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August 2~~1~~7, 1974

MEMORANDUM TO MR. WILLENS

SUBJECT: Marianas Tax System

The position of Congressman Burton is that the U.S. Internal Revenue Code should be imposed in the Marianas either as a territorial tax as in Guam or by direct application as if the Marianas were a state, without any power on the part of the Marianas to amend such law. At our August 8, 1974 meeting with the U.S. negotiators, it was agreed that we would attempt to draft a compromise proposal whereby the Marianas would adopt the Internal Revenue Code as a territorial tax but with certain powers of amendment.

Recommendation

I would propose as a compromise that (1) the Marianas adopt the Internal Revenue Code as a territorial tax (2) with the power of the Marianas legislature to amend the tax (3) subject to a congressional veto for the first ~~ten~~ five years of the application of the tax.*

Outline of Alternatives

The following three alternatives should be considered, although ~~I have a clear preference for the first alternative~~ the first alternative seems clearly preferable.

(1) Follow the Puerto Rican model of adopting the Internal Revenue Code as a territorial tax with the Marianas legislature having the right to amend the territorial tax in its sole discretion. The power to amend could be restricted

* This memorandum does not address whether the territorial tax should be made applicable on the effective date of the Status Agreement or on Termination. That question will be discussed in a subsequent memorandum

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in various combinations of ways:

(a) Make the amendment subject to congressional veto as was the case in Puerto Rico until 1950. See 48 U.S.C. § 826 repealed July 3, 1950. Under such a procedure, the Marianas legislature might be required to report all amendments to the U.S. Congress within a specified period after enactment, with the law to become effective within a specified period after filing of the report with Congress unless vetoed by Congress within such period. A variation of this proposal would be to require notice to Congress of all amendments to the territorial tax, leaving the veto power of Congress implicit but not expressed.

(b) Make the amendment subject to congressional veto for a specified number of years and then permit free amendment by the Marianas legislature.

(c) Permit no amendments to the territorial tax for a period of years while the Marianas gains experience with operation of the system, then permit amendment either without congressional approval, subject to congressional veto, or subject to congressional veto for a period of years.

(2) Permit amendment except in certain proscribed areas. It has been represented that Congressman Burton would permit the rates of the territorial tax to be increased by the Marianas but not decreased. Accordingly, the Marianas might be allowed to amend the territorial tax, provided that the rate of tax is not decreased. It should be recognized

that the tax rate can be altered in a number of different ways -- by changing the rate tables, by introducing credits or deductions, by exempting taxpayers from certain provisions, or by providing cash rebates outside of the tax system.*/ Any narrow prohibition against changing the rate tables would, from the United States' point of view, be essentially meaningless while any broad prohibition against changing the effective rate of tax would, as a practical matter, nullify the Marianas' right to amend its territorial code. Accordingly this alternative is not recommended.

(3) Adopt the Internal Revenue Code as a territorial tax but permit amendments so long as the territorial tax remains a "comparable system." The problem with this alternative is its utter vagueness; it provides an unreviewable standard that is rife with potential controversy. If the application of the territorial tax were ameliorated, such change would be subject to U.S. challenge; if the territorial tax were made more stringent than the U.S. Internal Revenue Code, Marianas taxpayers might challenge the comparability. Would the territorial tax be comparable if the marginal rates in each bracket were reduced by half? Would the system be comparable if fundamental structural changes were made, such as eliminating the distinction between capital gains and ordinary income? The "comparable system" alternative simply

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*/ As discussed infra, both Guam and the Virgin Islands have industrial incentive programs that provide for cash rebates of specified amounts collected under their territorial income tax.

does not seem feasible.*/

Discussion

I think it is highly unlikely that Congress would in fact veto any ordinary tax amendments that might be made by the Marianas legislature. Accordingly, I regard the veto as a fair concession for the Marianas to make to secure the right to amend its territorial tax. The congressional veto would also seem to be a fair answer to Congressman Burton's fears that the Marianas might manipulate its system to become a tax haven for wealthy Americans or to impair the economy of Guam. If the Marianas were to take such an unlikely step, Congress would simply exercise its veto power over changes in the territorial income tax.

It is also important to note that even without giving Congress a veto right, Congressman Burton's fears are largely unfounded that the Marianas might become a tax haven for individuals or corporations in a manner that permits unfair competition with Guam.

Tax Haven for Individuals

Since the Internal Revenue Code taxes U.S. citizens on worldwide income, the Marianas is not likely to ~~will not~~ become a tax haven for wealthy stateside citizens regardless of the ~~what~~ kind of territorial tax that is adopted in the Marianas. For example, A wealthy

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*/ This conclusion is shared by Tom Bissell, the possessions tax expert in the office of International Tax Counsel, Department of the Treasury, with whom I had a lengthy conversation on this subject on August 21, 1974.

stateside citizen with large amounts of passive investment income from U.S. securities would not avoid U.S. tax by moving to the Marianas. Under our proposal, section 931 of the Internal Revenue Code would apply to U.S. ~~United States~~ citizens in the Marianas just as it applies to U.S. ~~United States~~ citizens in Guam, so that a U.S. citizen would ~~only~~ be taxed on U.S. source income but not foreign source income if 80 percent of his income is earned in the Marianas or other U.S. possessions and 50 percent is from the active conduct of a trade or business in such possession.*/ This would give the Marianas the primary right to tax Marianas source income, but preserves the U.S. tax on U.S. source income. Thus, a U.S. taxpayer with interest and dividend income of $100,000 from U.S. sources would still be subject to U.S. tax on $100,000 even if he resides in the Marianas.

