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TALKING PAPER

Applicability of U.S. Internal
Revenue Code to the Marianas

A. Introduction.

The next topic that I would like to discuss is the extent to which the U.S. Internal Revenue Code should be made applicable to the Marianas. Specifically, what points relating to the Marianas tax structure should be specified in the status agreement with the United States?

I wish to emphasize at the outset that the U.S. internal revenue laws are exceptionally complicated, especially in the area of the taxation of United States possessions. In preparing our recommendations, we have carefully reviewed the application of the U.S. income tax laws in Guam, the Virgin Islands, American Samoa and Puerto Rico. I might add that we are not persuaded that any one of these possessions is an ideal model; our recommendations attempt to combine the best features of each system. We have also conferred at length with technicians in the U.S. Treasury Department and the Internal Revenue Service who have been a great help in explaining the various problems that have developed in the taxation of U.S. possessions.

B. Summary of Recommendations.

We have three major recommendations which I will state and then describe in detail together with our other recommendations.

First, Marianas citizens should continue to be exempt from U.S. income tax except with respect to any U.S. source income, i.e., any income earned in the United States.

Second, U.S. income tax derived from Marianas sources should be paid over to the Marianas as a form of tax sharing.

Third, the Marianas should have full authority to develop their own internal tax laws and, indeed, should begin an in-depth study of the type of tax system that will be best suited to its needs.

Now let me turn to our recommendations in some detail.

C. Application of U.S. Tax Laws.

1. U.S. taxation of Marianas citizens.

I just stated our primary recommendation that Marianas citizens be exempt from U.S. income tax on any income from Marianas sources or other sources outside the United States. This recommendation, in effect, would continue the present nontaxability of Marianas citizens under the U.S. income tax laws, even though they become U.S. citizens or nationals as a result of the status agreement. This would be an exception to the general rule that the U.S. income tax applies to the worldwide income of a U.S. citizen.

However, this recommendation should not be controversial for it is based on existing precedents in the Internal Revenue Code. For example, one section of the Internal Revenue Code (Section 932) currently provides that citizens of a possession who become U.S. citizens and are not residents of the United States will be taxed as nonresident aliens, i.e., they will be exempt from tax

on any foreign source income. Another provision that is only applicable to Puerto Rico (but is a useful analogy) provides that a bona fide resident of Puerto Rico generally is not subject to U.S. tax on income from Puerto Rico. We propose to follow these precedents.

Just as a Marianas citizen would generally be exempted from U.S. tax, so would a Marianas corporation. Generally, a foreign corporation (including one incorporated in the Marianas) is only subject to tax on U.S. source income, and certain foreign source income if it has an office in the U.S. This treatment results from existing U.S. law without the need for any amendment.

We also propose that existing precedents in the Internal Revenue Code relating to U.S. possessions be utilized to provide that Marianas citizens 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 in the United States.

2. U.S. tax incentive for doing business.

Second, we propose to harness an existing provision in the Internal Revenue Code as an incentive for U.S. stateside citizens and U.S. corporations to engage in business in the Marianas. By treating the Marianas as a possession, Section 931 of the Internal Revenue Code would exempt income earned in the Marianas by a U.S. stateside citizen or a U.S. corporation if 80% of the taxpayer's gross income is derived from possession sources and 50% is derived from the active conduct of a trade or business within a possession.

3. Treatment of Marianas as possession for U.S. tax purposes.

Third, we propose that the status agreement provide that the Marianas generally be treated as a possession for U.S. tax purposes. Treatment as a possession is beneficial under numerous provisions of the Code. For example, income from bonds issued by a possession (but not a foreign country like the Trust Territories) is exempt for U.S. income tax purposes. In a few relatively minor instances, a shift from foreign country to possession status may cause potentially adverse results for certain taxpayers. However, we feel that consistency generally requires treatment of the Marianas as a possession for all purposes of the Internal Revenue Code.

