

114TH CONGRESS
2D SESSION

H. R. 5039

To amend the Internal Revenue Code of 1986 to provide for economic recovery
in the possessions of the United States.

IN THE HOUSE OF REPRESENTATIVES

APRIL 21, 2016

Ms. PLASKETT introduced the following bill; which was referred to the
Committee on Ways and Means

A BILL

To amend the Internal Revenue Code of 1986 to provide
for economic recovery in the possessions of the United States.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. SHORT TITLE.**

4 This Act may be cited as the “Territorial Tax Parity
5 Act of 2016”.

6 **SEC. 2. MODIFICATION TO SOURCE RULES INVOLVING POS-**
7 **SESSIONS.**

8 (a) SOURCE RULES.—Section 937(b)(2) of the Inter-
9 nal Revenue Code of 1986 is amended by striking the pe-
10 riod at the end and inserting the following: “to the extent

1 such income is attributable to an office or fixed place of
2 business within the United States (determined under the
3 rules of section 864(c)(5)).”.

4 (b) SOURCE RULES FOR PERSONAL PROPERTY
5 SALES.—Section 865(j)(3) of such Code is amended by
6 adding “932,” after “931,” and before “933.”.

7 (c) EFFECTIVE DATE.—The amendments made by
8 this section shall apply to taxable years beginning after
9 December 31, 2016.

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2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. SHORT TITLE.**

4 This Act may be cited as the “Territorial Tax Equity
5 and Economic Growth Act”.

6 **SEC. 2. MODIFICATION TO RESIDENCE AND SOURCE RULES**
7 **INVOLVING POSSESSIONS.**

8 (a) BONA FIDE RESIDENT.—Section 937(a) of the
9 Internal Revenue Code of 1986 is amended—

10 (1) by striking the last sentence, and

1 (2) by amending paragraph (1) to read as fol-
2 lows:

3 “(1) who has a substantial presence (deter-
4 mined under the principles of section 7701(b)(3)(A)
5 (applied by substituting ‘122 days’ for ‘31 days’ in
6 clause (i) thereof) without regard to sections
7 7701(b)(3)(B), (C), and (D)) during the taxable
8 year in Guam, American Samoa, the Northern Mar-
9 iana Islands, Puerto Rico, or the Virgin Islands, as
10 the case may be, and”.

11 (b) SOURCE RULES.—Section 937(b) of such Code
12 is amended—

13 (1) by striking “and” at the end of paragraph
14 (1),

15 (2) in paragraph (2) by striking the period at
16 the end and inserting the following: “to the extent
17 such income is attributable to an office or fixed
18 place of business within the United States (deter-
19 mined under the rules of section 864(c)(5)),”, and

20 (3) by adding at the end the following:

21 “(3) for purposes of paragraph (1), the prin-
22 ciples of section 864(c)(2), rather than rules similar
23 to the rules in section 864(c)(4), shall apply for pur-
24 poses of determining whether income from sources
25 without a possession specified in subsection (a)(1) is

1 effectively connected with the conduct of a trade or
2 business within such possession, and

3 “(4) for purposes of paragraph (2), income
4 from activities within the United States which are of
5 a preparatory or auxiliary character shall not be
6 treated as income from sources within the United
7 States or as effectively connected with the conduct
8 of a trade or business within the United States.”.

9 (c) SOURCE RULES FOR PERSONAL PROPERTY
10 SALES.—Section 865(j)(3) of such Code is amended by
11 adding “932,” after “931,” and before “933.”.

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Congress should provide two tax incentives needed to attract, promote, and enhance economic development in the Territory.

The U.S. Virgin Islands economy has been battered by the economic damage caused by the Great Recession and, more recently, the 2012 closure of the HOVENSA refinery, which had been the Territory's largest private employer and the mainstay of the St. Croix economy for the last half century. Almost 2,000 persons have lost their jobs, annual tax revenue has fallen by over a hundred million dollars, and hundreds of millions more in economic activity have been lost.

The Government of the U.S. Virgin Islands respectfully submits that the federal government has a critical role to play in helping our Territory generate robust and sustainable economic growth that can help the Territory improve its long-term fiscal health—and avoid the situation that Puerto Rico is now in. We request that Congress provide for fair and balanced tax rules by including in the omnibus appropriations package two tax incentives related to our Economic Development Commission (EDC) program to attract, promote, and enhance economic development in our Territory.

First, Congress should modify the Jobs Act sourcing rule in Section 937(b)(2) of the Internal Revenue Code (IRC) by modifying the U.S. income limitation to exclude only U.S. source (or effectively connected) income attributable to a U.S. office or fixed place of business. A copy of a March 31, 2011 memorandum to Michael Mundaca, then Assistant Secretary of the Treasury for Tax Policy, explaining the need for the request is attached.

Under the long-standing rules governing the tax relationship between the Virgin Islands and the United States, a bona fide resident of the Virgin Islands (*i.e.*, a tax resident) may satisfy his or her U.S. income tax obligations by filing in, and paying the applicable tax to, the Virgin Islands. Under Section 934 of the U.S. Internal Revenue Code, the Virgin Islands is authorized to reduce the otherwise applicable tax on “V.I. source income” and “income which is effectively connected with the conduct of a V.I. trade or business,” regardless of source (“V.I. ECI”). This provision is a potentially powerful incentive for attracting investment to the Virgin Islands by allowing certain qualified U.S. source income (which would otherwise be subject to U.S. income tax rates under the V.I. mirror tax code) to be eligible for the concessionary tax rates under the EDC program. The Jobs Act, however, sharply limited the scope of this incentive by adding new IRC Section 937, which provides that no U.S. source income can qualify as V.I. ECI (the “U.S. income limitation”) unless specifically permitted under rules promulgated by the Treasury.

To date, Treasury has permitted only inventory sales of Virgin Islands manufactured goods in the U.S. market (which would constitute U.S. source income) to qualify as V.I. ECI, based on the Department's constrained interpretation of an express legislative statement in the Jobs Act that Congress expected that the rules would continue the historic rule regarding inventory. We understand that Treasury believes a statutory change or Congressional clarification would be needed to address the issue, and that it would not oppose such a change or clarification.

This limitation has resulted in unjustified and sometimes illogical restrictions on the EDC program, and it has hindered the growth and development of high tech and knowledge-based

industries in the Territory. For example, royalty income earned through licensing of a software created by a Virgin Islands company to clients in foreign countries may qualify as V.I. ECI under the Jobs Act rules and thus eligible for EDC tax incentives, while licensing of the same software to U.S. customers would not, thus incentivizing Virgin Islands high tech companies to look to foreign markets rather than the U.S. market. Similarly, a Virgin Islands captive insurer which insures foreign risks would qualify for EDC tax incentives, while the insurance of U.S. risks would not, ironically putting V.I. companies at a competitive disadvantage compared to companies in Bermuda and other Caribbean countries.

We therefore request that Congress modify the sourcing rules in the Jobs Act by adopting the model income tax treaty rules for determining effectively connected income and modifying the U.S. income limitation to exclude only U.S. source (or effectively connected) income attributable to a U.S. office or fixed place of business. Proposed language that would amend Subsection (b)(2) of IRC Section 937 is attached.

Second, Congress should ensure parity of treatment among the Territories with respect to the treatment of capital gains, by clarifying in IRC Section 865(j)(3) that capital gains income earned by V.I. taxpayers should be deemed to constitute V.I. source income regardless of the tax rate imposed by the V.I. government (to maintain eligibility of certain capital gains income for EDC tax incentives). This change would correct an apparent drafting oversight by conforming the sourcing of capital gains of V.I. EDC beneficiaries with the rules already applicable to Puerto Rican resident tax benefitted capital gains. Providing such parity would make our EDC economic growth program even more effective in attracting and retaining V.I. resident beneficiaries with capital gains.

Attached are a May 1, 2014 letter to Mark Mazur, Assistant Secretary of the Treasury for Tax Policy and a background paper that explain the need for the request. Treasury has indicated that there is no apparent tax policy for this V.I.-PR capital gains sourcing distinction and that it would not oppose such a provision. Proposed language that would amend Subsection (j)(3) of IRC Section 865 is also attached.

Attachments:

March 31, 2011 Memo. to Michael Mundaca, Ass't Sec. of Treasury for Tax Policy (re Modifying the U.S. Income Limitation)

May 1, 2014 Letter to Mark Mazur, Ass't Sec. of Treasury for Tax Policy; and Background Paper (Addressing the Capital Gains Sourcing Distinction)

Proposed Language to Amend IRC §§ 937(b)(2) and 865(j)(3)

782839.7

External Memorandum

Peter N. Hiebert
[REDACTED]

To: The Honorable Michael F. Mundaca
Assistant Secretary of the Treasury for Tax Policy

From: Peter N. Hiebert
Barry J. Hart
Counsel to the Government of the U.S. Virgin Islands

Date: March 31, 2011

Re: Determination of "Bona Fide Residency," "Source of Income," and "Effectively Connected Income" for U.S. Virgin Islands Taxpayers

Thank you for the opportunity to address the important question of the Treasury Department's treatment of "bona fide residency," "source of income," and "effectively connected income" under the provisions of Section 937(a) and (b) of the Internal Revenue Code of 1986, as amended ("Code"), as added by the American Jobs Creation Act of 2004 ("Jobs Act") and as it applies to taxpayers in the U.S. Virgin Islands ("USVI" or "Territory"). The scope and content of those provisions are critically important to USVI tax policy, and to the economic development program that relies heavily upon it. We believe that the current Treasury regulations implementing these provisions of the Jobs Act (the "Treasury Regulations"), particularly the "physical presence" test for establishing Territorial residency and the treatment of "effectively connected income" ("ECI"), set forth at Treas. Reg. §§ 1.937-1(c) and 1.937-2 and -3, are unnecessarily restrictive, and have resulted in severe harm to the USVI's most promising economic development efforts. The purpose of this Memorandum is to explain the USVI's objections to the current Treasury Regulations and provide alternative approaches that we believe would give effect to Congressional intent, be consistent with Treasury's commitment to preventing abusive schemes, and help restore the USVI's economic development program to its former promise.

