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August 24, 1973

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MEMORANDUM

SUBJECT: Taxation of U.S. Possessions

This memorandum will first summarize the U.S. taxation of citizens of United States possessions in general, including a brief description of the application of the income tax, the estate and gift tax, the income tax withholding provisions, the self-employment tax, and the social security payroll taxes. The memorandum will then summarize the dual application in Guam, the Virgin Islands, American Samoa and Puerto Rico of the United States tax laws and the territorial income tax adopted in each of these jurisdictions. The memorandum will not deal with the subject of excise taxes which will be covered in a separate memorandum on customs and duties.

A. U.S. Taxation of Possessions

1. U.S. Income Tax.

General Summary. United States citizens and corporations generally are taxable for U.S. tax purposes on their worldwide income. However, nonresident aliens and foreign corporations (i.e., those not incorporated in the U.S.) which are not engaged in a U.S. trade or business are subject to U.S. income taxation only on "fixed or determinable annual or periodic gains" from U.S. sources, such as interest,

01-05047

dividends, rents and salaries. (§§ 871, 881). */ U.S. income tax is imposed at the flat rate of 30% on the gross amount of such gains and the tax is required to be withheld at the source. (§§ 1441, 1442).

A foreign corporation not engaged in a trade or business in the United States is not subject to U.S. tax on capital gains from U.S. sources. A nonresident alien not engaged in a U.S. trade or business is not subject to capital gains tax on U.S. income unless the alien individual is physically present in the United States for 183 days during the taxable year in which he realizes the capital gain. (§ 871(a)(2)). If a nonresident alien is present in the United States for 183 days or more during a taxable year, his net capital gain from U.S. sources for that year is taxable at a flat 30% rate. (§ 871).

A nonresident alien individual or foreign corporation which is engaged in a U.S. trade or business is subject to tax on U.S. source income under two different methods. First, a tax of 30% is imposed on fixed and determinable annual or periodic income from U.S. sources not effectively connected with a U.S. trade or business. Second, a tax is imposed at the regular rates applicable to a U.S. taxpayer on net U.S. source income and certain foreign source income which is effectively connected with a U.S. trade or business

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*/ Unless otherwise indicated, all section references will be to the United States Internal Revenue Code of 1954, as amended.

of the nonresident alien individual or foreign corporation. (§§ 871(b) and 882).

Is Marianas now a "foreign country"

Section 911. A United States citizen who receives compensation for personal services or receives other earned income in a foreign country may be eligible to exclude up to $20,000 (in some cases $25,000) of such income from U.S. taxation if he can establish that he was a bona fide resident of a foreign country or was physically present in one or more foreign countries for a stated period of time. However, the benefits of section 911 are not available to a United States citizen with respect to income earned in a U.S. possession. Reg. § 1.911-2(f) defines "foreign country" to "not include a territory or possession of the United States."

Section 931. Section 931 grants relief to U.S. citizens and U.S. corporations engaged in trade or business in a U.S. possession. Pursuant to section 931, income from sources outside the United States is not subject to U.S. tax if a prescribed portion of income is derived from a possession of the United States. The term "possession" is defined by regulation to include the Panama Canal Zone, American Samoa, Wake and the Midway Islands, and Puerto Rico and Guam with respect to domestic corporations. (Reg. § 1.931-1(a)).

Section 931 is thus not applicable to the Virgin Islands and is only applicable to corporations but not individuals doing business in Guam and Puerto Rico. (§ 931(c)). Sections 933, 934 and 935 provide special relief applicable to these possessions as discussed infra.

In order to qualify for section 931 treatment, 80% or more of the taxpayer's gross income during the current three-year period must be derived from sources within a U.S. possession and 50% or more of such income must be derived from the active conduct of a trade or business within a possession of the U.S. Amounts paid for services performed by a citizen of the U.S. as an employee of the United States or any agency thereof are treated as being derived from U.S. sources in applying the percentage tests. § 931(i). Any amounts received by the taxpayer within the United States are to be included in the taxpayer's gross income irrespective of the actual source of the income. (§ 931(b)).

Section 931 may not be of any benefit to certain taxpayers because the price for applicability is the allowance of only one personal exemption and the loss of any foreign tax credits. See § 931(e) and (g).

