

TEB Phase III - Lesson 4

TEB International

U.S. Territories / Possessions

Overview

Introduction

Nongovernmental organizations formed in a U.S. territory are treated differently for tax purposes from those formed in a U.S. state or the District of Columbia. They are also treated differently from those formed in a foreign country. The income tax regime affecting U.S. territory organizations is governed by a combination of provisions in the U.S. Internal Revenue Code (IRC) and local territorial tax laws, as well as the particular relationship between a territory and the United States. Tax issues relating to each U.S. territory are unique in regard to its own tax system and political and tax relationship with the United States. Nevertheless, there are some key commonalities, which is a focus of this training material.

Tax-exempt bonds issued by a U.S. territory or local government located in a U.S. territory, however, are subject to the same laws as bonds issued by a state or local government in the United States. Accordingly, they must comply with the provisions of the U.S. IRC as they apply to all issuers of tax-exempt bonds. When issuers of tax-exempt bonds are located in the U.S. territories, there may also be certain additional protocols required when establishing contact with an issuer or taxpayer located in a U.S. territory.

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Overview, Continued

Objectives

At the end of this lesson, you will be able to identify:

- The general political and tax relationship between the United States and the five key U.S. territories
 - The different types of tax systems in place in the territories
 - What IRS offices serve as the liaison with the territory tax departments
 - How to make exchange of information requests to obtain tax information from a U.S. territory tax department
 - The legal authority which allows U.S. territories and local governments in the U.S. territories to issue tax-exempt bonds
 - The additional steps required when initiating audit or other activity with issuers of tax-exempt bonds located in the U.S. territories
 - How U.S. tax treaties apply to the territories
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Introduction

Introduction

U.S. territories are generally referred to as U.S. insular areas or possessions. These U.S. territories are not part of the fifty states or the District of Columbia. The Regulations contain several different definitions of U.S. possessions, depending on issues addressed in the particular section. Generally, U.S. territories or possessions can be divided into three groups.

The first group includes the five key territories, which will be the focus of this training material: American Samoa, the Commonwealth of the Northern Mariana Islands (CNMI), Guam, Puerto Rico, and the U.S. Virgin Islands (USVI). These territories have their own separate governments and impose some local-level taxes, similar to the states in this regard, but their tax systems are largely coordinated with U.S. income tax laws. Puerto Rico and the USVI are located south of the U.S. mainland in the Atlantic Ocean, while American Samoa, the CNMI, and Guam are scattered throughout the Pacific Ocean. In these territories, governments and associated entities are permitted to issue tax-exempt bonds in the U.S. capital markets.

The second group includes those territories that lack their own government and tax system: Johnston Island, Midway Island, Wake Island, and other U.S. islands that are not part of the 50 states or the District of Columbia. Residents of these territories are subject to the income and withholding taxes of the U.S. federal income tax system and, thus, must file individual and corporate income tax returns with the United States. Since these territories do not have their own governmental systems, they are not eligible issuers for tax-exempt bonds.

The final group of U.S. territories includes those territories associated with the U.S. as “freely associated states” - Republic of the Marshall Islands, Federal States of Micronesia, and Republic of Palau. These territories are generally treated as sovereign countries with the capacity to conduct their own affairs. For U.S. tax purposes, they are also generally treated as foreign countries, subject to a limited number of exceptions. Since these are considered sovereign countries, and no specific provision authorizes them to issue tax-exempt bonds, (see Indian Tribal Governments authorization in section 305.7871-1), these territories are not eligible to issue tax-exempt bonds.

This training material focuses on U.S. territory tax issues that are specific to tax-exempt and tax-advantaged bonds.

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Overview, Continued

General Political Relationship with the U.S.

Article IV of the U.S. Constitution gives Congress the ultimate responsibility for establishing federal policy for U.S. territories. Historically, unincorporated territories did not possess an inherent right to be considered for statehood.

Since the end of WWII, the U.S. government has adopted a flexible approach in dealing with the political aspirations of territorial inhabitants. As a result, each territory has freely chosen different types of political status based on its unique characteristics and needs. Since that time, only the Territory of Alaska and the Territory of Hawaii have applied for and achieved statehood. Since 1959, when Alaska and Hawaii became states, there have been no incorporated territories.

The United States currently has 13 unincorporated insular areas, including American Samoa, the CNMI, Guam, Puerto Rico, and the USVI. Each of these territories is generally governed by a separate contractual document entered with the U.S. government. Under these documents, U.S. territories have general authority over their internal affairs, while the United States controls foreign relations, interstate trade, currency, military issues, communications, agriculture, and Social Security.

