DRAFT
October 12, 1973

MEMORANDUM

SUBJECT: Preliminary Recommendations with Respect to Marianas Tax System.

At the request of the Marianas Political Status Commission, we have undertaken a study of the essential points relating to the Marianas tax structure that should be specified in the status agreement with the United States. This memorandum does not attempt to detail a specific tax system for the Marianas but rather focuses on the broad outlines of the tax relationship between the Marianas and the United States that need to be set forth in the status agreement. This memorandum also does not deal with the matter of social security taxes and customs and duties which will be dealt with in a separate report.

Summary of Research

In general, this memorandum raises two basic questions: (1) the extent to which the United States Internal Revenue Code of 1954 as amended (the "Internal Revenue Code") should be made applicable to the Marianas and (2) the extent to which the Marianas should adopt as its own territorial tax an income tax based on the Internal Revenue Code.

The starting point for our research was a detailed analysis of the taxation by the United States of those entities which are treated as possessions for U.S. tax purposes and an analysis of the territorial income tax adopted by those possessions. In this connection, we have studied with particular care the analogies of Guam, the Virgin Islands, American Samoa and Puerto Rico. Attached as Appendix A is a background memorandum which generally describes the application of the U.S. tax laws in these and other possessions.*/ In the course of our research, we have also conferred with technicians in the United States Treasury Department and United States Internal Revenue Service who are familiar with the problems of interpretation, administration and enforcement that have been encountered in applying the U.S. tax laws to these possessions.

This memorandum will first set forth a summary of our recommendations and then will discuss in detail the recommendations and various alternatives.

Summary of Recommendations

1. Sovereignty over taxes. The status agreement should provide that the Marianas legislature shall have the exclusive power to enact, alter, modify or repeal its internal tax laws, including any territorial income tax it might choose to adopt.

2. Tax sharing. The status agreement should establish the principle that U.S. income taxes derived from

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*/ The background memorandum will be referred to extensively in this memorandum and, unless otherwise noted, all page references will be to Appendix A.

the Marianas should be paid over to the Marianas by the United States. This principle can best be implemented by requiring that all income tax withheld by the United States */ from wages earned in the Marianas be covered into the Marianas treasury, for expenditure as the Marianas legislature shall provide. Amounts paid over to the Marianas would include U.S. income tax withheld from both civilian and military employees of the United States as well as from nongovernment employees.

3. U.S. taxation of Marianas citizens. The status agreement should provide that a person who is not a resident of the United States and who becomes a United States citizen or United States national solely by reason of birth, citizenship or residence in the Marianas shall be treated as a nonresident alien for purposes of the U.S. income tax and estate and gift tax laws. This would continue the present treatment of Marianas citizens as nonresident aliens for U.S. tax purposes notwithstanding the fact that they become U.S. citizens or U.S. nationals as a result of the status agreement. The effect of this provision would be that citizens or nationals of the Marianas who are resident in the Marianas and only have income from Marianas sources would not be subject to U.S. income tax; would not be subject to U.S. gift tax except to the extent that a gift is made of

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*/ Pursuant to Chapter 24, Subtitle C of Title 25 of the United States Code.

tangible property located in the United States; and would not be subject to U.S. estate tax except for property situated or deemed to be situated in the United States.

4. U.S. tax incentive for doing business in Marianas. As an incentive to attract U.S. business to the Marianas, the status agreement should provide that a United States citizen or United States corporation shall not be taxed on any foreign source income (including income earned in the Marianas) if the citizen or corporation meets the requirements set forth in section 931 of the Internal Revenue Code. Section 931 (as described on p.) generally exempts income earned outside the United States from U.S. tax if 80 percent of the gross income for a designated period is derived from sources within a U.S. possession and 50 percent or more of such income is derived from the active conduct of a trade or business within a possession. The Marianas would be treated as a possession for purposes of applying this section.*/

5. Treatment of Marianas as possession for U.S. tax purposes. The status agreement should provide that the Marianas shall be treated as a possession for the numerous additional provisions of the Internal Revenue Code where such treatment is beneficial. A summary of those provisions is attached as Appendix B.

