A threat and an opportunity

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The deep world recession currently occurring is ushering in a new world economic order. When we come out of this we won't be back to the happy-go-lucky times we lived at the turn of the past century. Major changes are going to happen in the world of finance, fiscal policies and business in general.

These changes are on the way. They aren't yet set exactly in the ways they will occur, but there is movement that requires our attention now. Three bills have been introduced in Congress that, if approved, would alter the tax framework that governs the decisions of U.S. companies to establish Puerto Rico corporations and do business here.

S. 260, before the Finance Committee, was introduced by Sen. Dorgan and 13 co-sponsors. It would amend the Internal Revenue Code to include in foreign-based company income—for purposes of determining the foreign-trade income of controlled foreign corporations—imported-property income. It defines "imported-property income" as income attributable to property manufactured outside the U.S. and imported for sale into the U.S. and provides for a separate application of limitations on the foreign-tax credit for imported-property income.

S. 506, also before the Senate Finance Committee, was introduced by Sen. Levin and five co-sponsors and is named the "Stop Tax Haven Abuse Act." There is a companion bill to this one in the House of Representatives introduced by Congressman Rogett and 63 co-sponsors. The House bill is H.R. 1265. These two identical bills would amend the Internal Revenue Code provisions related to tax-shelter activities to establish legal presumptions against the validity of transactions involving offshore secrecy jurisdictions (i.e., foreign tax havens identified in the act and by the Treasury secretary); treat certain foreign corporations managed and controlled primarily in the U.S. as domestic corporations; subject dividend equivalents and substitute dividends to the 30% tax on foreign income; and impose reporting requirements for transactions involving a passive foreign-investment company.

The bills intend to deal with the problem of tax evasion but are written in such a way that they affect existing provisions providing for tax deferral, which have channeled investment to Puerto Rico.

The Obama administration is currently focusing on taxation of U.S. multinationals' earnings from a revenue-raising perspective but a tax-policies task force that it created may have a broader focus. Taxation of multinationals raises competitiveness issues for U.S. multinationals and raises an economic-development issue for Puerto Rico. Puerto Rico isn't a tax haven. U.S. corporations can't avoid taxes by investing in the island but are able to defer U.S. taxes on profits earned in Puerto Rico until they repatriate these profits to the States.

The provisions in the U.S. tax code providing for this go back to the 1920s. They were intended for the economic development of areas such as the Philippines, then under U.S. sovereignty, and Puerto Rico, which were dependent on agricultural economies and extremely poor at the time. Puerto Rico began to make effective use of these provisions when it launched Operation Bootstrap in 1948. The tax-deferral incentive in the U.S. code, plus our tax exemption, low wages and low energy costs provided the thrust for the transformation, in two decades, of our agricultural economy into an industrial and service economy. This didn't mean we reached full employment. Our unemployment rate hovered around 12% and our rate of participation in the labor force was only 45%. But there was a structural change in the economy with manufacturing providing the largest number of jobs. We remained, however, poorer than Mississippi, the poorest state of the union.

The bean counters in the U.S. Treasury raised their eyebrows when they saw how much investment was coming to Puerto Rico. Bean counting is an institutional infirmity of treasury departments. Since they have to come up with the revenue to meet the budgets, they focus on the static short-term effects of tax provisions, rather than on their dynamic long-term effects.

Their first major attack in the pursuit of tax revenue came in 1975, when the U.S. was undergoing the deep recession that had resulted from the oil embargo decreed by Arab League OPEC (Organization of Petroleum Exporting Countries) countries. Puerto Rico was fortunate to have three heavyweights in key positions from which we had to face off this attack. Teodoro Moscoso, creator of Operation Bootstrap, was back at *Fomento* after heading the Alliance for Progress established by President Kennedy for the economic development of Latin America; Jaime Benítez, who had transformed the Land Grant College in Río Piedras into the multifaculty, well-accredited University of Puerto Rico with high prestige in the Americas, and Salvador Casellas, a public-spirited tax attorney with a broad vision of taxation and the economy, was our Treasury secretary.

These men understood the importance for Puerto Rico of the tax-deferral provisions. In different ways, they had used them to transform the Puerto Rico economy. They spent hours educating members of Congress and their staff as to the effects of the tax-deferral provisions on the Puerto Rico economy and the need to continue them. Once this groundwork was laid out, they launched an offensive. They argued that the revenue that Treasury expected to collect by repealing the tax-deferral provisions wouldn't come to the Treasury. The multinationals wouldn't repatriate the profits. They would invest them in foreign jurisdictions to avoid federal taxation.

Given this fact, why not restructure the provisions in the tax code so these profits would only remain in Puerto Rico subject to a Puerto Rican tollgate tax upon repatriation to the U.S.? Moscoso, Benítez and Casellas convinced the Ways & Means Committee leadership in the House and the leaders in the Senate Finance Committee that this was the way to go, and Section 936 was born. The transformation of our textile and petrochemical industrial sector into the high-tech pharmaceuticals, hospital supplies and electronic-based sector we have today was the result of 936.

I won't belabor my condemnation of the Rosselló-Romero surrender of 936 when the attack from the Treasury came in the mid-'90s against these provisions. We must accept the cards as they have been dealt to us if we are to play our hand wisely.

As the consideration of S. 506, S. 260 and H.R. 1265 goes forward, or as the Obama tax-policy task force engages the matter of the taxation of multinational overseas earnings, Puerto Rico will face a challenge of the magnitude we faced in 1975; a challenge to the foundations of our existing industries and to our ongoing economic development.

We must face up to this challenge without denial as to its severe efforts, as many in Puerto Rico did when we faced the 936 challenge. The demise of our economy runs parallel to the 10-year phaseout of 936. The *Fomento* pipeline of new projects has dried up.

The substitutes to 936 promoted by our government to compensate for its repeal were never legislated.

Taking all this on board, we must face the challenge united and with creativity. We can come out ahead as we did in 1975, with more effective tools for our economic development, but we must play our hand well.