

# The Taxman Cometh to U.S. Possessions

by **Alexis A. Fallon**

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*by Alexis A. Fallon*

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President Bush signed into law a new tax bill on October 22, 2004, the American Jobs Creation Act of 2004 (H.R. 4520) (the Jobs Act), which provides favored industries with tremendous tax breaks and closes many major tax loopholes. Initially, the purpose of the part of the legislation containing residency and source rules was to attack the promotion and abuse of the U.S. Virgin Islands as a tax haven for wealthy U.S. investors. At the 11th hour, however, the Senate Finance Committee and U.S. Treasury made significant changes to the bona fide residency requirements to apply to all U.S. possessions. (For additional coverage, see p. 578 of this issue.)

In the Commonwealth of the Northern Mariana Islands (CNMI), where individuals can obtain a rebate of up to 90 percent of income tax on CNMI-source income, the new tax law will affect residents who do not meet the new bona fide resident test. Guam does not have a similar program, so there is less taxpayer motivation to file income tax returns with Guam.

To tax savvy practitioners, the Jobs Act amends Internal Revenue Code section 935. IRC section 935 applies to Guam and to the CNMI by the application of the Covenant to Establish the Commonwealth of the Northern Mariana Islands in Political Union with the United States, Pub. L. No. 94-241, 90 Stat. 263 (1976), reprinted in 48 U.S.C. 1801 note. (See covenant section 601). While the Tax Reform Act of 1986 repealed section 935, it conditioned that repeal on Guam and the CNMI discontinuing the mirror code tax system and entering into an implementing agreement with the United States. The mirror code tax system uses the IRC as the local territorial income tax law. Until Guam and the CNMI discontinue the mirror code system, section 935 is still in effect. The new amendment in the Jobs Act recognizes that section 935 is still in effect for both Guam and the CNMI, but creates a new reference to the new bona fide residency requirements.

Under the new tax law, U.S. citizens and aliens of the possessions — Guam, the CNMI, the U.S. Virgin Islands, Puerto Rico, and American Samoa — must meet requirements to be considered bona fide residents of the possessions. To be a bona fide tax resident in the possessions, an individual must: be present at least 183 days during the year in the specified possession; not have a tax home outside of the specified possession; and not have a closer connection to the United States or a foreign country than to the specified possession. If the individual meets all of the requirements, the individual can qualify as a bona fide tax resident in the possessions.

Another significant change is the creation of new U.S. and Guam/CNMI income sourcing rules. The new sourcing rules will create a distinction limiting the types of income that can be sourced in Guam and the CNMI. There will also be a new U.S. reporting requirement for residents of the possessions who become or cease to be a bona fide resident in the possession. The U.S. Treasury will provide regulations as to the manner of reporting and impose a penalty of US \$1,000 for failure to properly report.

The other changes are to possession corporations' eligibility for the exemption from being treated as a foreign corporation for U.S. purposes, the exemption from being treated as a controlled foreign corporation, and the eligibility to use a possession tax credit. The changes are going to make it harder for a possession corporation to qualify for those exemptions and for taxpayers to use a possession tax credit.

The most significant effect for both the Guam and CNMI governments is the ability to retain tax revenue from all sources of income of its tax residents. The new residency rules will permit the IRS, not the local governments, to determine who are residents for tax purposes. While the local governments will have a say in determining residency through the tax coordination agreements, the new law diminishes the local governments' ability to determine their own tax residents. That places the Guam and CNMI treasuries at risk from those determinations by the IRS. For example, if the IRS determines that an individual does not qualify as a bona fide resident, the local treasuries will most likely have to refund the taxes paid by that individual. That will severely hamper the collection authority of the local governments because residents who are fearful of the IRS

may simply choose to pay the United States rather than risk a determination by the IRS that they are not bona fide residents.

Most rules will take effect in 2005. The 183-day rule will begin in 2005. The sourcing rules will apply to income earned after the date of the enactment of the law, October 22, 2004. For taxpayers that have U.S.-source income any time after October 22, the new source rules will apply. The actual effect of

those rules can only be speculated about at this time. It is uncertain if the IRS will attempt to use the new sourcing rules to limit the ability of the local governments to rebate income tax or require local governments to cover over any tax funds associated with U.S. income. The U.S Treasury and the IRS intend to issue regulations in the near future. Until that time, the effect of the new law is unsettled. ♦