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*/ A commonwealth may be treated as a possession for federal tax purposes, as in the case of Puerto Rico.

6. Development of Marianas tax system. As a second phase of its transition to commonwealth status, the Marianas should initiate the study and drafting of a tax system to be enacted by the Marianas legislature. The study should focus on the desirability of continuing the present Trust Territory taxes and should assess the need for a progressive income tax, inheritance or estate tax, and tax incentives or direct subsidies to promote economic growth. It is our initial recommendation that the Marianas should not adopt an income tax based on the Internal Revenue Code; a simpler income tax more suitable for the Marianas can be devised.

Discussion of Alternatives

In making the foregoing recommendations, we have carefully considered a number of alternatives. This section of the memorandum will discuss each recommendation in detail, review the alternatives that exist and set forth the arguments that support our recommendations.

1. Sovereignty over taxes. The recommendation that the Marianas legislature be given the exclusive power to enact its own internal tax laws is consistent with the domestic sovereignty to be accorded the Marianas as recognized in the Joint Communique of June 4, 1973. Furthermore, the recommendation gives the Marianas flexibility to devise the tax system best suited to its present and future needs.

In our view, it is both unnecessary and unwise to bind the Marianas to any specific tax system in the status agreement.

Precedent for this recommendation is found in Puerto Rico. Although Puerto Rico has adopted a territorial tax based on the Internal Revenue Code of 1939, the Puerto Rico legislature is specifically given the power "by due enactment to amend, alter, modify, or repeal the income tax laws in force in Puerto Rico." See p. . In Guam and the Virgin Islands, however, the Internal Revenue Code has been imposed as a separate territorial income tax without any power on the part of Guam or the Virgin Islands to amend or repeal it. See pp. and .

2. Tax sharing. We have recommended that the status agreement establish the tax-sharing principle that U.S. income tax derived from the Marianas be covered into the Marianas treasury.*/ A type of tax sharing is in effect with respect to Guam and the Virgin Islands, but not Puerto Rico and American Samoa.

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*/ This memorandum does not address the question of the extent to which any customs duties should be paid over to the Marianas. We do not recommend that estate and gift tax or any tax other than the U.S. income tax be required to be paid over to the Marianas. Any proceeds from U.S. estate and gift tax are likely to be negligible since non-resident aliens are not subject to estate and gift tax if they do not have United States property. Under our third recommendation, citizens of the Marianas would be treated as nonresident aliens for this purpose. It also should be noted that the Internal Revenue Service has interpreted the Guam and Virgin Islands tax-sharing provisions as not applying to estate and gift taxes.

The tax sharing might be accomplished by various forms of payment from the U.S. to the Marianas:

(1) payment of U.S. income tax withheld from wages earned in the Marianas by U.S. taxpayers, including both military and civilian personnel employed by the United States government;

(2) payment of income tax collected by the United States to the extent it is derived from Marianas sources; or

(3) by requiring a U.S. taxpayer who is resident in the Marianas at the end of the taxable year to satisfy any U.S. tax liability by direct payment of such liability to the Marianas.

After examining the Guam and Virgin Islands experience and discussing the matter with technicians at the U.S. Treasury, we have concluded that payment of U.S. withholding is the simplest and most practical route to tax sharing. However, further discussion with the Treasury would be in order with respect to the details of such a plan.

To fully assess the foregoing recommendation it is helpful to first review the Guam and Virgin Islands system.

a. <u>Virgin Islands</u>

Section 28(a) of the Revised Organic Act of the Virgin Islands, 48 U.S.C. § 1642, provides, among other things, that the proceeds of the United States income tax collected in the Virgin Islands, less the cost of collecting the tax, shall be covered into the treasury of the Virgin Islands. See pp. . The Act further provides that persons whose "permanent residence" is in the Virgin Islands shall satisfy their U.S. tax liability by paying their tax on income derived from all sources both within and outside the Virgin Islands into the treasury of the Virgin Islands.