Section 932. Although U.S. citizens are generally taxable on their worldwide income, section 932 treats U.S. citizens of certain possessions who are not otherwise citizens of the United States and who are not U.S. residents as nonresident aliens. As a result of this classification, these

01-05050

citizens are taxed only on income from U.S. sources. Section 932 applies to those persons who attained their U.S. citizenship by virtue of collective naturalization under an organic act or otherwise by reason of their birth or citizenship in a possession.*/ Section 932 is specifically made inapplicable to Puerto Rico and Guam (beginning in 1973).**/

Controlled Foreign Corporations. Ordinarily, U.S. tax is deferred on the foreign earnings of a foreign corporation until the earnings are distributed to the U.S. shareholders. Section 951 et seq. of the Internal Revenue Code ("Subpart F") provides, however, for the current taxation of U.S. shareholders on undistributed income from "controlled foreign corporations." Under section 957(c) a controlled foreign corporation does not include a corporation organized or created in a U.S. possession (including Puerto Rico) if 80% or more of its gross income during the most recent three-year period was derived from possession sources and 50% or more of gross income was derived from the active conduct in

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*/ Reg. § 1.932-1(a)(1) defines a citizen of a possession who is "not otherwise a citizen of the United States" as a "citizen of a possession of the United States who has not become a citizen of the United States by naturalization." This definition has not been followed by IRS which appears to have followed the definition set forth in the text. See Rev. Rul. 56, 1953-1 C.B. 303.

**/ The application of § 932 to the Virgin Islands is not clear. Section 932(b) provides that nothing in § 932 shall be construed to alter or amend 48 U.S.C. § 1397 providing for the application of the Internal Revenue Code in the Virgin Islands.

a possession of certain defined trades or businesses.

Section 957(d) provides that the term "United States person" does not include certain residents of Puerto Rico, the Virgin Islands and other U.S. possessions. The effect of determining that an individual is not a U.S. person is to exclude such individual in determining whether a foreign corporation organized in Puerto Rico, the Virgin Islands, or any other U.S. possession is a controlled foreign corporation.

Tax Exempt Bonds. The provisions of section 103 exempt from U.S. income tax interest on the obligations of a "State, Territory or a possession of the United States, or any political subdivision of any of the foregoing . . . ." It is thus advantageous to be classified as a territory or possession if revenue is to be raised through the issuance of governmental debt obligations.*/

Puerto? Rico.

2. Estate and Gift Tax.

Generally, the United States estate tax laws do not apply to nonresidents who are not U.S. citizens. Section 2209 of the Internal Revenue Code provides that a resident of a possession at the time of his death will, for purposes of the estate tax, be considered a "nonresident not a citizen of the United States" if he acquired his U.S.

*/ There are additional minor income tax provisions in which certain tax consequences may depend upon possession status. These provisions will be identified and catalogued in a later memorandum. The major provisions, however, are described in the text of this memorandum.

citizenship "solely by reason of (1) his being a citizen of such possession of the United States, or (2) his birth or residence within such possession of the United States." A nonresident not a citizen is taxed only on the transfer of property situated or deemed to be situated in the United States at the time of his death (§ 2103), such as U.S. real estate and debt or stock of a U.S. person or corporation (§ 2104). A graduated rate schedule is applicable to the estates of nonresidents who are not U.S. citizens, with a maximum rate of 25%, as opposed to 77% for U.S. citizens.

Gifts of intangible property by nonresidents who are U.S. citizens solely by reason of their citizenship, birth or residence in a possession are not subject to United States gift tax. (§ 2501(a)(2)). Gifts of tangible property by such persons are subject to gift tax only if the property is situated in the United States.

3. <u>Withholding Tax on Wages</u>.

Section 3401 <u>et seq</u>. of the Internal Revenue Code requires an employer to withhold federal income tax from an employee's wages. Several exceptions may apply to relieve an employer of the necessity of withholding income tax from an employee in a U.S. possession. Thus, section 3401(a) provides that the term "wages" does not include any of the following: (1) remuneration paid for services performed by a nonresident alien individual outside the United States (§ 3401(a)(6) and Reg. § 31.3401(a)(6)-1); (2) remuneration paid for services for an employer (other than the United States) performed in a possession of the United States by a citizen of the United States if, at the time of payment of such remuneration, the employer is required by the law of the possession to withhold income tax from such remuneration (§ 3401(a)(8)(A)(ii)); (3) remuneration paid for services for an employer (other than the United States) performed within a possession of the United States (other than Puerto Rico) if it is reasonable to believe that at least 80% of the remuneration to be paid to the employee by such employer during the calendar year will be for such services (§ 3401(a)(8)(B)); and (4) remuneration paid for services for an employer (other than the United States) performed by a citizen of the United States within Puerto Rico, if it is reasonable to believe that during the entire calendar year the employee will be a bona fide resident of Puerto Rico (§ 3401(a)(8)(C)).

