the filing of a consolidated return.

This "best of both worlds" tax benefit was removed by the Tax Reform Act of 1976. Although the 80 and 50 percent tests remained intact, possessions corporations were no longer permitted to be included in consolidated returns, thus eliminating the parents' tax benefits in both a profit year and a loss year (there were about 90 possessions corporations reporting a loss for 1980). It was also necessary for the company to make an election to be treated as a possessions corporation (the election was irrevocable for 10 years unless the Secretary of the Treasury consented). Also, the exemption of income was changed to a credit against U.S. income tax equal to that portion of the tax attributable to possessions business income and qualified possession source investment income.

The Tax Equity and Fiscal Responsibility Act of 1982 made two additional changes in the provisions for possessions corporations. First, it cut back the amount of passive investment income that a corporation could earn and still qualify for the possessions tax credit. The 50 percent active trade or business test was increased to 55, 60 and 65 percent for taxable years beginning in 1983, 1984 and 1985 (and thereafter), respectively. Secondly, the Act provided new rules for the allocation, between a U.S. parent corporation and an affiliated possessions corporation, of income attributable to intangible property.

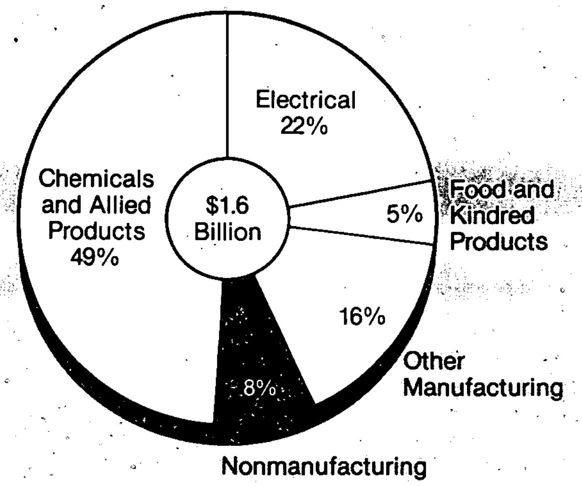
INDUSTRY HIGHLIGHTS

Manufacturers received most of the tax benefits permitted under the possessions system of taxation. Corporations manufacturing chemicals and allied products (pharmaceuticals, in particular) or electrical and electronic equipment claimed over 70 percent of the total possessions tax credit while representing less than 40 percent of the corporations.

While the companies that manufactured chemicals and drugs claimed an average credit of nearly $8 million, corporations that manufactured electrical and electronic equipment earned nearly $3 million of credit on the average. These two industries accounted for approximately 50 percent of the more than $12 billion in total receipts of all the possessions corporations. Nonmanufacturing corporations represented only about 20 percent of those claiming the credit, and their credit accounted for less than 10 percent of the total.

This reflects the incentives which the Government of Puerto Rico enacted to attract manufacturing companies to the island. Under Puerto Rico's Industrial Incentive Acts, U.S. corporations opening plants on the island have been granted various exemptions, up to 100 percent, from Puerto Rican taxes. In return, the companies have provided new employment opportunities, as well as new investments in the Puerto Rican economy. The exemptions from Puerto Rican tax applied to qualified passive investment income, as well as business income.

Figure B
Percent of Total Tax Credit by Industry, 1980



Of the 589 corporations that claimed the possessions tax credit in 1980, there were 303 corporations that reported over $375 million of "qualified possession source investment income," i.e., non-business income attributable to the investment, in a possession, of funds derived from the active conduct of business in that same possession. Interest from deposits in Puerto Rican financial institutions is generally considered qualified possession source investment income and is therefore eligible for the possessions tax credit.

Although the discussion so far has centered on the possessions credit claimed for business operations conducted in Puerto Rico, there were also 14 corporations that claimed the credit for operations in Guam and other U.S. possessions.

U.S. Possession	Number of returns	Credit (000)
Puerto Rico	575	$1,569,930
Guam	5	1,130
Other	9	1,674
Total	589	1,572,734

The data for these corporations are included in tables 1 and 2 of this article, although not shown separately.

The fourteen largest returns, those with total assets of $250 million or more, accounted for over one-third of the assets for all corporations that claimed the possessions tax credit and over 27 percent of the credit itself. Nine of the corporations manufactured chemicals and allied products and claimed a combined possessions tax credit of $285 million.

EMPLOYMENT DATA

One of the major benefits to the economy of Puerto Rico under the possessions corporation system of taxation is the expansion of employment opportunities. Employment data, based on the Federal unemployment insurance tax returns available for 282 possessions corporations in manufacturing industries reveals a total of 54,202 employees. It is estimated that employment in all possessions corporations in manufacturing industries in 1980 was approximately 77,000 or about 9 percent of the total employment in Puerto Rico of approximately 830,000 [2,3]. Four manufacturing industries accounted for over 73 percent of the employees of possessions corporations for which employment data are available.

