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Statement of the Puerto Rico Manufacturers Association
By Mr. Carlos Rivera Vélez, PhD, PE, President

For the Hearing Record
of the
Committee on Ways and Means
U.S. House of Representatives

Hearing on
The President's Fiscal Year 2016 Budget Proposal with U.S. Department of the Treasury Secretary Jacob J. Lew

February 3, 2015

Thank you Chairman Ryan, Ranking Member Levin and distinguished Members of the Committee. It is my pleasure to present this statement as President of the Puerto Rico Manufacturers Association (PRMA). The PRMA is a private, voluntary, non-profit organization established in 1928 to serve as the voice of manufacturing in the U.S.'s largest and most important Territory.

As Congress considers moving forward on the issues of reforming the tax code we wish to provide some background on the Federal Tax Code's unique treatment of U.S. companies operating in Puerto Rico as well as the importance of manufacturing to our overall economy. We also ask for your consideration and inclusion of our concerns during your deliberations over Tax Reform.

Puerto Rico has been part of the U.S. since 1898 and today is the home for 3.7 million U.S. Citizens. No jurisdiction of the U.S. is more dependent on manufacturing than Puerto Rico. In fact, manufacturing is currently the leading private sector employer and represents almost one-half of Puerto Rico's economy, far more than any State.

It's important to remember that manufacturing jobs in Puerto Rico are U.S. jobs employing U.S. citizens. Our goal for Tax Reform is simply to "do no harm".

SUMMARY OF KEY POINTS FOR YOUR CONSIDERATION:

- PRMA has taken no official position with respect to the President's Tax Reform measures as described in the Treasury Green Book for FY 2016.

- However, on a personal level, I believe that Treasury's recommended international provisions will harm Puerto Rico and will result in the loss of U.S. / Puerto Rico manufacturing jobs. Puerto Rico is part of the United States and the loss of Puerto Rico jobs directly impacts American Citizens as well as stateside suppliers.
- Historically, Federal tax law has fostered manufacturing and continues to play a pivotal role in attracting and keeping U.S. companies and U.S. jobs in Puerto Rico.
- We urge that Tax Reform should "do no harm" to Puerto Rico's economy by discouraging investment in Puerto Rico.
- Puerto Rico needs a seat at the table during deliberations on Tax Reform.
- Most subsidiaries of U.S. companies operating in Puerto Rico are organized as Controlled Foreign Corporations (CFCs) under the current tax code. However, they are treated as domestic in every other way.
- Puerto Rico is not a tax haven. We believe Puerto Rico is the only jurisdiction in the United States where CFCs employ U.S. Citizens, operating under a hybrid application of U.S. law and on U.S. soil.

TAX POLICY'S HISTORICAL ROLE IN PUERTO RICO'S ECONOMY:

Federal tax policy has traditionally recognized the unique relationship of Puerto Rico to the United States. Initially the provisions adopted as part of the Revenue Act of 1921 and later through the activities of the 1948 Operation Bootstrap (of which PRMA was a major participant) and the creation of IRC Section 936 as part of the Tax Reform Act of 1976, the U.S. Congress has traditionally adopted targeted policies, particularly tax policies, towards Puerto Rico that were "pro-growth" and spurred the conversion of Puerto Rico from an agrarian economy to one based on manufacturing.

Although initially a largely agrarian economy, the decades after World War II saw manufacturing replace agriculture as the driving force of the economy of Puerto Rico. In the 1940's employment by the manufacturing sector was approximately 56,000. That number dramatically increased in the late 1980s after the enactment of IRC Section 936 to approximately 106,000 and to a high of 155,000 by 1995. It was primarily due to the jobs offered by the manufacturing sector that living standards, wages and educational levels rose dramatically. Today more than 40% of the population has at least 13 years of education. Thanks to Congressionally driven tax policy, the economic miracle that is Puerto Rican manufacturing has grown from labor intensive basic manufacturing to a capital intensive industrialized sector to now a knowledge based advanced manufacturing model.