INTRODUCTION

The USVI remains a developing economy with per capita income barely half that of the United States and a poverty rate three times the national average. The USVI Government ("Government") is committed to transforming its economy from one based heavily on tourism to a diversified one that includes high-value service businesses—the kind of businesses that attract not only investment but also entrepreneurial and intellectual capital. To that end, the Government has committed significant resources to its Economic Development Commission ("EDC") program, which relies upon Congressionally-authorized tax incentives in order to attract new and dynamic service businesses to the USVI and create jobs and economic opportunity for its people.

Honorable Michael F. Mundaca
March 31, 2011
Page 2

The tax benefits administered by the EDC are essential to the economic growth and prosperity of the USVI: in 2004, service businesses associated with the EDC program contributed nearly 20% of the USVI's total General Fund revenues and supported 8% of the USVI's total employment. But since the imposition of more stringent residency and income sourcing requirements by the American Jobs Creation Act of 2004 ("Jobs Act") and subsequent Treasury Regulations, the EDC program has all but fallen into disuse: applications to the program have fallen from 74 in 2003 to just 12 in 2009. The resulting decline in tax revenues, employment, and commercial growth has harmed the entire USVI economy and the people who depend on it.

This blow to the USVI's economic prospects was not Congress' intent. The purpose of the Jobs Act revisions to the possessions' residency and income rules was simply to prevent a small number of abusive tax-avoidance schemes, which the IRS had condemned as unlawful even under the old law. Congress certainly did not intend to cripple the EDC program. And to ensure that any such effect could be remedied, Congress conferred on Treasury broad authority to promulgate regulations defining possession "bona fide residency," "source of income", and "effectively connected income." We take this opportunity to urge Treasury to exercise that authority to revisit and revise its approach to determining Territorial residency, source of income, and ECI in terms that will restore viability to the EDC program as an important engine for job creation, revenue generation and economic growth, while continuing to prevent opportunities for taxpayer abuse.

BACKGROUND

A. The USVI's Economic Challenge

The USVI is an island Territory, geographically removed from the U.S. mainland and lacking in both natural resources and a significant manufacturing base. Subject to U.S. minimum wage laws and federal labor, environmental and other regulatory requirements, the USVI is also vulnerable to industrial and commercial competition from lower-wage, non-U.S. jurisdictions nearby and throughout the hemisphere. Historically, its economy has been based heavily on tourism—an industry of limited scalability and growth potential—which accounts for approximately 80% of both Territorial GDP and private sector employment.¹ The result is an economy that struggles even in good times: for USVI families with young children, the poverty rate exceeds 40%, and the overall poverty rate is nearly double that of Mississippi, the poorest U.S. State. The perceived lack of economic opportunity in the USVI has led to a "brain drain" of the USVI's most promising young people, who typically emigrate to the United States after college to pursue employment and professional opportunities.

¹ Source: CIA World Factbook, Field Listing: Population Below Poverty Line, available at <https://www.cia.gov/library/publications/the-world-factbook/geos/vq.html>

Honorable Michael F. Mundaca
March 31, 2011
Page 3

B. The USVI Economic Development Program

Like most developing economies, the USVI has long used tax incentive programs to attract business and investment. Historically, the USVI's EDC program focused on tourism and manufacturing: it provided tax benefits to companies in traditional categories like rum and dairy production, oil refining, watch manufacturing, transportation, hospitality, and utilities.² With the decline of the manufacturing sector in the face of tariff liberalization and increased foreign competition, those efforts, by the turn of the century, had become largely outpaced by globalization and resulted in stagnant economic growth.

Beginning in 2001, the Government embarked on a new economic development strategy that promised not only to increase revenues, but to effect structural improvements in the USVI economy itself. That year, the Government reorganized and expanded the EDC program by refocusing it on "designated service businesses" ("DSBs")—companies that can leverage modern telecommunications technologies to service an international clientele from a USVI base. Indeed, by USVI law, a DSB may *only* provide its services "to customers located outside the Virgin Islands."³ Although the category of DSBs is potentially broad, in practice the DSB program consists largely of very high-income services businesses—typically, hedge funds, asset management, investment services, and consultancies.

Under the program, a DSB's qualified USVI income is eligible for a 90% tax exemption if certain conditions are met, including (1) proof of the company's physical presence in the USVI; (2) completion of an extensive application process; (3) due diligence by the EDC's professional staff; (4) public hearings; and (5) specific authorization from the Governor. A qualified applicant must then satisfy continuing requirements involving the investment of capital, employment of at least 10 full-time employees (a substantial number of whom must be local residents), provision of health and retirement benefits and training to those employees, and contributions to local charities or other job-training programs. Each beneficiary receives a compliance orientation conducted by the EDC's Director of Compliance and, thereafter, is assigned a compliance officer who ensures that the beneficiary's continuing obligations are satisfied.

The development focus on DSBs had an immediate impact on the USVI economy. In 1999, there were only 7 DSBs operating in the USVI, with gross sales of \$113 million.⁴ By 2003, there were 44 such entities, generating gross sales of \$643 million—an increase of 470%.⁵ By 2004, just three

² PricewaterhouseCoopers, "Economic Impact of [the Jobs Act] on U.S. Virgin Islands," Jan. 12, 2005 ("PwC Report") at 14-15. The PwC Report was provided to both the Treasury Department and the Department of the Interior in connection with their implementation of the Jobs Act in January 2005.

³ 29 V.I.C. § 703(g).

⁴ PwC Report, Table 12.

⁵ *Id.*

Honorable Michael F. Mundaca
March 31, 2011
Page 4

years into the program, DSBs were responsible for 29% of all USVI income tax receipts.⁶ Moreover, because DSBs provide the kind of high-paying, high-qualification jobs that are otherwise lacking in the USVI economy—and because DSBs are required by law to employ 80% USVI residents—those jobs provide a dynamic counterweight to the historical problem of “brain drain.” The DSBs thus provide an essential resource for the human and intellectual capital that are critical to the USVI’s developing economy.

The direct financial and employment benefits of the EDC program, however, were only part of an even larger economic success story. The infusion of DSBs into the USVI economy also had a significant multiplier effect.⁷ Successful DSBs and their employees pour money back into the local economy by purchasing homes, services and goods. Those purchases in turn generate yet more local employment, which further stimulates the local economy in a virtual cycle of growth.

Based on the growth rate of the DSB program from 2001-2004, the number of qualified DSBs was projected to rise from 49 in 2004 to 79 in 2007, with the income tax revenue generated by the program rising from \$114 million to \$227 million in those three years. Those additional tax revenues would have funded a significant portion of the USVI’s annual budget during that period—to say nothing of the additional jobs, consumer spending, real estate investments, and other benefits that increased use of the program would have brought. But, as explained below, none of that happened.

C. The Jobs Act of 2004: Restricting Territorial Residency and Income Rules

In early 2004, in the wake of media coverage describing certain abuses of the EDC program, the IRS issued Notice 2004-45, warning certain EDC beneficiaries and tax promoters against taking “questionable” tax positions with respect to USVI residency and source of income. In particular, Notice 2004-45 warned against U.S. persons falsely claiming bona fide USVI residency and EDC benefits while continuing to live and work in the U.S. It also warned against U.S. persons claiming as USVI source income monies received for services performed in the United States, or claiming that non-USVI source income could be treated as “effectively connected” with the conduct of a trade or business within the USVI. At the same time, the Senate Finance Committee investigated the EDC program and concluded that, under the subjective “facts and circumstances” test then applicable in determining residency under Section 932, some U.S. taxpayers (encouraged by unscrupulous promoters) were able to gain EDC benefits by falsely claiming USVI residency based on such flimsy evidence as a driver’s license or voter registration card.

⁶ *Id.*, Table 13.

⁷ *Id.* at 24-26 and Table 20.

