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October 23, 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 excise taxes and customs and duties which will be dealt with in a separate report.

Summary of Research

This memorandum considers the basic question of 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. 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

018583

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

A. Applicability of Internal Revenue Code

1. 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 only be subject to income tax on U.S. source income, but not on any foreign source income (including income earned in the Marianas). In effect, this would continue the present treatment

*/ The background memorandum will be referred to in this memorandum with the citation p. A__.

018584

of Marianas citizens as nonresident aliens for U.S. income tax purposes notwithstanding the fact that they become U.S. citizens or U.S. nationals as a result of an act of the U.S. Congress. The existing estate and gift tax treatment of Marianas citizens should also be continued by treating them as nonresident aliens. As a result of these recommendations, 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 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.

2. 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 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.*/

3. Treatment of Marianas as possession for U.S. income tax purposes. The status agreement should provide that the Marianas shall be treated as a possession for the numerous additional provisions of the U.S. income tax law where such treatment is beneficial. In a few relatively minor instances, a shift from foreign country to possession status may result in the loss of existing tax benefits or cause potentially adverse consequences for certain taxpayers. However, consistency requires the treatment of the Marianas as a possession for purposes of these provisions as well as for the provisions that are beneficial. Appendix B sets forth a summary of all provisions of the Internal Revenue Code that would be affected by the treatment of the Marianas as a U.S. possession for tax purposes.

4. Applicability of social security taxes. Further consideration must be given to whether the Marianas should request coverage under the U.S. social security system which is funded by a payroll tax on employers and employees and by a tax on the earnings of the self-employed. The social security provisions include the Federal Insurance Contributions Act ("FICA") and the Federal Unemployment Compensation Act ("FUTA"). FICA is applicable in Guam, the

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

Virgin Islands, Puerto Rico, and American Samoa, but FUTA is only applicable in Puerto Rico.

5. Other provisions. Technical adjustments may need to be made in other provisions of the Internal Revenue Code with respect to the Marianas so that the system works harmoniously. The Marianas should also seek to preserve one existing U.S. tax advantage that would be lost upon the dissolution of the Trust Territory of the Pacific Islands. Section 872(b)(4) provides that income derived by a nonresident alien individual from a series E or H U.S. savings bond is exempt from tax if such individual acquired the bond while a resident of the Trust Territory of the Pacific Islands. Unless this provision is amended to apply to the Mariana Islands, savings bond income would be taxable to a Marianas citizen as U.S. source income.

B. Tax Sharing

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

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*/ Pursuant to Chapter 24, Subtitle C of the Internal Revenue Title.

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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.

C. Marianas Tax System

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

2. Development of new 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, gift 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 the mirror image of the Internal Revenue Code as its own territorial income tax; 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.

018588

A. Applicability of Internal Revenue Code

1. U.S. taxation of Marianas citizens.

a. Income tax. A major issue is whether Marianas citizens should be subject to the U.S. income tax laws to the same extent as any stateside U.S. citizen (i.e., taxed on their worldwide income) or should be given an exemption for foreign source income and only taxed on U.S. source income. There are precedents for both approaches. For example, the Internal Revenue Code fully applies to Guamanian residents who are U.S. citizens (although such taxes are paid over to Guam). However, the U.S. income tax only applies to American Samoans to the extent they have U.S. source income. We have recommended that Marianas citizens, like American Samoans, should be exempt from U.S. income tax except to the extent they have U.S. source income. This continues the existing U.S. tax treatment of Marianas citizens even if they become U.S. citizens, and properly assigns to the Marianas the primary responsibility for taxing its citizens.

This recommendation can be implemented by following one of two precedents in the Internal Revenue Code. First, section 932 could be extended to the Marianas by treating the Marianas as a U.S. possession for purposes of that section. Section 932 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. A nonresident alien individual is only subject to tax on U.S. source income, and is exempt from tax on foreign source income (including any income from the Marianas).*/

Alternatively, a statutory provision might be patterned after section 933. Section 933 provides that a bona fide resident of Puerto Rico during the entire taxable year is not subject to U.S. tax on income derived from Puerto Rico, except any amounts received for services performed as an employee of the United States. Although sections 932 and 933 produce similar results, section 932 is more favorable in some circumstances since it excludes all foreign source income from the possession, and also excludes income earned in the possession as an employee of the United States.

Another solution may be a hybrid of sections 932 and 933 providing that income derived from sources without

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*/ It should be noted, howevever, 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. If section 932 were made applicable to the Marianas and if the adverse side effect of nonresident alien status were considered to be a significant problem, 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.

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the United States shall be exempt from U.S. income tax in the case of a citizen of the Marianas who is not a resident of the United States but who is a United States citizen or national solely by reason of his birth, citizenship or residence in the Marianas.

This recommendation should not involve any revenue loss to the United States to the extent that it, in effect, continues the existing income tax treatment of Marianas citizens as nonresident aliens.

b. Estate and gift tax. The United States estate and gift tax laws do not apply to nonresident aliens in the Marianas who have no property located in, or deemed to be located in, the United States. Our recommendation would continue the present tax treatment of Marianas citizens even though those citizens become U.S. citizens or nationals as a result of the status agreement. This estate tax result would occur under the existing rules of section 2209 of the Internal Revenue Code if the Marianas is deemed to be a possession for tax purposes. That section 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 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." This same

test is applied by sections 2501 and 2511(a) to exempt transfers of property by citizens of possessions from gift tax unless the property is tangible property situated in the United States.

