

Internal Revenue Service  
**memorandum**

DWhite CC:FI&P

date: December 23, 1988

to: James R. Streeter, Special Assistant to the Under Secretary,  
Department of Interior

from: Acting Chief Counsel

---

subject: Mariana Islands Housing Authority Bonds

The Commonwealth of the Northern Mariana Islands ("CNMI") has raised certain questions regarding the impact of the Covenant to Establish a Commonwealth of Northern Mariana Islands (the "Covenant") on the taxability of certain bonds issued in 1984 by the Mariana Islands Housing Authority ("MIHA"). You have requested our opinion concerning these questions for purposes of the Section 902 Consultations.

The CNMI claims that the interest on the bonds is not subject to federal income tax because it views the Covenant, which provides in section 607 that bonds issued by the CNMI are exempt from taxation by the United States, as a treaty or treaty equivalent that supercedes any Code provisions which may provide otherwise. The CNMI also claims that if interest on the Bonds is determined to be taxable the net proceeds of all taxes collected must be covered over to the CNMI treasury.

Our position is that the bonds must meet the requirements of section 103 of the Internal Revenue Code in order to be tax-exempt. This position is based on section 103(m) of the 1954 Code which provides that the interest on bonds issued after December 31, 1983, is not tax-exempt unless the bonds meet the requirements of the Code. This provision of the Code changed prior law under which certain bonds, such as bonds issued by Puerto Rico, could be tax-exempt notwithstanding their failure to meet the requirements of the Code. Our examination of the MIHA bonds indicates that they are similar to those described in Rev. Rul. 85-182, 1985-2 C.B. 39 and are not tax-exempt qualified mortgage bonds described in section 103A(c) of the 1954 Code.

Our position concerning cover over is that only a portion of any taxes collected should be covered over to the Treasury of the CNMI.

Mr. James R. Streeter

Legal Effect of the Covenant

The Covenant, by definition, is not a treaty or treaty equivalent. A treaty, entered into by the President with concurrence of two-thirds of the Senate, is a compact between independent nations. The Covenant, however, is a political status agreement which defines the relationship between the United States and the CNMI, a possession of the United States.<sup>1</sup>

The Covenant is similar to agreements executed by the United States with its other territories and possessions. These agreements are legislative acts of Congress and as such, are federal statutes, not treaties. Had the United States considered the Covenant to be a treaty, the treaty ratification procedures would have been followed rather than the procedures for legislative action.

Moreover, whether the Covenant can be considered a treaty or treaty equivalent is not determinative because the provisions of the agreement and the Code at issue do not conflict. Thus, the rules of statutory construction for resolving conflicts between treaties and acts of Congress do not apply to this case.<sup>2</sup>

Section 607 of the Covenant simply grants bonding authority to the CNMI, and sets forth the general rule that the interest on bonds issued by the CNMI is exempt from federal taxation. As such, section 607 is a corollary to the general rule of section 103(a) of the Code which exempts from income tax the interest on state, local and territorial or possession bonds. Section 103(m) of the 1954 Code provides for an exception to the general rule. Accordingly, section 103(m) implicitly amends section 607 of the Covenant as well as all similar provisions of non-Code federal law. Thus, section 607 of the Covenant should be deemed to provide that bonds issued after December 31, 1983, by the CNMI or its authority are exempt from taxation by the United States only

---

<sup>1</sup> Although, the CNMI did not become a U.S. possession until November 3, 1986 (termination date of the trusteeship agreement), prior to such date it was treated as a U.S. possession in most instances because U.S. laws applicable to Guam, unless specified otherwise, became applicable to the CNMI.

<sup>2</sup> Even if there was a conflict, however, section 103(m) of the 1954 Code would override any conflicting provisions of the Covenant on the matter because it became effective later in time. Section 103(m) became effective no earlier than 1982, whereas section 607 of the Covenant became effective in 1978.

Mr. James R. Streeter

if the requirements of the Code are met. This construction of the two laws is proper, especially in view of the well-established principle that laws should be construed harmoniously where that can be reasonably done.

Cover over of Taxes by the United States

The CNMI maintains that if the interest on the Bonds is taxable, then Code and non-Code statutes require the United States to cover over (i.e., transfer) into the CNMI treasury any federal income taxes received or collected from the holders of the bonds. Our position is that the cover over amount is limited to certain high income individual bondholders.

Under both the Code<sup>3</sup> and the non-Code statutes<sup>4</sup> the United States is required to cover over federal income taxes collected on income sourced within the CNMI. The sourcing rule under section 861(a)(1) of the Code provides that interest from the United States or its agencies or instrumentalities (other than a possession of the United States or an agency or instrumentality of a possession), a state or its political subdivisions, or the District of Columbia is treated as income from sources within the United States. Because the tax law of the CNMI is the "mirror image" of the Code<sup>5</sup>, section 861, as applied on a mirror basis,

---

<sup>3</sup> Section 7654 of the Code. Note: Section 7654 as added by section 1276(a) of the Tax Reform Act of 1986 (the "1986 Act") is not presently applicable to the CNMI because the effective date for the changes to the Code section depends upon the execution of an implementing agreement between the United States and the CNMI. Section 1277 of the 1986 Act. At this time, no implementing agreement has been entered into between the United States and the CNMI. Therefore, section 7654 as it existed prior to the Act applies to this case.