Honorable Michael F. Mundaca
March 31, 2011
Page 5

1. **Section 937(a): Congress enacts a newly restrictive approach to Territorial residency but provides broad discretion to Treasury to promulgate “appropriate” implementing rules.**

In response to such abuses, the Senate Finance Committee, during its consideration of the Jobs Act, adopted an amendment to the Code that would have repealed the subjective “facts and circumstances” test then in effect in favor of a more objective analysis employing a test “similar to” the “substantial presence” test set forth in Section 7701(b)(3)—the test used to determine whether foreign nationals are USVI (and U.S.) “residents” for U.S. income tax purposes.⁸ Under the latter test, a foreign taxpayer would have qualified as a U.S. resident for U.S. income tax purposes if he (1) was present in the United States on at least 31 days in the calendar year; *and* (2) was present in the United States for a minimum weighted average of 122 days in the current year and the two preceding years, *unless* for a given year he was present for less than 183 days, and had both a “tax home” in and a “closer connection” to another country. Consistent with that test, the Government submitted a proposal to the Joint Committee on Taxation (“Joint Committee” or “JCT”) under which a USVI taxpayer could claim USVI residency if he was physically in the USVI (1) at least 183 days in any one tax year, *or* (2) a weighted average of 122 days a year for any three-year period, or if (failing those tests) the taxpayer could establish that he had a “closer connection” to the USVI than to the United States. Following discussions with Joint Committee staff, the USVI then modified its proposal by making the “closer connection” test a mandatory addition to the 3-year weighted average test.

Treasury, however, submitted an alternative proposal during the House-Senate Conference Committee deliberations on the Jobs Act that defined residency much more restrictively. Under Treasury’s proposal, a USVI (or other U.S. possession) taxpayer was required to establish that he (1) was physically present in the territory for at least 183 days in any tax year; (2) had no “tax home” other than the USVI; and (3) had a “closer connection” to the USVI than to the United States or any other jurisdiction. Treasury’s proposal made no reference to the 122-day three-year weighted average test borrowed from Section 7701(b)(3)—thus, on its face, making it more difficult for a U.S. citizen to claim USVI (or other possession) residency than for a foreign national to be deemed a USVI (or U.S.) resident.

The Conference Committee adopted Treasury’s more restrictive test, which ultimately became Code Section 937(a).⁹ Importantly, however, in enacting the more restrictive residency test, Congress made clear that Treasury had broad discretion to make “exceptions” by regulation to that test “as appropriate.”¹⁰ The legislative history explains that such exceptions should be made for, “in particular, persons whose presence outside [the Virgin Islands or other possessions] for extended periods of time *lacks a tax avoidance purpose.*”

⁸ S. 1637, 108th Cong. § 497 (as passed by Senate, May 11, 2004).

⁹ See H.R. REP. NO. 108-755 (2004) (Conf. Rep.), as reprinted in 2004 U.S.C.C.A.N., 1341, 1830-31.

¹⁰ *Id.*

Honorable Michael F. Mundaca
March 31, 2011
Page 6

2. **Section 937(b): Congress enacts a newly restrictive approach to Territorial income rules but also provides broad discretion to Treasury to promulgate “appropriate” implementing rules.**

Neither the Senate nor the House versions of the Jobs Act contained any provisions with respect to the possessions’ source of income or ECI rules.¹¹ Treasury, however, included in its alternative proposal a new statutory framework, not included in either the Senate- or House-passed bills, which severely limits the amount of USVI ECI that can qualify for EDC benefits. The Treasury substitute generally provided that rules “similar to” the rules for determining whether income is income from sources within the United States or effectively connected with the conduct of a trade or business within the United States shall apply for purposes of determining whether income is USVI source income or USVI ECI. However, the Treasury proposal also provided that, unless otherwise excepted in regulations, U.S. source income and ECI would generally not be treated as income from within the USVI or as USVI ECI (the “U.S. income limitation rule”), thus limiting, without the benefit of legislative hearings, the scope of USVI tax incentives and the opportunities to develop a modern and diversified economy.

The Conference Committee adopted Treasury’s more restrictive source of income and ECI rules, which are now codified in Code Section 937(b)(1) and (2).¹² The effect of the U.S. income limitation rule under Section 937(b)(2) is, perversely, to discourage USVI companies from doing business in the United States. For example, if a USVI-based software company licenses \$40 million in software products, developed and produced in the USVI, to U.S. customers and \$40 million to European customers, the \$40 million in European royalties will qualify as USVI ECI—but the substantively identical \$40 million in U.S. royalties will not.

However, as it did with the residency requirements, Congress also made clear that Treasury had broad discretion to make “exceptions” by regulation “as appropriate” which would allow some categories of U.S. source income (and U.S. ECI) in certain circumstances to be treated as USVI source income or USVI ECI.¹³ The legislative history explains, illustratively, that such exceptions should be made “to continue the existing treatment of income from the sale of goods manufactured in a possession.”¹⁴ This exception would protect the EDC manufacturing sector, including rum distilling, watch and jewelry manufacturers and other manufacturing industries in the Virgin Islands which might otherwise be harmed by the new sourcing and ECI limitations. It would not, however, extend to income generated by the kinds of information-age or other high-value service businesses that are now the focus of the USVI’s economic development efforts.

¹¹ S. 1637, 108th Cong. § 497 (as passed by Senate, May 11, 2004); H. R. 4520 108th Cong. (as passed by House, June 17, 2004).

¹² See H.R. REP. NO. 108-755, at 1830.

¹³ *Id.*

¹⁴ *Id.*

Honorable Michael F. Mundaca
March 31, 2011
Page 7

D. Treasury's Possessions Regulations: Implementing the Provisions of the Jobs Act

1. Residency Regulations: Treas. Reg. § 1.937-1.

In April 2005, Treasury promulgated Proposed Regulations pursuant to Code Section 937(a). The Final Treasury Regulations, issued in November 2006, provide that to establish "bona fide residency" in the USVI (or other possession), a taxpayer must meet a physical presence test, a tax home test, and a "closer connection" test. The physical presence test may be satisfied in relevant part either by demonstrating physical presence in the USVI (1) "for at least 183 days during the taxable year," or (2) "for at least 549 days during" the relevant three-year period, provided that he was "also present . . . for at least 60 days during each [of those three years]."¹⁵ This three-year averaging test is computed on a non-weighted basis.

In other words, the Final Regulations—which remain in effect—take the three-year weighted averaging method of Section 7701(b)(3) and substantially lengthen it, from a required average of 122 days of physical presence over a three-year period to a required (non-weighted) average of 183 days over a three-year period, while also imposing the additional "tax home" and "closer connection" requirements mandated by Section 937(a)(2). The result is a possession residency determination for U.S. citizens that is substantially harder to satisfy, not only than the old "facts and circumstances" test that preceded Section 937(a), but also the Section 7701(b)(3) "substantial presence" test that applies to USVI (and U.S.) residency determinations for foreign nationals.¹⁶

2. Possession Source Income and ECI Regulations: Treas. Reg. §§ 1.937-2 and -3.

In Section 937(b), Congress authorized Treasury to create by regulation appropriate exceptions to the U.S. income limitation set forth in Section 937(b)(2). But Treasury has largely declined to do so. The Final Regulations governing possessions' source income and ECI, Treas. Reg. §§ 1.937-2 and -3, respectively, both include a blanket rule that possession source income and ECI shall not include income that is either U.S. source income or U.S. ECI.¹⁷ The lone exception applies narrowly to "sale[s] of inventory property" under Treas. Reg. § 1.863-3(f), which refers to inventory "produced (in whole or in part) . . . within the United States and sold within a possession, or produced (in whole or in part) . . . in a possession and sold within the United States."¹⁸ Such sales may be treated as possession ECI even if such income is also determined to constitute U.S. source income or U.S. ECI. But the USVI, in particular, lacks a significant manufacturing base; and the inventory exception does not extend to

¹⁵ See Treas. Reg. § 1.937-1(c)(1)(i), (ii). Treas. Reg. § 1.937-1(c)(1)(iii), (iv), and (v) provide additional tests for physical presence. The Government understands that these additional tests are rarely able to be satisfied by EDC participants.

¹⁶ See Treas. Reg. § 1.937-1(c)(2).

¹⁷ See Treas. Reg. § 1.937-2(c), -3(c).

¹⁸ See Treas. Reg. §§ 1.937-2(d), -3(d) and 1.863-3(f).

Honorable Michael F. Mundaca
March 31, 2011
Page 8

income generated by modern industries like finance, consulting, and software development—the industries most critical to the USVI's future growth and prosperity.

As a result of these limitations, the USVI (and other U.S. possessions) will be forced to rely on legacy industries of limited scalability, such as manufacturing and tourism, for its economic development, or to focus on foreign markets rather than the United States.

E. Consequences of the Treasury Regulations for USVI's Economic Development Program

The effects of Section 937 and the Final Treasury Regulations on the USVI's economic development efforts were immediate and devastating. At least seven EDC beneficiaries dropped out of the program within a few months of the new law taking effect.¹⁹ New EDC applications dropped from 74 in 2003 to 21 in 2005, and to just 12 in 2009.²⁰ The job opportunities created by new EDC beneficiaries fell from 1,660 in 2004 to 798 in 2005, to just 282 in 2009.²¹ Worse, of just eight new Certificates of Benefit issued by the EDC program in 2009, only two were issued to DSBs.²² The resulting impact on tax revenues and employment has been severe. It is fair to say that Treasury's highly restrictive regulations governing residency and ECI have all but crippled the USVI's most successful economic development program.

PROPOSED REVISIONS TO THE SECTION 937 RESIDENCY AND ECI REGULATIONS

The Government is grateful to you and to the Treasury Department for your willingness to revisit the Territorial residency and ECI regulations. We believe that an accommodation can be reached that would both serve Congress' and Treasury's purpose of preventing fraud and abuse of the USVI's EDC program and permit the revitalization of that essential part of the USVI's (and other possessions') ongoing economic development efforts.

