To: Mr. J.M. Wilson, Jr.
From: Adrian de affenried
Subj: Series E and H Savings Bonds

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The MSC has proposed that favorable tax treatment under Section 872 (b)(4) of the IRC be continued for the Marianas after the change of political status for the TTPI. Section 872 of the IRC defines what is included in gross income for purposes of the federal taxation of nonresident aliens on income produced from U.S. sources. Subsection (b)(4) of that Section excludes Series E/H bond income from the taxable income of nonresident aliens so as to encourage nonresident aliens of the Ryukyu Islands and citizens of the TTPI to invest in Series E and H U.S. Savings Bonds. Because the purchase price of a Series E or H bond is $10,000, it would appear that this favorable tax exemption would benefit only a few of the more wealthy residents of the Mariana Islands and TTPI corporations operating in the district.

Congressmen Burton and Meeds, on the other hand, appear to be opposed to extending favorable treatment under Section 872 (b)(4) to the Marianas after a change in status. They have noted that this might be creating a favorable tax haven for certain individuals. Particular problems that could arise from acceding to the MSC request are as follows:

(1) Although residents of the Marianas will become either U.S. citizens or nationals, nonresident aliens will not be altogether precluded from residing or forming corporations in the Commonwealth; thus, foreign merchants could establish a residence or business in the Marianas before a change in status and invest captial into Series E or H bonds and be accorded the favorable income exemption.

(2) Some foreign nationals could use residents of the Marianas as "fronts", as is now practiced by the Japanese, to invest their money into Series E or H bonds, either before a change in status or after a change

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in status (if the exemption is continued for the Marianas under the Commonwealth status).

(3) Some wealthy Marianas residents could invest capital, from either U.S. bank loans (at interest rates lower than is to be paid under the Series E/H bonds) or other sources, into Series E or H bonds and avoid U.S. taxation.

(4) U.S. corporations, by forming TTPI corporations, could utilize the tax exemption to funnel capital into Series E/H bonds before the change in status and still remain in the Marianas to take advantage of other tax benefits.

(5) Some TTPI corporations (under U.S. ownership) now operating in Micronesia could open an office in the Marianas, invest in Series E/H bonds, and claim favorable tax exemptions on income from the bonds.

However, the tax advantages of Series E/H bonds do not appear to be overly attractive when compared to completely tax exempt municipal bonds whose earning ratios are much higher than Series E/H bonds. Also, most corporations and private investors are more attracted to higher earning capital investments although the risks are higher than the more secure U.S. saving bonds. Consequently, it would appear that few corporations or individuals would chose to invest capital in Series E/H bonds over other tax investment advantages.

Nevertheless, to avoid any possibility that this particular tax advantage might be abused, if the MSC request is honored, it is recommended that a cut-off date be established after which new investments in Series E/H bonds will not receive the tax exemption. This would permit those individuals who have in good faith chosen to take advantage of the tax

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exemption before a change in status to continue to receive favorable treatment on their prior investments. In the alternative we could explore the possibility of eliminating the tax exemption altogether after a change in status for all income from Series E/H bonds but retaining the benefit for interest received on the investments made before the change in status.

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