U.S. Tax Policy and Puerto Rico's Fiscal History

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Diane Lourdes Dick, *U.S. Tax Imperialism in Puerto Rico*, 65 **Am. U. L. Rev.** (forthcoming 2016), available at SSRN.

Puerto Rico faces a host of public finance woes. It owes over $70 billion in public sector debt. On May 2, 2016, it missed a major debt payment to its Government Development Bank bondholders. Congress is currently considering legislation that will allow Puerto Rico to restructure its debts. Without debt restructuring, further defaults seem inevitable. Puerto Rico has attempted to use its tax laws to ease its public finance problems. However, in March, the United States District Court for the District of Puerto Rico ruled in *Wal-Mart Puerto Rico v. Zaragoza-Gomez* that an increased tax imposed by Puerto Rico on certain cross-border, related-party property transactions violated the U.S. Constitution and the Federal Relations Act. The court acknowledged that the tax was implemented to quickly raise revenue to ameliorate Puerto Rico's fiscal challenges, but it struck down the tax nonetheless. As of this writing, Puerto Rico's fiscal future remains uncertain.

Puerto Rico's economic and fiscal condition and its tax policy are, of course, related, and the United States has played an important role in both. But what exactly is the United States' economic relationship with Puerto Rico? What do U.S. tax and fiscal policies with respect to Puerto Rico tell us about that relationship? And how have these policies influenced the economic trajectory of the island? Tax aficionados may be broadly familiar with tax incentives for investment in Puerto Rico, but what deeper story lies beneath?

Diane Lourdes Dick takes up these questions in her article entitled *U.S. Tax Imperialism in Puerto Rico.* The article develops a theory of U.S. tax imperialism, which I understand to be a subset of economic imperialism, by detailing the ways in which U.S. tax policy has been used to control the economic trajectory of the territory for the benefit of the mainland.

Professor Dick describes three historical stages of such tax imperialism:

In the first stage, beginning after the Spanish-American War of 1898 and continuing through 1919, the United States revamped Puerto Rico's tax laws, which had developed under Spanish rule. In essence, U.S. interventions during this period decreased reliance on indirect taxes (for example, by replacing older consumption-type excise taxes with more narrowly defined excises) and increased Puerto Rico's reliance on direct taxes on personal and corporate income. An existing tax on income from property was also replaced with one based on property valuations. Professor Dick discusses the impact of this property tax in pressuring Puerto Rican landowners to either sell or productively utilize their property; the effects of the tax on land ownership; and the tax's role in the formation of a single-crop sugar economy, which benefitted large U.S. sugar corporations.

In the second stage, spanning 1920 through 1974, Professor Dick characterizes the United States as pursuing tax and economic policies designed to utilize Puerto Rico as a low-cost provider of manufacturing inputs for U.S. corporations, thereby reducing dependence on foreign sources for these inputs. For example, a federal tax exemption for the foreign-source income of certain U.S. corporations that derived income from U.S. possessions was enacted. This exemption was converted into the Section

936 possessions tax credit by the Tax Reform Act of 1976. When paired with changes in Puerto Rico's tax laws exempting U.S. corporations from Puerto Rico's income, property, and other taxes, this exemption effectively provided U.S. companies with a blanket tax holiday in Puerto Rico.

In the third stage, from 1975 to the present, by contrast, concerns about capital flight from the United States mainland to Puerto Rico and other locations led to a shift in U.S. tax policies, with a new emphasis on incentivizing capital to flow *out* of Puerto Rico and back to the U.S. mainland. Professor Dick notes that the U.S. now allowed U.S. parent corporations to claim a full dividend-received deduction for income earned in U.S possessions. However, Puerto Rico's counter-move—extension of Puerto Rico's withholding tax to repatriated dividends—worked to offset the incentive to repatriate earnings to the U.S. mainland. U.S. legislators eventually responded by repealing the Section 936 possessions tax credit in 1996 (subject to a ten-year phaseout), with complete elimination for tax years beginning after December 31, 2005. But the repeal led many corporations operating in Puerto Rico to convert their subsidiaries to controlled foreign corporations, effectively keeping capital offshore and preventing the U.S. Treasury from taxing it, thus thwarting the U.S. goal of encouraging repatriation of earnings back to the United States.

In setting out a three-stage theory of tax imperialism and by situating U.S. tax and fiscal policy against the broader backdrop of U.S. economic policy in Puerto Rico, *U.S. Tax Imperialism in Puerto Rico* challenges the dominant narrative surrounding U.S.-Puerto Rico economic relations and Puerto Rico's current fiscal condition. This narrative tends to portray the U.S. as a benevolent patron and to blame Puerto Rico for its continuing fiscal difficulties. Professor Dick's article illuminates the tax and economic imperialism underlying the evolution of U.S. tax policy with respect to Puerto Rico, presenting a wide-ranging analytical history of the economic relationship between the U.S. and its territory and discussing how U.S. tax policies have contributed to Puerto Rico's current fiscal problems. As I read it, the main takeaway is not so much that any one policy is necessarily bad in and of itself, but that as a matter of motivation, the U.S. has been using Puerto Rico for its economic advantage for over a hundred years and has designed Puerto Rico's tax policies to U.S. ends.

U.S. Tax Imperialism in Puerto Rico is a careful, interesting, and timely account of how the U.S. has designed tax policies with respect to Puerto Rico since 1898, but its contribution does not end there. The article also raises broader questions. For example, one wonders whether similar dynamics have been in play with respect to the other U.S. territories. Another important question concerns Puerto Rico's relatively unnoticed place in the history of capital flight from the United States. According to Professor Dick's account, capital flew from the U.S. to Puerto Rico as a result of tax incentives. But then it fled further and more permanently abroad due to the increasing use of controlled foreign corporations by U.S. corporations. The growth in controlled foreign corporations occurred in response to the repeal of the possessions tax credit and the broader shift in U.S. tax policy in Puerto Rico after 1975. This account potentially muddies the usual story about capital lockout and capital flight: it suggests that contrary to the usual narrative, offshoring of U.S. capital cannot be entirely attributed to direct comparisons between the U.S. and other sovereign competitors. Rather, at least some capital may have moved from the U.S. to U.S. possessions such as Puerto Rico, and then to more distant shores as a result of U.S. tax policy with respect to the *possessions*. This is a topic that merits further investigation.

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