Order Code RL32708

CRS Report for Congress

Federal Taxes and the U.S. Possessions: An Overview

Updated May 19, 2008

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Prepared for Members and
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Congressional
Research
Service

Federal Taxes and the U.S. Possessions: An Overview

Summary

Residents of the U.S. possessions are generally U.S. citizens. Typically, the United States taxes its citizens on their worldwide income, but residents of the U.S. possessions — Puerto Rico, the U.S. Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands — are generally not required to pay federal income taxes on income whose source is within the possessions. Similarly, federal excise taxes do not apply in the possessions, and residents of the possessions may qualify for exemption from federal estate and gift taxes. For their part, corporations that conduct business operations in the possessions can also qualify for reduced federal taxes, although one federal tax benefit, delivered by the possessions tax credit and the Puerto Rican economic activity tax credit have expired.

In short the United States generally does not apply its taxes to the possessions. The precise outlines of the federal tax jurisdiction vary from territory to territory. And there are exceptions: Social Security taxes generally apply in the possessions.

The possessions apply their own tax systems. In some cases, their territorial tax systems are required to reflect federal tax provisions exactly: some possessions are required to apply so-called "mirror" tax systems. In other cases, however, the possessions' own tax systems depart significantly from federal tax rates and rules.

This report provides background information concerning a number of policy issues that have received congressional consideration. Analysis of these policy issues is beyond the scope of this report. Some of these issues involve the political status of the possessions and their relationship with the United States; whether the possessions are taxed unfairly or more favorably than the states, taking into account their limited participation in federal spending programs; and whether the possessions that use the mirror system of taxation have sufficient fiscal flexibility, given the difference between their economies and that of the United States.

This report will be updated in the event of significant changes in federal tax laws as they apply to the possessions.

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Federal Taxes and the U.S. Possessions: An Overview

Introduction[1]

The United States normally taxes its citizens on their worldwide income, regardless of the income's economic source; U.S. taxes also apply to the worldwide income of corporations chartered in the United States. Residents of the U.S. possessions — Puerto Rico (PR), the U.S. Virgin Islands (USVI), Guam, American Samoa (AS), and the Commonwealth of the Northern Mariana Islands (CNMI) — are generally U.S. citizens,[2] however, they are not subject to U.S. federal taxes on income they earn in the possessions.[3] In addition to tax deferral opportunities that benefitted many firms operating in the possessions, U.S. firms located in the U.S. for a time received favored treatment under the federal corporate income tax under the Puerto Rican Economic Activities Tax Credit (26 U.S.C. 30A). The special tax credit, however, expired January 1, 2006. Most federal excise taxes do not apply in the possessions, although an exception is the tax on petroleum and the other environmental excise taxes. And estate and gift taxes generally do not apply to persons who were residents of the possessions.

In short, U.S. federal taxes do not, for the most part, apply to the U.S. possessions. There are exceptions: residents of the possessions generally pay Social Security taxes. And the precise extent of federal taxation in the insular areas varies once one moves beyond possessions-source income earned by possessions residents. As we shall see, for example, in the case of some possessions residents of U.S. are subject to federal taxes on possessions-source income; in other cases they are not.

The possessions' own tax systems likewise vary, as does federal law's role in defining those systems. Three of the possessions — the Virgin Islands, Guam, and the CNMI — are required to "mirror" the U.S. Internal Revenue Code and use federal tax rules and rates as their own, albeit in some cases with a substantial degree of flexibility. PR and American Samoa, however, are permitted to determine their own tax systems. PR's system does depart in some significant ways from the current federal system, while American Samoa's tax system mirrors the federal code with some modifications.

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[1] This report was originally authored by former Congressional Research Service Economist, David L. Brumbaugh.

[2] Residents of American Samoa are U.S. nationals rather than U.S. citizens. For this report, references to the United States include the 50 states and the District of Columbia.

[3] For more background and economic data on the possessions, see Government Accountability Office, *U.S. Insular Areas: Economic, Fiscal, and Accountability Challenges*, GAO Report GAO-07-119 (Washington, D.C.: Dec. 2006).

