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Exclude Puerto Rico From Tax Reform

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The year 2017 has been a disastrous one for the residents of Puerto Rico. In the Summer, the island's government effectively filed for bankruptcy, which effectively foreclosed its access to capital markets and set it down an uncertain path of recovery. A few months later, of course, the island was pummeled by two hurricanes in close succession, Irma and Maria, which left a trail of devastation in their wake. The latter was, in fact, described as "the worst hurricane in a century to strike the Caribbean island."

However, the damage to the Puerto Rican economy may not be over. The comprehensive tax reform legislation being negotiated by Congress includes a new tax on Controlled Foreign Corporations (CFCs) that, in its current iteration, may result in a hefty tax increase on the facilities of U.S. corporations operating on the island, which would likely result in fewer jobs and lower wages on the island. Exempting the island from this provision would be an inexpensive and economically sensible step for Congress that would be a great benefit for the residents of the island.

The purpose of the new CFC tax is meant to save American jobs from cheaper labor in foreign countries: with the U.S. moving towards a territorial tax regime in the new tax code Congress wanted to put certain "guardrails" on foreign-sourced income to ensure that the code does not inadvertently create an incentive for U.S. corporations to locate more business activity in foreign countries that have sharply lower tax rates. While there is nothing wrong with that goal, Puerto Rico is an unincorporated US territory and its residents are US citizens, yet the current legislation would categorize it as "foreign" in the US Tax Code.

Applying the new CFC tax provision to the island could be disastrous for the island, threatening the jobs of over 235,000 Americans employed in manufacturing on the island and which account for nearly half of the island's GDP.

A likely response to the higher tax regime on the island is that companies will consider abandoning their reconstruction efforts and simply close their operations in Puerto Rico.

Puerto Rico needs more than just hurricane aid – it is in need of long-term support to help it resume economic growth. The current unemployment rate on the island is over 10%, while average household income in Puerto Rico is less than half of that in the poorest US state. Over 65% of households in Puerto Rico saw a drop in income from 2012-2016, and over half the children on Puerto Rico born into poverty.

Given its current economic morass and substantial damage from the hurricane--a significant proportion of its residents still do not have power--it is no surprise that Puerto Rico also faces widespread outmigration. Its population has been steadily decreasing over the last decade. Between 2005 and 2015, almost half a million people migrated from Puerto Rico, and the hurricanes of 2017 caused another 200,000 to pack up and leave so far.

Americans would benefit from a simplified tax code that reduced pernicious economic incentives and encouraged businesses to invest and expand their businesses in the US, and the tax code will help to achieve that--for people who live in the 50 U.S. states, at least. However, as currently structured it will serve exacerbate Puerto Rico's problems at a time when it simply cannot countenance another economic blow.

Puerto Rico is struggling to rebuild after the hurricanes and new taxes on U.S. business operating on its land will allow it to do none of those. While the intent of the members of Congress who helped draft the tax bill was to help keep American jobs out of foreign countries, but Puerto Rico is American territory with American citizens. It should not be unfairly targeted by this legislation.

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