This tax-sharing provision has been interpreted by the Internal Revenue Service in a rather restricted manner U.S. income tax is paid over to the Virgin Islands only to the extent that a resident of the Virgin Islands at the end of the taxable year is required to pay his U.S. income tax liability to the Virgin Islands. It is our understanding that where a taxpayer changes his residence from the United States to the Virgin Islands in the middle of the tax year, the United States will pay income tax withheld in the United States and estimated tax payments to the Virgin Islands, although this has apparently been a problem.

b. Guam

Section 30 of the Organic Act of Guam, 48 U.S.C. § 1421(h), provides that

> "all customs duties and Federal income taxes derived from Guam . . . and the proceeds of any other taxes which may be levied by the Congress on the inhabitants of Guam . . . shall be covered into the treasury of Guam."

See p. .

We were informed by the U.S. Treasury Department that it is administratively impossible to determine the U.S. tax revenue derived from Guam sources as required by Section 30 of the Organic Act because tax returns generally do not require identification of such income. Accordingly, the U.S. worked out a procedure with Guam to pay over U.S. income tax withheld from the wages of U.S. military and civilian employees stationed in Guam on a quarterly basis. Payments with respect to U.S. civilian employees permanently stationed in Guam are based on a record of actual withholding. Payments with respect to military personnel are computed on the basis of an estimate derived from actual withholding for April and October.

The foregoing system is still in effect, though modified significantly by legislation enacted in 1972.

Under the present Guam tax system, an individual is required to pay his entire U.S. and Guam tax liability either to the United States or Guam depending on his year-end residency. Section 935(b) of the Internal Revenue Code. In the case of high-income individuals, however, the U.S. tax is reallocated between Guam and the United States depending on whether it has a U.S. or Guam source. Section 7654 of the Internal Revenue Code. A special tax return is being devised so the required allocation can be determined. In addition to other amounts paid to Guam, section 7654(d) of the Internal Revenue Code provides for payment to Guam of the amount of U.S. income taxes deducted and withheld by the United States

> "with respect to compensation paid to members of the Armed Forces who are stationed in Guam but who have no income tax liability to Guam with respect to such compensation by reason of the Soldiers and Sailors Civil Relief Act."

See p.

c. <u>Marianas proposal</u>

Our recommendation for the Marianas attempts to incorporate the best features of the Guam model. The U.S. Treasury has indicated that payment of U.S. income taxes withheld from wages is the simplest and most manageable system of tax sharing. To avoid the interpretative problem that has arisen in Guam, the status agreement should clearly specify that it covers wages withheld from both U.S. civilian and military employees. Consideration should also be given to covering U.S. tax withheld from the wages of private employees (<u>e.g.</u>, a U.S. citizen working in the Marianas for a U.S. company) although additional thought must be given to the administration and enforcement of such a feature which has not been tried in Guam. We do not recommend that aspect of the Guam and Virgin Islands system which requires that the U.S. tax liability of a resident be paid directly to the Guam or Virgin Islands treasury. Such a system is only appropriate where the possession -- as in the case of Guam and the Virgin Islands -- has adopted the Internal Revenue Code as its own territorial tax and thus has an administrative familiarity with the tax it has collected. In terms of efficiency and cost, it seems far better to utilize the United States as the collection agent rather than having the Marianas serve in that role.

