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MEMORANDUM

FOR: The Joint Drafting Committee

SUBJECT: Tax System In The Marianas

In order to implement the principal of maximum local self-government recognized in the joint communique of June 1973, representatives of the Northern Marianas Islands propose that the status agreement recognized the right of the Marianas to develop it's own internal tax laws. This proposal won the approval of the United States Delegation and the basic principals were included in the joint communique of December 1973.

Subsequent to that commitment by the United States Delegation, however, certain members of the House Interior Committee have expressed their concern about the manner in which the Internal Revenue Code is proposed to apply to the Marianas under the new political status. The United States Delegation now apparently believes that the tax provisions in previously agreed to must be altered. Recognizing that there is strong feeling about this issue in Congress, and desiring to continue the progress that has been made in the negotiating sessions, the Marianas representatives on the joint drafting committee present in this memorandum a compromise tax proposal which is designed to meet the needs and to protect

11096

the interests of both parties.

Review of agreed provisions.

The essence of the agreement previously reached between the Marianas Political Status Commission and the United States Delegation concerning taxation was that the Marianas would develop its own taxation provisions, and that the Internal Revenue Code of the United States would apply to the Marianas as it applies to other territories and possessions. The Marianas, of course, intends to exercise it's legislature powers in a responsible manner. It has absolutely no intention of becoming a tax haven for wealthy Americans, or in any fashion impairing the economoy of Guam. As this section will demonstrate, the proposal previously agreed to was a fair and reasonable proposal which protected the interests of the Marianas in maximum local self-government and protected all the legitimate interests of the United States as well.

Individuals. Under the proposal previously agreed to, Section 931 of the Internal Revenue Code would apply to U.S. Citizens in the Marianas just as it applies to U.S. Citizens in Guam. This means that a U.S. Citizen would be taxed on U.S. source income but not on foreign source income if 80% of his income is earned in the Marianas or other U.S. possessions and 50% is from the act of conduct

of a trade or business in such possession. [On May 22, 1974, the Ways and Means Committee announced a tentative decision to amend the Internal Revenue Code to increase the 50% active trade or business requirement to 80%]. This proposal would have given the Marianas the primary right to tax Marianas source income and would have preserved 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 have been subject to a U.S. tax on the entire $100,000 even if he resided in the Marianas. Thus, regardless of the kind of territorial tax that might have been adopted in the Marianas, a wealthy stateside citizen with large amounts of passive investment income from U.S. securities could not have avoided U.S. tax simply by moving to the Marianas.

The requirement that a taxpayer earn 80% of his income in a possession and 50% in a active trade or business in a possession is narrowly drawn precisely to avoid making any possession a tax haven. The stateside citizen who fails to meet the percentage requirements of Section 931 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. This means that even if the Marianas adopted no income tax system, the stateside citizen would still pay the same total tax bill as

11098

he would if the Marianas adopted the Internal Revenue Code _in haec verba_–the only difference being that all the revenue would be collected by the United States in that instance.

Corporations. One objection to the proposal previously agreed to by the United States and the Commission is that, unless the Marianas adopt the Internal Revenue Code as territorial tax, the Marianas could provide tax incentives (through reduced corporate tax rates, for example) that might unfairly compete with neighboring Guam. Actually, the problem is precisely the reverse–how to protect fledgling 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. Under Title 54 of the Guam Code a system of incentives for corporations engaged in a variety of businesses is created. In order to qualify for the incentive, a corporation must either be 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% of it's income from possession sources and 50% from the Act of Conduct of a trade or business in a possession). A qualified corporation is eligible for, among other benefits, a rebate of up to 75% of all corporate income tax payable to the government of

Guam for a period of up to twenty years. In otherwords, a Guam corporation which is subject to the corporate income tax at a rate of 48% under the mirror image of the United States Internal Revenue Code may receive a 75% rebate so that in fact it pays an effective rate of only 12%. A rebate of up to 75% of corporate income tax on dividends paid by a qualified 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.

There is more to the point about the Guamanian tax rebate program than the need to protect the Marianas against unfair competition from it's neighbor. The rebate program also shows that the mere fact that a possession adopts the United States income tax as a territorial tax-as Guam has done in effect through the mirror image-is no guarantee that it will not alter the effective rate of tax of a taxpayer by providing cash rebates outside the income tax system or by reducing the impact of other taxes such as the property tax. Accordingly, it is simply not accurate to insist that the Marianas must adopt the exact replica of the United States Income Tax Law in order to avoid unfair competition with Guam when Guam already has in effect a full panaply of tax incentive provisions designed to attract new business. Indeed, under the circumstances,

it is highly unlikely that any type of tax system adopted by the Marianas would have any effect on the Guam economy.

Compromised Proposal.

As the foregoing analysis indicates, the case for requiring the imposition of the Internal Revenue Code as a territorial tax in the Marianas is far from clear. We continue to believe that the proposal we originally put forward and which the United States accepted after review is well precidented and entirely fair. In the spirit compromise, however, we are willing to consider the following scheme. The status agreement will provide that the Marianas will adopt the Internal Revenue Code of the United States as a territorial income tax. The legislature of the Northern Marianas Islands would retain the power to amend that tax to suit local conditions subject, however, to a Congressional veto of such changes for a period of five years after the effective date of the provision.

The compromise scheme here proposed is very similar to the system which is in fact in Puerto Rico. It recognizes the strong feelings in the Congress that the Internal Revenue Code is an appropriate starting place for the territorial income tax of the Marianas, and that for at least a limited period of time Congress will retain complete control over the local tax system. On the otherhand, the compromise scheme

also recognizes the importance of tax policy as a matter of local self-government, and reserves to the popularly elected representatives of the people of the Marianas the right to fashion an appropriate tax structure. The necessity for the Marianas Legislature to retain the power to amend the tax to suit local conditions is plain not only as a matter of principal but as a practical matter as well. The complexity of the Internal Revenue Code and it's well known loop-holes cry out for providing local control over its application as a territorial tax. Numerous court cases under the Guam and Virgin Island territorial tax provisions provide ample testimony that the mirror image system itself has potential pitfalls. Indeed, we understand that at this very moment the Virgin Islands is preparing a request to Congress to amend it's territorial tax to correct serious interpretive problems. We further have been informed that the Treasury Department is contemplating legislation to clarify ambiguities in the 1972 Guam Legislation-legislation which was designed to cure problems in the original mirror image system.

The need for a Congressional veto over changes in the tax system is less clear. The Marianas, of course, intends to exercise it's legislative powers in a reasonable manner. It has absolutely no intention of becoming a tax haven for wealthy Americans or in any fashion impairing the economy of Guam. However, in view of the strong Congressional

interest in local tax affairs in the Marianas, the scheme we have proposed provides for such a veto for a limited period of time.

11103