03/4

April 30, 1974

MEMORANDUM FOR MR. WILLENS

SUBJECT: Marianas -- Taxes

The U.S. working drafts dated April 1974 of Sections 403 and 601 of the Status Agreement provide that the internal revenue laws of the United States shall not become applicable in the Marianas until ten years after the establishment of the Marianas as a commonwealth. During the interim period, "the Marianan Government will enact non-discriminatory internal revenue laws under which the people of the Marianas will assume an increasing local tax burden, consistent with the stages of their economic development. These laws will include individual and corporate income, taxes, as well as estate and gift taxes, all of which will be progressive and will reflect local conditions." The following points occur to me:

1. I am not sure what the term "non-discriminatory" means in this context. The equal protection clause of the Fourteenth Amendment prohibits unreasonable classifications in the tax area, and many state constitutions reach the same result by providing that their tax laws will be uniformly applied. Does the non-discriminatory requirement essentially parallel these requirements?

2. It should be noted that only the U.S. <u>income tax</u> has been applied as a territorial tax in Guam and other

possessions where the "mirror image system" applies. However, the U.S. estate and gift tax laws have not previously been imposed in a possession as a territorial tax. Puerto Rico has adopted an estate and gift tax, but the Virgin Islands has adopted an inheritance tax (i.e., a tax on the beneficiary rather than on the estate) and the Guam legislature is considering an inheritance tax. In light of the precedents, it seems inappropriate to require the Marianas to adopt an estate and gift tax.

3. The term "progressive" is subject to many interpretations. Does it mean a progressive rate structure (the 48% corporate tax rate is proportional, not progressive) or a tax system which, in cumulative effect, is progressive? The recent book by Peckman and Okner, Who Bears the Tax Burden?, indicates some of the problems of measuring progressivity.

4. The statement that the internal revenue laws of the United States will not become applicable until after ten years is ambiguous. The Internal Revenue Code will immediately become applicable to Marianas citizens who become U.S. citizens (with certain special provisions). I suspect the draft means that the U.S. internal revenue laws will not be applied as a territorial tax until after ten years.

F.D.L.