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OPINION

TO: Director, Department of Administration
FROM: Attorney General [Signature]
SUBJECT: Income Taxation of COLA Certificates; COLA Payments; and Interest

Question Presented

Whether payments issued pursuant to the COLA Certificates, COLA payments, and interest paid pursuant to Superior Court Case No. SP0206-93 is subject to taxation under the Guam Territorial Income Tax.

Answer

Yes. Amounts received as payment pursuant to the issuance of the COLA certificates, COLA payments, as well as the payment attributed to interest is considered gross income pursuant to Guam Territorial Income Tax §61 and is subject to taxation under the income tax code.

Discussion

PL 29-18 provides for the issuance of Certificates of Claim to each COLA awardee. Section 2 of law adds a new subsection (d) to 5 GCA §6404. Specifically, 5 GCA §6404(d)(2) provides that upon redemption of these certificates the entire amount paid "shall be exempt from any and all Guam taxes." (Emphasis in original). The redemption amount includes not only the principal amount of the COLA payment, but 7% interest per annum as allowed on undisputed unpaid government claims.

A. Guam Territorial Income Tax ("GTIT")

The U.S. income tax laws in force in the United States are applicable to Guam pursuant to 48 USC §1421i. 48 USCA §1421i(a) provides:

The income-tax laws in force in the United States of America and those which may hereafter be enacted shall be held to be likewise in force in Guam: *Provided*, That notwithstanding any other provision of law, the Legislature of Guam may levy a separate tax on all taxpayers in an amount not to exceed 10 per centum of their annual income obligation to the Government of Guam.

(emphasis added).

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Opinion binder

This income tax, payable to the government of Guam, is referred to as the "Guam Territorial Income Tax" ("GTIT"). 48 USCA §1421i(b). In applying the GTIT, except as manifestly otherwise required, the applicable provisions of the Internal Revenue Codes of 1986 and 1939, shall be read to substitute "Guam" for the "United States", "Governor or his delegate" for "Secretary or his delegate", as well other applicable substitutions as specified In the Organic Act. 48 USCA §1421i(e). This substitution process is commonly referred to as "mirroring". *Sayre & Co. v. Riddell*, 395 F2d 407 (9th Cir. 1968).

As further noted in *Sayre*:

The general conclusion that we draw from the available evidence, then, is that Congress intended that Guam should apply the Internal Revenue Code (with those deletions prescribed by section 1421i(d)(1)) to persons and income within its territory just as the United States applies the Code to persons and income within its territory.

The interpretative omissions and substitutions of language authorized by section 1421i(d)(1) and (e) are those which are necessary to effectuate this intention. We may not adopt a construction inconsistent with it, as we did in *Atkins-Kroll*, simply because we consider the result more equitable. *Deviations from the intended dual structure by substantive revision of the basic scheme of the Code as applied to Guam must be left to Congress.*

Sayre & Co. v. Riddell, 395 F.2d 407, 412 -413 (9th Cir. 1968) (fn omitted; emphasis added).

As such, the Government of Guam does not have authority to amend, or deviate from the GTIT. Only the U.S. Congress may amend such provisions. Therefore, any tax exemptions provided by the Guam Legislature in P.L. 29-18 with respect to *income* tax is inapplicable to the extent such income is not otherwise specifically exempted from taxation under the GTIT.

B. PL 29-18

1. Principal Payment Amounts

PL 29-18 provides for the issuance of Certificates of Claim to each COLA awardee. Section 2 of law adds a new subsection (d) to 5 GCA §6404. Specifically, 5 GCA §6404(d)(2) provides that upon redemption of these certificates the entire amount paid "*shall be exempt from any and all Guam taxes.*" (Emphasis in original). The redemption amount includes not only the principal amount of the COLA payment, but 7% interest per annum as allowed on undisputed unpaid government claims.

With respect to the principal amount of the COLA award, such amount constitutes "gross income" and will be subject to taxation unless the GTIT specifically exempts such from income.¹ The Income Tax Regulations, specifically 26 C.F.R. §1.61-11, provides in part:

¹ GTIT §61 provides in part:

- (a) Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:
- (1) Compensation for services, including fees, commissions, fringe benefits, and similar items;
 - (2) Gross income derived from business;
 - (3) Gains derived from dealings in property;
 - (4) Interest;
 - (5) Rents;
 - (6) Royalties;

Pensions and retirement allowances paid either by the Government or by private persons constitute gross income unless excluded by law. Usually, where the taxpayer did not contribute to the cost of a pension and was not taxable on his employer's contributions, the full amount of the pension is to be included in his gross income. But see sections 72, 402, and 403, and the regulations thereunder.

While such payments, if made by a "qualified pension, profit-sharing and stock bonus plan" under GTIT §401 *et seq.* may normally be exempt from taxation, in this particular case, the COLA payment is not a payment made from a qualified plan.