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Thus ~~In addition~~, the stateside citizen who fails to ~~does not~~ meet the percentage requirements of section 931 ~~for income from possession sources~~ would be subject to U.S. tax on his worldwide income, including any Marianas source income, with a tax credit for income tax paid in the Marianas on Marianas source income. ~~Thus~~, Even if the Marianas adopted no ~~an~~ income tax system ~~with rates equal to a fraction of the U.S. rates~~, the stateside citizen would still pay the same total tax bill as he would if the Marianas adopted an identical Internal Revenue Code -- ~~U.S. tax at full rates less a credit for the~~ the only difference being that all the revenue would be collected by the United States.

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*/ On May 22, 1974, the Ways and Means Committee announced a tentative decision to amend the Internal Revenue Code to increase the 50 percent active trade or business requirement to 80 percent.

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~~tax paid to the Marianas~~. The requirement that a taxpayer must earn 80 percent of his income in a possession and 50 percent in an active trade or business in a possession is narrowly drawn precisely to avoid making a possession a tax haven.

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T[redacted] Corporations

The ~~view~~ suggestion has been ~~expressed~~ made that, unless the Marianas adopts the Internal Revenue Code as a territorial tax, the Marianas could provide tax incentives (through reduced corporate rates for example) that might unfairly compete with Guamanian corporations. Actually, the problem is precisely the ~~opposite~~ reverse -- how to protect fledgling ~~Marianas~~ businesses in the Marianas from the competition of the more fully developed economy of Guam. Guam presently has in force tax rebate provisions for new industry that substantially reduce the imposition of the Guam territorial income tax.*/ ~~and make Guam a tax haven for some.*/ However, in this instance "tax haven" is not used in a pejorative sense, for the tax rebates are an effective incentive for promoting the growth of industry in Guam. This should be encouraged, just as it should in the Marianas.~~

Title LIV of the Guam Code establishes the Guam Economic Development Authority and a system of incentives for corporations engaged in business which creates new employment,

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*/ The Virgin Islands has a similar investment incentive program involving tax rebates. Virgin Islands Code, Title 29, § 701.

replaces imports, reduces consumer prices or creates vitally needed facilities. In order to qualify for the incentives, a corporation must be either a Guam corporation or a United States corporation limited to doing business in Guam and qualifying under section 931 of the Internal Revenue Code, i.e., having 80 percent of its income from possession sources and 50 percent from the active conduct of a trade or business in a possession. A corporation obtaining a qualifying certificate is eligible for, among other benefits, a rebate of up to 75 percent of all corporate income tax payable to the Government of Guam for a period of up to 20 years. In other words, a Guam corporation that is subject to corporate tax at a rate of 48 percent under the mirror image of the U.S. Internal Revenue Code may receive a 75 percent rebate so that it pays an effective rate of only 12 percent. A rebate of up to 75 percent of corporate income tax on dividends paid by a qualifying corporation is also provided for a period of up to five years in addition to a ten-year rebate on real property tax and a ten-year rebate of the Guam tax on income derived from certain leasing operations.

The significant point to note from the Guam experience is that the mere fact that a possession adopts the United States income tax as a territorial tax is no guarantee that it will not alter the effective rate of tax of a taxpayer by providing cash rebates outside the income

Under the circumstances it is highly unlikely that the type of tax system adopt in the Marianas would have any effect on the Guam economy.

tax system or by reducing the impact of other taxes such as the property tax.

Accordingly, it is simply not logical to say that the Marianas must adopt the exact replica of the U.S. income tax law in order to avoid unfair competition with Guam when Guam already has in effect a full panoply of tax incentive provisions designed to ~~provide a tax holiday for new business~~ attract new business. stop

Since there is no congressional restriction on the ability of Guam to offer rebates and other industrial tax incentives, equal treatment should be applied to the Marianas. However, it should be noted that in 1960 Congress found it desirable to limit the ability of the Virgin Islands to provide grants and other subsidies which have the effect of reducing the income tax paid to the Virgin Islands under the mirror image of the U.S. Internal Revenue Code. Thus, section 934 of the Code provides that, in the case of the Virgin Islands, no rebate can be made to an individual citizen of the U.S. unless he is a bona fide resident of the Virgin Islands during the entire taxable year and only to the extent his income is derived from sources within the Virgin Islands. A rebate cannot be given to a U.S. or Virgin Islands corporation except to the extent such corporation derived its income from sources outside the United States and 80 percent or more of its gross income is derived from sources within the Virgin Islands and 50 percent or more of such income is derived from the active conduct of a trade or business within the Virgin Islands.