With respect to the Virgin Islands, Reg. §31.3401 (b)(12) provides that

> "No tax shall be withheld for the United States under Chapter 24 from a payment of wages by an employer, including the United States or any agency thereof, to an employee if at the time of payment it is reasonable to believe that the employee will be required to satisfy his income tax obligations with respect to such wages under Section 28(a) of the Revised Organic Act of the Virgin Islands [48 U.S.C.A. § 1642]. That section provides that all persons whose permanent residence is in the Virgin Islands 'shall satisfy their income tax obligations under applicable tax statutes of the United States by paying their tax on income derived from all sources both within and outside the Virgin Islands into the treasury of the Virgin Islands.'"

4. <u>FICA Tax</u>.

The Federal Insurance Contributions Act ("FICA"), set forth in §3101 et seq. of the Internal Revenue Code, imposes a tax on every employer and employee with respect to an employee's wages for old-age, survivors and disability insurance and hospital insurance.

Section 3121(b) defines the term "employment" to include services performed <u>within the United States</u> by an employee for the person employing him, irrespective of the citizenship of either, and services performed outside the United States by a citizen of the United States as an employee for an American employer. The term "American employer" is defined in § 3121(h) to include a corporation organized under the laws of the United States or of any State.

The FICA tax is made applicable to Puerto Rico, Guam, the Virgin Islands and American Samoa by defining the term "United States" to include such possessions. (§ 3121 (e)(2)).

The term "employment" does not include employment for the government of Puerto Rico or the Virgin Islands, but generally does include employment for the government of Guam or American Samoa. (§ 3121(b)(7)). Section 3125 provides that the return and payment of FICA taxes imposed on the income of individuals who are officers or employees of the government of Guam or American Samoa may be made by the

Governor of Guam or American Samoa respectively and may be made without regard to the wage limitation imposed by §§ 3111 and 3121(a)(1).

5. Self-Employment Tax.

The Self-Employment Tax Act, set forth in § 1401 et seq. of the Internal Revenue Code, imposes a tax upon the self-employment income of every individual for purposes of providing old-age, survivors, disability and hospital insurance. The self-employment tax is designated as part of the federal income tax. The tax is imposed on the self-employment income of all United States citizens and resident aliens. A nonresident alien is not deemed to have any self-employment income subject to the self-employment tax. (§ 1402(b)) The self-employment tax is fully applicable to citizens of Puerto Rico, Guam, the Virgin Islands and American Samoa who are citizens of the United States. See §§ 1402(a)(6) and (9). The tax is also applicable to citizens of these possessions who are not citizens of the United States, i.e., they are not treated as nonresident aliens for purposes of the self-employment tax. (§ 1402(b)).

6. Federal Unemployment Tax Act.

The Federal Unemployment Tax Act ("FUTA"), set forth in § 3301 et seq. of the Internal Revenue Code, imposes an excise tax on every employer, measured with respect to an employee's wages, for purposes of providing unemployment benefits. This tax is generally not applicable to employment in a United States possession except Puerto Rico. */ The term "employment" is defined in § 3306(c) to include (1) any service performed within the United States by an employee for the person employing him, irrespective of the citizenship or residence of either, and (2) any service performed outside the United States (except in the Virgin Islands) by a citizen of the United States as an employee of an American employer. The term "United States" is defined to include Puerto Rico (§ 3306(j)(2)) and the term "American employer" is defined to include an individual who is a U.S. resident or a U.S. corporation. (§ 3306(j)(3)). The term "employment" does not include employment for the U.S. Government or an instrumentality thereof. (§ 3306(c)(6))

Accordingly, the FUTA tax is applicable to employment in Puerto Rico and is not applicable to employment in the Virgin Islands. The tax generally is not applicable to employment in other U.S. possessions except for employment with an American employer other than the U.S. Government.