Each territory's political relationship with the U.S. is somewhat similar to that of a state, but each relationship also differs in some key respects.

Territory Contractual/ Statutory Documents

American Samoa: There is no organic act or covenant between American Samoa and the United States. American Samoa is managed by the Secretary of the Department of Interior, who in turn, allowed American Samoa to draft its own constitution under which its government functions.

CNMI: "*The Covenant to Establish a Commonwealth of the Northern Mariana Islands in Political Union with the United States of America*," 48 U.S.C. §1801 et seq. Article VI of the Covenant pertains to Revenue and Taxation. The complete text of the Covenant can be accessed at <http://www.cnmilaw.org/covenant.htm>

Guam: "*The Guam Organic Act of 1950*," 48 U.S.C. §1421, designated Guam as a U.S. unincorporated territory. Section 1421h and section 1421i of the Act pertains to tax issues. The complete text of the Act can be accessed at: http://www.law.cornell.edu/uscode/usc_sup_48_10_8A_20_I.html

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Introduction, Continued

**Territory
Contractual/
Statutory
Documents,
(continued)**

Puerto Rico: The *Puerto Rico-Federal Relations Act*,” 48 U.S.C. §731 et seq., frames the relationship between Puerto Rico and the U.S. government.

U.S. Virgin Islands: The *1936 Organic Act*,” 48 U.S.C. §1405 et seq., amended by “*The Revised Organic Act of 1954*,” 48 U.S.C. §1541 et seq. frames the relationship between the USVI and the United States.

**Types of Tax
Systems in U.S.
Territories**

American Samoa, the CNMI, Guam, Puerto Rico, and the USVI each have their own independent taxing authorities and each imposes its own income taxes on residents. Technically, these income laws do not supplant U.S. federal tax laws, but rather by a series of gross income exemptions specific to each territory, the United States cedes primary taxing jurisdiction to territory taxing authorities as it concerns their bona fide residents. See Sections 931 (American Samoa), 932 (USVI), 933 (Puerto Rico), 935 (Guam and CNMI), and 937(a), and the regulations thereunder for determining when individuals qualify as bona fide residents).

U.S. territories and local governments located in the U.S. territories may issue tax-exempt debt. The tax-exempt bonds are issued and sold in the U.S. bond market. As such, the bonds are subject to regulations under the U.S. regulatory and legal system, in addition to any applicable laws of the respective territories in which their issuers may be located.

While the tax laws of each jurisdiction are unique, they do have key similarities.

Puerto Rico has codified its own tax system. However, its system bears many similarities to the U.S. IRC. Puerto Rico is the U.S. territory with the largest population and greatest amount of tax-exempt debt issuance.

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Introduction, Continued

Types of Tax Systems in U.S. Territories, (continued)

Three of the territories – the CNMI, Guam, and the USVI – have each adopted a “mirrored” version of the U.S. Internal Revenue Code, which is referred to as a “territorial” income tax. Under this system, the territory has not entirely codified the U.S. Code as a local territorial income tax, but instead uses the U.S. Code with appropriate substitutions in language. For example, if the U.S. Code states that certain income is sourced within the United States, in imposing its mirrored code, Guam, for example, would substitute “Guam” for the “United States.”

American Samoa has not technically adopted a “mirrored” U.S. Code, like the CNMI, Guam, and the USVI. Instead, it has adopted as its income tax laws the income tax laws in force in the United States on December 31, 2000. For example, the tax rates, standard deduction, and personal exemption in American Samoa are the same as they were in the U.S. Internal Revenue Code in force on December 31, 2000. Therefore, American Samoa’s tax system differs from those U.S. territories with a mirrored code because any amendments to the U.S. Code after 2000 are not applicable for purposes of American Samoa’s territorial income tax.

Tax Coordination Agreements and Memorandums of Understanding

Tax Coordination Agreements (TCAs)

The IRS has entered “tax coordination” or “tax implementation” agreements (TCAs) with each of the five major U.S. territories – American Samoa, the Commonwealth of the Northern Mariana Islands, Guam, Puerto Rico, and the U.S. Virgin Islands. Legally, TCAs are not deemed tax treaties. They are a combination of a tax information exchange agreement and a section 6103(d) agreement. They are not ratified by the U.S. Congress, and they are signed by the IRS Commissioner.

TCAs were entered for the IRS and the territory tax department to exchange information, provide mutual assistance to prevent the evasion and avoidance of tax, provide mutual assistance and training, and overall to develop and improve tax administration systems and procedures. The terms of the TCAs are subject to provisions of U.S. and territory statutes, regulations, and published procedures.

