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APPENDIX B .

PROVISIONS OF THE INTERNAL REVENUE CODE
AFFECTED BY STATUS AS A U.S. POSSESSION

A. Sections Where Beneficial Treatment Results from Possession Status.

A number of provisions of the Internal Revenue Code accord beneficial treatment to U.S. taxpayers with respect to transactions involving a "possession of the United States" as opposed to a "foreign country." Any change in the status of the Marianas from a foreign country to a possession for tax purposes would bring the following provisions into play: ^{*/}

1. Section 37 generally provides the elderly with a tax credit against certain retirement income, including income from pensions and annuities under a public retirement system. A "public retirement system" is defined in section 37(f) to include a fund established "by the United States, a State, a Territory, a possession of the United States, any political subdivision of any of the foregoing, or the District of Columbia." The term "possession" is not defined. See Reg. § 1.37-3(a)(3).

^{*/} All section references are to the United States Internal Revenue Code of 1954, as amended. All references to "Reg." are to the Income Tax Regulations that interpret and amplify the Internal Revenue Code.

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2. Section 38 allows a 7% investment credit for investment in certain tangible property. The credit is generally not available for property which is used predominantly outside the United States except the credit is available under section 48(a)(2)(vii) for "any property which is owned by a domestic corporation (other than a corporation entitled to the benefits of section 931 or 934(b)) or by a United States citizen (other than a citizen entitled to the benefits of section 931, 932, 933, or 934(c)) and which is used predominantly in a possession of the United States by such a corporation or such citizen, or by a corporation created or organized in, or under the law of, a possession of the United States." See Reg. § 1.48-1(g)(2)(vii).

3. Section 103(a)(1) provides that gross income does not include interest on "the obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia." It is advantageous to be classified as a possession for this purpose so that interest on bonds issued by the Marianas would be exempt in the hands of U.S. taxpayers thus expanding the market for such bonds.

4. Section 115(a)(2) provides that gross income does not include "income accruing to the government of any possession of the United States, or any political subdivision thereof."

5. Section 162(a) allows an individual a deduction for ordinary and necessary business expenses, including traveling expenses while away from home in the pursuit of a trade or business. The place of residence of a member of Congress (including any delegate) "within the State, congressional district, Territory, or possession which he represents in Congress" is considered his home, but amounts expended for living expenses are not deductible in excess of \$3,000.

6. Section 164 allows a deduction for the following taxes: (1) state and local, and foreign, real property taxes; (2) state and local personal property taxes; (3) state and local, and foreign, income, war profits and excess profits taxes; (4) state and local general sales taxes, and (5) state and local taxes on the sale of gasoline, diesel fuel, and other motor fuels.^{*/} Section 164(b)(3) provides that "a State or local tax includes only a tax imposed by a State, a possession of the United States, or a political subdivision of any of the foregoing. . . ." In some instances taxes are deductible whether they are foreign taxes or state and local taxes (e.g., real property taxes, income taxes). But in other instances taxes are only deductible if they fall in the state and local category (e.g., personal property taxes, general sales taxes, gasoline taxes). Thus, treatment of the

^{*/} In the case of foreign income taxes, a credit may be elected under section 901 rather than a deduction.

Marianas as a possession could increase the deductions available to a U.S. taxpayer paying personal property taxes, general sales taxes or gasoline taxes to the Marianas.

7. Section 170 permits a deduction for certain charitable contributions. A charitable contribution is defined to include a contribution or gift to or for the use of "a State, a possession of the United States, or any political subdivision of any of the foregoing . . . but only if the contribution or gift is made for exclusively public purposes." Section 170(c)(1). A charitable contribution is also defined to include a contribution or gift to a corporation, trust, or community chest, fund or foundation "created or organized in the United States or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States." Section 170(c)(2)(A). The statute further provides that a contribution by a corporation to a trust, chest, fund, or foundation is deductible only if used "within the United States or any of its possessions" exclusively for charitable purposes. Section 170(c).