7. Administration and Collection of Tax.

Section 7651 provides certain rules for the administration and collection of tax in U.S. possessions, except as otherwise provided in § 28(a) of the Revised Organic Act of the Virgin Islands and § 30 of the Organic Act of Guam

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*/ In 1956 Puerto Rico enacted a local Employment Security Act. Payroll taxes paid pursuant to that Act qualify as credits under FUTA.

relating to the payment of certain taxes into the treasuries of the Virgin Islands and Guam. See pages 14 and 21, *infra*.

Section 7651(1) provides that the U.S. can enforce its tax against a delinquent taxpayer or property in a possession in the same manner as against a taxpayer in the States. Section 7651(2) provides for the administration and collection of any U.S. tax imposed in the possessions themselves, and provides that such tax "shall be paid into the Treasury of the United States as internal revenue collections. Section 7651(3) provides that "this section shall apply notwithstanding any other provision of law relating to any possession of the United States.

8. Interest Equalization Tax.

The Interest Equalization Tax ("IET"), set forth in section 4911 *et seq*. of the Internal Revenue Code, imposes an excise tax on each acquisition by a United States person of stock of a foreign issuer or of a long-term debt obligation of a foreign obligor. The term "United States person" is defined in section 4920(a)(4) to include a citizen or resident of the United States. Accordingly, the IET is applicable to an acquisition of stock or debt by any citizen of a possession who is also a U.S. citizen. The term "foreign obligor" as defined in section 4920(a)(3) includes a corporation incorporated in a possession. Accordingly, acquisition of stock or debt obligations of a corporation incorporated in a possession may be subject to the IET. However, the IET does not apply to the acquisition by a United States person of a debt obligation issued by the government of a less developed country corporation, or a debt obligation issued by an individual or partnership resident in a less developed country in return for money or property which is used wholly within a less developed country. (§ 4916). Pursuant to Executive Order 11285, 1966-2 C.B. 480, the President has declared Puerto Rico and all possessions of the United States as less developed countries for purposes of the IET.

B. Income Taxation in Guam, the Virgin Islands, American Samoa and Puerto Rico

1. Guam.

The United States and Guam are separate taxing jurisdictions and Guamanian individuals are subject to the income tax laws of both jurisdictions.*/ Like other U.S. citizens, Guamanians are subject to U.S. income tax on their worldwide income but are eligible for the foreign tax credit with respect to income tax paid to Guam. Corporations incorporated in Guam or the United States and doing business in, or receiving income from, both jurisdictions are also subject to the income tax laws of both. However, the dual application of the income tax laws of the United States and Guam to individuals and corporations is ameliorated by certain provisions described below.

The income tax laws applicable in Guam follow what is known as the "mirror image" system, *i.e.*, Guam income taxes are determined by applying the United States income tax laws but by substituting the word "Guam" for the words "United States" wherever they appear in the Internal Revenue Code. Under the "mirror image" system, the tax laws of Guam are automatically changed whenever the Internal Revenue Code is amended. Thus, Section 31 of the Organic Act of Guam (attached as Appendix A) provides that "the income tax laws enforced in the United States of America and those

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*/ See Rev. Rul. 8, 1953-1 C.B. 300; Rev. Rul. 55-184, 1955-1 C.B. 500.

which may hereafter be enacted shall be held to be likewise in force in Guam." 48 U.S.C. § 1421(i)(a). The income tax laws in Guam are deemed to be a separate Territorial income tax payable to the government of Guam and designated the "Guam Territorial Income Tax." 48 U.S.C. § 1421(i)(b).*/ The tax system is administered and enforced by the government of Guam. 48 U.S.C. § 1421(i)(c).

In addition to providing Guam with revenue collected under the Guam Territorial Tax, Section 30 of the Organic Act of Guam, 48 U.S.C. § 1421(h), provides that customs duties, U.S. federal income taxes and certain other proceeds derived from Guam be remitted to Guam:

> "§ 1421h. Duties and taxes to constitute fund for benefit of Guam
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> All customs duties and Federal income taxes derived from Guam, the proceeds of all taxes collected under the internal-revenue laws of the United States on articles produced in Guam and transported to the United States, its Territories, or possessions, or consumed in Guam, and the proceeds of any other taxes which may be levied by the Congress on the inhabitants of Guam, and all quarantine, passport, immigration, and naturalization fees collected in Guam shall be covered into the treasury of Guam and held in account for the government of Guam, and shall be expended for the benefit and government of Guam in accordance with the annual budgets except that nothing in this chapter shall be construed to apply to any tax imposed by chapter 2 or 21 of Title 26."