A. Proposed Revisions to the Physical Presence Test for Determining Bona Fide V.I. Residency

The Government's proposed solution is essentially a return to the principles of the original 2004 Senate bill: A Treasury regulatory regime that is similar to the "substantial presence" test of Section 7701(b)(3).²³ The Government's proposal would leave the existing alternative physical presence tests

¹⁹ See Letter from USVI Gov. Charles W. Turnbull to The Hon. John W. Snow, Secretary of the Treasury, April 28, 2005.

²⁰ Declaration of Percival Clouden, *Appleton v. Comm'r*, No. 7717-10 (Tax Ct. Aug. 18, 2010), at ¶ 11.

²¹ See US Virgin Islands Economic Development Commission, FY 2009 Annual Report, ("EDC Annual Report") at 13 (available at http://www.usvieda.org/eda_report2009/index.html).

²² *Id.* at 14, Table 1.

²³ See H.R. REP. NO. 108-755, at 1831.

Honorable Michael F. Mundaca
March 31, 2011
Page 9

for U.S. citizens set forth in Treas. Reg. § 1.937-1(c)(1) intact, but for one change: It would revise the “physical presence” test of Treas. Reg. § 1.937-1(c)(1)(ii) to adopt the 122-day three-year weighted average test of Section 7701(b)(3), rather than the 183-day non-weighted average test required by the current Treas. Reg. § 1.937-1(c)(1)(ii), and add a minimum annual physical presence requirement of 90 days (rather than the current 60 days). The “tax home” and “closer connection” tests of Treas. Reg. § 1.937-1(d) and (e) would remain unaltered. Thus, a U.S. citizen could claim bona fide USVI residency by showing that (1) he or she was physically present in the USVI for 183 days in the current tax year, or for a weighted average of 122 days over the last three tax years, together with a minimum of 90 days of physical presence in each year (or one or more of the other physical presence tests), (2) his or her “tax home” is in the USVI, and (3) he or she did not have a closer connection to the United States or a foreign country than to the USVI during the taxable year.²⁴

As we explain below, such a compromise would be consistent with Congress’ intention to prevent the exploitation of EDC benefits by “individuals who continue to live and work in the United States,” and would serve both Treasury’s interest in administrability and the USVI’s interest in revitalizing its once-promising economic development efforts.

1. The proposed substantial presence test is consistent with Congress’ wish to prevent exploitation of EDC tax benefits by U.S. persons and to “rationalize” the law of Territorial residency.

As explained above, the impetus for Congress’ decision to abandon the old “facts and circumstances” residency test in favor of the more stringent requirements of Section 937(a) was its “understand[ing]” that “certain U.S. citizens and residents are claiming that they are exempt from U.S. income tax . . . based on a position that they are bona fide residents of the Virgin Islands,” despite continuing “to live and work in the United States,” and that some of those “same individuals” were able to “secure a reduction of up to 90 percent of their Virgin Islands income tax liability” under the EDC program.²⁵ The express purposes of Section 937(a) were, first, to give effect to Congress’ belief “that the various exemptions from U.S. tax provided to residents of possessions should not be available to individuals who continue to live and work in the United States”; and second, to ensure that “the special U.S. income tax rules applicable to residents in a possession” would be “rationalized,” that is, made more objective than the old “facts and circumstances” test.²⁶ Consistent with those purposes, Congress also gave Treasury broad authority to “create exceptions to” the Section 937(a) regime “as appropriate . . . to cover, in particular, persons whose presence outside a possession for extended periods of time lacks a tax avoidance purpose.”²⁷ That is, Congress explicitly provided the Treasury

²⁴ We note that under Treas. Reg. § 1.937-1(c)(2), foreign nationals would continue to be deemed USVI residents under the Section 7701(b)(3) physical presence test, which requires only a 31-day minimum physical presence each year.

²⁵ See H.R. REP. NO. 108-755, at 1830-31.

²⁶ *Id.*

²⁷ See H.R. REP. NO. 108-755, at 1832.

Honorable Michael F. Mundaca
March 31, 2011
Page 10

with authority to create less stringent residency rules for persons who are genuinely resident in the USVI, but are required to travel extensively outside the Territory for purposes other than tax avoidance. The Government's proposed "substantial presence" test is entirely consistent with both of Congress' goals.

First, a taxpayer who "continues to live and work in the United States" (and so receives the benefits of public services funded by U.S. tax revenues) likely could not satisfy the proposed 122-day three-year weighted average USVI presence requirement, and almost certainly could not satisfy both the "tax home" and "closer connection" requirements. For that reason, the potential for abuse—in the form of U.S. persons claiming USVI residency and EDC benefits on the basis of tenuous connections to the Territory—is very low, if not non-existent. This is particularly true in light of the rigorous EDC application process and the mandatory compliance reviews that are now conditions of EDC participation. In 2009, EDC's compliance personnel completed 25 compliance reviews, 12 of which identified one or more instances of noncompliance with program requirements—including noncompliance with the USVI residency requirement.²⁸ Failure to remedy noncompliance with the USVI residency requirement results in expulsion from the EDC program.

In addition, it bears repeating that the Government's proposal retains both the "tax home" and "closer connection" requirements of the existing Treasury Regulations. As you know, an individual's "tax home" is considered to be "located at the individual's regular or principal (if more than one regular) place of business," except that a taxpayer is not "considered to have a tax home in a foreign country for any period for which [his] abode is in the United States."²⁹ As the IRS Office of the Associate Chief Counsel recently explained, this "abode" limitation has meant that taxpayers with "strong familial, economic and personal ties in the United States and only transitory ties in the foreign country where the taxpayers worked" are deemed to have a "tax home" in the United States.³⁰ The "tax home" requirement has been employed to prevent U.S. tax avoidance by, for example, contractors who alternate blocks of time working abroad with blocks of time at home in the United States.³¹

Similarly, an individual seeking to demonstrate USVI residency must also satisfy the "closer connection" test of Treas. Reg. § 1.937-1(e), which requires that he or she "did not have a closer connection to the United States or a foreign country than to the [USVI] during any part of the taxable year." Such a "closer connection" to another jurisdiction exists where the individual "has maintained more significant contacts with the foreign country [or the United States] than with the [USVI]," based on, but not limited to, facts and circumstances, such as the location of the individual's permanent home; his or her family; his or her personal belongings and those of his or her family; personal banking institution; business activities (aside from those constituting the individual's "tax home"); driver's

²⁸ See EDC Annual Report at 15.

²⁹ Treas. Reg. §§ 1.937-1(d)(1) and 1.911-2(b).

³⁰ See AM 2009-03 (Feb. 13, 2009).

³¹ See, e.g., *LeMay v. Comm'r*, 837 F.2d 681 (5th Cir. 1988).

Honorable Michael F. Mundaca
March 31, 2011
Page 11

license; voter registration; and social, political, cultural, or religious organizations with which the individual has a current relationship.³²

Thus, the existing “tax home” and “closer connection” tests provide a potent mechanism for ensuring that U.S. citizens claiming USVI residency are genuinely based in the USVI. The continuing vitality of those requirements should greatly mitigate any lingering Treasury reservations about the potential for abuse under the modified physical presence test proposed by the Government.

Second, the proposed “physical presence” test would amply fulfill Congress’ wish to “rationalize” the law of Territorial residency. The difficulty of the pre-2004 “facts and circumstances” test was its subjectivity: it was difficult for both taxpayers and tax authorities to know *ex ante* how a particular residency determination would come out.³³ “Rationalizing” the residency rules required a more objective standard, which both the straightforward 183-day minimum-presence test of Section 937(a)(1) and the more flexible 183-day three-year average test of Treas. Reg. § 1.937-1(c)(1)(ii) provide. But the modified “physical presence” test proposed here—with its 122-day three-year weighted average test—is equally objective, and would in fact “rationalize” the law of taxpayer residency in ways that the existing Treasury Regulations do not.

Specifically, the use of a modified “physical presence” test in a revised Treas. Reg. § 1.937-1(c)-1(iii) would more closely align the principles of Territorial residency for U.S. citizens with the principles of U.S. (and USVI) residency as applied to foreign nationals. The current Treasury Regulations already provide that residency of nonresident aliens is determined using the 122-day weighted-average test of Section 7701(b)(3).³⁴ For decades, Territorial residency and U.S. residency were both governed by the subjective “facts and circumstances” test. But in 1984, Congress abandoned the “facts and circumstances” test for foreign nationals. As the Joint Committee then explained, “Congress believed that the tax law should provide a more objective definition of residence for income tax purposes.”³⁵ The resulting “objective definition” was the substantial presence test of Section 7701(b)(3).³⁶ In adopting that test, Congress explained its view that the 122-day three-year weighted average presence requirement “meets the criteria of objectivity and establishing nexus with” the taxing jurisdiction, such that subjecting the taxpayer to tax in that jurisdiction was “appropriate.”³⁷ So too

³² See 26 U.S.C. § 7701(b)(3)(B)(ii); Treas. Reg. §§ 301.7701(b)-2(b), (d)(1)(i)-(viii), (d)(2).