MANUFACTURING GROWTH AND TRANSITION:

Because of these tax policies and in spite of the recent economic recession impacting our island for the past nine years, Puerto Rico's manufacturing sector has shifted from one based on labor such as the manufacturing of food, tobacco, leather and apparel to the more capital-intensive industries of pharmaceuticals, chemicals, machinery and electronics operating nearly 2,000 plants on our island.

Puerto Rico ranks the fifth in the world for pharmaceutical manufacturing with more than 70 plants. As of 2014, Puerto Rico based plants produced 16 of the top 20 best selling drugs on the U.S. mainland.

Puerto Rico is also the world's third largest biotech manufacturer with more than two million square feet of dedicated plant space and is the seventh largest medical device producer hosting more than 50 plants on the island. Manufacturing accounts for 48. 6 % of Puerto Rico's Gross Domestic Product (GDP) and directly employs 8% of the work force or about 74,000 people. We estimate an additional 80,000 Puerto Rico residents are indirectly employed by our sector.

We also estimate an additional 80,000 Stateside jobs supported by Puerto Rico's manufacturing companies (CFCs). Therefore, our manufacturing sector has the multiplier effect of contributing 234,000 jobs (direct, indirect and induced) to the US and Puerto Rico economies. For example, one of our member companies reports that it annually transports over $140 million worth of product from Puerto Rico just through the Port of Jacksonville, Florida.

Manufacturing companies paid $1.4 billion in income taxes in 2009 or 57.9% of all corporate income tax collected. The role of CFCs in Puerto Rico's economy is of such importance that during the current fiscal year, seven (7) of these companies doing business in Puerto Rico represent 20% of the revenues of the Government of Puerto Rico's budget or $2 billion.

Manufacturing offers better wages for U.S. Citizens in Puerto Rico. Unfortunately, while approximately 42% of our population lives below the "poverty line" and the current unemployment rate is at 14%, workers in the manufacturing sector earn an average wage of $39,000, which is actually 30% higher than the per capita average. We are also proud to report that in an economy in which fully 40% of the workers earn minimum wage, manufacturing wages are a major factor in improving the standard of living for all of Puerto Rico's residents.

IRC SECTION 936 FOSTERED MANUFACTURING:

In spite of these positive numbers, the overall economic picture for Puerto Rico generally and for manufacturing specifically must be balanced by the "hard" facts that manufacturing has lost a significant number of jobs particularly since the repeal of IRC Section 936 in 1996.

In it's 1993 Report to the Chairman of the Senate Finance Committee, the General Accounting Office (GAO) summarized the IRC Section 936 credit as follows: *Under section 936, the tax credit equals the full amount of the U.S. income tax liability on possessions source income. Firms qualify for the credit if, over a three year period preceding a taxable year, 80 percent or more of their income was derived from sources within a possession and 75 percent or more of their income was derived from the active conduct of a trade or business within a possession. This provision effectively exempts all possessions source income from U.S. taxation. Dividends repatriated from a U.S. subsidiary to a mainland parent qualify for a dividends-received deduction, thus allowing tax-free repatriation of possessions income. In addition, the provision exempts from U.S. taxation the income earned on qualified investments made by section 936 firms from their profits earned in the possessions. This income is called qualified possessions source investment income, or QPSII. Puerto Rico established rules to ensure that QPSII funds invested through the island's financial intermediaries meet the act's requirements.*

The enactment of IRC Section 936 had a positive and direct impact on Puerto Rico's economy. In 1989, the GAO noted that 13 years after enactment of IRC Section 936, manufacturing firms in Puerto Rico employed 105,500 individuals directly comprising 11% of the total employment of 952,000. By 1997, that number stood at 155,000 Americans directly employed by the Puerto Rico manufacturing sector.

However today, the number of U.S. citizens employed directly by manufacturing has been reduced to approximately 74,000. It's fair to say that this drastic reduction is mostly due to the elimination of IRC Section 936 more than any other single factor. In fact, a number of corporate decision makers cited the loss of IRC Section 936 as the primary reason for either the closure or relocation of facilities to Mexico, China and the Dominican Republic.