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*/ In addition to the Guam Territorial income tax, Guam has a number of additional taxes analogous to those that might be imposed by a State, including: a document tax, annual excise and admission tax, real property tax, vehicle transfer tax, business privilege tax, and a use tax. Title XX Guam Code.

Section 1421(h) makes clear, however, that self-employment tax (chapter 2 of Title 26) and FICA tax (chapter 21 of Title 26) are not paid over to Guam.*/

Section 7654(d), added to the Internal Revenue Code in 1972, provides that in addition to other amounts allocated to Guam, the United States will pay to Guam all amounts of taxes deducted and withheld by the United States with respect to military wages paid to Armed Forces personnel situated in Guam. Such personnel otherwise would have no tax liability to Guam with respect to those wages because of the operation of the Soldiers and Sailors Civil Relief Act, 50 App. U.S.C. § 574, which has the effect of treating such personnel as nonresidents of Guam.**/ As recognized by the Ways and Means Committee report, Section 7654(d) appears

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*/ See pages 9-10, *supra*, for discussion of the applicability of the self-employment tax and FICA tax to Guam.

**/ The Soldiers and Sailors Civil Relief Act provides (50 App. U.S.C. § 574(1):

> "For the purposes of taxation in respect of any person, or of his personal property, income, or gross income, by any State, Territory, possession, or political subdivision of any of the foregoing, or by the District of Columbia, such person shall not be deemed to have lost a residence or domicile in any State, Territory, possession, or political subdivision of any of the foregoing, or in the District of Columbia, solely by reason of being absent therefrom in compliance with military or naval orders, or to have acquired a residence or domicile in, or to have become resident in or a resident of, any other State, Territory, possession, or political subdivision of any of the foregoing, or the District of Columbia, while, and solely by reason of being, so absent."

to have restated existing law, since taxes paid by Armed Forces personnel in Guam are also required to be paid over to Guam under Section 30 of the Guam Organic Act, 48 U.S.C. § 1421(h) (quoted above).

In 1972 Congress enacted Public Law 92-606 (attached as Appendix B) to correct several aberrations in the "mirror image" tax system of Guam. One important change of the legislation was to eliminate dual filing and tax requirements for individuals previously subject to the jurisdiction of both Guam and the United States. Prior to the amendment, most individual taxpayers who derived income from both Guam and the United States had to file tax returns with both jurisdictions, although application of the foreign tax credit generally eliminated liability in one jurisdiction. To eliminate the burden and complication of dual filings, Section 935 was added to the Internal Revenue Code, effective beginning in 1973.

Section 935(b) provides that an income tax return need be filed with only one jurisdiction -- either with Guam or with the United States -- depending on the taxpayer's residence at the end of the taxable year. The taxpayer's entire tax liability under both Guam and U.S. income tax laws is then paid to the jurisdiction where the return is filed. If the individual is a U.S. resident at the end of the taxable year, his return and tax are made to the United States. If the individual is a Guam resident at the end of the taxable year, his return and payment of tax are made to Guam. If the individual is a resident of neither jurisdiction at the end of the taxable year, Guam is the controlling jurisdiction if the individual is a Guam citizen but not a U.S. citizen. Otherwise, he must file his return with the United States. In the case of a joint return, the return is filed with the jurisdiction where the spouse having the greater adjusted gross income would be required to file a return. Section 935(d) provides that declarations of estimated tax are filed with the jurisdiction where the taxpayer would be required to file his return if his taxable year closed on the date he is required to file such declaration.

To prevent a distortion in the allocation of revenue between the U.S. and Guam which might result from the rules of section 935, Congress in 1972 also added section 7654 to the Internal Revenue Code entitled "Coordination of United States and Guam Individual Income Taxes." Section 7654 provides that where an individual (and his spouse if filing joint returns) has at least $5,000 of gross income from sources within the other jurisdiction and at least $50,000 of adjusted gross income from all sources, there is to be a division of the net collections of income taxes between the United States and Guam at least annually. Net collections attributable to U.S. source income are to be covered into the U.S. Treasury, and net collections attributable to Guam sources are to be covered into the Guam Treasury. All other net collections (i.e., those attributable to foreign source income) are to be retained by the jurisdiction in which the taxpayer files his return.