IRS Resources, including Exchange of Information Programs

Deputy Commissioner (International), LB&I

International Division of LB&I provides leadership and guidance to IRS operating divisions on international matters. It focuses on promoting efficient and effective international tax administration by helping taxpayers operating internationally to understand and meet their tax responsibilities.

International Division of LB&I is responsible for timely and effective communication of U.S. tax treaties and tax information exchange agreements. International Division of LB&I pursues increased global coordination, identifies emerging international issues, provides tax assistance to U.S. taxpayers residing overseas, and, when requested, assists foreign governments in strengthening their internal tax systems.

Included within International Division is the U.S. Territories Program.

U.S. Competent Authority

The term “U.S. competent authority” refers to the designated representative of the United States for purposes of carrying out tax treaties. The IRS Deputy Commissioner, International, is designated as the “Competent Authority” for the United States under international tax treaties. As mentioned above, the U.S. Territories Program is designated as the competent authority for tax issues related to U.S. territories and possessions.

U.S. Territory Program

The U.S. Territories Program represents the U.S. competent authority on territory tax issues and coordinates:

- Technical issues resulting from certain U.S. Code sections unique to the U.S. territories
- The administration of the TCAs with each U.S. territory tax department
- Technical issues that cross IRS operating divisions, including cover over payments to the territory tax departments

This office is the primary IRS liaison with the U.S. territory and insular area tax departments, the U.S. Treasury, Department of Interior, and other federal agencies. It takes the lead in resolving income tax issues involving the U.S. territories.

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IRS Resources, including Exchange of Information Programs, Continued

U.S. Territory Program (continued)

Two IRS offices are responsible for the Service's relationship with the U.S. territory tax agencies:

- SBSE's Governmental Liaison & Disclosure (GLD)
- LB&I's Deputy Commissioner International (INTL)

These offices coordinate technical issues, including exchange of information requests, resulting from certain U.S. Code sections unique to the U.S. territories, as well as technical issues that cross IRS operating divisions.

Note: The U.S. Territories Program office handles all tax issues relating to American Samoa, the CNMI, Guam, Puerto Rico, and the USVI, as well as the Republic of the Marshall Islands, Federal States of Micronesia, and Republic of Palau.

No Direct Contact with U.S. Territory Tax Officials

Under no circumstances should IRS employees contact a U.S. territory government tax official in connection with an examination or investigation without first clearing the contact with the U.S. Territories Program.

As the U.S. competent authority, the Deputy Commissioner (International), LB&I, is the only person authorized to exchange information with other tax authorities (except as redelegated to the Director, Treaty Administration and International Coordination).

It is an unauthorized disclosure for anyone to provide tax returns or return information directly to a tax official of a U.S. territory, if they are not specifically authorized to do so.

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IRS Resources, including Exchange of Information Programs, Continued

TEB procedures for initiating activity in U.S. Territories

The U.S. Territories Program is responsible for coordination of all Service activities within the U.S. territories. These include examinations and other compliance initiatives, as well as outreach efforts. The U.S. Territories Program Manager is responsible for alerting territory tax officials to planned Service activities. They can also handle any procedural arrangements which may be necessary. Prior to commencing any compliance or other activity, such as an examination of a tax-exempt bond issued within a U.S. territory, TEB should contact the U.S. Territories Program Manager and alert them to the planned activity.

In the event official travel is required to a U.S. territory, the U.S. Territories Program Manager can coordinate travel arrangements and will obtain the appropriate official U.S. government passports where necessary.

Mutual Agreement Procedures

The TCAs authorize mutual assistance with regard to the U.S. territories. The Service has established cooperative programs (or so-called “mutual agreement procedures”) to resolve tax disputes arising from inconsistent positions taken by the Service and a U.S. territory tax agency. Taxpayers can request competent authority assistance when they consider that actions of the United States, a territory, or both result or will result in taxation that is contrary to the provisions of a TCA.

Rev. Proc. 2006-23

Rev. Proc. 2006-23, 2006-1 C.B. 900, provides guidance on the U.S. territory mutual agreement procedures with the U.S. Competent Authority relating to U.S. territory tax matters. This revenue procedures outlines the timing for making a competent authority request, the place for filing, information required, small case procedures, coordination with other judicial or administrative procedures, the role of IRS Appeals, protective measures, withdrawals, and fees.

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IRS Resources, including Exchange of Information Programs, Continued

Exchange of Information Requests

The TCAs also include various provisions for the exchange of information (EOI) and mutual assistance with respect to taxes in order to prevent the evasion or avoidance of taxes due to either of the two signatory governments.