Before adding more details, a cautionary note is in order: residents of the possessions are generally exempt from federal taxes, but one cannot automatically conclude that residents of the possessions are taxed more or less favorably than residents of the 50 states and the District of Columbia. One reason is that the territorial tax systems are generally imposed at a higher level than state income taxes. Another reason is federal spending: participation by the possessions in federal spending programs in some cases departs substantially of that of the U.S. states.

The General Framework: How the Possessions Fit into the U.S. Tax System

First, a brief overview of how the United States defines its tax jurisdiction *vis a vis* the rest of the world. The next section provides a point of comparison for federal tax treatment of the possessions. The tax treatment of the possessions are somewhat of a hybrid of international and domestic tax law.

U.S. International Tax Framework

The U.S. bases its tax jurisdiction partly on residence or income "destination." As noted above, U.S. taxes apply to the worldwide income of U.S. citizens and residents, whether the income is earned at home or abroad. The U.S., however, allows its taxpayers to credit foreign taxes they pay abroad against U.S. taxes they would otherwise owe on foreign income. The U.S., thus, concedes that the country where income is earned has the primary jurisdiction to tax as the "source" jurisdiction of the income.

Consistent with the "source of income" tax principle, U.S. residents and nonresident aliens are generally subject to U.S. taxes on income earned in the United States. The U.S., thus, asserts primary tax jurisdiction over U.S. sourced income, regardless of the citizenship status of the earner.

U.S. treatment of corporations parallels that of individuals. Corporations chartered in the U.S. — the business counterparts of U.S. citizens — are subject to U.S. taxes on their worldwide income but can claim foreign tax credits for taxes paid on foreign income. Foreign corporations are generally taxed on their U.S. income but their foreign earnings are not subject to U.S. taxes. Under this structure, U.S. firms that conduct their foreign operations through subsidiary foreign corporations can (with some exceptions) postpone U.S. taxes on foreign income indefinitely. This deferral of taxes in some cases constitutes a tax benefit for U.S. firms with foreign income.

U.S. Possessions Tax Framework

U.S. tax treatment of the possessions is mostly outside of the international structure; a separate set of rules governs federal taxation of the possessions. In some respects, however, U.S. taxation of the individuals who reside in the possessions is like its treatment of foreigners. As noted above, possessions residents are exempt from federal taxes on possessions-source income but are — with some exceptions —

taxed on income sourced from a U.S. state. Also, U.S. residents are subject to federal taxes on their possessions-source income as if it were foreign-source income. However, possessions taxes can generally be claimed as foreign tax credits. Thus, as with foreign-source income, the United States in a sense concedes primary tax jurisdiction to the territory where the income is earned. With some exceptions, it retains primary tax jurisdiction over U.S. state sourced income earned by possessions residents.

Generally, corporations chartered in the possessions are treated like foreign-chartered corporations under the Internal Revenue Code. In principle, they are exempt from federal taxes on possessions income; U.S. firms that invest in the possessions through possessions subsidiaries can — at least potentially — obtain a deferral of federal taxes. Most U.S. firms that operate in the possessions, however, have traditionally chosen instead to use the possessions tax credit or, in the past, the Puerto Rican economic activities credit: two alternative tax credits that until recently conveyed a larger tax benefit than deferral. In 1996, however, Congress passed legislation phasing out the tax credits and repealing them completely beginning in 2006. Thus, firms located in the U.S. will choose to operate in the possessions through possessions-chartered corporations so as to avail themselves of the deferral tax benefit. But with the deferral of tax for possessions corporations, the federal government, in effect, grants primary jurisdiction to tax corporate income to the possession where the income is earned.

Puerto Rico

Individuals

Federal individual income tax treatment of Puerto Rico (PR) is largely determined by section 933 of the Internal Revenue Code. As noted above, the U.S. normally taxes its citizens on their worldwide income, regardless of where it is earned, and individuals born in PR are U.S. citizens. However, section 933 exempts individuals who are residents of PR for the entire year from federal taxes on income earned in PR, except in the case of income earned as U.S. government employees. Section 933 applies only to income from Puerto Rican sources; residents of PR are subject to federal taxes on income from the U.S. or foreign countries.

