

Office of Chief Counsel
Internal Revenue Service
Memorandum

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to:

(Small Business/Self-Employed)

from: Ricardo A. Cadenas
Chief, Branch 7
(International)

subject: Calculation of Military Cover Over Amounts to Guam with Regard to Jointly-Filed
Income Tax Returns

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

- (1) In the case where a military employee is married to and filing jointly with a working non-military spouse, should the entire net tax [shown] on the jointly filed account be covered over to [Guam under I.R.C. § 7654 (Internal Revenue Code of 1954),] or should only the tax attributable to the military employee be covered over?
- (2) Would the definition of the term "Net Collections" as it relates to Section 7654 include the income taxes imposed on the income attributable to the non-military spouse of a jointly-filed return?

- (3) Does the military member's State of Legal Residence designation convey to their non-military spouse?

CONCLUSIONS

- (1) The response to this question varies according to the specific facts and circumstances surrounding a jointly-filed income tax return. Therefore, please refer below to the discussion of various factual situations.
- (2) The term "Net Collections" under section 7654(a) generally includes the income taxes imposed on the income attributable to the non-military spouse on a jointly-filed return. However, please see below for further discussion of the issue.
- (3) The "State of Legal Residence" or "Home of Record" of members of the U.S. Armed Forces does not generally apply to the non-military spouse, under the SCRA. However, please see below for further discussion of the issue.

FACTS

Our responses in this memorandum focus specifically on Guam. Notwithstanding, because the Commonwealth of the Northern Mariana Islands (the "CNMI") Covenant provides that the income tax rules of the CNMI are to mirror the Internal Revenue Code (the "Code") in the same manner "as those laws are in force in Guam", our analysis concerning Guam applies equally to the CNMI.¹ Based on the legal principles discussed below, we will analyze various scenarios involving the processing of joint returns where the U.S. Armed Forces employs one spouse who is either a bona fide resident of Guam, or who is stationed in Guam, and files a joint return with the Internal Revenue Service.

If, under I.R.C. § 7654(d), income tax amounts deducted and withheld from income attributable to military personnel stationed in Guam are previously covered over to Guam, then the amounts determined in each of the fact patterns described below should be adjusted to prevent duplicate cover over. The fact patterns we consider are as follows:

Fact Pattern #1:

The military employee is stationed in Guam during a full calendar year. The military employee and his non-military spouse are both residents of a U.S. State (e.g., Texas).

¹ See CNMI Covenant, Article VI, Revenue and Taxation, Section 601. Also, because neither the CNMI nor Guam has entered a "tax implementing agreement" with the federal government regarding rules for the prevention of tax evasion, the elimination of double taxation, and the exchange of tax information, the Internal Revenue Code of 1954 continues to apply to these possessions. See H.R. REP. NO. 99-841 (1986), *reprinted in* 1986 U.S.C.C.A.N. 4075, 4769. Accordingly, unless otherwise stated, all references to the Code shall be to the Internal Revenue Code of 1954.

Both husband and wife live and work in Guam. The couple files a joint return with the IRS pursuant to I.R.C. § 935(b).

Fact Pattern #2:

The military member is stationed in Guam and he and his non-military spouse are both residents of Guam. Both husband and wife live and work in Guam. The couple files a joint return with the IRS.

Fact Pattern #3:

The military member is a resident of Guam and is stationed in a U.S. State (e.g., Texas). The military member is married, and husband and wife are residents of Guam for tax purposes. Both spouses live and work in Texas. The couple files a joint return with the IRS.

LAW AND ANALYSIS

Under the provisions of section 935 of the Code, residents of Guam are required to file income tax returns with Guam, but not with the United States. Similarly, citizens of Guam who are not otherwise citizens of the United States are required to file an income tax return only with Guam. See I.R.C. § 935(b). Residents of the U.S. mainland who derive income from Guam are not required to file income tax returns under Guam's territorial tax law; they satisfy any potential Guamanian income tax liability on Guam-source income by filing with the United States. See *id.*

Section 935 also allows the filing of a joint return for Guam taxpayers. It provides that the residence and citizenship of the spouse who has the greater adjusted gross income (AGI) for the taxable year determines where the joint return shall be filed. See I.R.C. § 935(b)(3).

Section 7654 provides for the division of income taxes between the United States and Guam and states that net collections attributable to Guam-source income shall be covered into the treasury of Guam. See I.R.C. § 7654(a)(2). However, this section only applies to individuals for a taxable year if section 935 applies to such individual and, in the context of a joint return, such individual and his spouse have an AGI of \$50,000 or more and gross income of \$5,000 or more derived from sources within the jurisdiction (either the United States or Guam) with which the individual is not required under section 935(b) to file his return for the year. See I.R.C. § 7654(a).