<sup>4</sup> Section 703(b) of the Covenant provides that there will be paid into the CNMI Treasury to be expended to the benefit of the people thereof as the CNMI may by law prescribe, the proceeds of all customs, duties and federal income taxes derived from the CNMI.

<sup>5</sup> Section 601(a) of the Covenant provides that the CNMI would generally apply the Code as its territorial income tax law by substituting the "CNMI" for the "United States" where appropriate in order to give the law proper effect in the CNMI (i.e., the mirror code system).

Mr. James R. Streeter

provides that the interest income on bonds issued by the CNMI or its agencies or instrumentalities, is treated as income sourced within the CNMI. Thus, we agree that the interest income is sourced within the CNMI.

Section 7654 of the Code outlines specific rules for cover over by the United States to the CNMI. Although section 7654 expressly refers to Guam, section 601(c) of the Covenant provides that all references in the Code to Guam are deemed also to refer to the CNMI.

Section 7654 of the Code is only applicable to individuals to which section 935 applies.<sup>6</sup> Under section 935, certain individuals (i.e., citizens or residents of the CNMI and citizens or residents of the United States who derive income from the CNMI) are to file tax returns with the United States or the CNMI (but not both) based upon their residency at the end of the year and, in addition, are relieved of any tax liability to the jurisdiction in which they are not required to file a return.

Although Congress believed that the single filing/single liability rules of section 935 of the Code would result in an equitable division of revenue in the case of most individuals, Congress recognized that this system could result in a distortion of the allocation of revenue between the United States and the possessions if the income of the individuals involved is relatively large and the gross income from sources within the other jurisdiction is of significant size. As a result, section 7654 provides that if the individuals have adjusted gross income of \$50,000 or more and have gross income of at least \$5,000 from the jurisdiction other than that in which they reside, their taxes are to be allocated between the United States and the possessions generally in proportion to the source of their income and covered over accordingly.

The cover over rules of section 7654 of the Code allow the United States and the possessions to collect and pay to the other jurisdiction income taxes derived from sources in the other jurisdiction but which are not subject to the taxing and collecting authority of the other jurisdiction due to the single filing rule. As a result, sections 935 and 7654 apply to individual taxpayers rather than corporate taxpayers because there is no single filing requirement for corporate taxpayers.

---

<sup>6</sup>Section 935 of the Code, as amended by the Act is inapplicable to the CNMI because it has not entered into an implementing agreement. Thus, like section 7654, section 935 as it existed prior to the 1986 Act applies to this case.

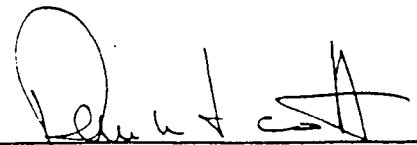
Mr. James R. Streeter

Generally, corporate taxpayers have to file two income tax returns and satisfy their tax liability with the possessions and the United States if they have income that is sourced within both jurisdictions during the taxable year. Thus, cover over between the taxing jurisdictions involving corporate taxpayers is generally unnecessary since each jurisdiction has the authority to tax and collect from corporate taxpayers.

In this case, section 935 of the Code would require the United States to cover an amount into the CNMI treasury; however, this amount would be limited to the net collections from individual bondholders who had adjusted gross income of \$50,000 or more and gross income of \$5,000 or more derived from sources within the CNMI.

The CNMI maintains that the cover over provision of the Covenant (which is not limited in application to the amount of net collection of taxes of individual taxpayers who meet the \$50,000/\$5,000 test) is inconsistent with and should take precedence over section 7654 of the Code. Our position is that sections 935 and 7654 of the Code and section 703(b) of the Covenant can be construed harmoniously. Section 703(b) of the Covenant was intended by Congress to grant the benefit of cover over by the United States to the CNMI as had been previously done for other possessions. The cover over of certain duties, fees, and taxes is one of several methods used by the United States to provide financial assistance to the possessions.

Section 7654 of the Code prescribes the means by which the United States is to provide the benefit of cover over of federal taxes to the CNMI as well as other possessions. As such, section 7654 is neither manifestly incompatible nor conflicting with section 703(b) of the Covenant. By including section 703(b) in the Covenant, Congress manifested a clear intention to make section 7654 applicable to the CNMI. Finally, both the IRS and the Department of Revenue and Taxation of the CNMI have consistently administered sections 935 and 7654 as being fully applicable to the CNMI.



PETER K. SCOTT