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IRS punts on secret $6 billion bailout for Puerto Rico

By Jonathan Strong - The Daily Caller 12:24 PM 04/04/2011

The Obama administration says it can't decide whether U.S. taxpayers should be on the hook for $6 billion in tax increases levied by Puerto Rico, but businesses are eligible for the disputed tax credits in the meantime.

And, if the IRS eventually decides the credits were improper, those firms won't have to pay back the billions of dollars they already received.

As reported by The Daily Caller in January, critics have charged the highly unusual arrangement would comprise an indirect bailout that lets Puerto Rico bolster its sagging fiscal state by levying taxes on international firms those firms don't actually have to pay.

The IRS is deciding whether to approve the tax credits or deem it a "soak up tax" that targets firms which can offset their tax increases with U.S. tax credits

Then, a decision was supposed to come any day, but the IRS shirked from the controversy, waiting three months before quietly announcing last week it is not making a final decision.

"The provisions of the Excise Tax are novel. The determination of the creditability of the Excise Tax requires the resolution of a number of legal and factual issues," the IRS said in a notice issued last week.

In the meantime, IRS says it "will not challenge" businesses seeking tax credits for the excise tax and, if it ever did decide the arrangement was improper, they wouldn't need to pay back the Treasury for the credits.

"Any change in the foreign tax credit treatment of the Excise Tax after resolution of the pending issues will be prospective, and will apply to Excise Tax paid or accrued after the date that further guidance is issued," the notice says.

The back story

Puerto Rico, desperate for revenues in the midst of the recession, surprised industry with a $6 billion tax on foreign firms – including a significant bloc of U.S. pharmaceutical firms – late October in a rare weekend legislative session without any public debate in advance.

Gov. Luis Fortuño signed the new tax into law Oct. 25. That day, the Washington, D.C.-based white shoe law firm Steptoe & Johnson issued him a legal brief arguing U.S. firms should receive money from the U.S. government to offset the Puerto Rico tax increase, which Fortuño sent to the IRS.

The international tax law in question is complicated, but experts agree the tax, and the request, are an unusual use of portions of the tax code intended to avoid double taxation on U.S. firms in countries that have reciprocity treaties with the U.S.

"We would call it creative," said James Hines, an expert on international tax issues and the L. Hart Wright Collegiate Professor of Law at the

University of Michigan Law School. “It’s an unusual tax for sure.”

It’s an “indirect bailout,” said Dan Mitchell, an international tax expert and senior fellow at the Cato Institute.

Factions within the IRS are fighting over the decision.

How it works

Usually, when businesses are taxed by states and U.S. territories that receive federal funding, firms can offset those taxes the same way an individual uses the tax deduction from a charitable contribution – by reducing the taxable amount of their income.

For instance, a firm with $1 million in income that paid $100,000 in state taxes would be taxed by the federal government for $900,000 worth of income.

In this case, some firms could receive a dollar-for-dollar credit for the increase in Puerto Rico taxes. For instance, a firm with $1 million in income that paid $100,000 in the new Puerto Rican tax would have its U.S. tax burden reduced by $100,000.

Puerto Rico business officials estimate the credits will reduce the dollar-for-dollar tax burden of the U.S. firms by at least $3.5 billion. That’s the amount they would get if they made no changes to take advantage of the rule, but firms there are racing to change their structures to benefit.

Who benefits?

Many U.S. pharmaceutical firms are located in Puerto Rico because of decades of tax breaks that rewarded sectors with significant intellectual property assets.

For this reason, the heavy-hitting pharmaceutical lobby is pressuring the Obama administration for the IRS to approve the change.

Phrma, the massive trade association that represents the firms, has close ties to the Obama administration and helped the president pass his health care law, as part of a deal the group cut early on in the process.