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DISCUSSION PAPER  
FOR  
MARIANAS JOINT POLITICAL/LEGAL WORKING GROUP

SUBJECT:    Applicability of United States laws to the  
Marianas:    Income Tax Laws

In accord with the Joint Communique of June 4, 1973, and previous discussion in this Working Group, counsel for the Marianas Political Status Commission have undertaken a study of the tax relationship between the Marianas and the United States that would be set forth in the formal Status Agreement. This discussion paper summarizes our preliminary recommendations in this area and is designed to provide a basis for consideration of these issues within the Working Group and, subsequently, by the principals in the negotiations.

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

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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. <sup>\*/</sup>

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.

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<sup>\*/</sup> 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.

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.