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Defects of Mirror Image System

1. Complexity. A primary reason for resisting the adoption of a mirror image system in the Marianas is the sheer complexity of the Internal Revenue Code.

Judge Learned Hand 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).

Persons familiar with our tax laws have expressed the fear that the complexity of our tax law "if not reversed, may well result in a breakdown of the self-assessment system." New York State Bar Association, Tax Section, A Report on Complexity and the Income Tax, 27 Tax L. Rev. 325, 329 (1971-72). See generally, Panel Discussions on Tax Reform, Panel

No. 1, Objectives and Approaches to Tax Reform and Simplification, Before House Ways and Means Committee on Feb. 5, 1973, 93d Cong., 1st Sess.; Symposium - Tax Simplification and Reform, 34 Law & Contemp. Prob. 671 (1969).

The suggestion has also been made that the complexity of our tax laws may lead to a taxpayer's revolt:

> "Others may be inspired by the reflection that, if 200 years ago men revolted on the principle that 'Taxation without representation is tyranny,' then today men may rise in righteous wrath because taxation with representation but beyond human comprehension is even worse."

"Americans United" Inc. v. Walters, 73-1 USTC ¶ 9165 (concurring opinion of Judge Wilkey).

The point legitimately can be made that the Internal Revenue Code is one U.S. product that, in fairness, should not be exported. If the Code were applied to the Marianas, there are a number of intricate provisions that would only rarely be applied, such as the Subpart F provisions, the personal holding company provisions, the reorganization provisions, the investment company provisions and many others. Yet the tax administrators of the territory would have to be trained to understand all of the substantive provisions of the Code, as well as the regulations, rulings and case law interpreting them, thus imposing a considerable but probably needless burden on the Marianas Government. Even the provisions that would be commonly applied are almost certainly more complex than is necessary for a

territory whose economy is undeveloped and whose population is small and relatively poor.

2. Progressivity. Adoption of the Internal Revenue Code in the Marianas has been supported as a means of insuring that the Marianas will have a progressive income tax. Several points should be made in rebuttal. First, although our income tax structure is highly progressive, rising from 14 to 70 percent, the effective rate of tax (i.e., tax as a percentage of economic income) is significantly less progressive. Based on 1972 figures, the effective rate of the U.S. income tax rises from two percent for families under $3,000 to 25 percent for the $100,000 income class to a maximum of only 32 percent for families with income of $1 million of more. */

Second, the U.S. tax system may be more accurately characterized as being proportional (i.e., the ratio of tax to income is the same for all income classes) rather than progressive. Accordingly, if the goal is to impose a progressive system of taxation in the Marianas, application of

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*/ Joint Prepared Statement of Joseph A. Peckman and Benjamin A. Oker, Hearings Before the Subcommittee on Priorities and Economy in Government of the Joint Economic Committee, 92d Cong., 1st Sess. 61 (1972). A chart from the Peckman and Oker testimony show the effective rates for various income classes and is attached to this memorandum as Appendix A.

the Internal Revenue Code may not be the means to that end.

In a recently published book entitled Who Bears the Tax Burden? (The Brookings Institution 1974), Peckman and Okner conclude that

> "the U.S. tax system is essentially proportional for the vast majority of families and therefore has little effect on the distribution of income. The very rich pay higher average effective tax rates than does the average family, but the difference is large only if the corporation income and property taxes are assumed to be borne by capital. If they are assumed to be shifted to consumers to a considerable degree, the very rich pay tax rates that are only moderately higher than average." (p. 10)

An important point illustrated by the Peckman and Okner study is that meaningful measurement of progressivity must take into account the combined effect of all taxes (not just the income tax) and must take into account transfer payments (e.g., welfare) made by the government.

Third, although there is a certain political magic in the concept of progressivity, there are those who would argue that a flat-rate proportional tax (say 20 percent of income) may be equally desirable as a matter of tax policy. See generally Blum and Kalven, The Uneasy Case for Progressive Taxation 19 U. Chi. L. Rev. 417 (1951-52); Galvin and Bittker, The Income Tax: How Progressive Should It Be? (1969). A proportional tax certainly has the advantage of simplicity, for a progressive rate structure leads to income-splitting techniques which in turn require complex counter measures in the law to prevent the avoidance of progressive rates. A

proportional tax is not necessarily desirable for the Marianas. The point, however, is that progressivity (with all of its definitional problems) should not be viewed as a cardinal principle to be imposed on the Marianas.

3. Loopholes. The fear has been expressed that rich and powerful interests in the Marianas, if allowed to adopt their own tax system, might produce a system filled with loopholes. This problem is not solved, however, by imposing the loopholes of our Internal Revenue Code on the Marianas. See generally the Ways and Means Committee Panel Discussions on Tax Reform, 93d Cong., 1st Sess. (1973). The question can be asked whether wealthy citizens of the Marianas would pay a meaningful tax under the Internal Revenue Code when so many wealthy Americans escape taxation under the Code. For example, data made public by the U.S. Treasury shows that in 1970 about 106 individuals had adjusted gross incomes above $200,000 but paid no income tax and that scores of other individuals paid only token amounts.

4. Technical Problems. The mirror image codes adopted in Guam and the Virgin Islands have contained technical defects, and it has been difficult in the past to persuade Congress to clear up those defects by corrective legislation. In order to obtain a "mirrored effect" between the federal tax law and a possession's tax law, the name of the possession must be substituted for the words "United States" and other changes in language must be made throughout the Internal

Revenue Code, including the omission of inapplicable language The problem is that some provisions of the U.S. Code cannot meaningfully be translated into a mirror image. For this reason Congress provided that the Guam territorial income tax laws shall include only those provisions of the federal income tax code that are "not manifestly inapplicable or incompatible . . . ." 48 U.S.C. § 1421i(d)(1). The taxing authorities have not always agreed on what provisions are manifestly inapplicable and there has been considerable litigation over the years interpreting the meaning of the mirror image Code in Guam and the Virgin Islands. */

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*/ See, e.g., Manning v. Blaz, 73-1 USTC ¶ 9368 (9th Cir. 1973) (reversing Guam's treatment of U.S. stateside citizens as nonresident aliens) and Great Cruz Bay v. Wheatley (unreported 1972 decision of Virgin Islands District Court on appeal to 3d Circuit raising similar issues to Blaz case). The problems raised in the Blaz case were eliminated by the 1972 Guam legislation.