In this particular case, the COLA payment is made pursuant to 4 GCA §8137.1, as enacted by PL 19-19. That provision provides for a cost of living allowance to be paid out of the General Fund and administered by the Retirement Fund. Because the funds are paid out of the General Fund, as opposed to a qualified pension plan granted tax exempt status pursuant to GTIT §401 *et seq.*, such payments are not deemed to be issued pursuant to a "qualified plan". As the payment would not be excluded from income taxation under GTIT §402 or §403, and would be taxable to the extent the recipient's adjusted taxable income exceeds a certain threshold under the GTIT.

2. Interest Payment Amount

The 7% interest paid on the COLA award would also be considered "gross income" for the purposes of GTIT §61. See GTIT §61(a)(4) (providing that "gross income" includes interest). Such amount will likewise be taxable to the extent the recipient's adjusted taxable income exceeds a certain threshold under the GTIT.

3. Interest Exclusion under GTIT §103

A question has arisen as to whether the COLA certificates would constitute a state or local bond under GTIT §103, thus excluding the interest awards from gross income. The COLA certificates are similar to the tax certificates discussed in *Hernandez v C.I.R.*, T.C. Memo 1998-46 ("Hernandez I") and *Hernandez v. C.I.R.*, T.C. Memo 1998-329 ("Hernandez II"). At issue in those cases was whether interest received upon the redemption of tax certificates sold at public auction would be excluded from gross income by the purchaser under I.R.C. §103(a) as interest earned on a State or local obligation. The Tax Court declined to hold that such interest was excludable from taxation and noted:

In *Hernandez I*, we held that interest earned on a Florida tax certificate is not excluded from petitioner's gross income under section 103. We held that a Florida tax certificate is not an obligation of the State of Florida or a political subdivision for purposes of section

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- (7) Dividends;
 - (8) Alimony and separate maintenance payments;
 - (9) Annuities;
 - (10) Income from life insurance and endowment contracts;
 - (11) Pensions;
 - (12) Income from discharge of indebtedness;
 - (13) Distributive share of partnership gross income;
 - (14) Income in respect of a decedent; and
 - (15) Income from an interest in an estate or trust.

(emphasis added).

103(c), because it is not issued by a municipality as an exercise of its sovereign borrowing power.

Hernandez v. C.I.R., T.C. Memo 1998-329, 1998 WL 643643, 2 (U.S.TaxCt., 1998).

Hernandez I explained the purpose of the §103 exclusion as follows:

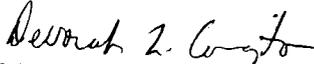
Consistent with the notion that exclusions from gross income are to be construed narrowly, *Commissioner v. Schleier*, 515 U.S. 323, 328, 115 S.Ct. 2159, 132 L.Ed.2d 294 (1995); *Harbor Bancorp & Subs. v. Commissioner*, 105 T.C. 260, 287, 1995 WL 605411 (1995), affd. 115 F.3d 722 (9th Cir.1997), not all interest-bearing obligations issued by State and local governments qualify as section 103(c)(1) obligations. Courts have long held that, in order to entitle the holder to an exclusion from gross income for interest earned thereon, the subject obligation must have been issued by the State or political subdivision as an exercise of its sovereign borrowing power. See, e.g., *Stewart v. Commissioner*, 714 F.2d 977, 981-982 (9th Cir.1983), affg. T.C. Memo.1982-209; *Drew v. United States*, 551 F.2d 85, 87 (5th Cir.1977); *United States Trust Co. v. Anderson*, *supra* at 577-578; *King v. Commissioner*, 77 T.C. 1113, 1118, 1981 WL 11392 (1981). This limitation derives from the notion that the purpose of the section 103 exclusion is to enable States and localities to obtain capital at lower than market rates of interest; the exclusion causes purchasers of tax-exempt bonds to accept interest at lower rates equal to the lower after-tax rates of interest earned by holders of taxable bonds of equivalent risk. *United States Trust Co. v. Anderson*, *supra*; see *Drew v. United States*, *supra*; *King v. Commissioner*, *supra*.

Hernandez v. C.I.R., T.C. Memo 1998-46, 1998 WL 44090, 7 (U.S.Tax Ct.1998) (emphasis added).

In this case, the COLA certificates, like the tax certificates in *Hernandez*, are not issued by the Government of Guam as an exercise of "sovereign borrowing power" nor were they issued to enable the Government of Guam to obtain capital. Rather, the COLA certificates are issued to pay a debt owed by the Government of Guam to its retirees. See PL 29-18, §2(d)(4): "Said Certificates are evidence of amounts payable by the Government of Guam...". "The holder must surrender the Certificate to receive payment of the award it represents." *Id.* (emphasis added). In sum, the COLA Certificates are not State or Local obligations for the purpose of GTIT §103.

Conclusion

The receipt of income, pursuant to the payment received from the COLA certificates and COLA awards are considered "gross income" and will be subject to income tax to the extent the recipient's adjusted taxable income exceeds a certain threshold under the GTIT. Additionally the amount attributed to the interest payment is also considered gross income and will also be subject to taxation under the GTIT.


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