8. Section 454(b) provides that in the case of certain noninterest-bearing short-term obligations issued on a discount basis by the United States or a State, Territory, or a U.S. possession the amount of discount treated as interest income will not be considered to accrue until the

date on which the obligation is paid at maturity, sold, or otherwise disposed of.

9. Section 501(c) exempts certain organizations from income tax. Under section 501(c)(19) a post or organization of war veterans "organized in the United States or any of its possessions" and meeting certain other tests is exempt from tax.

10. Section 583 provides a deduction for dividends paid to the United States on certain preferred stock in computing the taxable income of certain banking associations "organized under the laws of any State, Territory, possession of the United States, or the Canal Zone."

11. Sections 861 and 862 set forth rules for determining income from sources within and without the United States. Section 861(a)(6) provides that U.S. source income includes income derived from the purchase of personal property without the United States (other than within a possession of the United States) and its sale within the United States. Section 863(b)(3) provides that gains, profits, and income "derived from the purchase of personal property within a possession of the United States and its sale within the United States" will be treated as derived partly from sources within and partly from sources without the United States. The combined effect of Section 861(a)(6) and 863(b)(3) is to reduce the tax liability of nonresident aliens and foreign corporations to the extent that they are only liable for tax on U.S. source income.

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12. 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. income tax if a prescribed portion of income is derived from a possession of the United States. Section 931 is not applicable to the Virgin Islands and is only applicable to corporations but not individuals doing business in Guam and Puerto Rico. Section 931(c).

13. Although U.S. citizens are generally taxable on their worldwide income, section 932 treats a U.S. citizen of a possession (who is not otherwise a citizen of the United States) and who is not a U.S. resident as a "nonresident alien individual." As a result of this classification, these 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).

14. Section 933 sets forth a special rule with respect to the taxability of income from sources within Puerto Rico. Section 934 sets forth certain limitations on the reduction of U.S. tax liability payable to the Virgin Islands pursuant to Section 28(a) of the Revised Organic

Act of the Virgin Islands. Section 935 specifies rules for coordination of Guam and United States individual income taxes.

15. Under the rules of section 951 et seq. certain undistributed income ("Subpart F income") of a "controlled foreign corporation" is subject to current taxation in the hands of the controlling U.S. shareholders. Under section 954, Subpart F income does not include certain dividends, interest and gains from qualified investments in less developed countries if there is a specified increase in qualified investments by the corporation in less developed countries. Section 955(c)(3) defines the term "less developed country" to include "any foreign country (other than an area within the Sino-Soviet bloc) or any possession of the United States with respect to which, on the first day of the taxable year, there is in effect an order by the President of the United States designating such country or possession as an economically less developed country for purposes of this subpart." By Executive Order 11071, 1963-1 C.B. 137, the President has ordered that certain foreign countries "including trust territories" plus "the Commonwealth of Puerto Rico and all possessions of the United States" are considered less developed countries for purposes of Subpart F and certain other sections.

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 a specified period was derived from possession sources and 50% or more of gross income was derived from the active conduct of certain defined trades or businesses in a possession. Section 957(d)(3) provides that the term "United States person," with respect to a corporation organized under the laws of a possession, does not include an individual who is a bona fide resident of a possession and whose income derived from sources within possessions of the United States is excluded from tax under section 931(a). The effect of determining that an individual is not a U.S. person is to exempt him from the Subpart F provisions and to exclude such individual in determining whether a foreign corporation has the requisite U.S. ownership to be defined as a controlled foreign corporation.

16. Section 2014 provides a foreign estate tax credit for United States citizens and residents to alleviate double taxation from the imposition by the United States of a tax on the entire estate and the imposition by a foreign country of an estate tax on property situated within that country. Section 2014(g) provides that death taxes paid to a U.S. possession will be treated as paid to a foreign country so that the foreign estate tax credit will apply. This provision is especially important with respect to the estate tax on estates of decedents who are residents of U.S.

possessions and who acquired their U.S. citizenship completely independently of their connections with the possession. The U.S. estate tax generally does not apply to residents of a possession who acquired their U.S. citizenship solely by virtue of their birth, residence or citizenship in a possession, provided they do not own property situated in, or deemed to be situated in, the United States.