Industry	Number of Corporations	Employees Number	Employees Percent
Food and kindred products	10	5,355	9.9
Apparel	52	11,361	21.0
Chemicals	52	10,347	19.1
Electrical and electronic equipment	74	12,712	23.5
Total	282	54,202	100.0

All manufacturers operating in Puerto Rico reported a total employment of 157,000 for 1980 [4]. Possessions corporations employed approximately one-half of all employees in the manufacturing sector of Puerto Rico.

The significant number of employees of possessions corporations highlights their value to the economy of Puerto Rico in light of the 17.1 percent unemployment rate reported for the year ending June 30, 1980. It appears that the possessions corporation system of taxation has benefited both the Commonwealth of Puerto Rico through additional employment in Puerto Rico, and the corporations themselves through the credit.

SOURCES OF DATA

The data in this article were tabulated from all returns filed no later than June 30, 1982 by possessions corporations for accounting periods ending between July 1980 and June 1981. Because 100 percent of the returns filed were used for the statistics, they are not subject to sampling error. General information about nonsampling error may be found in the Appendix of this report. Table 1 gives various details from the income statement, balance sheet and tax computation schedule as reported by the corporations claiming a credit [5]. These data are classified by selected industry. Table 2 provides data reported on the tax credit computation schedule and are classified by size of total assets. The data in table 2 are based on the 571 possessions corporations for which the possessions tax credit computation schedules were available.

REFERENCES

[1] U.S. Department of the Treasury, The Operation and Effect of the Possessions Corporation System of Taxation--Fourth Report, 1983.

[2] U.S. Department of Commerce, Bureau of the Census, Statistical Abstract of the United States--1981.

[3] See U.S. Department of the Treasury, op. cit.

[4] Ibid.

[5] It should be noted that the data in Table 1 are not directly comparable to those found in Table 5-2 of the Treasury Report which covers all corporations that made an election under Internal Revenue Code section 936 to be treated as possessions corporations even though they may not have been able to claim a credit for 1980. Moreover, the data in Table 5-2 were based on returns filed no later than January 31, 1982.

Table 1. — All Corporation Income Tax Returns With U.S. Possession Tax Credit: Selected Balance Sheet and Income Statement Items, Income Tax, and Possessions Tax Credit, by Industry

[Money amounts are in thousands of dollars]

Industry	Number of corporations	Total assets	Depreciable assets	Accumulated depreciation	Retained earnings	Total receipts	Business receipts
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
All industries	589	15,775,166	3,587,303	1,138,728	10,606,627	12,086,402	11,319,684
Manufacturing, total	473	12,750,508	2,300,897	827,401	9,983,741	9,813,751	9,225,373
Food and kindred products	18	900,829	175,931	46,188	680,295	819,277	782,250
Tobacco manufactures	3	147,108	24,389	9,129	90,427	201,368	195,431
Textile mill products	8	120,977	10,165	5,828	115,791	51,989	48,345
Apparel	72	346,453	34,167	17,237	267,410	432,795	419,044
Furniture and fixtures	3	7,328	2,598	1,353	4,328	7,471	7,244
Paper and allied products	5	12,352	4,121	1,242	7,753	23,794	23,693
Printing and publishing	4	22,799	4,016	1,534	18,255	17,202	15,934
Chemicals and allied products	98	6,795,523	1,335,034	472,810	5,157,303	4,017,995	3,673,745
Rubber products	10	64,137	31,308	5,272	37,106	60,989	58,175
Leather and leather products	14	91,894	10,001	4,973	75,756	138,724	136,811
Stone, clay, and glass products	8	35,079	8,546	5,173	30,125	56,851	54,385
Primary metal industries	4	20,409	744	455	13,602	17,627	16,661
Fabricated metal products	23	189,265	36,652	10,496	149,851	142,458	136,169
Machinery	13	184,217	17,921	5,363	161,366	148,161	140,155
Electrical and electronic equipment	118	2,754,115	319,116	128,690	2,391,524	2,179,890	2,045,953
Motor vehicles and equipment	6	39,268	4,457	1,598	35,213	36,704	35,546
Scientific instruments	35	410,677	58,944	16,360	315,979	303,235	289,423
All other manufacturing	31	608,079	222,788	93,701	431,659	1,157,222	1,146,409
Nonmanufacturing, total	113	3,013,432	1,283,291	310,458	613,811	2,261,892	2,083,781
Mining and construction	9	16,617	3,558	1,246	10,459	21,952	20,947
Transportation and public utilities	5	818,154	904,291	183,250	8,258	252,782	251,273
Wholesale trade	27	536,250	178,096	69,618	352,247	1,198,921	1,167,754
Retail trade	22	208,829	103,709	40,056	72,490	487,892	462,963
Finance, insurance, and real estate	23	1,235,952	23,509	1,991	58,591	116,854	10,303
Services	27	197,630	70,128	14,297	111,766	183,491	170,541
Nature of business not allocable	3	11,226	3,115	869	9,075	10,758	10,530

