MARIANAS POLITICAL STATUS COMMISSION

December 6, 1973

POSITION PAPER ON APPLICABILITY OF U.S. INTERNAL REVENUE CODE TO COMMONWEALTH OF THE MARIANA ISLANDS

401609

The Joint Communique of June 4, 1973 provides that the question of whether certain areas of federal legislation, including tax, will apply in the Marianas may be dealt with explicitly in the formal agreement establishing the future political status of the Marianas. Pursuant to this understanding, the Commission has 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 position paper 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. This position paper 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.

The starting point for the Commission's 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, the Commission has studied with particular care the analogies of Guam, the Virgin Islands, American Samoa and Puerto Rico. In the course of this research, counsel for the Commission 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.

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 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.

These recommendations do not represent a departure from existing precedents. The Internal Revenue Code only applies to American Samoans to the extent that they have U.S. source income. Moreover, under Section 933 of the Code 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. Even in those territories where the Internal Revenue Code does apply fully to the residents who are U.S. citizens, as in Guam, other provisions of law provide that these taxes are paid over to the local treasury.

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

401612

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 section 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.

2. <u>U.S. tax incentive for doing business in Marianas.</u> 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

401[illegible]3

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. Counsel for the Commission has prepared 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, which is available for review by the U.S. Delegation.

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."

401414

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 Virgin Islands, Puerto Rico, and American Samoa, but FUTA is only applicable in Puerto Rico. The Commission will be prepared to make a recommendation on this issue at the next session of negotiations.

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 Commission desires 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.

401615

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 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.

A type of tax sharing is in effect with respect to Guam and the Virgin Islands. After examining the experience in these territories and discussing the matter with technicians at the U.S. Treasury, the Commission has concluded that payment of U.S. withholding appears to be the simplest and most practical route to tax sharing. Further discussion with Treasury officials would be in order with respect to the details of such a plan.

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

---

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

401616

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.

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.

401617

The recommendation that the Marianas legislature be given the exclusive power to enact its own internal tax laws is consistent with the self-government 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.

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.

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. The Commission has 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

401618

the 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.

The Commission recognizes that these recommendations leave the Marianas with the serious responsibility of deciding how and to what extent to tax the citizens of the future Commonwealth of the Mariana Islands. We are also aware that the U.S. Congress, as a condition to future financial support of the Marianas until self-sufficiency is attained, will want to be assured that the Marianas people are assuming the financial responsibilities of self-government. During the last session of negotiations the Commission evidenced its willingness to undertake these responsibilities. The preparation of a draft tax law for the Marianas is one of the high priority items for which the Commission is seeking Phase I planning support from the U.S. Delegation. Once such support is made available, the Commission will undertake the necessary studies leading to the drafting of a tax law for consideration by the Marianas legislature under the new political status