17. Section 2208 provides that a decedent who was a citizen of the United States and a resident of a U.S. possession at the time of his death will, for purposes of the estate tax, be considered a "citizen" of the United States within the meaning of that term wherever used in the estate tax provisions, "unless he acquired his United States 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." The effect of this provision is that U.S. citizens who are residents of U.S. possessions and who acquired their U.S. citizenship completely independently of their connections with the possession are treated in the same manner as other resident citizens of the United States for estate tax purposes.

18. Section 2209 provides that a decedent who was a citizen of the United States and a resident of a U.S. possession at his death will, for purposes of the estate tax, be considered a "nonresident not a citizen of the

United States" "but only if such person acquired his United States 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." The estate of such a decedent is subject to the tax imposed by section 2101 which is the estate tax applicable to a "nonresident not a citizen of the United States." Generally, in such a case, the estate tax only applies to property situated or deemed to be situated in the United States.

19. The provisions of sections 2208 and 2209 are repeated, for purposes of the gift tax, in sections 2501(b) and (c). The effect of such provisions is that U.S. citizens who are residents of U.S. possessions and who acquired their U.S. citizenship completely independently of their connections with the possession are subject to the gift tax in the same manner as other resident citizens of the United States. However, a citizen and resident of a possession who acquired his U.S. citizenship solely by reason of his citizenship, birth or residence in the possession is only subject to the gift tax with respect to gifts of tangible personal property situated in the United States.

20. Section 3401, relating to collection of income tax at the source on wages, provides that the term "wages" does not include services for an employer (other than the United States or any agency thereof) (1) performed in a foreign country or in a possession of the United States by such a

citizen if the employer is required by the law of the foreign country or possession to withhold income tax upon such remuneration; (2) performed by a citizen of the United States within a possession of the United States other than Puerto Rico, if it is reasonable to believe that at least 80% of the remuneration that would be paid to the employee by such employer during the calendar year will be for such services; or (3) 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. Section 3401(a)(8)(A), (B), and (C).

21. Section 6851 provides for the termination of the taxable year and immediate demand for tax where a taxpayer is found to be departing from the United States to avoid the collection of income tax. Section 6851(c) provides that "in the case of a citizen of the United States or of a possession of the United States about to depart from the United States, the Secretary or his delegate may, at his discretion, waive any or all of the requirements placed on the taxpayer by this section."

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B. Sections Where Benefits May Be Lost Under Possession Status or Where Potentially Adverse Consequences May Result.

In the few instances described below, a change in status from foreign country to possession may result in the loss of certain benefits or may produce potentially adverse tax consequences.

1. Section 872 provides for the taxability of a nonresident alien individual on U.S. source income. Section 872(b) (4) excludes from gross income of a nonresident alien "income derived by a nonresident alien individual from a series E or series H United States savings bond, if such individual acquired such bond while a resident of the Ryukyu Islands or the Trust Territory of the Pacific Islands." An attempt should probably be made to preserve this exemption for income from U.S. savings bonds after the Marianas ceases to be part of the Trust Territory of the Pacific Islands. Otherwise, such income would be taxable to Marianas citizens as U.S. source income.

2. Section 882 provides that a foreign corporation engaged in a trade or business within the United States will be taxed on its income which is effectively connected with such trade or business. Section 882(e) provides, in the case of a corporation created or organized in a possession of the United States which is carrying on a banking business in a possession, interest on obligations of the United States will be treated as income which is effectively connected with the

conduct of a U.S. trade or business whether or not the corporation is engaged in a U.S. trade or business.

3. Under 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 possession or territory of the United States." It should be noted, however, that loss of section 911 benefits to a U.S. taxpayer upon the transition of the Marianas to possession status would be offset by the availability of section 931 benefits. See p. 6, supra.

4. The Interest Equalization Tax ("IET"), set forth in sections 4911 et seq., 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. Because the IET is only applicable to a United States person, it presently is not applicable to citizens of the Marianas who are treated as citizens of a foreign country. However, the IET would become applicable to

Marianas citizens who become U.S. citizens as a result of the status agreement. The term "United States person" is defined in section 4920(a)(4) to include a citizen or resident of the United States; the term "United States" when used in a geographical sense is defined in section 4920(a)(6) to include a U.S. possession.