This recommendation should not involve any revenue loss to the United States since it continues the existing treatment of Marianas citizens as nonresident aliens.

2. 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. This result would be achieved under section 931 of the Internal Revenue Code as presently written if the Marianas is treated as a possession. 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.*/

*/ Wages as an employee are treated as being derived in the active conduct of a trade or business. However, under § 931(i) amounts paid for services performed by a U.S. citizen as an employee of the United States are treated as derived from U.S. sources and hence are taxable.

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 is 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 -- both earned income and investment income -- from the Marianas and other sources outside the United States would be exempt from U.S. tax and without any dollar limitation, a significantly greater benefit than is available under section 911.

We have not made any estimate as to the potential U.S. revenue loss that would result from extending section

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

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931 to the Marianas but it is likely to be relatively slight.*/

3. 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 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.

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*/ Any revenue loss under section 931 would be offset by revenue gained from replacing section 911. In 1969, the estimated revenue loss from the section 911 exemption for income earned abroad by U.S. citizens was $45 million; the revenue loss from the section 931 exclusion of income earned in U.S. possessions was $90 million. Surrey, Federal Income Tax Reform, 84 Harv. L. Rev. 352, 356 (1970).

This recommendation can be implemented by means of a provision similar to section 7701(c) which provides, "Where not otherwise distinctly expressed or manifestly incompatible with the intent thereof, references in this title to possessions of the United States shall be treated as also referring to the Commonwealth of Puerto Rico."

4. Applicability of social security taxes. We have not yet reached a final conclusion on the desirability of including the Marianas in the U.S. social security system. There is ample precedent for applying the Federal Insurance Contributions Act ("FICA"), which is financed by a payroll tax on employers and employees, to the Marianas. FICA presently applies in the Virgin Islands, Puerto Rico, American Samoa, and Guam. In reaching a decision on this matter, the costs and benefits of the social security system presently in effect in the Trust Territory should be compared with the costs and benefits of the U.S. social security system. Additional thought must also be given to whether the Federal Unemployment Tax Act ("FUTA") should be made applicable in the Marianas. FUTA is presently applicable only in Puerto Rico. For a general discussion of FICA and FUTA, see pp. A9-11.

5. Other provisions. Technical adjustments may need to be made in other provisions of the Internal Revenue Code with respect to the Marianas so that the system works

harmoniously. For example, the provisions for withholding from wages (section 3401 of the Internal Revenue Code) should be amended so that U.S. income tax is not withheld from the wages of a Marianas citizen employed by the U.S. Government. The Marianas should also seek to preserve one existing U.S. tax advantage that would be lost upon the dissolution of the Trust Territory of the Pacific Islands. Section 872(b)(4) provides that income derived by a non-resident alien individual from a series E or series H U.S. savings bond is exempt from tax if such individual acquired the bond while a resident of the Trust Territory of the Pacific Islands. Unless this provision is amended to apply to the Mariana Islands, savings bond income would be taxable to a Marianas citizen as U.S. source income.

B. 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

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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 first 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.

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to Guam and the Virgin Islands, but not Puerto Rico and American Samoa.

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 the first alternative is preferable. Payment of U.S. withholding appears to be 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.

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a. Virgin Islands

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 p. A20. 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 result is not clear under the applicable statutory provisions.

b. Guam

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

018598

> "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. A14.

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, section 7654 requires the U.S. tax collections to be reallocated between

Guam and the United States depending on whether the tax has a U.S. or Guam source. 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."

c. Marianas proposal

Our recommendation for the Marianas attempts to incorporate the best features of the Guam model. The U.S. Treasury has implied 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 (*e.g.*, 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. 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 better to implement a tax-sharing plan by utilizing the United States as the collection agent -- through withholding on the wages of U.S. employees.

We have not yet estimated the potential U.S. revenue loss under this recommendation.*/

C. Marianas Tax System

1. Authority 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.

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*/ To the extent that military personnel are not subject to income tax in the Marianas by virtue of the Soldiers and Sailors Civil Relief Act, the revenue loss would be equivalent to the U.S. tax withheld from the wages of such personnel. However, there would be no substantial revenue loss from U.S. payment of civilian withholding to the Marianas to the extent such payment alleviates the need for the U.S. to grant a foreign tax credit for income tax paid to the Marianas on such wages.

In our view, it is both unnecessary and premature 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." 48 U.S.C. § 845. 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.

2. <u>Development of Marianas tax system</u>. Assuming that the Marianas is given the authority to devise its own tax system, 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 a gift tax, an inheritance or estate tax and the desirability of enacting any other taxes. In this regard, it should be noted that the United States may well demand that the Marianas meet a certain minimum tax effort as a condition for U.S. financial assistance.

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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 adopt the mirror image of the Internal Revenue Code as its own territorial income tax, though it may wish to utilize parts of the Internal Revenue Code as a model. Although incorporation of the Internal Revenue Code in its entirety would unquestionably simplify the drafting of an income tax law, we feel this advantage may be outweighed by the complexity of the Internal Revenue Code.*/ Furthermore,

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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).

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.