³³ See H.R. REP. NO. 108-755, at 1829-30 (describing the “subjective facts-and-circumstances test” and proposing “rationalizing” amendment).

³⁴ Treas. Reg. §§ 1.937-1(c)(2), (g), Example 4.

³⁵ STAFF OF JOINT COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 463 (Comm. Print 1984); see also H.R. REP. NO. 98-432, pt. 1, at 222.

³⁶ See H.R. REP. NO. 98-861, at 188-189, 967 (1984) (Conf. Rep.) (setting forth text of § 7701(b)(3) and describing the new substantial presence test as applying “regardless of the subjective intent” of the taxpayer).

³⁷ GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 465 (explaining the purpose of § 7701(b)(3)’s substantial presence test).

Honorable Michael F. Mundaca

March 31, 2011

Page 12

here: if the 122-day three-year weighted average test is sufficient to confirm U.S. (and USVI) residency for a foreign national for purposes of U.S. (and USVI) income tax, the Government submits that the same test should be sufficient to determine USVI residency for a U.S. citizen for purposes of USVI income tax.

The Government is aware that Treasury has previously declined to adopt Section 7701(b)(3) for determining Territorial residence for U.S. citizens, because of its view that in enacting Section 937(a), “Congress considered but specifically rejected adopting Section 7701(b) as the general rule for determining residency in a possession.”³⁸ The Government respectfully submits that this characterization of the legislative history—or at least the conclusion drawn from it—is incorrect. As noted above, the Senate amendment proposed determining Territorial residency using a test “determined by the Secretary [of the Treasury], similar to the substantial presence test of Section 7701(b)(3).”³⁹ The Conference did *not* reject the Senate approach, but rather “follow[ed] it “with modifications.”⁴⁰ There is no indication in the Conference Report that Congress believed the substantial presence test of Section 7701(b)(3) was necessarily inadequate to achieve its stated intent to ensure that “exemptions from U.S. tax provided to residents of possessions should not be available to individuals who continue to live and work in the United States.”⁴¹ To the contrary, Congress’ decision to confer upon the Treasury Department broad discretion to create “exceptions” to the modified scheme “as appropriate” suggests Congress’ recognition that a more flexible approach to physical presence is appropriate where taxpayer conduct is not motivated by any tax avoidance purpose.

One possibility, of course, is that Congress chose not to simply adopt Section 7701(b)(3) wholesale for application to Territories because it believed that Territorial residency for U.S. citizens should be more difficult to establish than U.S. residency for aliens. Even if that were true—and the legislative history does not support it—the Government submits that the modified physical presence test proposed here mitigates Congress’ concern by rejecting the 31-day presence minimum threshold for U.S. citizens to establish USVI residency and replacing it with a 90-day minimum—59 days longer than the Section 7701(b) 31-day minimum requirement, and 30 days more than the 60-day minimum threshold of existing Treas. Reg. § 1.937-1(c)(1)(ii). And in all events, Territorial residency for U.S. citizens is more difficult to establish given the closer connection and tax home requirements.

³⁸ T.D. 9248, 2006-1 C.B. 524 (as corrected by Ann. 2006-32, 2006-1 C.B. 913); *see also* T.D. 9297, 2006-2 C.B. 1089.

³⁹ *See* H.R. REP. NO. 108-755, at 1830.

⁴⁰ *Id.*

⁴¹ *Id.*

Honorable Michael F. Mundaca
March 31, 2011
Page 13

2. Adopting the proposed substantial presence test is well within Treasury's discretion to craft regulatory exceptions for situations not involving a tax-avoidance purpose, and would pose no problems of implementation or administration.

In enacting the highly restrictive 183-day presence requirement of Section 937(a), Congress conferred upon Treasury substantial discretion to "create exceptions to" the stringent Section 937(a) regime "as appropriate . . . to cover, in particular, persons whose presence outside a possession for extended periods of time lacks a tax avoidance purpose."⁴² The modified substantial presence test proposed here, the Government submits, falls comfortably within that discretion. As Treasury has previously acknowledged, "the realities of life in the [T]erritories might require periodic temporary absences from the [T]erritories for business pursuits" that make compliance with the strict provisions of Section 937(a)(1) and Treas. Reg. § 1.937-1(c)(1) very difficult.⁴³ Because of the Territory's distance from major world markets and financial centers, USVI businesses frequently require extensive travel outside the Territory to service clients. This is particularly true for DSBs, which by definition may only provide services to clients outside the USVI.⁴⁴ The business travel necessary to sustain and grow those businesses is wholly unrelated to the legitimacy of the taxpayer's residence in the USVI. More important, such travel plainly "lacks a tax avoidance purpose," and so represents an appropriate circumstance for the exercise of Treasury's discretion to create exceptions to the rigid 183-day rule of Section 937(a)(1).

In the past, both the Government and other interested parties have proposed that Treasury address the business-travel issue by permitting taxpayers to treat some number of business-travel days as "days of [physical] presence in a [T]erritory" for purposes of calculating residency.⁴⁵ Treasury has declined to do so—not because such an exception would be contrary to the letter or the spirit of the residency rules, but because Treasury claims it "would be administratively difficult to implement and monitor."⁴⁶ A modified physical presence test, however, presents no such difficulties: because the proposed test differs from the existing Treasury Regulations only in numerical degree, its implementation and administration would be identical to existing Treasury practices. Treasury's administrative objections to prior attempts to accommodate the unique needs of USVI-based businesses have no application here, and present no barrier to the Government's proposed revision to one of the five (5) disjunctive elements of the physical presence test.

⁴² See H.R. REP. NO. 108-755, at 1830.

⁴³ T.D. 9297, 2006-2 C.B. 1089.

⁴⁴ 29 V.I.C. § 703(g).

⁴⁵ T. D. 9297, 2006-2 C.B. 1089 (describing commenter's request for a 30-day allowance for business travel).

⁴⁶ *Id.*; see also T.D. 9248, 2006-1 C.B. 524 (as corrected by Ann. 2006-32, 2006-1 C.B. 913).

Honorable Michael F. Mundaca
March 31, 2011
Page 14

3. The proposed substantial presence test gives effect to Congress' long-established commitment to economic development in the USVI.

For decades, Congress has consistently supported the use of tax incentives to promote economic development in the USVI. The tax-benefit program of Section 934(b), which (as discussed above) permits the USVI to provide tax incentives for "income derived from sources within the Virgin Islands or income effectively connected with the conduct of a trade or business within the Virgin Islands" was established in 1960, and, since that time, has formed a core element of U.S. economic policy toward the USVI.⁴⁷ It is the legislative basis for the entire EDC program.

The Jobs Act was not intended to disrupt or reduce U.S. support for the EDC or the economic development program for which it is responsible. Nothing in the statute or the legislative history suggests that Congress intended to do anything but curb taxpayer abuse, or that Congress intended the Jobs Act to have a significantly deleterious effect on the EDC program. To the contrary: the legislative history demonstrates that Congress presumed a vigorous continuation of the EDC program.⁴⁸ But as we have explained, the more restrictive residency analysis of Section 937(a)(1) cut much deeper than Congress intended. Instead of merely foreclosing the tax-avoidance schemes of a few unscrupulous promoters, Section 937(a) rendered participation in the EDC program non-viable for legitimate businesses—and had a particularly devastating effect on the USVI's long-term efforts to draw high-value DSBs to the Territory. No longer confident of their ability to service their international clientele within the confines of the new Section 937(a)(1) physical-presence requirements, many such businesses withdrew from the program—and many more elected not to apply at all. The result has been the evisceration of the once-promising DSB program, and the loss of hundreds of millions of dollars and hundreds of high-paying jobs for the USVI economy.

Adopting a modified physical presence test would revitalize the EDC program, permitting its return to the level of success that Congress, in enacting Section 937(a), clearly intended it to maintain. The more flexible approach to physical presence would permit the USVI to attract the high-value financial services and advisory businesses that depend on international clients and thus on the ability to

⁴⁷ Section 934 has its origins in a 1957 USVI law which, in an effort "to encourage persons, firms and corporations to establish and develop new business enterprises" and "make additional investment capital available," special "exemptions from payment of certain taxes or fees" and "special subsidies shall be allowed to new business enterprises." V.I. Session Law 224 (1957) (quoted in *HMW v. Wheatley Indus.*, 504 F.2d 146, 150-51 (3d Cir. 1974)). Given the opportunity to reject the USVI legislation, Congress chose instead to ratify it. The resulting statute was Section 934, which remains a centerpiece of U.S. economic support for the USVI. See *HMW v. Wheatley Indus.* at 151-52.

⁴⁸ The JCT analysis accompanying the Conference Report indicates a revenue gain for the U.S. Treasury of only \$8 million in 2006 (the first year the law was effective for a full year for all taxpayers). Assuming full taxation by the IRS of the income that Section 937(a) would render ineligible for EDC tax benefits, and further assuming taxation by USVI tax authorities of such income at the EDC reduced rate, the JCT analysis suggests an average revenue loss to the USVI of only \$0.8 million in 2006—less than 1% of the \$120 million in income taxes paid to the BIR in 2003. The JCT's analysis thus strongly suggests Congress' understanding that the changes to the residency rules would merely eliminate abuse and would not materially impact the program as a whole,

Honorable Michael F. Mundaca

March 31, 2011

Page 15

travel extensively to serve those clients. Such flexibility, in turn, would restore the EDC to the great promise it demonstrated in 2001-2004, while also providing an objective measure of residency that would guard against the abuses that characterized the old subjective regime.