4. Applicability of social security taxes.

We recommend that further intensive study be given to the question whether the Marianas should request coverage under the U.S. social security system, also called the Federal Insurance Contributions Act or "FICA". This system is funded by a payroll tax on employers and employees and by a tax on the earnings of the self-employed. FICA is presently applicable in Guam, the Virgin Islands, Puerto Rico and American Samoa. A detailed analysis of the costs and benefits of FICA compared to the costs and benefits of the present Trust Territory social security system is a necessary first step which should immediately be undertaken.

5. Miscellaneous.

Finally, we emphasize that numerous minor adjustments may have to be made in the Internal Revenue Code to ensure that the system works harmoniously with respect to the Marianas.

D. Tax Sharing.

Our second major recommendation is that the status agreement should embrace the principle that U.S. income taxes derived from the Marianas should be paid over to the Marianas.

This recommendation also is based on certain existing precedents. For example, U.S. tax revenues are shared in the Virgin Islands by providing that a year-end resident of the Virgin Islands satisfies his U.S. tax liability by paying it to the Virgin Islands. Tax sharing is accomplished in Guam through a more complicated system. An individual is required to pay his entire U.S. and Guam tax liability either to the U.S. or Guam depending on his year-end residency. In the case of certain wealthy individuals these tax collections are then reallocated to Guam or the U.S. depending on the source of the income. In addition, a special provision of the Internal Revenue Code provides that U.S. income tax withheld from the wages of U.S. military personnel stationed in Guam is paid over to Guam, notwithstanding that these wages would not be subject to Guam tax by virtue of the U.S. Soldiers and Sailors Relief Act.

After considerable thought, we have concluded that a system of paying U.S. tax directly to a possession may only be workable where that possession (as in the case of Guam and the Virgin Islands) has adopted the mirror image of the U.S. Internal Revenue Code as its own tax and thus is familiar with, and can enforce, the tax it is collecting.

For reasons that I will discuss momentarily, we recommend that the Marianas not adopt the mirror image of the U.S. Internal

Revenue Code. Accordingly, we suggest that the most straightforward route to tax sharing would be to provide that U.S. income tax withheld from the wages of military and civilian employees of the U.S. as well as employees of private employers be paid over to the Marianas.

We have no estimate as to the cost of such a proposal at this time; it would chiefly depend on the estimated payroll of any U.S. military base established in the Marianas.

It also should be noted that any proposal for tax sharing may, from the U.S.'s point of view, require the Marianas to demonstrate a certain minimum (and perhaps increasing) tax effort of its own. It is, therefore, appropriate to turn now to the internal tax system the Marianas should have.

E. Marianas Tax System.

We strongly recommend that the status agreement recognize the authority of the Marianas to devise its own internal tax laws. Puerto Rico, for example, has this authority. On the other hand, Congress has imposed the "mirror image" of the U.S. Internal Revenue Code as a territorial income tax in Guam and the Virgin Islands which have no authority to amend it. Thus, we are urging the Puerto Rican precedent to be followed in this instance.

Assuming the authority of the Marianas to enact its own tax system, we recommend that a detailed study be undertaken to determine the precise shape of that system. The study must focus on whether a progressive income tax is needed, whether a gift tax,

estate tax or inheritance tax is needed, whether any other taxes are advisable, and whether a system of tax incentives should be adopted to encourage the location of business in the Marianas. Tentatively, we recommend that the Marianas should not (like Guam or the Virgin Islands) adopt the mirror image of the U.S. Internal Revenue Code as its own internal income tax. We feel that the U.S. Internal Revenue Code is far too complex, and that a simpler income tax better suited to the Marianas can be devised.

F. Summary.

In closing I would like to emphasize three points.

First, the foregoing recommendations are, we believe, extremely reasonable. They follow precedents that Congress has already approved and enacted as part of the Internal Revenue Code.

Second, the recommendations do not involve any significant revenue loss to the U.S., with the possible exception of the tax sharing proposal. The cost of the tax sharing proposal will chiefly depend on the size of any U.S. military payroll in the Marianas, since income tax withheld from such wages would be paid over to the Marianas under our proposal.

Third, taxation is not an exact science. There are undoubtedly other ways to achieve the same objectives and we certainly would welcome any additional suggestions.

I would now be happy to answer any questions you might have.