I. Objections to the mirror Code

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1. The income tax provisions of the Code are extremely complex, and include provisions which will rarely, if ever, be applied, such as the Subpart F provisions, the personal holding company and foreign personal holding company provisions, the reorganization provisions, the investment company provisions, and many others. Even the provisions that will be applied in practice are almost certainly more complex than is necessary for a territory whose economy is undeveloped and whose population is small and relatively poor. Nevertheless, the tax administrators of the territory would have to be trained to understand most 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 government of the territory.

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2. It could be expected that application of a mirror Code would result in the imposition of income taxes almost exclusively on statesiders and on business earnings, and almost none on the native inhabitants of the territory. This is because natives engaged in subsistence farming or fishing, and those who receive cash incomes but who are considered poor by stateside standards, would generally avoid paying any territorial income tax because of the

personal exemptions and the low-income allowance, even though they may be fully able to pay a token amount of income tax (such as the present 1 percent of gross income imposed under the TTPI income tax law), which would give them a sense of taking part in the government's fiscal programs. For example, an individual filing a joint return and claiming five exemptions, earning $5,000 for a taxable year, would pay no income tax under the 1973 federal income tax tables.

3. The mirror Code contains numerous defects, and it has proven almost impossible in the past to persuade Congress to clear up those defects through corrective legislation. Certain defects were resolved as to the Virgin Islands in 1921, the same year that a mirror Code was imposed on the Virgin Islands, and in 1958 as to Guam (eight years after a mirror Code was imposed on it), but unresolved problems remain. The central defect in the mirror Code is that, under the mirror Code the possession which has the mirror Code remains a "possession" of the United States, while there is no provision which results in treating the United States as either a foreign country or as a possession for purposes of the possession's income tax laws. This has the following results:

what were they?

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a) Section 931 (exclusion for income earned by a U.S. citizen from sources within a U.S. possession) could be construed so as to allow an exclusion from gross income, for purposes of the possession's tax law, of gross income from sources within that possession. This problem was resolved as to the Virgin Islands by making section 931 inapplicable to the Virgin Islands, and as to Guam by expressing deleting section 931 from the Guam mirror Code.

b) Section 932(a), which treats citizens of a possession who are not resident in the United States as nonresident aliens for U.S. tax purposes, cannot be construed so as to treat a statesider not resident in the possession as a nonresident alien for purposes of the possession's tax law; nor can such a result be obtained under section 871 of the possession's tax law, since statesiders cannot be considered as nonresident aliens. The result is that, while a citizen of the possession who is not resident in the United States is treated as a nonresident alien for federal income tax purposes -- and thus is subject to a flat 30 percent tax on passive investment income from sources within the

United States -- a statesider who is not resident in the possession is entitled to compute his tax on passive investment income from sources within the possession under section 1 of the possession's tax law, which would normally result in an effective tax rate of less than 30 percent. See Manning v. Blaz, 73-1 USTC ¶9638, as to Guam, and Great Cruz Bay v. Wheatley (unreported 1972 decision of Virgin Islands District Court, on appeal to 3rd Circuit Court of Appeals) as to the Virgin Islands.

c) Since the United States is neither a "possession" nor a "foreign country" for purposes of the possession's income tax law, in theory a foreign tax credit under section 901 for income taxes paid to the United States should not be allowed to a resident of the possession in computing his possession income tax. This problem has apparently been avoided by the possessions tax authorities by unilaterally granting the credit, even in the absence of clear statutory authority, so as to avoid hardship to taxpayers with U.S.-source income.

even in Guam?

d) Statesiders employed by the U.S. Government and working in the possession are subject to tax in the possession on their federal salary, including

withholding tax under section 3401(a), although the various possessions have unilaterally declared that they will not enforce the withholding tax provisions because the same employees are subject to federal withholding under section 3401(a) of the Internal Revenue Code. Serious problems have arisen in several of the possessions with respect to federal employees who subsequently receive a refund of their federal withholding tax but who do not endorse their refund check over to the possession's tax authorities. Explain

In addition, a serious question of enforcement can arise under the mirror Code with respect to court jurisdiction of income tax disputes. If a separate federal District Court is not established in the possession, there would be no forum under the mirror Code in which taxpayers could sue for refund claims, nor would there be any court such as the U.S. Tax Court in which deficiency assessments could be judicially redetermined in advance of collection by the tax authorities. The latter problem has been cleared up in Guam and the Virgin Islands by local legislation conferring Tax Court-type jurisdiction on the local federal district court; such a solution could probably not be followed, however, where no district court were established in the possession.

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II. Adaptation of a mirror Code to local needs

If a mirror Code is to be imposed on the possession, objections 2 and 3, above, could be substantially resolved if the mirror Code were revised slightly by Congress at the time it is made applicable to the possession, and if the possession's legislature is given the express authority to modify the mirror Code from time to time to resolve unforeseen defects. If Congress is concerned that local amendments may someday emasculate the mirror Code as an effective revenue-raising measure, it might want to require any local amendments to be approved by the Treasury Department and/or the Interior Department. Although Congress would clearly retain the constitutional power to override any such amendments that it did not like, it might prefer to adopt an informal disapproval procedure that would not require a formal resolution of one or both houses of Congress, and which could operate in conjunction with the Treasury or Interior approval procedure.

Objection #2, discussed above, was apparently resolved for a time by the American Samoan legislative requiring a 2 1/2 percent "minimum tax" to be paid by every American Samoan taxpayer. This was repealed several years ago, however, for reasons that are unknown to us. In this connection, the TTPI experience

in collecting its one percent personal income tax might be helpful.

Objection #3 has been resolved by American Samoa by adopting corrective legislation from time to time, and by conferring jurisdiction over all tax litigation on the American Samoan High Court. Certain amendments to the mirror Code might not have been approved, however, if Treasury, Interior, or Congress had been required to give their advance consent. For example, in 1970 the American Samoan mirror Code was amended so as to impose the 30 percent withholding tax on American Samoan-source passive investment income under §881 of the mirror Code on corporations formed in the United States (previously they had been excepted from §881 of the mirror Code). The effect has been to impose substantial taxes primarily on U.S. film companies receiving royalties for film rentals from American Samoa.

III. Other problems

Other problems which probably should be considered before Congress adopts legislation concerning the Marianas tax system:

1. Should a collection district system be adopted between the U.S. and the Marianas, as was done as to Guam in 1972? This would prevent the U.S. from taxing natives at a 30 percent rate on U.S.-source passive

investment income such as dividends, interest, and distributions from private pension and profit-sharing plans (a serious Guamanian complaint before 1972).

2. Tax relationship between Guam and the Marianas.

Are there presently natives of one jurisdiction working in the other, and is the interchange expected to increase in the future? Would a 3-way collection district system be too complicated?

3. Problem of federal employees working in the Marianas. Can Congress adopt a Guam-type solution, or will we end up with the mess that has resulted in American Samoa?

4. Tax incentives. Would Congress want to limit the scope of tax rebates which the Marianas might want to offer under some future industrial incentive law?

5. Is there any chance that the Marianas could be placed under the fiscal jurisdiction of Guam, or are they afraid of losing their fair share of appropriated funds?

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