B. Proposed Revisions To The ECI Regulations

The Government has no objection in principle to the possession source of income regulations of Treas. Reg. § 1.937-2, which are generally uncontroversial. But the possession ECI regulations of Treas. Reg. § 1.937-3 are another matter. The Government believes that the Treasury Regulations' restrictive approach to determining possession ECI and the U.S. income limitation rule has resulted in substantial economic distortion, and with it, avoidable harm to the USVI's economic development program.

The Government proposes to ameliorate these economic distortions by modifying Treas. Reg. § 1.937-3 to reflect two basic principles: first, the twin determination that USVI ECI (and thus eligibility for USVI tax benefits) should be firmly tied to USVI economic activity, and the ECI regulations should advance Congress' longstanding commitment, embodied in Section 934(b), to using ECI as a mechanism for expanding the USVI's economic development program; and second, that the U.S. income limitation rule under Section 937(b)(2) should be revised to eliminate anomalous outcomes and prevent U.S. base erosion, yet not needlessly encroach on the general ECI rule under Section 937(b)(1). To implement those principles, the Government proposes that Treasury modify its regulations under Section 937(b)(1) to employ an approach to determining possession ECI similar to that employed in allocating income between the United States and its foreign treaty partners under the U.S. Model Income Tax Treaty ("Model Treaty"). The Government further proposes that Treasury modify its regulations under Section 937(b)(2) to narrow the U.S. income limitation rule, such that any income is eligible to be treated as possession ECI, unless it is U.S. source income attributable to an office or a fixed place of business in the United States. In addition, the Government proposes a slightly different Section 937(b)(2) U.S. income limitation for U.S. source compensation, which the Government believes is appropriate given the unique issues posed by compensation income.

As we explain below, this approach to determining possession ECI is consistent with both Congress' longstanding commitment to the use of tax incentives to encourage possessions' economic development, and with Congress' delegation of broad regulatory authority to Treasury with respect to ECI issues under Section 937(b). It is also fully in keeping with Treasury's mandate to prevent erosion of the U.S. tax base. And while it is true that Treasury has previously declined to adopt the Model Treaty approach, the Government submits that Treasury has never fully considered the devastating effect of the existing regulatory scheme on the USVI's EDC program—a consequence that cannot be reconciled with Congress' enduring commitment to promoting the USVI's economic development.

Honorable Michael F. Mundaca
March 31, 2011
Page 16

1. **Treasury's existing regulations for determining possession ECI are inconsistent with Congress' intention to encourage the use of ECI-based tax incentives in the USVI.**

As we have explained, the tax-benefit program established by Congress in Section 934 has formed a core element of U.S. economic policy toward the USVI for more than 50 years.⁴⁹ The use of ECI-based tax incentives is an integral part of that policy: Although the original Section 934 permitted tax incentives based only on USVI source income, in 1986 Congress revised the statute to extend eligibility for tax incentives to USVI ECI, for the express purpose of enhancing and expanding the USVI's economic development efforts.⁵⁰ In the Jobs Act, Congress essentially ratified these Section 934 ECI principles in Section 937(b)(1).

However, in enacting the Section 937(b)(2) U.S. income limitation, Congress circumscribed—subject to regulatory exceptions—the Section 937(b)(1) general ECI rule. As written, Treas. Reg. § 1.937-3 gives effect to the highly restrictive approach to all possessions' ECI embodied in Section 937(b)(2)—but takes no account of the specific (and among the possessions, unique) Congressional commitment to USVI tax incentives involving USVI ECI embodied in Section 934.

The Government submits that this one-sided approach to determining possession ECI, in the general possession ECI rule and the U.S. income limitation rule, is inconsistent with Congressional intent. Nothing in the legislative history suggests that, in enacting Section 937(b), Congress intended to abandon or modify its commitment embodied in the expansion of Section 934(b) nearly twenty years before. To the contrary: the Conference Report expressly contemplates granting Treasury the authority in both the general possession ECI rule and the U.S. income limitation rule to “create exceptions to the [] general rules regarding . . . income effectively connected with a possession trade or business *as appropriate*”—with no stated limitations except the general mandate to prevent “opportunities for erosion of the U.S. tax base.”⁵¹ The two suggestions for inclusion in Treasury's regulation—an exception for “the existing treatment of income from the sale of goods manufactured in a possession” and exceptions for measures intended “to prevent abuse”—are clearly intended to be illustrative, not exclusive.⁵²

In short, Treasury's narrow implementation of Section 937(b)(1) and (2) in the Treasury Regulations is much more restrictive than Congress intended—and is squarely at odds with the economic development goals embodied in Section 934(b).

⁴⁹ See footnote 47.

⁵⁰ Tax Reform Act of 1986, Pub.L. No. 99-514, § 1275(c)(1), (2)(B) (1986).

⁵¹ H.R. REP. NO. 108-755, at 1831-32.

⁵² *Id.*

Honorable Michael F. Mundaca
March 31, 2011
Page 17

2. **A Model Treaty-based approach to determining possession ECI would both promote economic development in the possessions and prevent erosion of the U.S. tax base, consistent with Congress' goals in enacting both Section 934 and Section 937.**

A modified Model Treaty approach would enable Treasury to give effect to both of Congress' competing commands in this area: permitting the broad use of ECI-based tax incentives to encourage economic development while also stemming any potential erosion of the U.S. tax base. In several ways, the Model Treaty approach is a natural analogue on which to base possession tax policy. For many tax purposes, U.S. possessions are already treated like foreign jurisdictions. And the policy goals of foreign ECI determinations and possession ECI determinations are essentially the same. Much like a treaty partner, the USVI seeks to avoid double taxation of its residents and encourage foreign businesses and residents to locate and invest in the USVI. Similar to its goal with treaty partners, the U.S. goal with respect to establishing a taxing mechanism for the USVI should be to avoid "double taxation and [prevent] fiscal evasion with respect to taxes on income."⁵³ That possession tax policy goal would not be frustrated if the United States utilized the Model Treaty provisions here. Put another way, the Government submits that there is no tax policy justification for treating possession taxpayers less favorably than foreign taxpayers—especially in the case of the USVI, as to which Congress has expressly approved the use of ECI-based tax incentives to bolster the local economy.

- a. **Background: How the Model Treaty allocates tax jurisdiction**

In the treaty context, the U.S. has long determined appropriate taxing jurisdiction based on the subject income's relation to a fixed location, with no regard to the source of the income. In fact, a threshold requirement for taxation under the Model Treaty is the existence of a "permanent establishment" or "a fixed place of business [including a branch, office or place of management] through which the business of an enterprise is wholly or partly carried on."⁵⁴ The Model Treaty attributes business profits to a permanent establishment if such business profits are "derived from the assets used, risks assumed and activities performed by the permanent establishment."⁵⁵ Hence, a U.S. taxpayer's permanent establishment in a treaty partner's jurisdiction and business profits "attributable to" such a permanent establishment are the threshold requirements for the treaty partner to tax such U.S. taxpayer's business profits.

The "attributable to" test described in the Model Treaty incorporates the "asset-use" and "business-activities" tests of Section 864(c)(2) as well as the fixed place of business test of Section 864(c)(5). Treasury acknowledges that the "attributable to" test is analogous to the "effectively connected income" concept in Section 864(c), and notably makes no reference to a restriction limiting a treaty partner's taxation of U.S. source income. In fact, Treasury concedes that profits attributable to a

⁵³ U.S. Model Income Tax Convention, November 15, 2006 ("Tax Convention").

⁵⁴ Tax Convention, Article 5.

⁵⁵ U.S. Model Technical Explanation Accompanying Tax Convention ("Technical Explanation"), Article 7, ¶ 2.

Honorable Michael F. Mundaca
March 31, 2011
Page 18

permanent establishment may be from sources within or without the foreign jurisdiction.⁵⁶ The IRS has similarly noted the substantial similarity of the Treaty “attributable to” and Section 864(c)(2) “effectively connected” tests.⁵⁷

Finally, the Model Treaty provides rules for a treaty partner to source and tax compensation income, providing that such income is taxable by the jurisdiction where the employee is a resident, unless the employment takes place at the second treaty partner’s location, in which event the underlying compensation is taxable by the second jurisdiction. Notwithstanding the general rule for compensation, if in a given taxable year, an employee works in the second treaty partner’s location for a maximum number of days (usually 183) and his remuneration is paid and ultimately borne by his employer in his jurisdiction of residence, then no portion of the compensation earned in the second treaty partner’s location in that given year will be taxable by the second treaty partner. That is to say, 100% of the employee’s compensation will be taxable in his jurisdiction of residence.⁵⁸

In short, the Model Treaty uses an effectively connected income methodology for its foreign treaty partners that is more expansive than the Section 937(b)(1) ECI regulations when applied to the USVI, thereby giving such treaty partners authority to tax a larger portion of U.S. and non-U.S. source income. If the United States and the USVI were two separate taxing jurisdictions that negotiated a tax treaty based on the Model Treaty, an office or fixed place of business within the USVI would constitute a USVI permanent establishment. Business profits and compensation attributable to such a permanent establishment (whether U.S. or non-USVI source) would be taxable by the USVI under the less restrictive provisions of the Model Treaty.

b. Implementing Model Treaty principles in determining possession ECI

Consistent with these Model Treaty provisions, and with the legislative goals of both Section 934(b) and Section 937(b), the Government had previously proposed that Treasury (1) adopt in its regulations under Section 937(b)(1) an ECI test that combined the asset-use and business-activities tests of Section 864(c)(2) and the fixed place of business test of Section 864(c)(5). The Government again makes that proposal. Specifically, Treas. Reg. § 1.937-3(b) should be amended to adopt the Section 864(c)(2) asset-use and business-activities tests and the fixed place of business test of Section 864(c)(5). Also, the U.S. income limitation rule of Treas. Reg. § 1.937-3(c) should be narrowed to preclude from characterization as USVI ECI only U.S. source income attributable to a U.S. fixed place of business.