Although Marianas citizens might become subject to the IET if they purchase stock or bonds of certain foreign issuers or obligors (e.g., stock in a Japanese corporation), investment in the Marianas by U.S. persons (including Marianas citizens) would probably be exempt from the IET under section 4916. That section provides that the IET does not apply to the acquisition of (1) a debt obligation issued or guaranteed by a less developed country, (2) stock or debt of a less developed country corporation, or (3) a debt obligation issued by an individual or partnership resident in a less developed country in return for money or other property which is used wholly within a less developed country.

The term "less developed country" is defined in section 4916(b) to include any foreign country (other than an area within the Sino-Soviet bloc) or any possession of the United States, with respect to which there is in effect an Executive Order by the President of the United States designating such country as an economically less developed country

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for purposes of the IET. Under Executive Order 11285, 1966-2 C.B. 480, "trust territories," the Commonwealth of Puerto Rico and all possessions of the United States are defined as less developed countries. Accordingly, the Marianas treatment as a less developed country will not be altered by a change in status from foreign country to possession.

5. Chapter 42 of Subtitle D of the income tax laws sets forth special regulatory rules for private foundations. Section 4941 imposes an excise tax on acts of self-dealing between a "disqualified person" and a private foundation. A government official is treated as a disqualified person for this purpose (section 4946(a)(1)(I)) and certain transactions with government officials are treated as acts of self-dealing. A government official is defined to include "an elective or appointive public office in the executive, legislative, or judicial branch of the government of a State, possession of the United States, or political subdivision or other area of any of the foregoing . . . held by an individual receiving gross compensation at any annual rate of \$15,000 or more. . . ." Section 4946(c)(5). The term "government official" also includes delegates to Congress, an employee of the United States earning compensation at least equal to a GS-16 and a personal or executive assistant or secretary to any of the foregoing.

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6. Section 7651 provides certain rules for the administration and collection of taxes in possessions, except as otherwise provided in the relevant organic acts relating to Guam and the Virgin Islands. Section 7651(1) provides that the United States can assess and collect its tax in a possession in the same manner as in the United States. Section 7651(2) (A) provides that U.S. tax will be collected in a possession under the direction of the Treasury and such tax "shall be paid into the Treasury of the United States as internal revenue collections." Section 7651(2) (B) provides for the full applicability in a possession of all provisions relating to the administration, collection and enforcement of U.S. tax. Section 7651(3) states that section 7651 "shall apply notwithstanding any other provision of law relating to any possession of the United States." Section 7651 will have to be amended to reflect any agreement with the Marianas that is inconsistent with its provisions, such as any agreement to share U.S. tax revenues collected in the Marianas.

7. Section 7701(a) (30) defines a United States person to include "a citizen or resident of the United States." The treatment of certain U.S. citizens in possessions as nonresident aliens pursuant to section 932 only applies to the income tax laws set forth in Subtitle A of the Internal Revenue Title. Accordingly, a Marianas citizen may still be

treated as a United States person for other purposes of the tax laws. For example, section 6038 in Subtitle F requires every United States person to furnish certain defined information with respect to any foreign corporation which that person controls. This section would appear to be applicable to a Marianas citizen who becomes a U.S. citizen as a result of the status agreement -- probably an unintended result. A careful study must be made to ensure that the definition of United States person in section 7701(a)(30) does not produce other unintended results.

C. Sections That Are Not Affected by Marianas' Change in Status Because They Apply to "Foreign Country or Possession."

A number of provisions of the Internal Revenue Code apply with respect to a "foreign country or a possession of the United States." See sections 56, 117, 273, 275, 461(a), 638, 641, 853, 861, 864(b)(1), 872(b), 901, 960, 963, 1014, 2016, 2056(c), 2523(a), 5002, 5685, 5702, 5704, 5853, 6416-18, 6511, 7516, and 7622. Accordingly, any change in the status of the Marianas from a foreign country to a possession for tax purposes would not affect the application of such provisions.