To make a formal EOI request to obtain territory-based information, an agent should contact his or her manager who will then contact the TE/GE function's subject matter expert (SME), as indicated on the TE/GE international web pages. The SME will make direct contact with the LB&I U.S. Territories Program Manager. Under no circumstances should an employee make direct contact with a U.S. territory tax department.

Obtaining Tax Information from U.S. Territory Tax Agency

Since information returns related to tax-exempt bonds issued by U.S. territories are submitted directly to the IRS in the United States, copies of those returns may be obtained from within the records of the IRS, without requiring any special procedures. These include form 8038 and related filings, such as Form 8038-G, 8038-T, 8038-B, etc.

However, there may be instances where we need to obtain information from a borrower that is not available through information filings related to the bond issue. For example, an examiner may wish to review the tax return of a conduit borrower to verify the type of depreciation used for a private activity bond project. In this case, the examiner must follow special procedures to request the information from the U.S. territory tax agency.

To obtain tax information from a U.S. territory tax agency under exchange of information provisions of a TCA, the employee will:

- Complete a Form 8796, *Request for Return Information*. Form 8796 Section C, Block 3 (Signature/Authorized Representative) must be legible and contain the name and signature of an IRS employee that is authorized to "request and receive" income tax information from a U.S. territory tax agency.
- Obtain the appropriate approval for the request
- Submit the Form 8796 to the appropriate Disclosure Office

It generally takes about 30 to 60 days to receive a reply to an EOI request.

Applicability of U.S. Income Tax Rules

Authority for Issuance of Tax Exempt Bonds

Section 103 of the Code provides that interest on state and local bonds is not included as gross income on federal tax returns. Section 103(c)(2) specifies the term “state” includes any possession of the United States.

Therefore, governmental issuers in the U.S. territories are entitled to issue the same types of tax-exempt and tax-advantaged debt as issuers in the fifty states and the District of Columbia. All the Regulations governing tax-exempt bond issuance (§§ 103, 141-150, etc.) will also apply to these types of bonds when they are issued by governmental issuers located in the U.S. territories.

Issuance of Debt by U.S. Territory State or Local Government

As discussed above, U.S. territory governments and their associated entities are permitted to issue tax-exempt bonds in the U.S. capital markets.

The IRS Office of Tax Exempt Bonds is responsible for overseeing compliance with the federal regulations concerning issuance of tax-exempt bonds. This authority also includes those obligations of U.S. territories.

If the government of Puerto Rico wanted to raise capital for new infrastructure projects, it could do so by selling tax-exempt bonds. Eligible projects might include highways, bridges, water and sewer projects, public buildings, and various other projects with a governmental purpose. Either the government itself or one of its authorized governmental agencies would issue the bonds. The bond issue would be sold to investors and the proceeds used to pay for the costs of the project.

Tax-exempt bonds, issued by U.S. territories, are sold in the United States, to U.S. investors, including individuals and institutional buyers (e.g. mutual funds, insurance companies). The interest on the bonds is considered tax-exempt, and is not included as gross income on the investor’s tax returns. In turn, the governmental issuer benefits from paying a lower interest rate on the debt, since the bonds bear a lower interest rate than taxable bonds when their interest is tax-exempt.

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Applicability of U.S. Income Tax Rules, Continued

Volume Cap for Private Activity Bonds

The regulations contain a special rule for determining volume cap for private activity bonds, in § 146(d)(4). This rule applies only to U.S. territories or possessions with a population less than that of the least populous U.S. state. For those possessions, the per capita volume cap limitation in any given year is determined by dividing the minimum allocated state ceiling amount by the population of the least populous U.S. state. The per capita amount is then multiplied by the population of the U.S. possession to determine the maximum private activity bond volume cap for that possession.

The volume cap limitation for private activity bonds for U.S. territories is published annually in a revenue procedure which sets forth various inflation adjustments for the following calendar year. The amounts for 2017 pertaining to § 146(d) are published in Rev. Proc. 2016-55, which sets the state ceiling for private activity volume cap at the greater of \$100 multiplied by the state population or \$305,315,000 per state.

Public Approval Requirement

Private activity bonds issued by U.S. territories are subject to the same public approval requirements as bonds issued within the United States. This is commonly known as the TEFRA requirement since it was added to the Code by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

The public approval requirements for private activity bonds are contained in § 147(f), which states that in order to be a qualified bond, the issue must be approved by:

- 1) The governmental unit which issued the bond or on behalf of which the bond was issued, AND
- 2) Each governmental unit having jurisdiction over the area in which the facility financed by the bond is located.