Residents of The U.S. are in principle subject to federal taxes on income from PR. Income taxes paid to the possessions can generally be claimed as foreign tax credits which means some or all of the federal taxes that would otherwise apply may be offset.

PR's own tax system is distinct from those of the other insular areas in that it does not "mirror" the federal Internal Revenue Code. The differences between the Puerto Rican and federal tax rates and the rules governing income and deductions can be significant. For example, in 2007, PR's tax rates for individuals range from 7% to 33%. U.S. federal tax rates ranged from 10% to 35%. The personal exemption amount under the PR income tax in 2007 was $3,000 for married filers and $1,300 for individual filers. PR taxpayers then deduct an additional $1,600 for each dependent. The federal personal exemption was $3,400 for each filer, spouse, and dependent in 2007. Thus, for married couple with two dependents, the PR total personal exemption would be $6,200 whereas the total federal personal exemption would be $13,600.

The PR standard deduction in 2007 was $3,150 for married couples and $2,100 for individuals. The federal standard deduction was $10,700 for couples and $5,350 for individuals. PR filers like U.S. filers can also choose to itemize deductions rather than use the standard deduction amount.

Corporations in Puerto Rico

As outlined above, U.S. firms that operate in the possessions through possessions-chartered corporations are not immediately subject to U.S. corporate income tax. Possessions-source income receives a deferral of federal taxes as long as it is not repatriated to the U.S. parent. In addition, however, an alternative, more generous tax benefit for corporations had been available in PR and the possessions in the form of the possessions tax credit and an economic activity tax credit. In general, the possessions tax credit provided a tax exemption for a specified portion of a firm's possessions income. The economic activity tax credit provided a tax credit whose size was linked to a firm's wages and depreciation in the possessions. The tax credits, however, expired January 1, 2006.

In the years following World War II, PR depended on the possessions tax credit and its own set of tax benefits to attract investment to PR from The U.S.. Most observers agree that the tax benefit and increased investment that the tax preferences initially prompted the transformation of the Puerto Rican economy from one based on agriculture to one based on manufacturing, services, and trade. At the time, however, the credit was criticized on several grounds: that it had a high revenue cost compared to its employment effect; that a large share of the benefit did not accrue to residents of PR; and that it distorted deliberations over PR's political status. As a result, over time the credit was subject to a series of modifications designed to limit its revenue cost and tie the credit's benefit and effects more tightly to a taxpayer's activity in PR. In 1993, provisions were enacted that capped the possessions tax credit at 40% and that linked the alternative Economic Activities Credit to wages and depreciation claimed on tangible investment.

The modifications culminated with the *Small Business Job Creation Act of 1996*, (P.L. 104-188), which phased out the credits and repealed them beginning January 1, 2006. Under the phase-out provisions, before complete repeal, the credit could only be claimed by firms that used the credit before 1996 ("existing claimants"). In addition, the 1996 act subjected both the possessions tax credit and the economic activity credit to an additional annual cap that limits business income eligible for the credits to an amount linked to a pre-1996 base-period, increased by a specified growth factor. The caps were designed to prevent even existing claimants from greatly expanding their use of the credits during the phase out period.

PR's corporate income tax consists of a normal tax and surtax whose rates combine to a top corporate tax rate of 39%. At the same time, however, certain types of firms may qualify for substantially reduced taxes under PR's industrial incentives program.[4]

Federal Excise Tax Rebates

As explained more fully below in the section on excise taxes, most federal excise taxes do not apply in PR or the other possessions. An exception, however, is provided by section 7652 of the Internal Revenue Code, which applies a special excise tax to items produced in PR or the U.S. Virgin Islands (USVI) and shipped to the United States. The tax is equal to any excise tax that would apply to an identical item produced in one of the U.S. states or the District of Columbia. The tax was first imposed to ensure that producers in the possessions would not have a tax advantage over goods produced in the U.S. that are subject to excise taxes.[5]

For example, rum that is produced in either the USVI or PR and that is sold in the states is subject to the same tax as rum produced in the states. Most of the revenue from the so-called "equalization" tax, however, is returned ("covered over") by the federal government to the treasuries of PR and the USVI.[6] In addition, the *Caribbean Basin Initiative of 1983* provides that all revenue from federal excise taxes on rum imported into the U.S. from any source — including any foreign country — is remitted to the treasuries of PR and the USVI.[7] Congress has frequently modified the "cover over" administration, following is a brief legislative history.

