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October 15, 2010

Rum Battle in Caribbean Leaves Tax Hangover

By **DAVID KOCIENIEWSKI**

Rum and politics have made a fiery mix since America's earliest days, when a young politician named George Washington won election to the House of Burgesses in colonial Virginia with the help of spiked punch at the polls.

There have been rum wars involving pirates and slave traders, and rumrunners who made a mockery of Prohibition.

Now the spirit once called Kill-Devil has set off a bitter dispute between two United States islands, Puerto Rico and the Virgin Islands, over a tax that the federal treasury collects on rum.

The fight began when the Virgin Islands persuaded the world's largest distiller, which said it was leaving Puerto Rico, to move to St. Croix by offering a staggering \$2.7 billion in tax incentives. The new distillery, for Captain Morgan spiced rum, will provide no more than 70 permanent jobs on the south shore of St. Croix — but it will entitle the Virgin Islands to collect billions in rum tax revenue from Washington.

That bounty comes at the expense of Puerto Rico, where 90 percent of the revenue from the rum tax had been used for public projects and social services rather than corporate incentives. The Virgin Islands has promised to give nearly half its tax revenue back to the distiller, the British company [Diageo](#), prompting a series of charges and countercharges between neighbors roughly 50 miles apart in the Caribbean.

The aftershocks could even change what people drink in the United States. The tax incentives are so generous that Virgin Island producers might ultimately try to use highly subsidized sugar cane to make blended whiskeys, vodka and gin, distillers on the mainland say. That could threaten the jobs of grain farmers and distilleries in the American heartland.

The deal could also cost American taxpayers. With Puerto Rico's economy reeling and its government budget already strained, some island officials say they cannot rule out needing to ask Washington for aid to cover basic expenses once covered by the rum tax.

“We’d have to make it up one way or another,” said Puerto Rico’s resident commissioner, Pedro R. Pierluisi, the island’s nonvoting delegate to Congress. “It’s not going to be pretty.”

The billions of dollars at stake are the result of a quirk in the tax code that was intended to aid the islands while preventing their offshore distilleries from gaining an unfair advantage over competitors in the states.

Because rum producers in the islands are exempt from federal excise taxes, the government imposed an “equalization tax” on Puerto Rican rum producers in 1917 and gave the money to the commonwealth. In 1954, the United States extended the arrangement to the Virgin Islands.

For half a century, the program allowed the islands to replenish their depleted treasuries and pay for infrastructure, schools and social services. Puerto Rico used less than 10 percent of the \$450 million it received last year to provide marketing support and production subsidies to rum companies, according to government officials, leaving the rest for the island.

In 2007, Diageo explored a possible move of its Captain Morgan production to Honduras or Guatemala, where labor costs and supplies were cheaper.

At the same time, Diageo approached the governor of the Virgin Islands, John P. de Jongh Jr., about moving to St. Croix. The two signed a deal the following year. It requires Diageo to stay in the Virgin Islands for 30 years in return for incentives so rich they are double the cost of actually producing the rum.

Diageo, based in Britain, will get a new plant built at taxpayer expense, exemption from all property and gross receipt taxes for the length of the deal, a 90 percent reduction in corporate taxes, plus marketing support and production incentives totaling tens of millions a year.

The generous subsidies have led to charges by some Puerto Rican officials and Virgin Islands residents that the governor was misled into using public money for corporate welfare.

“We’re not against big businesses,” said Michael J. Springer Jr., a candidate for the Virgin Islands Senate, “but for the government of the Virgin Islands to give that much money to a foreign corporation when it was intended to help the residents and their communities, is outrageous. In the meantime, the government is borrowing to pay its operating expenses.”

But officials for Diageo said it had no intention of staying in Puerto Rico, and Mr. de Jongh

asserts that the concessions were needed to keep the company from moving out of the United States entirely.

Even after the incentives, the Virgin Islands will gain a stable source of revenue for 30 years, he said, with rum tax proceeds projected to climb to more than \$230 million by 2038, from \$90 million in 2008.

The infusion of cash has already helped the government retain 2,000 employees, Mr. de Jongh said. “We will strengthen the government pension fund, build schools, fix and construct roads, and continue to move the U.S. Virgin Islands toward fiscal self-reliance,” he said.

Jennifer Nugent-Hill, a trustee at the University of the Virgin Islands and vice president at a shipping company, said the infusion of rum tax revenue would be one of the most significant economic developments in the island’s history, empowering its residents “to control our own destiny.”

On Puerto Rico, government officials have little hope of replacing the \$120 million in annual revenue that will leave with Diageo in 2012. It will cost the island 340 jobs, as well. Mr. Pierluisi has pushed a bill in Congress that would forbid either entity from offering more than 10 percent of its rum tax revenue as subsidies.

But the measure has languished, in part because of opposition by Donna M. Christensen, the delegate for the Virgin Islands. Others accuse Puerto Rico of opposing the deal to favor its biggest distillery, Bacardi, which has government ties.

Roberto Serralles, whose family distillery stands to lose millions in business, called the moves by the Virgin Islands an underhanded raid.

“If Tennessee got G.M. to relocate by offering a subsidy that was more than the cost of making a car, wouldn’t the people in Michigan be upset?” asked Mr. Serralles, whose family has produced rum on Puerto Rico for six generations. “And you have to wonder — why is the government in the business of using federal funds to guarantee profits of a huge multinational corporation?”

The dispute extends beyond Caribbean sands. Distillers on the mainland are concerned about a \$1 billion subsidy the Virgin Islands recently awarded Fortune Brands, the American company that makes Cruzan Rum, Jim Beam Bourbon and other spirits.

Fortune will receive an assortment of tax-financed incentives, including \$100 million for improvements to its distillery on the island and a wastewater treatment program. The

agreement also ensures that the company will pay no more than 16 cents a gallon for molasses, the main ingredient of rum, now selling for more than \$2 on the open market.

According to [Treasury](#) records, the company won approval to bottle three blended whiskeys using molasses-based cane spirits rather than grain spirits.

A Fortune spokesman said the company merely wanted to preserve its “flexibility” and had no plans to use cane spirits in other products. Some distillers worry, though, that cane spirits — filtered into a nearly flavorless alcohol — may be used to make vodka, gin and other liquors.

“If our own federal government is also letting its taxes subsidize foreign corporations and offshore producers, it makes it harder to survive,” said Philip E. Prichard, whose independent distillery in Tennessee makes rum and bourbon. “It flies in the face of entrepreneurship.”