In the case of U.S. corporations, the dual application of the Guamanian and U.S. income tax laws is eliminated by section 931 which excludes Guamanian-source income from gross income for U.S. tax purposes if sufficient income is earned from possession sources. See pages 3-4, supra.

The 1972 amendments corrected another problem with respect to the dual taxation of certain corporations under U.S. and Guamanian law. Under section 881 of the Internal Revenue Code a 30% tax is imposed on certain passive income (such as interest and dividends) received by a foreign corporation from U.S. sources; this tax is required to be withheld at its source under section 1442. Under the mirror image system, these same provisions are in effect in Guam. The 1972 amendments provide that a Guam corporation will not be considered a foreign corporation for purposes of sections 881 and 1442 and, accordingly, that a U.S. corporation will

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*/ Section 931 does not apply to U.S. individuals earning income in Guam (§ 931(c)); they are eligible for relief under § 935.

not be considered a foreign corporation for purposes of the identical Guam provisions. See sections 881(b) and 1442(c). As a result of this change, U.S. corporations will not be subject to the 30% Guam withholding tax on their Guam-source passive income which is not effectively connected with a Guam business.

2. Virgin Islands

As in Guam, the Internal Revenue Code has a dual application in the Virgin Islands as the governing U.S. tax law and as a separate territorial tax.*/ See Dudley v. Commissioner, 258 F.2d 182 (3d Cir. 1958). The Naval Appropriations Act, approved July 12, 1921 (42 Stat. 122), codified as 48 U.S.C. § 1397, provides:

> "The income-tax laws in force in the United States of America and those which may hereafter be enacted shall be held to be likewise in force in the Virgin Islands of the United States, except that the proceeds of such taxes shall be paid into the treasuries of said islands. (July 12, 1921, ch. 44, § 1, 42 Stat. 123.)"

Section 28(a) of the Revised Organic Act of the Virgin Islands, approved July 22, 1954, 48 U.S.C. § 1642, provides for a form of revenue sharing as follows:

> "The proceeds of customs duties, the proceeds of the United States income tax, the proceeds of any taxes levied by the Congress on the inhabitants of the Virgin Islands, and the proceeds of all quarantine, passport, immigration, and naturalization fees collected in the Virgin Islands, less the cost of collecting all of said duties, taxes, and fees, shall be covered into the treasury of the Virgin Islands, and shall be available for expenditure as the Legislature of the Virgin Islands may provide: Provided, That the term 'inhabitants of the Virgin Islands as used in this section shall include all persons whose permanent residence is in the Virgin Islands, and such persons shall satisfy their income tax obligations under applicable taxing statutes of

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*/ The Virgin Islands has a number of local taxes including an inheritance tax, miscellaneous excise taxes, property tax, gasoline tax and stamp tax.

> the United States by paying their tax on income derived from all sources both within and outside the Virgin Islands into the treasury of the Virgin Islands: Provided further, That nothing in this chapter, sections 104 and 111 of Title 21, and section 3350(c) of Title 26 shall be construed to apply to any tax specified in section 3811 of Title 26."

Although the income tax laws of the United States and the Virgin Islands arise from an identical statute (*i.e.*, the Internal Revenue Code), they are separate and distinct taxing jurisdictions. However, pursuant to 48 U.S.C. § 1642, inhabitants of the Virgin Islands are required to file only with the Virgin Islands, paying their Virgin Islands tax and any United States tax to the Virgin Islands. The term "inhabitants of the Virgin Islands" includes all persons whose "permanent residence" is in the Virgin Islands as of the last day of the taxable year of the taxpayer. Rev. Rul. 60-291, 1960-2 C.B. 407; see also Rev. Rul. 73-315, 1973-31 I.R.B. 5. Persons who are not inhabitants of the Virgin Islands on the last day of their taxable year may be required to file returns with both the Virgin Islands and the United States. For example, dual filing would be required of a U.S. stateside citizen earning business income in the Virgin Islands. He would pay tax to the Virgin Islands on his business income derived there, and claim a foreign tax credit for these taxes on his U.S. tax return.

