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Shifts in Tax Policy Need to Address Puerto Rico's Status.

Treasury Secretary Steven Mnuchin rcently met with Puerto Rico Gov. Wanda Vázquez and other officials to inform them of the need to phase out the 4 percent excise tax imposed on American Foreign Controlled Corporations (CFC). This tax was conceived in 2010 by then Gov. Luis Fortuño as a short-term measure to generate additional revenues to the failing Puerto Rican government, which the IRS has allowed the CFC's to take as a tax credit.

Since then, this excise tax generates an estimated $1.8 billion yearly to the commonwealth's coffers. CFC's in Puerto Rico report approximately $40 billion yearly in profits, most of it generated outside of the island but reported in Puerto Rico for its tax advantages.

The Obama's administration had withheld a ruling on the constitutionality of the issue under the assumption that it was a temporary measure. Each governor since has extended the law, which is now set to expire in 2027.

This taxation news would appear to be of little consequence for the greater part of the population. In fact, Mnuchin's statements constitute a shift in Treasury policy and invites welcome attention to the current constitutional underpinnings of how the United States exercises its authority over Puerto Rico.

Underlining this shift in tax policy is the unincorporated nature of the Territory of Puerto Rico. This judicial doctrine developed by the Supreme Court in the so-called insular cases at the turn of the 20th century, was created to address tariff and tax matters on goods imported to the United States from Puerto Rico. This doctrine holds that not all constitutional protection are applicable to the territories. The unincorporated territory doctrine is the ghost in the machine that has allowed for congressional discretion — some would argue justifiably "colonial" — in its treatment of Puerto Rico.

With the approval of the Supreme Court, Congress has discriminated for 120 years in favor of powerful economic forces at the expense of the general welfare of American citizens in Puerto Rico. First were the sugar barons, now it's the pharmaceutical companies. In the recent past, Section 936 of the Internal Revenue Code allowed for significant tax credits and incentives — aptly referred to at the time as "corporate welfare" — for American based manufacturers that were constitutionally unavailable in the rest of the country.

The triple exempt tax advantages of Puerto Rico's bonds, which made them so attractive in the municipal bond market and contributed to our decades long public debt financing addiction, are also based in this same constitutional justification.

Puerto Rico's current fiscal and economic crisis is due in great part to the unincorporated territory doctrine, that until recently benefited the short-term interests of investors and manufacturers, at the expense of long-term economic stability and growth. It is perfectly understandable why the defenders of the status quo lobby to obtain preferential tax treatments. These preferential tax treatments, however, have likely lead Puerto Rico to PROMESA and the Financial Oversight and Management Board (FOMB).

Within this context, Mnuchin statements that the federal government will not continue to give tax credit to CFC's — which make payments made under local law 154, and that the government of Puerto Rico must phase it out within 6 months — are a welcomed first step in leveling the playing field between Puerto Rico and other state jurisdictions. Puerto Rico legislative leadership has already said it will be filing the required legislation.

Under the existing 2017 Internal Revenue Code, the Puerto Rico government can make up its revenues shortfalls by imposing a 10.5 percent income tax on its foreign corporation's intangible assets, which will receive an 80 percent credit from the IRS. This income tax is estimated to produce close to $3.7 billion to the commonwealths revenues. Of course, many of these same "foreign corporations" have individual agreements with the Puerto Rico Treasury that inure them from taxation and may not be constitutionally impaired.

This been said, a change in tax policy that fails to address how Puerto Rico is classified under the Internal Revenue Code — that is, as a foreign jurisdiction — will always be subject to modifications as Congress sees fit at any given moment. As long as Puerto Rico is kept as an unincorporated territory, which gives Congress the constitutional cover to treat it as a foreign jurisdiction, it will remain hostage to the vagaries of special interests.

Any proposed changes in the Internal Revenue Code must begin with an explicit acknowledgment by Congress that Puerto Rico is an incorporated territory that needs to be treated as any other stateside jurisdiction.

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