3. U.S. taxation of Marianas citizens. We have recommended that a person who is not a resident of the United States and who becomes a United States citizen or United States national solely by reason of his citizenship, birth or residence in the Marianas shall be treated as a nonresident alien for purposes of the U.S. income, estate and gift tax laws.

a. Income tax. This recommendation would continue the present treatment of Marianas citizens as non-resident aliens for U.S. income tax purposes notwithstanding the fact that they become U.S. citizens or U.S. nationals as a result of the status agreement. Accordingly, Marianas citizens with income solely from Marianas sources would not be subject to U.S. income tax, which preserves their existing treatment. However, nonresident aliens with U.S. source income are presently subject to U.S. tax on that income (see pp. 1-3) and would continue to be so taxed.

To achieve the result we advocate, section 932 of the Internal Revenue Code should be amended to apply to the Marianas. That section generally provides that an individual who is a citizen of a possession of the United

States (but not otherwise a citizen of the United States) and who is not a resident of the United States is subject to income tax as a nonresident alien.*/

Section 932 is specifically made inapplicable, however, in the case of a citizen of Puerto Rico or, beginning in 1973, a citizen of Guam. Excepting Guamanians from this provision was supported by the U.S. Treasury on the grounds, in part, that Guamanians found this characteristic politically objectionable.**/ Irrespective of this view, nonresident alien status for U.S. tax purposes would be of significant tax benefit to the majority of Marianas citizens, who do not have any U.S. source income.

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*/ There is an ambiguity in the regulations which interpret section 932 which should be corrected if such provision is extended to Marianas citizens. 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." However, contrary to the apparent meaning of the regulations, the IRS has interpreted section 932 to apply to citizens of a possession who become U.S. citizens by virtue of a collective naturalization act. See Rev. Rul. 56, 1953-1 C.B. 303. To avoid any misunderstanding, section 932 should explicitly be made to apply to a person who acquires U.S. citizenship solely by reason of (1) his being a citizen of the Marianas, or (2) his birth or residence within the Marianas. This language is patterned after the language used in section 2209 of the Internal Revenue Code relating to the application of the estate and gift tax laws to citizens of a possession who are treated as nonresident aliens.

**/ See statement of John S. Nolan, Deputy Assistant Secretary of the Treasury, Before the House Interior and Insular Affairs Committee on H.R. 15007, Sept. 15, 1970, p. 5.

It should be noted, however, that nonresident alien status has certain negative effects for a taxpayer with U.S. source income, such as wages earned in the United States or investment income from the United States. The most significant of these effects is that in computing U.S. income tax, a nonresident alien is not allowed to use the standard deduction or file a joint return with his spouse to take advantage of lower rates for married persons and he is only allowed one personal exemption.*/

b. Estate and gift tax. The United States estate and gift tax laws do not apply to nonresident aliens who have no property located in, or deemed to be located in, the United States.**/ Our recommendation would continue the present tax treatment even though citizens of the Marianas become U.S. citizens or nationals as a result of the status agreement. This result can be achieved by amending section 2209 of the Internal Revenue Code to apply to the Marianas. That section provides that a resident of a possession at the time of his death will, for purposes of the estate tax, be

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*/ An attempt should be made to ascertain whether any citizens of the Marianas might be disadvantaged by treatment as nonresident aliens for U.S. income tax purposes. If this is determined to be a significant problem, which we doubt, the Marianas might propose that the United States allow a Marianas citizen the election to be taxed as a United States citizen under the normal rules rather than as a nonresident alien.

**/ For a discussion of the application of the estate and gift tax laws to a nonresident alien with U.S. property, see pp. .

considered a "nonresident not a citizen of the United States" if he acquired his 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."

4. U.S. tax incentive for doing business in the Marianas. We have recommended that the status agreement should provide that a United States citizen or United States corporation will not be taxed on any foreign source income (including income from the Marianas) if the taxpayer has earned a designated percentage of income in the active conduct of a trade or business in the Marianas. To achieve this result, section 931 of the Internal Revenue Code would be amended to apply to the Marianas. Section 931 generally exempts foreign source income from U.S. tax if 80 percent of the gross income for a specified period is derived from sources within a U.S. possession and 50 percent or more of such income is derived from the active conduct of a trade or business within a possession.