With respect to any inconsistency between section 7654, the regulations, and the Organic Act of Guam, Treas. Reg. § 301.7654-1(a) states as follows:

- (1) Section 7654 and this section set forth the general procedures to be followed by the Government of the United States and the Government of Guam in the division between the two governments of revenue derived from collections of the income taxes imposed for any taxable year

beginning after December 31, 1972[.] To the extent that section 7654 and this section are inconsistent with the provisions of section 30 of the Organic Act of Guam (48 U.S.C. 1421h), relating to duties and taxes to be covered into the treasury of Guam and held in account for the Government of Guam, such section 30 is superceded.

The United States covers over to Guam the net collections of income tax on the compensation paid to military personnel stationed in Guam, even though they have no income tax liability to Guam with respect to such compensation by reason of the Servicemembers Civil Relief Act (the "SCRA").² See I.R.C. § 7654(d). Thus, there is always cover over with respect to the income tax revenue generated from the compensation of the military spouse who is stationed in Guam, without the application of the threshold amounts referenced in I.R.C. § 7654(a). See Treas. Reg. § 301.7654-1(c)(1)(ii). In determining "net collections of income taxes", an "allocation" may be necessary based upon the source of income reported on the joint return (either the United States or Guam) in accordance with procedures set forth in Treas. Reg. § 301.7654-1(b).

The Code source rules indicate that source of compensation is determined by reference to the location where the services are performed. Compensation for personal services performed in the United States is considered as having a source within the United States. See I.R.C. § 861(a)(3). Likewise, compensation for personal services performed in Guam is considered Guam-source income.

Section 908 of the American Jobs Creation Act, Pub. L. 108-357, which added section 937 to the Internal Revenue Code of 1986, affects the rules on residency in U.S. Possessions, including Guam and the CNMI. Section 937 also provides rules for determining when income is considered to be from sources within a U.S. Possession and whether income is effectively connected with the conduct of a trade or business within any U.S. possession. Section 937 is applicable for tax year 2004 and beyond with a transition period for residency reporting that includes an individual's three taxable years ending before the end of such individual's 2004 tax year. We limit our analysis to the cover over of income taxes between the United States and Guam where the residency of the individual is established, and do not purport to analyze factors bearing on residency under section 937.

Conclusion to Fact Pattern #1:

In this situation, husband and wife should file a joint income tax return where they are considered residents for the taxable year according to the single-filing rule of section 935. Therefore, husband and wife would appropriately file their joint return with the IRS Service Center corresponding to Texas.

² The SCRA, 50 App. U.S.C., sec. 571(Residence for Tax Purposes), provides that military personnel will maintain their State or territorial domiciliary status for tax purposes while they are absent from the State or territory in question on military duty.

Both spouses earn income while working in Guam, and there is withholding by the United States on the compensation paid on account of the military spouse. Under I.R.C. § 7654(d), the U.S. Treasury would cover the tax revenue from the income on the military member over to the Guam treasury.

If both spouses report and pay taxes to the IRS for their full tax liability shown on a joint income tax return, an allocation may occur depending on whether the threshold amounts of I.R.C. § 7654(a) are met. Where the couple has an AGI that does not meet the minimum threshold amounts, an allocation would be necessary and the U.S. Treasury would cover over to Guam the portion of the income tax revenue on the joint return attributable to the income of the military spouse and not cover over the portion of the income tax revenue attributable to the income of the non-military spouse. See Treas. Reg. § 301.7654-1.

In contrast, where the couple has an AGI that meets the minimum threshold amounts, the tax revenue from the income of the spouses shall be allocated by source. Here, where both husband and wife live and work in Guam, an allocation would not be necessary and the U.S. Treasury would cover over to Guam the income tax revenue on the joint return attributable to the income of both spouses. See I.R.C. §§ 7654(a), (d). If the joint return filed with the IRS indicates that the Guamanian employer withheld income taxes from the wages of the non-military spouse and paid such amounts to the Guam treasury, then the IRS would need to make an adjustment in its determination of “net collection” to be covered over, reflecting that such withholding amount has already been “paid” to Guam.

Conclusion to Fact Pattern #2:

In this situation, husband and wife should file a joint income tax return where they are considered residents for the taxable year according to the single-filing rule of section 935. Thus, they should have filed their joint return with the Guam treasury. Nonetheless, we are addressing the situation where the couple erroneously files a joint income tax return only with the IRS. The cover over determination is substantially the same as that of Fact Pattern #1, above. However, apart from the cover over determination by the IRS, the Guam treasury may seek compliance from the taxpayers who fail to comply with tax filing obligations owed to Guam.

