Is the U.S. Treasury bailing out Puerto Rico?

By Cate Long – June 17th, 2013

Puerto Rico budget negotiations for fiscal 2014 are in the final stretch for the year's July 1 start date. A massive $1.5 billion difference between spending and revenues must be closed. Discussion has included expanding the commonwealth's sales tax to services and transactions between businesses. Local businesses fought hard against this proposal, and eventually, Governor Garcia Padilla switched focus. Reuters explains:

[Puerto Rico Treasurer Melba] Acosta told reporters that policymakers had agreed to scale back by 73 percent the governor's proposed sales-tax expansion, which was strongly opposed by local businesses. The expanded sales tax will be levied only on a small group of industries and will raise $287 million during fiscal 2014.

To make up for the lost revenue, the government will assess a business tax on gross sales on a sliding scale, depending on sales volume. It is expected to generate $522 million.

Another measure would push corporate tax rates back up to 1994 levels, returning the top rate to 39 percent. Rates were slashed by 30 percent under a tax reform enacted in 2011. The measure is expected to generate $270 million.

Acosta says that tax increases on corporations that pay U.S. taxes will mostly be refunded by the Treasury, so they will not affect the Puerto Rico economy:

'The idea is that companies pay less income have smaller patent,' said the secretary, who yesterday served as interim governor. The expectation is that the corporations who pay federal taxes can deduct the payment of the patent in federal taxes.

For the back story on what Acosta is referring to, an interesting story ran in the Daily Caller in 2011:

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.

We don’t know if Acosta is relying on the same Steptoe and Johnson IRS letter to provide a tax rebate to U.S. firms. The Puerto Rico General Assembly has not yet passed the legislation.

If there is a plan to bail out Puerto Rico with backdoor corporate tax credits, then bondholders will cheer as the value of their bonds backed by a general obligation should appreciate in price. But with Detroit going bankrupt and other cities in vulnerable conditions, U.S. taxpayers need to know if the Treasury has made a policy decision to backstop Puerto Rico. I’d think a “strategic” rationale for assistance would be hard to make since the FAA just gave permission for Puerto Rico’s main airport to be sold to a Mexican firm.

Voting on the tax package is expected to happen this week, but the background for Acosta’s comments needs more exploration. Puerto Rico is not getting stronger. It will require more and more support.