The regulations contain a definition in § 5f.103-2(g)(1) of a governmental unit for purposes of the public approval requirement, which states that the term governmental unit has the same meaning as in § 1.103-1. Thus, a governmental unit can be a U.S. possession, or any political subdivision thereof.

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Applicability of U.S. Income Tax Rules, Continued

Consistent Definition of State to include U.S. Possessions

In the regulations covering tax-exempt bonds, the term ‘state’ is consistently defined to include U.S. possessions. For example, in the regulations covering qualified tax credit bonds, this definition appears in § 54A(e)(3), which specifies that the term ‘state’ includes any possession of the United States.

Other Volume Cap Allocations

The U.S. territories or possessions are included in national volume cap allocations for several different types of bonds. Notice 2009-50 sets forth the allocations of \$10 billion of Recovery Zone Economic Development Bonds and \$15 billion of Recovery Zone Facility Bonds. The allocations in the notice include amounts for the five key territories, American Samoa, Guam, Northern Mariana Islands, Puerto Rico and the Virgin Islands. The Notice specifically references § 103(c)(2), as it applies to §§ 1400U-1 through 1400U-3, in that it provides that the term ‘state’ includes the District of Columbia and U.S. possessions.

Likewise, Notice 2016-20 sets forth the maximum face amount of Qualified Zone Academy Bonds (QZABs) that may be issued for each of the key territories for the calendar years 2015 and 2016.

Foreign vs. Domestic Corporation Classification

In general, a corporation formed in or organized under the laws of a U.S. territory is deemed a foreign corporation for U.S. tax purposes. See §§ 7701(a)(5) and 7701(a)(9).

Corporations created at U.S. embassies, military bases, legations, consulates, and the like that are located in a foreign country may also be deemed domestic corporations under § 7701. See Rev. Rul. 68-521, 1968-2 C.B. 600, and Rev. Rul. 70-310, 1970-1 C.B. 209

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Applicability of U.S. Income Tax Rules, Continued

**Employer
Identification
Number
Assignment**

The IRS assigns a “66” prefix to TINs issued to organizations formed in a U.S. territory.

**Applicability of
U.S. Tax
Treaties**

U.S. tax treaties typically do not apply to the U.S. territories because the treaty definition of “United States” does not include territories. Thus, benefits provided under tax treaties - i.e., reduced withholding tax rates - do not extend to U.S. territory residents.

U.S. territories do not have the authority to enter tax treaties with foreign countries.

Additional Resources

All Islands Tax Administrators

The All Island Tax Administrator's Association (AITAA) is an association comprised of high ranking representatives from the tax departments of several U.S. territories, including American Samoa, the CNMI, Guam, Puerto Rico, and the USVI, as well as the Republic of the Marshall Islands, Federal States of Micronesia, and Republic of Palau. The AITAA generally meets twice per year with the IRS, through the LB&I Territories Program office. At these meetings, AITAA members provide updates on current tax issues in their respective jurisdictions, and the IRS, U.S. Treasury, and Department of Interior provide the territory tax departments with significant updates in U.S. tax and economic laws affecting the territories.

U.S. Territory Tax Department Websites

American Samoa Tax Division: <http://www.americansamoa.gov>

CNMI Division of Revenue and Taxation: <http://www.cnmidof.net/rev/>

Guam Department of Revenue and Taxation: <https://www.guamtax.com/>

Puerto Rico Departamento de Hacienda: <http://www.hacienda.gobierno.pr/>

Virgin Islands Bureau of Internal Revenue: <http://www.vibir.gov/>

IRS Publications

Publication 570, *Tax Guide for Individuals With Income From U.S. Possessions*. This publication deals with tax issues relating to individuals. However, it is also useful in sorting through other U.S. territory tax issues, including the residence of employees for withholding tax purposes, sourcing of income, and contact information for territory tax authorities.

Publication 1321, *Special Instructions For Bona Fide Residents Of Puerto Rico Who Must File A U.S. Individual Income Tax Return (Form 1040 or 1040A)*.

Summary

Review of Lesson 4

The U.S. territories have a unique relationship with the United States. There are some key resources available, primarily the LB&I U.S. Territories Program office. This office represents the U.S. competent authority on territories tax issues, coordinates various tax-related issues with the territories, and can facilitate exchange of information requests for territory-based information.

Tax-exempt bonds issued by state and local governments and their agencies located in the U.S. territories are subject to the same regulatory framework as if they had been located within the United States. However, certain protocols may be necessary when communicating with U.S. territory government officials, and it is important to enlist the assistance of the U.S. Territories Program prior to engaging in any official activity.

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