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Serial 370227

Aug 17 1949
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Dear Mr. McGill:

Pursuant to your request made at our conference of August 13, 1949, (attended by the Assistant Chief of Naval Operations for Island Governments and representatives of the Treasury Department), I am submitting this brief informal memorandum relative to problems arising out of the reinstatement of the provisions of Section 2470(a)(2) of the Internal Revenue Code, effective August 27, 1949.

Available statistics on copra exports and potential production show that the Trust Territory under the most favorable of conditions can be expected to supply no more than from 1% to 2% of the normal annual imports of the United States. In contrast, the Philippines supplied 98.2% in 1948 and customarily enjoys a virtual monopoly of the United States market. Trust Territory copra exports are therefore of insignificant importance to either the United States or the Philippine Republic.

On the other hand, such exports are of vital importance to the economy of the Trust Territory and therefore to the Federal Department charged with the responsibility of administering the Trust Territory under the terms of the Trust Agreement signed by the United States and the United Nations, presently the Department of the Navy. In the fiscal year ended 30 June 1949 the approximate dollar value of all exports of the Trust Territory was only \$775,000.00 of which copra accounted for 83.6% or \$647,000.00. Other products are of very minor importance and offer little promise of future development.

The Trust Territory is at an extreme competitive disadvantage in world trade not only because of meager natural resources but because of the difficulty and expense of collecting copra, and other products, in very limited quantities from small, widely separated islands for transshipment out of the area from a central point. The cost of one short ton of Trust Territory copra CIF San Francisco, including \$20.00 per ton for the producer, is \$154.09. The market price of copra in San Francisco on 12 August 1949 was \$155.00 per short ton.

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The imposition of the 2 cents per pound processing tax on coconut oil will mean a reduction of \$26.00 per ton in the value of Trust Territory copra in San Francisco. The immediate effect will be that the purchase price in the Trust Territory will have to be reduced by that amount. This would amount to a reduction of 32.5% in the principal source of native income.

A principal responsibility of the United States under the Trusteeship Agreement with the United Nations for the Trust Territory of the Pacific Islands is the promotion of the economic advancement and self-sufficiency of the inhabitants of that area. Other obligations which the United States has accepted under this Agreement are the maintenance of peace and security, the establishment and development of political institutions, the developing of the inhabitants of the area toward self-government and independence, the promotion of social advancement of the inhabitants, the protection of fundamental rights and freedoms, the promotion of educational advancement for the inhabitants and the negotiation of favorable commercial and other agreements with other countries-- all of which are wholly dependent upon the degree of development of the economic life of the area. In the absence of a sound local economy, which in fact has been and will continue to be based on copra production, the burden of fulfilling the undertakings assumed by the United States under the Trusteeship Agreement would rest upon U. S. taxpayers. Further, it appears that, under the provisions of the Trust Agreement, the United States would be precluded from exploiting the economy of the Trust Territory by taxation or otherwise or from taking any action which might, directly or indirectly, be detrimental to the economic welfare of the area.

With respect to the status of the Trust Territory of the Pacific Islands, it appears that this area is in the nature of, though is not technically, a possession of the United States and should be so considered in the application of United States laws to this Territory. By Article 3 of the Trust Agreement, the United States is granted full power of administration, legislation and jurisdiction over the Trust Territory and may apply to that area, subject to any modification it deems advisable, such of the laws of the United States as may be deemed appropriate to local conditions and requirements. Article 9 of this Agreement entitles the United States to constitute



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the Trust Territory into a customs, fiscal, or administrative union or federation with other territories under United States jurisdiction and to establish common services between such territories and the Trust Territory of the Pacific Islands. These provisions, coupled with the responsibility assumed by the United States under Article 6-- to promote the economic welfare and self-sufficiency of the area--confer upon the United States authority to administer the Trust Territory, for all practicable purposes, as if it were a part of the sovereign domain of the United States. These elements have formed the basis for a conclusion by the Department of State that the Trust Territory was not a foreign nation in the usual sense and have led to a recommendation of that Department to the Department of Commerce that the Trust Territory be exempt from the requirement of prior authorization for exports of controlled materials from United States to the Trust Territory.

In so far as international relations and policies are concerned, it is interesting to note that the United Nations has thoroughly considered the Trust Territory problem in the light of its tariff and trade regulations, has determined that preferential treatment should be granted by the United States in favor of imports of the Trust Territory and that the United States should accord it duty free treatment and the application of the same rate of internal tax on the processing of coconut oil as may be applied to like products of the Philippine Republic. This conclusion was reached after an exhaustive examination by a special working group of the United Nations set up to investigate the request of the United States that this area be granted such preferential treatment. It was found that (a) this area had heretofore been granted preferential treatment by Japan so long as they remained under Japanese mandate and that such treatment should not be eliminated with the inauguration of the United States administration, (b) the granting of preferential treatment would place the Trust Territory in the same position as other Trust Territories, (c) the production figures and export possibilities of this area are so unimportant that the granting of a tariff and trade waiver would not cause substantial injury to the trade of other United Nation members, (d) the reduction of the 2¢ per pound in the tax on the processing of coconut oil from copra would improve the income derived from the islands' copra exports and would not increase the total volume of such exports in the light of the more efficient production of the Philippines, (e) the United States could afford duty free entry of all products of



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the Trust Territory and would not be obligated to extend the same treatment to like products of trade of United Nation members, and (f) the application of the 1¢ per pound tax on coconut oil processed from copra to areas other than the Trust Territory and the Philippines would not be prejudicial to the interest of United Nation members.

The status of the Trust Territory of the Pacific Islands as being in the nature of a possession of the United States, though not being subject to the same degree of sovereignty as are the possessions of the United States, has been recognized heretofore in the administration of the tax laws of the United States. For example, special arrangements have been made by the Bureau of Customs for the importation of handicraft articles manufactured or produced by the natives of the Trust Territory which permit entry of these articles into United States customs free.

Recently, steps have been taken by way of submission of legislative proposals to the Congress to clarify the status of the Trust Territory in the tax law. However, pending decision by the Congress, the Department of the Navy, as interim administering agency for the Trust Territory, and the Department of the Interior, as ultimate administering authority, urge that the copra production of the Trust Territory be exempt from the provisions of Section 2470(a)(2) of the Internal Revenue Code along with the possessions of the United States. Precedents for so treating the Trust Territory have already been established by United States taxing authorities with respect to customs duties on imports from this area. In so far as international policy is concerned, the attitude of the United Nations in granting authority to the United States to accord preferential treatment to products of the Trust Territory, both as to customs duties and the coconut oil tax, was based upon the peculiar status of the Trust Territory under United States jurisdiction and the practical international considerations involved and appears to merit serious consideration in this matter. Further, in the light of the responsibilities of the United States assumed under the Trust Agreement, it appears that the United States is precluded from doing anything directly or indirectly that may impair the economic self-sufficiency of the Trust Territory.

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Accordingly, it is recommended that this matter be called to the attention of the proper officials in the Treasury Department so that a decision may be obtained at the earliest practicable date.

Sincerely yours,

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