The *Deficit Reduction Act of 1984* (P.L. 98-369) placed a cap on the rebate of excise taxes on rum and other distilled spirits. The 1984 Act increased the federal tax rate on spirits from $10.50 per proof-gallon to $12.50; subsequent legislation increased the rate to $13.50 per proof-gallon. The 1984 Act also provided, however, that the rebate to PR and the USVI would be calculated based on prior law's $10.50 rate. In imposing the cap, Congress stated that it did not wish to expand the rebate (as would have occurred automatically with the tax-rate increase) until it had

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[4] A description of Puerto Rico's industrial incentives tax program is located at [http://www.pridco.com/english/tax_&_business_incentives/tax_incentives/3.1tax_incentives_overview.html].

[5] Karla Hoff, "U.S. Federal Tax Policy Towards the Territories: Past, Present, and Future," *Tax Law Review* (Fall, 1981), p. 57.

[6] The rebates are paid by the U.S. Alcohol and Tobacco Tax and Trade Bureau within the U.S. Treasury. According to data provided by that agency in the federal FY2009 budget, the payment to Puerto Rico in 2007 was $462 million.

[7] The Caribbean Basin Initiative reduced customs duties on imported rum. This introduced the possibility that sales in the U.S. of rum shipped from the possessions would fall, and so too would cover-overs to the possessions of federal excise taxes from rum manufactured in the possessions. The additional cover-overs were enacted to offset the expected loss of revenue. U.S. Congress, House, Committee on Ways and Means, *Caribbean Basin Economic Recovery Act*, H.Rept. 98-266, 98th Cong., 1st Sess. (Washington: GPO, 1983), p. 26.

addressed the question of whether the rebates were proper, given that similar cover overs were not made to the U.S. states.[8]

The *Omnibus Budget Reconciliation Act of 1993* (OBRA93, P.L. 103-66) temporarily increased the cap to $11.30 per proof-gallon, effective for shipments of rum and distilled spirits brought into the U.S. during the five-year period October 1, 1993 through September 30, 1998. The increase was enacted in the context of a scaling-back by the act of the possessions tax credit. With the expiration of OBRA93's temporary increase in the rebate's cap, the limitation returned to its previous $10.50 level. The *Ticket to Work and Work Incentives Improvement Act of 1999*, (P.L. 106-170) and the *Job Creation and Worker Assistance Act of 2002*, (P.L. 107-147), however, provided temporary increases in the cap to $13.25 per proof-gallon through December 31, 2003. In conjunction with the extension of a number of other tax provisions not related to the possessions, the *Working Families Tax Relief Act of 2004*, (P.L.108-311) extended the $13.25 amount through 2005. The *Tax Relief and Health Care Act of 2006*, (P.L. 109-432) extended the $13.25 amount through 2007. The president's FY2009 budget proposes to extend the higher amount two years, through 2009, as does S. 2886.

U.S. Virgin Islands

Section 932 of the federal tax code coordinates the USVI and the federal taxation of USVI residents and U.S. state residents with USVI income. Under its terms, individuals who are residents of the USVI at the close of the tax year are not subject to federal income taxes on their worldwide income, be it from the USVI, U.S., or foreign sources. The exemption is contingent on the person reporting their worldwide income to the USVI, identifying its source, and paying their USVI tax liability on the income. The treatment of USVI residents thus departs somewhat from that of PR's residents, who are exempt from federal taxes only on Puerto Rican-source income. For U.S. state residents with USVI income, section 932 provides that taxes are to be paid to the U.S. and the USVI in proportion to the share of gross income earned in each location.