Section 934 was added to the Internal Revenue Code in 1960 to prevent the Virgin Islands from granting tax rebates or subsidies with regard to taxes paid to the Virgin Islands which are attributable to income derived from U.S. sources. Thus, section 934 provides as follows:

> "(a) General Rule.— Tax liability incurred to the Virgin Islands pursuant to this subtitle, as made applicable in the Virgin Islands by the Act entitled 'An act making appropriations for the naval service for the fiscal year ending June 30, 1922, and for other purposes', approved July 12, 1921 (48 U.S.C. 1397), or pursuant to section 28(a) of the Revised Organic Act of the Virgin Islands, approved July 22, 1954 (48 U.S.C. 1642), shall not be reduced or remitted in any way, directly or indirectly, whether by grant, subsidy, or other similar payment, by any law enacted in the Virgin Islands, except to the extent provided in subsection (b) or (c)."

Rebates and subsidies are permitted under section 934(b) if they are made to a U.S. corporation or a Virgin Islands corporation to the extent that these corporations derive their income from sources outside the United States. As a further condition, 80% or more of the corporation's income for the three-year period preceding the close of the taxable year must have been derived from within the Virgin Islands, and fifty percent of the corporation's income for this period must have been derived from the active conduct of a trade or business within the Virgin Islands. Rebates and subsidies are permitted under Section 934(c) if made to U.S. citizens who are bona fide residents of the Virgin Islands for the entire taxable year, to the extent that their incomes are derived from sources within the Virgin Islands. Income earned as an employee of the United States or an agency thereof will not be treated as being derived within the Virgin Islands, nor will gains or losses on sales or exchanges of securities.

Consistent with Section 934 of the Internal Revenue Code, the Virgin Islands has adopted an industrial incentive program, 29 Virgin Islands Code & 701 et seq. Certain business investments in the Virgin Islands are eligible for a "certificate of tax exemption and subsidy benefits" which entitles the holder to a subsidy in the first five years equal to seventy-five percent of income tax liability paid to the Virgin Islands and fifty percent of such liability for the second five years.

3. American Samoa

The legislature of American Samoa has adopted the Internal Revenue Code of 1954 as a territorial income tax. Section 18.0401(a) of the Revised Code of American Samoa (attached as Appendix D) provides as follows:

> Sec. 18.0401 - IMPOSITION OF INCOME TAX:
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> (a) Income Tax Laws in Force: The income tax laws in force in the United States of America and those which may hereafter be enacted, where not clearly inapplicable or incompatible with the intent of this section, are hereby adopted by American Samoa. They shall be deemed to impose a separate territorial income tax, payable to the Government of American Samoa. These laws include, but are not limited to, the following provisions of the United States Internal Revenue Code of 1954: subtitle A; chapters 24 and 25 of subtitle C, with reference to the collection of income tax at source on wages; and all provisions of subtitle F which apply to the income tax, including provisions as to crimes, other offenses, and forfeitures contained in chapter 75. For reference purposes, this chapter, and all provisions of the United States Internal Revenue Code of 1954 adopted by the above reference, may be cited as the "Samoan Income Tax Act."

Under Section 18.0401(b) administration and enforcement of the Samoan Income Tax Act is the responsibility of the Treasurer of American Samoa under the supervision of the Governor.

American Samoa has adopted one major amendment to the Internal Revenue Code providing for a minimum tax on individuals of two percent of adjusted gross income if such tax is higher than the tax normally computed.

Because the United States and American Samoa are separate tax jurisdictions, the tax laws of both may be applicable to certain taxpayers. However, section 931 excludes American-Samoa-source income from the gross income of a U.S. citizen or U.S. corporation for U.S. tax purposes if a prescribed portion of income is derived there. See pages 3-4, supra.

4. Puerto Rico.

The Constitution of the Commonwealth of Puerto Rico, approved by the United States Congress and made effective on July 25, 1952, provides in Article VI, Section 2 that "the power of the Commonwealth of Puerto Rico to impose and collect taxes and to authorize their imposition and collection by municipalities shall be exercised as determined by the Legislative Assembly and shall never be surrendered or suspended. . . ." (48 U.S.C. § 731(d)). Section 3 of Article VI provides that "the rule of taxation in Puerto Rico shall be uniform."