Finally, the Government proposes new rules for certain compensation. Generally, U.S. source compensation will not be USVI ECI and is ineligible for the benefits under Section 934(b). However,

⁵⁶ *Id.*

⁵⁷ Rev. Rul. 81-78, 1981-1 C.B. 604; *see also* Rev. Rul. 91-32, 1991-1 C.B. 107 (“effectively connected income” and “attributable to” principles are substantially similar).

⁵⁸ *See* Tax Convention, Article 14.

Honorable Michael F. Mundaca
March 31, 2011
Page 19

the Government proposes that certain compensation be treated as USVI ECI if earned in respect of "preparatory and auxiliary" services conducted in the U.S. by a USVI employee or independent contractor who is physically present in the U.S. for no more than 183 days in the taxable year.

c. The Government Proposal

i. Section 937(b)(1): Possession ECI

Under the Government's proposal, a USVI taxpayer seeking to classify income as USVI ECI would have to demonstrate, first, that the income bears a material economic nexus with the USVI, in the sense that the income is derived from assets held by an active "trade or business" in the USVI, and second, that the operations of that business were a "material factor" in realizing the income.⁵⁹ In addition, in order to ensure that any income eligible for USVI tax incentives treatment is genuinely rooted in USVI economic activity, the Government's proposal would require that all USVI ECI must also be attributable to a USVI office or fixed place of business.⁶⁰ As a matter of USVI law, all EDC beneficiaries must have an office or other fixed place of business within the USVI, in order to maximize local USVI employment and spur local economic development; the addition of a similar requirement for determining ECI should provide additional reassurance, if any is needed, that recipients of USVI tax incentives under Section 934(b) are engaged in genuinely USVI-based economic activities, and are not improperly contributing to the erosion of the U.S. tax base.

A possession ECI test requiring a demonstration of both an economic nexus to the possession and attribution to a fixed place of business in that possession is essentially the test used for U.S. treaty partners, and would have two salutary effects. First, it would restore parity between possession taxpayers and foreign taxpayers. Second, it would eliminate the economic distortions created by the existing regulations, which arbitrarily confine possession ECI from non-USVI sources to certain narrow categories of Section 864(c)(4) income, *i.e.*, rents and royalties for the use of intangible property; interest and dividends derived from certain banking and financial transactions; insurance income; and the sale of certain personal property.⁶¹

As more fully explained in the Government's July 11, 2005 submission in connection with the IRS hearings on the temporary and proposed Treasury Regulations (a copy of which was previously tendered to you), the Foreign Investors Tax Act of 1966 ("FITA") enacted Section 864(c)(4) to curb perceived abuses by foreign persons using U.S. offices to generate certain narrow categories of income not previously subject to U.S. or foreign taxation. The Government submits that FITA's response to this particular foreign tax avoidance practice nearly 50 years ago has no relevance to the current legislative goals of Sections 934 and 937(b)(1) to promote the Territory's economic development by permitting tax incentives for income (*of whatever character and wherever sourced*) "attributable to," or

⁵⁹ 26 U.S.C. § 864(c)(2).

⁶⁰ 26 U.S.C. § 864(c)(5).

⁶¹ 26 U.S.C. § 864(c)(4)(B)(i)-(iii); (c)(4)(C).

Honorable Michael F. Mundaca
March 31, 2011
Page 20

“effectively connected with” the conduct of Territorial trade or business. Further, nothing in the legislative history to the Jobs Act requires Treasury to limit USVI ECI from non-USVI sources to the narrow categories of income described in Section 864(c)(4).

ii. Section 937(b)(2): The U.S. Income Limitation Rule

To preclude any opportunity for abuse, the Government proposes that the U.S. income limitation rule under Section 937(b)(2) be retained—but in modified form. Under the Government’s proposal, the U.S. income limitation rule should include generally all U.S. source income attributable to a U.S. office or a fixed place of business. Such a rule properly addresses Treasury’s legitimate concerns about abuse and U.S. base erosion, while also giving full effect to the competing policy goal of promoting USVI economic development.

The legislative history of the Jobs Act clearly evidences Congressional intent to preserve the USVI manufacturing base, and the “inventory property” exception of Treas. Reg. § 1.937-3(d) narrowly reflects that intent. But there is no compelling tax policy reason for excluding from USVI ECI all U.S. source non-manufacturing income attributable to a USVI trade or business. Indeed, the sweeping U.S. income limitation rule in existing Treas. Reg. § 1.937-3(c) leads to gross economic distortions. For example, under the inventory property exception, a *sale* of a USVI-developed software product to a U.S. customer would qualify for Section 937(b)(1) ECI treatment, but a *license* of the same software to the same U.S. customer would not. An identical transaction, whether structured as a sale or as a license to a European customer, would unquestionably be eligible for treatment as Section 937(b)(1) USVI ECI. Similarly, interest on a loan underwritten in the Virgin Islands to a borrower in Buenos Aires would qualify as V.I. ECI, but interest on the same loan to a borrower in Salt Lake City would not.

As a matter of both economics and tax policy, these distinctions make no sense. As currently in force, the Section 937(b)(2) U.S. income limitation arbitrarily favors some transaction forms over others, and unfairly discriminates against taxpayers who market their goods or services in the United States rather than abroad. The Government submits that these anomalous outcomes serve no legitimate purpose, and are in conflict with the clear Congressional intent of Section 934(b). Rationalizing the regulations as the Government proposes would give effect to that intent, without jeopardizing the policy goal, embodied in Section 937(b)(2), of preventing erosion of the U.S. tax base.

Finally, the Government submits that a special rule is appropriate for the Section 937(b)(2) U.S. source limitation on U.S. source compensation. As a general rule, compensation may be sourced to the U.S. or another taxing jurisdiction using a time-based pro-ration method or another method that takes into account the value of the services provided at a particular situs. Thus, if a bona fide USVI resident provides to U.S. clients “high-value” investment services from a USVI office, and also provides “secondary” services to those clients at meetings in the U.S., the compensation sourced to the USVI would be limited to the USVI-rendered “high-value” services. Under current Treas. Reg. § 1.937-3(c),

Honorable Michael F. Mundaca
March 31, 2011
Page 21

however, compensation earned in connection with the secondary services provided in the U.S. would neither be USVI source income nor eligible for treatment as USVI ECI.

Under the Government's proposal, U.S. source compensation could still be eligible for treatment as USVI ECI—but only if three criteria are met. First, as with all other kinds of income, the compensation must not be attributable to a fixed place of business in the United States. In response to Treasury's legitimate concerns about the potential for abuse and erosion of the U.S. tax base, however, two more tests must also be met. Second, the compensation must be from activities in the U.S. that are merely "preparatory and auxiliary" to an economic activity in the USVI.⁶² Third, even if the U.S. activities are merely preparatory and auxiliary, the individual taxpayer providing such U.S. situs preparatory and auxiliary services must be present in the United States for no more than 183 days in the taxable year.

These additional Section 937(b)(2) U.S. source limitations on compensation—which the Government had not previously proposed—should ensure that the availability of Section 937(b)(1) ECI treatment for certain U.S. source compensation income will not be vulnerable to abuse, and will not lead to erosion of the U.S. tax base.

* * * * *

CONCLUSION

The Government is grateful for the opportunity to address these issues with you. The EDC program is essential to the continued growth of the USVI economy and the welfare of its people. We believe that the proposed revisions to the Territorial residency and ECI Regulations described herein are entirely consistent with Congressional intent, long-standing U.S. tax policy towards the U.S. Territories, and the public interest. We look forward to further discussions with you and your staff with respect to this proposal.

⁶² Although the determination of what constitutes "preparatory and auxiliary" is based on the facts and circumstances of each case, Rev. Rul. 72-418, 1972-2 C.B. 661 provides some indication of the IRS' view on what constitutes "preparatory and auxiliary." In the ruling, the IRS held that the business activities conducted by the U.S. office of a German bank were preparatory and auxiliary in nature and did not rise to the level of a permanent establishment. The U.S. office essentially served as a clearinghouse for information relevant to the bank facility, conducting a variety of activities such as: (1) investigating and obtaining information regarding commercial and financial information of interest to the German bank, (2) assisting the bank's U.S. and German customers to obtain information; and (3) establishing and maintaining contracts in the U.S. In addition, this term is regularly used in the treaty context and is described in the Technical Explanation as including activities such as the purchase of goods or merchandise, the collection of information or the advertising or the supply of information. Technical Explanation, Article 5 ¶ 4.