The USVI income tax system is generally a "mirror" of the federal system: the USVI uses income tax provisions of the federal tax code as its own, with the term "Virgin Islands" substituted for "United States" where the latter appears in the code. The USVI's mirroring of the federal system is required by federal law; it was established by the *Naval Appropriations Act of 1922*. Within the general mirror framework, however, the USVI has a certain amount of flexibility. For example, the USVI can impose a surtax of up to 10% within the mirror framework; it also has the authority to impose local income taxes in addition to mirrored taxes.

Notwithstanding the mirroring requirement, the USVI also has the authority to grant tax rebates, subject to certain restrictions. As with PR, however, the possessions tax credit and economic activity credit expired in 2006. Firms that invest

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[8] U.S. Congress, Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (Washington: GPO, 1984), p. 1,226.

in the USVI would generally have access to deferral as an alternative tax benefit to the tax credits just as PR would.

The USVI's ability to provide tax benefits within the mirror system is limited by section 934 of the federal tax code, which provides that benefits can only be provided with respect to USVI income and cannot be applied to the USVI tax liability of individuals who are U.S. state residents. Within the limits of section 934, the USVI has enacted a program of tax incentives designed to stimulate economic development. Under its terms, investors can receive a tax reduction of up to 90% of their tax liability. The program is administered by the Virgin Islands Economic Development Authority.[9]

The mirror system's interaction with federal taxes has produced certain ambiguities in the past and in some cases have led to attempted tax-sheltering activity. Several of these problem areas were addressed by the *Tax Reform Act of 1986* (P.L. 99-514), which implemented the current basic versions of sections 932 and 934.[10]

More recently, the *American Job Creation Act of 2004* (AJCA, P.L. 108-357) addressed several perceived ambiguities in residence and source-of-income rules that some taxpayers were apparently using to avoid federal tax on what was actually income sourced to a U.S. state. The legal positions taken by the taxpayers (and not accepted by the Internal Revenue Service) were described in IRS notice 2004-45, issued in June, 2004. Key to the taxpayers' positions was residence for tax purposes. Under prior law, residence in the USVI for tax purposes was determined on the basis of facts and circumstances rather than by a "bright line" test. According to the IRS, taxpayers actually living and working in the U.S. attempted to establish USVI residence with only a minimal connection to the USVI. Under Internal Revenue Code section 932, an individual establishing USVI residence would pay taxes to the USVI rather than to the federal government.

But purported establishment of USVI residence still left the matter of USVI taxes, which, under the mirror code, generally apply at the same rates applicable under the federal income tax. Here, the taxpayers in question were able to obtain up to 90% reductions in tax using tax incentives provided by the Virgin Islands' Economic Development Authority. As described above, section 934 prohibits the USVI from providing tax benefits with respect to income whose source is not the

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[9] For a description of the program, see Marjorie Rawls Roberts, "U.S. Virgin Islands Promulgates New Law on Investment Incentives," *Tax Notes International*, vol. 22, April 16, 2001, p. 1876. See also the Economic Development Authority's website at [http://www.usvieda.org/].

[10] In enacting the 1986 provisions, Congress believed "the interaction of the Internal Revenue Code with the Virgin Islands Revised Organic Act and the mirror system gave rise to numerous areas of ambiguity and problems of interpretation. These technical difficulties made administration of the law problematic, creating a climate of uncertainty for investors, and raising the possibility of unintended tax benefits for some and harsh consequences for others." U.S. Congress, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, joint committee print, 100th Cong., 1st sess. (Washington: GPO, 1987), pp. 1,118-1,119.

USVI, thus posing a potential obstacle to the tax-avoidance strategy — the income in question was from the provision of services in the U.S.. However, the taxpayers used several arguments to maintain that their income from services provided in the U.S. was USVI-source income for tax purposes.[11]

Section 908 of the AJCA established a single, multi-part test for residence in the possessions that replaces the facts-and-circumstances basis of prior law. The new test requires that a person establishing residence in a possession must be present in the possession for at least 183 days of the tax year, must not have a tax home outside the possession, and must not have a closer connection to a U.S. state than to the possession. The AJCA also applies the federal tax code's existing and general rules for determining the source of income to determining the source of income with respect to the possessions.