Treating the Marianas as a "possession" for purposes of section 931 offers potentially greater benefits to those stateside U.S. citizens who reside in the Marianas than are presently available to them. As a U.N. trusteeship, the Marianas are treated as a foreign country for purposes of the U.S. income tax laws. Accordingly, a U.S. citizen who is a bona fide resident of the Marianas or is present in the Marianas for 510 days during a period of 18 consecutive months is exempt from U.S. tax on $20,000 ($25,000 in some cases) of earned income attributable to services performed in the Marianas. However, section 911 does not apply to income earned in a possession or territory of the United States.*/ If the Marianas is to be treated as a possession for other purposes of the Internal Revenue Code, it should be treated as a possession for purposes of section 911. Accordingly, the benefits of section 911 would no longer be applicable to a U.S. citizen residing in the Marianas. However, if a U.S. citizen meets the requirements of section 931, all income from the Marianas -- both earned income and investment income -- would be exempt from U.S. tax and without any dollar limitation, a significantly greater benefit than is available under section 911.

5. Treatment of Marianas as possession for U.S. tax purposes. We have recommended that the status agreement should provide that the Marianas be treated as a possession for the numerous provisions of the Internal Revenue Code where such treatment is beneficial to U.S. taxpayers having income from the Marianas. The chief example of the favorable treatment resulting from possession status is section 931 of the Internal Revenue Code discussed in the previous section

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*/ Section 1.911-2(f) of the Income Tax Regulations.

of the memorandum. Other provisions of the Internal Revenue Code are listed in Appendix B, together with a brief explanation of their application. In a few instances listed in Appendix B the possession status of the Marianas would produce less favorable results for U.S. taxpayers than foreign country status. Section 911 is a prime example as discussed in the previous section of this memorandum. However, consistency requires that the Marianas be treated as a possession for purposes of these sections as well as the sections that would produce tax benefits.

6. <u>Development of Marianas tax system</u>. We have recommended that the status agreement recognize the power of the Marianas to enact its own tax system. If this recommendation is adopted, we feel it would be inappropriate and premature to define the nature of the Marianas tax system in the status agreement. Instead, we recommend that the Marianas initiate a detailed study of its future tax structure to be followed by the drafting of a tax code. Such a study would focus on the extent to which the existing Trust Territory taxes should be retained, whether a progressive income tax should be adopted, the need for an inheritance or estate tax and the desirability of enacting any other taxes.

In examining the question of whether a progressive income tax should be adopted, the study should consider whether such a tax should be patterned after the Internal

Revenue Code. We have tentatively concluded that the Marianas should not use the Internal Revenue Code as a model. Although utilizing the Internal Revenue Code as a model would unquestionably simplify the drafting of an income tax law, we feel this advantage is outweighed by the sheer complexity of the Internal Revenue Code.*/ Furthermore, we understand from the U.S. Treasury that numerous interpretative problems have arisen in Guam and the Virgin Islands where the mirror image of the Internal Revenue Code has been imposed as a separate territorial tax.

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*/ Learned Hand, a prominent federal judge, has perhaps best expressed the frustration that so many have experienced in working with the Internal Revenue Code:

> 'In my own case the words of such an act as the Income Tax, for example, merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception--couched in abstract terms that offer no handle to seize hold of--leave in my mind only a confused sense of some vitally important, but successfully concealed, purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time. I know that these monsters are the result of fabulous industry and ingenuity, plugging up this hole and casting out that net, against all possible evasion; yet at times I cannot help recalling a saying of William James about certain passages of Hegel: that they were no doubt written with a passion of rationality; but that one cannot help wondering whether to the reader they have any significance save that the words are strung together with syntactical correctness."

L. Hand, The Spirit of Liberty 213 (Dillard ed. 1952).