Unfortunately, as manufacturing jobs have disappeared few other local employment opportunities remain. This has caused a sizeable "brain drain" as tens of thousands of skilled workers have left Puerto Rico in search of new employment. Over the past decade, an estimated 300,000 US citizens representing approximately 7% of the total population (mostly the young and those with higher educational levels) left the island for better opportunities on the mainland. This troubling trend suggests greater social consequences if the shrinking manufacturing sector were to continue. Economic circumstances are driving this “brain drain” leaving many of our talented citizens with little choice but to immigrate to the mainland or remain on the island becoming dependent on social programs.

Even in the context of IRC Section 936 repeal, the U.S. Congress recognized the consequences of this repeal and its impact on Puerto Rico and provided for a ten-year transition period. Subsidiaries of U.S. companies were given the opportunity to re-organize as Controlled Foreign Corporations. Although not as generous as IRC Section 936, the CFC mechanism provides a special tax incentive offering a potent financial reason for U.S. companies to remain or expand operations in Puerto Rico.

We believe Puerto Rico is the only jurisdiction in the United States where CFCs employ U.S. Citizens, operating under U.S. law and on U.S. soil. This is truly a unique situation to consider during Congress’ deliberations on Tax Reform.

TAX REFORM 2015:

Considering Congress’ historical use of the Federal tax code as a tool to foster and support economic growth in the U.S. Territory of Puerto Rico, we urge full consideration of the impact of future Tax Reform on Puerto Rico’s economy and job base. We believe Congress shares a bi-partisan goal of fostering manufacturing and encouraging investment in American jobs. Again, we note that Puerto Rico jobs are American jobs.

The GAO’s 1993 Report also reviewed the factors that U.S. corporations consider when they contemplate establishing a plant or similar facility in a foreign location. The GAO identified six primary considerations including energy costs, transportation costs, labor costs, stability, infrastructure, and tax structure.

Thankfully, Puerto Rico has a stable government and excellent infrastructure given the millions of dollars invested in recent years on infrastructure improvements. We have world-class seaports, airports and a modern ground transportation network.

Conversely, the Island has a highly skilled and educated workforce but labor costs are the highest in the Caribbean. In addition, local and federal labor laws make Puerto Rico one of the most heavily regulated jurisdictions in the U.S. and certainly much higher than others in the Caribbean basin area.

Puerto Rico is an island and highly dependent on imports of raw materials, food and oil; increasing costs for manufacturing and business operations. While there is a planned conversion over to liquefied natural gas (LNG), currently, energy is generated using imported oil resulting in higher energy costs. A recent comparison with Florida found that energy costs in Puerto Rico are three times that of Florida: on average 27 cents per kilowatt-hour in Puerto Rico versus 9 cents in Florida. The average for the United States is 11 cents per kilowatt-hour.

The bottom line is that we have several factors that must be considered when we compete to foster investment in manufacturing operations in Puerto Rico. Our neighbors in the region as well as our global competitors are aggressively pursuing our manufacturing to re-locate their U.S. operations from Puerto Rico by offering cheaper labor costs, cheaper energy costs, less restrictive regulation and access to the U.S. market.

Therefore, the ability of Puerto Rico to remain economically competitive internationally may well depend on how the U.S. Congress treats U.S. companies operating subsidiaries in Puerto Rico under reforms to the tax code.

We share your goal of giving U.S. manufacturing a competitive edge when Tax Reform is enacted. We also ask for the opportunity to work with you on this task while ensuring no harm to manufacturing jobs in Puerto Rico. Puerto Rico is a vital element of the U.S. manufacturing sector and we wish to continue fostering opportunity for U.S. citizens on our island as well as Stateside.

In conclusion, I would like to thank the Committee for your consideration and ask that we be invited to appear before your Committee during any upcoming hearings on tax reform. I'm looking forward to working with you as Congress deliberates the future of the Federal Tax Code.

Supplemental Sheet

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