As noted above in the discussion of PR, federal excise taxes apply to goods produced in the USVI and shipped to the U.S.. The federal government returns the revenue from the excise taxes to the USVI plus (with PR) a share of revenue collected on rum imported into the United States from foreign countries. As with PR, however, the rebate with respect to tax on rum and distilled spirits is capped at $13.25 per proof gallon, $0.25 less than the full federal rate of $13.50. The cap reverted to a lower amount at the end of 2007.

Guam

Federal individual income tax treatment of Guam residents is similar to that of USVI residents. Under the provisions of section 935 of the U.S. Internal Revenue Code, residents of Guam are required to file tax returns with Guam, but not with the U.S. federal government; Guam residents satisfy their federal tax liability by filing a tax return with Guam. Thus, as with the USVI, residents of Guam are completely exempt from federal taxes on income from U.S. based sources and foreign sources as well as income earned within Guam itself. Similarly, residents of the U.S. are not required to file tax returns under Guam's territorial tax; they satisfy any potential tax liability on Guam-source income by filing with the U.S.

Under the terms of the *Guam Organic Act of 1950*, Guam is required to mirror the income tax provisions of the federal Internal Revenue Code as its own tax system.[12] *The Tax Reform Act of 1986* (TRA86, P.L. 99-514) contained provisions giving Guam the authority to devise its own tax system. Implementation of the act's provisions, however, was made contingent on the signing of an agreement between Guam and the federal government regarding rules for the prevention of tax evasion, rules for the elimination of double taxation, and the exchange of tax information between Guam and the federal government. In addition, TRA86 provided for the

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[11] For example, tax code section 932(c) provides that for residents of the USVI, the Virgin Islands is treated as including the United States. According to the IRS, some taxpayers took the position that U.S.-source income was thus USVI income, for tax purposes. See IRS notice 2004-45 (*Internal Revenue Bulletin* 2004-28, June 24, 2004.)

[12] 48 U.S.C. § 1421.

potential reimposition of the mirror system if the tax system adopted by Guam were to fail to produce as much tax revenue as the mirror system. At present, however, this second condition is moot; while an implementation agreement has been drafted, it has not gone into effect. Thus, as of this writing, Guam continues to mirror the income tax provisions of the U.S. Internal Revenue Code.

The TRA86 also repealed section 935 of the Internal Revenue Code. Although, as with repeal of the mirror system, section 935 continues to apply pending adoption of the required implementing agreement. In place of section 935, the act applied a revamped version of tax code section 931 to Guam along with the Commonwealth of Northern Mariana Islands and American Samoa. Under its terms — in a manner similar to the treatment of PR — residents of the three possessions are exempt from federal taxes only on income from sources within the possessions; they are generally subject to federal taxes on income earned outside the possessions. At the same time, however, the new provisions provided for the United States to cover over to Guam all tax collected from Guam residents.[13] Again, however, section 931 does not yet apply in Guam or the Northern Mariana Islands.

The tax treatment of U.S. military personnel has been of special concern to Guam over the years due to the large number of military personnel stationed on Guam and the relatively large number of Guamanians serving in the U.S. Armed Forces and stationed outside Guam. Under the *Soldiers and Sailors Relief Act*, military personnel generally do not lose their State or territorial domiciliary status for tax purposes because they are absent from the State or territory in question on military duty.[14] Thus, Guamanians in the military service in the U.S. or abroad are generally Guam residents subject to taxation by Guam under section 935 of the tax code. By the same logic, non-Guamanian military personnel stationed on Guam would ordinarily not pay taxes to Guam. However, section 7654 of the tax code provides for the U.S. Treasury to remit or "cover over" to Guam federal taxes withheld on military personnel stationed on Guam. Also, Guam's organic act provides for taxes withheld by the federal government on Guamanian military personnel outside Guam to be covered over to Guam.[15]

For corporations, the possessions tax credit and Economic Activities Credit were available in Guam for "existing claimants." As with PR, the credits expired on January 1, 2006, but in contrast to PR and the USVI, the credits were not subject to the caps that apply during the phase out period. In complement to the federal tax benefits, Guam has enacted a tax incentive program for inbound investment under

[13] From the perspective of an individual Guam taxpayer with income from non-Guam sources, new section 931would make a difference; he or she would have to pay tax to the federal government. Because of the cover over, however, there would be no fiscal impact on Guam.