Both spouses earn income while working in Guam, and the United States withholds on the compensation paid on account of the military spouse. The U.S. Treasury would cover over to the Guam treasury the net collection of income taxes attributable to the compensation paid to the military member. If the joint return filed with the IRS indicates that the Guamanian employer withheld income taxes from the wages of the non-military spouse and paid such amounts to the Guam Treasury, then an adjustment is necessary in computing cover over to Guam to account for the fact that Guam has received a portion of the total tax liability corresponding to the joint return. Thus, the cover over amount should equal the total tax liability shown on the joint return less withholding amounts already paid to Guam.

If, however, both spouses report and pay taxes to the IRS for their full tax liability shown on a joint income tax return, an allocation may occur depending on whether the threshold amounts of I.R.C. § 7654(a) are met. Where the couple has an AGI that does not meet the minimum threshold amounts, an allocation would be necessary and the U.S. Treasury would cover over to Guam the portion of the income tax revenue on the joint return attributable to the income of the military spouse and not cover over the portion of the income tax revenue attributable to the income of the non-military spouse.

In contrast, where the couple has an AGI that meets the minimum threshold amounts, the tax revenue from the income of the spouses shall be allocated by source. Here, where both husband and wife live and work in Guam, an allocation would not be necessary and the U.S. Treasury would cover over to Guam the income tax revenue on the joint return attributable to the income of both spouses. See I.R.C. §§ 7654(a), (d).

Conclusion to Fact Pattern #3:

In this situation, husband and wife should file a joint income tax return where they are considered residents for the taxable year according to the single-filing rule of section 935. Thus, the couple should have filed their joint income tax return with the Guam Treasury. Nonetheless, we are addressing the situation where the couple erroneously files a joint income tax return only with the IRS. Aside from the cover over determination by the IRS discussed below, the Guam treasury may seek compliance from the taxpayers that fail to comply with tax filing obligations owed to Guam.

Under the SCRA, the military spouse is not considered to have lost residency in, or to be absent from, Guam for tax purposes when present in the United States on military orders. Thus, the portion of the income tax revenue on the joint return attributable to the income of the military spouse would be covered over to the treasury of Guam. The IRS has historically covered over to Guam net collections of taxes with respect to members of the Armed Forces who maintain a “home of record” in Guam, without the limitations of the AGI thresholds of section 7654. The compensation earned in the United States by the non-military spouse is considered U.S.-source income. Accordingly, the portion of the total amount of tax indicated on the joint return corresponding to the non-military spouse would be considered allocable to U.S. source income, and that portion of the tax is not subject to cover over.

We note that if husband and wife had correctly filed a joint return with Guam and paid the income tax to Guam, then the portion of income tax reported on the return and attributable to the non-military spouse would require the treasury of Guam to cover over such amount to the U.S. Treasury, in cases where the thresholds of section 7654 are met.

Would the definition of the term “Net Collections” as it relates to Section 7654 include the income taxes imposed on the income attributable to the non-military spouse of a jointly-filed return?

The term “Net Collections” under section 7654(a) generally includes the income taxes imposed on the income attributable to the non-military spouse on a jointly-filed return. Where a joint return has been filed, as provided for in sections 935(a)(4) and (b)(3) and Treas. Reg. § 1.935-1(b)(2), and one spouse is not an individual described in section 935(a)(1), (2) or (3), then net collections shall include income taxes collected on account of a joint return, only when the spouse with the higher AGI is an individual as described in section 935 (a)(1), (2) or (3). Net collections shall not include income taxes collected on account of a joint return when the spouse indicating the higher AGI is not an individual as described in section 935(a)(1), (2) or (3).

We note, however, that section 7654(d) provides for additional cover over with respect to income taxes “deducted and withheld” from the compensation paid to certain military personnel stationed in Guam. Thus, there is cover over to Guam with respect to such an individual, notwithstanding that he or she may not indicate the higher AGI on a joint return. There are many possible variations in facts, so please refer to the above fact patterns that describe some commonly occurring situations.

Does the military member’s State of Legal Residence designation convey to their non-military spouse?

The “State of Legal Residence” or “Home of Record” of members of the U.S. Armed Forces does not generally apply to the non-military spouse, under the SCRA. However, in a situation where the non-military spouse is a resident of a State (e.g., Texas), and both spouses move from Texas to a U.S. Possession (e.g., Guam), it is possible that both spouses could claim that they are residents of Texas for federal tax purposes. See Treas. Reg. § 1.935-1(b)(1). Also, note that we refer to the residence of the spouse with the higher AGI in making the determination of whether a joint return should be filed with the United States (or Guam). See I.R.C. § 935(b)(3).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



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Please call (202) 435-5262 if you have any further questions.

By: _____
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