Industry	Total deductions	Cost of sales and operations	Net income	Income tax before credits	U.S. possessions tax credit	Income tax after credits
	(8)	(9)	(10)	(11)	(12)	(13)
All industries	8,528,414	6,620,907	3,532,562	1,599,768	1,572,734	25,334
Manufacturing, total	6,532,815	5,120,563	3,255,509	1,474,330	1,450,946	22,120
Food and kindred products	636,345	535,096	182,932	82,647	80,472	1,217
Tobacco manufactures	169,985	73,501	31,382	14,436	14,033	403
Textile mill products	36,359	30,131	15,630	7,171	6,533	638
Apparel	346,818	319,593	85,506	38,910	37,366	1,524
Furniture and fixtures	6,753	4,211	718	330	290	41
Paper and allied products	22,133	20,418	1,661	764	764	-
Printing and publishing	11,362	8,284	5,840	2,636	2,636	-
Chemicals and allied products	2,272,088	1,472,714	1,730,109	778,394	768,450	9,845
Rubber products	40,397	33,591	20,591	9,452	9,407	45
Leather and leather products	119,960	107,759	18,714	8,556	8,478	78
Stone, clay, and glass products	49,595	44,115	7,255	3,291	3,280	11
Primary metal industries	14,598	13,368	3,029	1,393	1,393	-
Fabricated metal products	102,846	86,347	39,598	18,160	18,158	2
Machinery	104,223	90,042	43,484	19,852	19,771	60
Electrical and electronic equipment	1,382,611	1,158,888	788,739	360,517	353,417	6,935
Motor vehicles and equipment	25,510	22,186	11,195	5,145	5,124	21
Scientific instruments	181,858	141,223	121,335	55,659	55,186	471
All other manufacturing	1,009,372	959,096	147,790	67,018	66,188	829
Nonmanufacturing, total	1,987,010	1,492,765	274,882	124,478	120,906	3,138
Mining and construction	16,659	13,685	5,293	2,379	2,370	9
Transportation and public utilities	198,088	94,712	54,694	25,082	25,061	10
Wholesale trade	1,048,869	981,201	150,052	68,865	66,662	2,201
Retail trade	477,438	307,982	10,454	4,667	3,682	568
Finance, insurance, and real estate	107,123	148	9,731	4,082	3,941	141
Services	138,833	95,037	44,658	19,403	19,190	209
Nature of business not allocable	8,589	7,578	2,169	959	884	76

NOTE: Detail may not add to total because of rounding.

Table 2. — Corporation Income Tax Returns With Form 5735 Filed in Support of U.S. Possessions Tax Credit: Possession Source Gross Income and Deductions, Total and Qualified Taxable Income, Income Tax and Possessions Tax Credit, by Size of Total Assets

[Money amounts are in thousands of dollars]

Item	All returns	Size of total assets					
		Assets zero or not reported	$1 under $100,000	$100,000 under $250,000	$250,000 under $500,000	$500,000 under $1,000,000	$1,000,000 under $5,000,000
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Number of returns	571	9	8	7	17	60	180
Total assets	15,466,711	-	233	1,195	6,594	44,367	446,018
Qualified gross income, total	6,257,163	81,264	1,871	2,237	7,938	40,919	339,254
From trade or business	5,780,668	28,818	1,871	2,231	7,744	40,600	334,171
From sale of assets	100,670	41,220	-	-	-	-	-
Possession source investment income	376,801	11,225	-	6	194	319	5,083
Deductions, total	2,916,226	20,302	1,613	1,967	5,855	25,764	231,378
Definitely allocable	2,714,302	17,531	1,613	1,785	5,601	22,740	221,165
Not definitely allocable	201,924	2,771	-	182	254	3,024	10,213
Qualified taxable income	3,339,950	60,962	258	271	2,082	15,156	107,598
Taxable income from all sources	3,391,136	60,970	256	271	2,083	15,298	108,226
Income tax against which credit was allowed	1,556,117	24,075	93	119	887	6,710	48,923
U.S. possessions tax credit	1,529,774	24,073	93	119	885	6,656	48,531

Item	Size of total assets--Continued					
	$5,000,000 under $10,000,000	$10,000,000 under $25,000,000	$25,000,000 under $50,000,000	$50,000,000 under $100,000,000	$100,000,000 under $250,000,000	$250,000,000 or more
	(8)	(9)	(10)	(11)	(12)	(13)
Number of returns	80	87	57	31	21	14
Total assets	575,823	1,452,814	1,977,918	2,167,672	3,525,874	5,268,204
Qualified gross income, total	278,451	615,343	776,773	952,951	1,117,491	2,042,670
From trade or business	266,177	576,518	722,692	882,877	1,010,857	1,906,110
From sale of assets	178	1,356	-	12,852	-	45,065
Possession source investment income	12,096	38,444	54,081	57,222	106,634	91,495
Deductions, total	109,460	242,756	264,626	439,322	460,964	1,112,220
Definitely allocable	106,104	228,248	256,045	396,514	393,343	1,063,614
Not definitely allocable	3,356	14,508	8,582	42,808	67,621	48,606
Qualified taxable income	168,991	372,306	512,147	513,629	656,098	930,451
Taxable income from all sources	170,196	377,280	524,133	519,858	663,177	949,388
Income tax against which credit was allowed	78,099	173,304	242,158	240,103	304,984	436,661
U.S. possessions tax credit	77,549	170,842	235,542	236,234	301,742	427,508

NOTE: Detail may not add to total because of rounding.