The broad grant of legislative power to enact tax legislation is confirmed by section 845 of Title 48 of the U.S. Code which provides that "the Puerto Rico legislature shall have power by due enactment to amend, alter, modify, or repeal the income tax laws in force in Puerto Rico." However, all laws enacted by the legislature of Puerto Rico must be reported to the United States Congress "which reserves the power and authority to annul the same." 48 U.S.C. § 826.

Exercising its constitutional prerogatives, the Puerto Rican legislature adopted the Puerto Rican Income Tax Act of 1954. The Act is patterned closely after the Internal Revenue Code of 1939 which was the current U.S. tax law at the time the Puerto Rican tax was adopted.*/ However, there are numerous differences in rates and other provisions. To encourage industrial development, broad tax exemption is granted to qualifying businesses under the Puerto Rican Industrial Incentive Act of 1963. Exemption under the Act is generally available to individuals or companies establishing new manufacturing or hotel operations in Puerto Rico. Exemption covers income tax, property tax and municipal taxes and may extend for 10, 12, 15 or 17 years depending on the location of the facility within Puerto Rico. The Puerto Rican income tax laws (including the Industrial Incentive Act) are summarized in Sierra, Tax Advantages Available to U.S. Companies Doing Busienss in Puerto Rico, 38 J. Taxation 310 (1973), attached as Appendix E. See also 139 Tax Management Portfolio, U.S. Business Operations in Puerto Rico.

The United States tax laws are applicable to citizens of Puerto Rico who are U.S. citizens and to U.S. corporations doing business in Puerto Rico.**/ However,

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*/ The Internal Revenue Code of 1954 was adopted on August 16, 1954.

**/ Section 9 of the Puerto Rican Federal Relations Act, 48 U.S.C. § 734, provides that "the statutory laws of the United States not locally inapplicable, except as hereinbefore or hereinafter otherwise provided, shall have the same force and effect in Puerto Rico as in the United States, except the internal revenue laws other than those contained in the Philippine Trade Act of 1946 or the Philippine Trade Agreement Revision Act of 1955." This provision was first enacted in 1900 before the imposition of the federal income tax laws at a time when the Internal Revenue laws consisted of various excise taxes and a special wartime levy. The present significance of the words "except the internal revenue

[footnote continued]

several provisions of the Internal Revenue Code moderate the dual application of the Puerto Rican and U.S. income tax.

A United States corporation doing business in Puerto Rico can qualify as a "possessions corporation" under section 931 if it derives at least 80% of its gross income from sources within a possession and at least 50% from the active conduct of a trade or business within a possession. In general, a possessions corporation is not subject to U.S. tax on its foreign source (i.e., Puerto Rican) income. See pages 3-4, supra.

A United States corporation doing business in Puerto Rico can also qualify as a Western Hemisphere trade corporation ("WHTC") under sections 921 and 922. A special deduction against taxable income (equivalent to a 14 percentage point rate reduction) is allowed to a WHTC which is defined as a U.S. corporation all of whose business is done in a country or countries in North, Central or South America, or in the West Indies and which satisfies certain income tests. A WHTC must have derived at least 95% of its gross income for a 3-year period from sources outside the United States and 90% of its gross income from the active conduct of a

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[footnote continued from previous page]

laws" seems to be limited to its original context since section 7651(3) of the Internal Revenue Code provides that the Internal Revenue Code applies "notwithstanding any other provision of law relating to any possession of the United States." As provided in section 7701(c), Puerto Rico is generally included within the term "possession" when used in the Internal Revenue Code.

trade or business. The WHTC provisions apparently are little used in the case of Puerto Rico since more favorable tax treatment is available to a U.S. corporation under section 931 or to a Puerto Rican corporation. See Mihaly, Tax Advantages of Doing Businessin Puerto Rico, 16 Stan. L. Rev. 75, 95 (1963).

Under section 933 an individual who is a bona fide resident of Puerto Rico during the entire taxable year is not subject to U.S. income tax on income derived from Puerto Rican sources except amounts received for services performed as an employee of the United States. If an individual has been a bona fide resident of Puerto Rico for at least two years prior to his change of residence, the section 933 exemption applies to income attributable to the period prior to the change of residence.

F.D.L.