[14] 50 U.S.C. Appendix §§ 501-593

[15] According to federal budget documents, the total amount of cover overs to Guam of withheld taxes is currently $42 million per year. U.S. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2005, Appendix* (Washington: GPO, 2004), p. 639.

its territorial income tax. The incentives consist of rebates of up to 100% of tax.[16]

Recent federal tax legislation relating to Guam focused on the operation of Guam's mirror tax system as it applies to foreign investors. In general, the United States tax code applies a flat "withholding" tax to dividends and similar income earned by foreign portfolio investment in the United States. At the same time, the United States has entered into numerous bilateral tax treaties with foreign countries that substantially reduce or eliminate the withholding tax; the purpose of the reductions is to attract foreign investment to the United States. Since Guam's territorial income tax mirrors the federal tax code, a 30% withholding tax applies to foreign non-residents who invest in Guam. Since Guam is not considered part of the United States for tax purposes, however, the treaty-mandated reductions applicable to foreigners' investments in the U.S. do not apply to investment in Guam. In 2002, Congress enacted the *Guam Foreign Investment Equity Act* (P.L. 107-212), which authorizes Guam to apply the treaty-mandated reduced withholding tax rate to foreign investors in Guam.

Commonwealth of the Northern Mariana Islands

Federal taxation of Commonwealth of Northern Mariana Islands (CNMI) residents follows the treatment of Guam residents. Residents of the CNMI satisfy their federal and CNMI tax liabilities by filing returns with the CNMI and are thus effectively exempt from federal taxes on their worldwide income. Residents of the U.S. satisfy their CNMI tax liability on any CNMI-source income by filing with the United States. Technically, the statutory source for the treatment is section 601 of the *Northern Mariana Islands Covenant* (Public Law 94-241). However, the Covenant generally applies the provisions of section 935 of the Internal Revenue Code to the CNMI.

The CNMI Covenant also provides that the income tax rules of the CNMI are to mirror the Internal Revenue Code in the same manner "as those laws are in force in Guam." The mirror system is thus the starting point for the CNMI. At the same time, however, the Covenant provides that the CNMI may impose additional local taxes and can provide rebates of any taxes applied by the mirror system to income from CNMI sources. The CNMI has used this flexibility to depart substantially from the mirror system; the Commonwealth provides substantial rebates of mirrored taxes and imposes its own tax on wages and salaries as well as a separate tax on certain types of non-wage income (e.g., income from the sale or lease of personal property). The CNMI also imposes a business gross receipts tax. The net result is a hybrid tax system that is probably less progressive than the system would be if there were no rebates. At the same time, a 2000 General Accounting Office (now the Government Accountability Office) report found that taxes collected under the gross receipts tax

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[16] For a description see the website of the Guam's Economic Development Authority, at [http://www.investguam.com/?pg=home].

from the garment and tourism industries in the CNMI have helped make the CNMI more fiscally self-sufficient than the other possessions.[17]

As with Guam, TRA86 gave the CNMI authority to abandon its nominal use of the mirror system. And like Guam, the CNMI has not yet de-coupled. As with other possessions, the possessions tax credit and economic activity credit expired on January 1, 2006.

American Samoa

Federal taxation of residents of American Samoa (AS) is governed by section 931 of the tax code; under its terms, Samoans are exempt from federal taxes on income they earn in Samoa but are subject to federal taxes on income earned elsewhere. The treatment of AS thus follows that of Puerto Rico in this respect.

Like PR, AS had the authority to legislate its own tax system even before TRA86. AS, however, generally has adopted the federal tax system as its own, albeit with certain modifications, and thus uses a system similar to the mirror system in practice.

