



OFFICE OF THE SECRETARY OF THE TREASURY  
WASHINGTON, D.C. 20220

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January 27, 1975

Dear Adrian:

Dave Foster and I have reviewed the Covenant between the United States and the Northern Marianas Islands which you sent us last month, and have the following comments:

Section 402(b) -- We assume that the new federal District Court for the Northern Marianas Islands will have jurisdiction over all cases arising under the new Marianas income tax law, both as regards deficiency assessments by the Marianas Tax Commissioner and refund suits by taxpayers. This is because section 601(a) appears to incorporate into the Covenant all of the rules contained in 48 U.S.C. section 1421i, relating to the Guam territorial income tax. Section 1421i(h)(1) provides that the District Court of Guam "shall have exclusive original jurisdiction over all judicial proceedings in Guam, both criminal and civil, regardless of the degree of the offense or of the amount involved, with respect to the Guam Territorial income tax."

Section 602 -- This section limits the extent to which the Marianas legislature can enact rebates of the Marianas income tax to rebates of tax on Marianas - source income. Thus section 602 is similar to the comparable restrictions that are imposed by section 934 of the Internal Revenue Code (the "Code") on the income tax rebates that can be granted by the Virgin Islands. In several respects, however, section 602 differs from section 934 of the Code.

(1) Individuals eligible for rebates -- All individuals who are residents of the Marianas could be made eligible for rebates under whatever rebate system the Marianas legislature adopted. This general rule is similar to that in section 934(c) of the Code. However, individual residents of the Virgin Islands must be U.S. citizens in order to be eligible under any rebate system that the Virgin Islands adopts, and they must be residents of the Virgin Islands during the entire taxable year. In contrast, the proposed

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Marianas system would permit the coverage under a Marianas rebate system of any individual who qualified as a resident of the Marianas for income tax purposes -- whether a citizen, a national, or an alien -- and residence would only need to be shown as of the close of the taxable year rather than for the entire taxable year. See section 935(b)(2) of the Code, relating to determination of date of residence under the U.S. - Guam filing system. We have no objection to the fact that a Marianas rebate system could be broader than a Virgin Islands rebate system in these two respects.

(2) Income of individuals eligible for rebate -- Any Marianas rebate system for individuals would be limited to Marianas income tax imposed on Marianas source income. This is also similar to the rule in section 934(c), except that section 934(c) contains two additional limitations. Neither the salary of federal employees, nor gain or loss from the sale or exchange of securities is treated as Virgin Islands - source income, with the result that neither type of income may be covered by a Virgin Islands rebate system. The first limitation reflects a Congressional policy against allowing federal employees to escape U.S. tax on their salary, a limitation reflected in other sections of the Code which otherwise allow an income tax exclusion for salaries (see, for example, sections 911(a)(1) and (2), 931(i), and 933(2)). The second limitation reflects a concern that the rather artificial source rules in the Code concerning capital gains could be used to create Virgin Islands - source income simply by passing title to securities in the Virgin Islands. In light of both these policies, it may be advisable to include both these limitations in the final draft of the Covenant or in the implementing legislation.

(3) Corporations eligible for rebates -- Section 602 would permit the Marianas to rebate income taxes both to Marianas corporations, and to foreign corporations (including corporations organized in the United States) which have either Marianas-source income or income effectively connected with the conduct of a trade or business in the Marianas. However, any such rebates would be limited to Marianas-source income. Section 934(b) applies somewhat differently, in that (a) it allows a Virgin Islands rebate system to cover any corporation which has satisfied an 80 percent/50 percent gross income test similar to that applied to "possessions corporations" under section 931 of the Code, but (b) a corporation that does not meet the two gross income tests contained in section 934(b) apparently cannot be covered at all by a Virgin Islands rebate system. In contrast, section 602 would allow a corporation that failed an 80/50 gross income test to be covered by a

rebate system, but only to the extent of Marianas - source income. It may be advisable to adopt the rule of section 934(b) in the final draft of the Covenant or in the implementing legislation, although at the moment we have no clear preference.

(4) Passive income of corporations -- The Covenant does not adopt a rule similar to that in section 881(b) of the Code, under which both the United States and Guam exempt corporations organized in the other jurisdiction from imposition of a 30 percent withholding tax on certain passive investment income. If we did not discuss this problem with you, it was probably an oversight. If a provision similar to section 881(b) of the Code is not adopted, then a Marianas corporation receiving dividends, interest, and other kinds of passive income from U.S. sources will be subject to a 30 percent U.S. withholding tax on such amounts. Similarly, a U.S. corporation receiving dividends, interest, and other passive income from Marianas sources will be subject to a 30 percent Marianas withholding tax on such amount. The principal reason that section 881(b) was adopted as between the United States and Guam was because it was believed that the imposition of the 30 percent Guam withholding tax was retarding investment in Guam in the form of loans to Guamanian corporations and purchases of the stock of Guamanian corporations. Thus it may be desirable to adopt a rule similar to section 881(b) in the final draft of the Covenant.

Section 604(a) -- This section provides that the United States may levy excise taxes on goods manufactured, sold or used, and on services rendered in the Marianas to the same extent that such taxes are applicable within Guam. We have several problems with this section.

(1) We assume that this section does not apply to excise taxes that are imposed by the United States on goods from foreign countries and from the possessions which are imported into the United States (such as the alcohol, tobacco, gasoline, and other excise taxes imposed on products entering the United States from Puerto Rico and the Virgin Islands, and to a lesser extent from the other possessions). If it is intended that such taxes be covered, then the section should be expanded to make this clear.

(2) If the section is only intended to cover federal excise taxes that are imposed internally within Guam, the language appears to be too restrictive, and should be

clarified in the implementing legislation. For example, the section does not appear to cover stamp taxes (although the term "excise" taxes might be broad enough to include stamp taxes), nor does the language appear to cover federal excise and stamp taxes not imposed on goods and services, such as on the issuance of insurance policies by foreign insurers (section 4371 of the Code) or on the acquisition by U.S. persons of foreign securities (imposed through June 30, 1974 by the Interest Equalization Tax, under section 4911 of the Code). I should note that at the present time there appear to be few, if any, federal excise taxes that are imposed internally within Guam. However, the Interest Equalization Tax until its expiration last year was imposed internally within Guam, and it would not appear to be covered by the language of section 604(a).

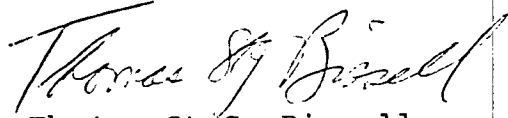
Section 703(b) -- We assume that the language regarding the covering-over to the Marianas of "federal income taxes derived from" the Marianas is intended to include the withholding tax collected from the wages of both military and civilian employees of the federal government.

Property taxes on U.S. and on military personnel -- You also asked me whether the Covenant could have the effect of permitting the Marianas to tax either the personal property of military personnel stationed in the Marianas, or the personal or real property of the U.S. Government located there. It would appear that the Marianas could not tax such property by reason of 4 U.S.C. §107 (relating to property of the U.S. Government) or 50 U.S.C. §574 (relating to non-business personal property of military personnel temporarily stationed in a possession), both of which apply to Guam and are thus made applicable to the Marianas by reason of section 502(b) of the Covenant. The provisions of section 603(b), permitting the Marianas to impose customs duties on goods entering the Marianas, do not appear to relate to property taxes.

As we mentioned to you recently, once the Covenant has been finally approved we would be prepared to draft the implementing legislation that would be necessary to put the Covenant into effect.

Please call either Dave or me if you have any questions about our comments on the Covenant.

Sincerely yours,



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