TRA86 extended to AS section 7654's cover over of taxes on Samoans serving in the U.S. military and of non-Samoan military personnel stationed in AS. Before the act, the cover over was made to Guam and the CNMI but not AS. As with the provisions of the act affecting Guam and the CNMI, TRA86 Act's provisions for AS were contingent on an implementing agreement, which has been signed and is in effect. Along with the other possessions, the possessions tax credit and economic activity credit expired on January 1, 2006. Instead, AS provides tax reductions under its corporate income tax as investment incentives that complement the possessions tax credit. In December, 2006, the *Tax Relief and Health Care Act* (P.L. 109-432) extended the economic activities version of the possession credit for American Samoa through 2007.

Federal Excise Taxes

Most federal excise taxes do not apply in the possessions. For example, the telephone excise tax does not apply to telephone charges paid in the possessions and air transportation to or from the possessions is generally not subject to federal excise tax. And shipments of manufactured products to the possessions are treated like exports; federal excise taxes do not apply to items manufactured in the U.S. and shipped to the possessions.[18] Federal excise taxes likewise generally do not apply to

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[17] U.S. Government Accountability Office, *Northern Mariana Islands: Garment and Tourist Industries Play a Dominant Role in the Commonwealth's Economy*, GAO report RCED/GGD-00-79 (Washington: Feb., 2000), p. 51.

[18] With respect to all the possession except the CNMI, this provision is contained in section (continued...)

items produced in the possessions themselves, as long as the items remain in the possessions.

There are exceptions to this general picture. As described above in the sections on PR and the USVI, federal excise taxes apply to goods shipped from those possessions to the U.S. and the revenue from the tax is returned to the possessions' treasuries. Another exception is environmental excise taxes, including the excise tax on petroleum refiners and the tax on ozone-depleting chemicals. These taxes are fully applicable in the possessions.[19]

Federal Estate and Gift Taxes

In general, federal estate taxes apply to the estates of decedents who were U.S. citizens; they apply to estates of nonresident aliens only in the case of tangible property located in the U.S. While residents of the possessions are generally U.S. citizens, a special provision exempts them in the same manner as nonresident aliens if their U.S. citizenship is derived solely from their being a citizen of a possession or their birth or residence in a possession. Thus, for example, the estate of a person born in the U.S. but who moves to a possession would generally be subject to the tax, while the estate of a life-long possessions resident would not.[20] Similarly, a gift giver who is a U.S. citizen and a resident of a possession and who derives citizenship by being a citizen of a possession or by birth in a possession is treated as a nonresident of the U.S. under the federal gift tax. Thus, the gift tax applies only to property located in the U.S..

Social Security and Unemployment Taxes

Unlike other taxes, Social Security taxes generally apply in the U.S. possessions along with the corresponding benefits. Federal unemployment taxes apply in PR and the USVI, but not in the other possessions.[21]

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[18] (...continued)
7653 of the U.S. Internal Revenue Code. The CNMI Covenant applies the provision to the Northern Mariana Islands. U.S. Government Accountability Office, *U.S. Insular Areas: Information on Fiscal Relations with the Federal Government*, GAO testimony GAO/T-GGD-95-71(Washington: Jan. 31, 1995), p. 20.

[19] Section 4612(a) of the Internal Revenue Code explicitly includes the possessions within the United States for purposes of the environmental taxes.

[20] Sections 2208 and 2209 of the Internal Revenue Code contain these provisions.

[21] These provisions are contained in section 3306(j) of the Internal Revenue Code.

Customs Duties

PR is within the U.S. customs territory; the other possessions are not. Thus, articles imported into PR from foreign countries are subject to U.S. customs duties, where they are not otherwise exempt, whereas articles imported into the other possessions are not subject to federal duties. At the same time, however, under the provisions of the *Foraker Act of 1900*, federal customs duties collected on goods entering PR are covered over to the treasury of PR, in a manner similar to excise taxes.[22] According to the U.S. budget, customs cover over amounted to $93 million in FY2007.[23]

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[22] Apr. 12, 1900, ch. 191, 31 Stat. 77.

[23] U.S. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2009, Appendix* (Washington: GPO, 2008), p. 498. Our discussion of the applicability of federal customs is based on that in U.S. Government Accountability Office, *U.S. Insular Areas: Information on Fiscal Relations with the Federal Government*, p. 24.