Sourcing of Capital Gains by a V.I. Resident

Background

Prior to 1986, the source rules for capital gains had been unclear, and subject to potential abuse by U.S. taxpayers in applying the foreign tax credit provisions. To provide clarity and prevent abuse, Congress mandated in the Tax Reform Act of 1986 ("TRA 1986") that gain derived from the sale of personal property (other than inventory) by a U.S. resident is generally treated as U.S. source income under Section 865(g)(a) of the Internal Revenue Code. Similar income by a nonresident (including U.S. citizens) generally is treated as foreign source income. A U.S. possession is treated as a foreign country under this general rule. Thus, a U.S. citizen who was a bona fide resident of a possession (*e.g.*, the USVI or Puerto Rico) generally derived possession source gains on the sale of capital gain property.

A special rule in Section 865(g)(2), overriding the above Section 865(a) general rule, applied to U.S. citizens (and resident aliens) who did not pay at least a 10% tax on such capital gains. That is, such U.S. citizens (and resident aliens), even if they generally were bona fide residents of a possession (or foreign country), were treated as U.S. residents for sourcing purposes, and hence their gains also treated as U.S. source, if such gains were not subject to a minimum 10% tax rate in the possession (or foreign country).

The TRA 1986 legislative history reveals that this 10% minimum tax was based on the perceived tax policy concern that income subject to no or nominal (<10%) tax by a foreign country (or possession) should not be treated as foreign source income in order to prevent taxpayers from manipulating the foreign tax credit limitation rules for U.S. tax avoidance purposes. This tax policy concern is not present in the case of a bona fide resident of a Mirror Code possession who is subject to income tax on his worldwide income, including U.S. source income, and pays tax exclusively to the possession tax authority. In addition to the demonstrable absence of potential abuse of the U.S. foreign tax credit limitation in the case of bona fide VI residents, no apparent consideration was given to the possible material adverse effect of such special rule on the various Congressionally authorized tax incentive programs of the USVI and Puerto Rico.

In 1988, Congress passed the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"), which in relevant part amended Section 865 to authorize Treasury to promulgate regulations to override the Section 865(g)(2) 10% minimum tax requirement for capital gains of Puerto Rico residents, who are generally subject to U.S. tax on non-Puerto Rico source income, including U.S. source income. The TAMRA legislative history notes, without explanation, that the Treasury authority to promulgate such regulations was to apply only to possessions that were "delinked" from the so-called "Mirror Code" *i.e.*, the Code as applied to a possession, presumably because residents of de-linked possessions, like Puerto Rico, are generally subject to U.S. income tax on their non-possession source income. While Puerto Rico had long ago

delinked from the Mirror Code, the USVI has not. Pursuant to this authority, Treasury issued a notice in 1989 clarifying that Puerto Rico is allowed to reduce its capital gains tax rate to less than 10% under its tax incentive programs.

A bona fide resident of the Virgin Islands – in contrast to a bona fide resident of Puerto Rico -- pays tax on his or her worldwide income to the USVI and *not* to the United States. Under Section 934(b), the USVI is permitted to reduce its Mirror Code rate of tax on Virgin Islands source income, as well as Virgin Islands effectively connected income (“VI ECI”), regardless of source (including U.S. source income). Thus, prior to enactment of the American Jobs Creation Act of 2004 (“Jobs Act”), the Section 865(g)(2) limitation had, as a practical matter, little, if any, material impact on the ability of the USVI to reduce the rate of tax on the capital gains of bona fide residents of the Virgin Islands participating in its tax incentive programs. With the enactment of the Section 937(b)(2) U.S. source limitation rule as part of the Jobs Act, however, capital gains income that also qualifies as VI ECI may now no longer be eligible for USVI tax incentive and economic development programs. The interaction of Sections 865(g)(2) and 937(b)(2) thus creates an unintended adverse impact on USVI tax incentive and economic development programs and a competitive advantage in favor of Puerto Rico.

Accordingly, the GVI in a letter to Assistant Secretary for Tax Policy Mark Mazur dated May 1, 2014 requested that Treasury exercise its regulatory authority under Section 937(b) to eliminate this disparate treatment. In particular, Section 937(b) grants the Treasury regulatory authority to issue regulations setting forth when income will be deemed from sources within a possession, generally using rules “similar to” rules for determining when income is from sources within the United States. The May 1 letter requested that Treasury issue a comparable notice putting the Virgin Islands on the same basis as Puerto Rico with respect to the treatment of capital gains income. After meeting with Assistant Secretary Mazur last February, Treasury advised Governor Mapp that it agreed with the GVI position on the merits and would support technical tax legislation to exempt the Virgin Islands from the Section 865(g)(2) source override.

WINSTON
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F

BARRY J. HART
Partner

May 1, 2014

Mark J. Mazur
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

John A. Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Ave, NW
Washington, D.C. 20224

William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
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Re: USVI Resident: Sourcing of Capital Gains from Sales of Personal Property

Dear Secretary Mazur, Commissioner Koskinen, and Mr. Wilkins:

I am writing on behalf of the Government of the United States Virgin Islands ("GVI") to discuss the issue of the disparate and unjustified sourcing of gains from the sale of nondepreciable, non-inventory personal property (*i.e.*, capital gain property) by a bona fide United States Virgin Island ("USVI") resident vs. the sourcing of such capital gain property by a bona fide Puerto Rican resident. In addition, enclosed is a proposed Notice for Treasury to issue (similar to Notice 89-40) conforming the USVI and Puerto Rican source rules for capital gains of bona fide residents of those respective possessions.

EFTA00301285

DISCUSSION**Section 865 (Tax Reform Act of 1986 (TRA 1986))**

Prior to 1986, the source rules for capital gains had been unclear, and subject to potential abuse by U.S. taxpayers in applying the foreign tax credit provisions. To provide clarity and prevent abuse, Congress mandated in the TRA 1986, enacting the Internal Revenue Code of 1986, as amended ("Code"), that gain derived from the sale of personal property (other than inventory) by a U.S. resident is generally sourced under Section 865(a) in the United States. Similar income by a nonresident (including U.S. citizens) generally is treated as foreign source. A U.S. possession is treated as a foreign country under this general rule. Thus, a U.S. citizen who was a bona fide resident of a possession (e.g., the USVI and Puerto Rico) generally derived possession source gains on the sale of capital gain property.

A special rule in Section 865(g)(2), overriding the above Section 865(a) general rule, applied to U.S. citizens (and resident aliens) who did not pay at least a 10% or greater tax on such capital gains. That is, such U.S. citizens (and resident aliens), even if they generally were bona fide residents of a possession (or foreign country), were treated as U.S. residents for sourcing purposes, and hence their gains also treated as U.S. source, if such gains were not subject to a minimum 10% tax rate in the possession (or foreign country).

The TRA 1986 legislative history reveals that this 10% minimum tax was based on the perceived tax policy concern that income subject to no or nominal (<10%) tax by a foreign country (or possession) should not be treated as foreign source to prevent taxpayers from manipulating the foreign tax credit limitation rules for U.S. tax avoidance purposes. This tax policy concern is not present in the case of a bona fide resident of a Mirror Code possession who is subject to income tax on his worldwide income, including U.S. source income, and pays tax exclusively to the possession tax authority. In addition to the demonstrable absence of potential abuse of the U.S. foreign tax credit limitation in the case of bona fide VI residents, no apparent consideration was given to the possible material adverse effect of such special rule on the various Congressionally authorized tax incentive programs of the USVI and Puerto Rico.

Section 865(j) (Technical and Miscellaneous Revenue Act of 1988) (TAMRA))

In 1988, TAMRA in relevant part amended Section 865 to add Section 865(j)(3), authorizing the Treasury to promulgate regulations to override the Section 865(g)(2) 10% minimum tax requirement for purposes of Sections 931, 933 (Puerto Rico), and 936.

The TAMRA legislative history notes, without explanation, that the Treasury authority to promulgate such regulations was to apply only to possessions that were "delinked" from the so-called "Mirror Code" *i.e.*, the Code as applied to a possession. While Puerto Rico has delinked from the Mirror Code, the USVI has not delinked.

Notice 89-40

In Notice 89-40, 1989-1 CB 681, the IRS announced that it would promulgate regulations under Section 865(j)(3) providing that Section 865(g)(2) will not apply to a bona fide resident of

Puerto Rico. Thus, the Notice provided that the source of a bona fide Puerto Rican resident's capital gains is to be determined under the general rules of Section 865(a) without regard to Section 865(g)(2), *i.e.*, whether or not Puerto Rico imposed a 10% or greater tax on such capital gains.

Inasmuch as Section 933 exempts only Puerto Rico source income from U.S. taxation, the intended effect of Notice 89-40 was to ensure that Puerto Rico retained exclusive taxing jurisdiction over the capital gains of a bona fide resident of Puerto Rico, regardless of the rate of tax Puerto Rico elected to impose. Thus, Puerto Rico is allowed to reduce its capital gains tax rate to less than 10% under its tax incentive programs.

Section 937 (The American Jobs Creation Act of 2004 (AJCA))

In contrast, a bona fide resident of the Virgin Islands pays tax on his or her worldwide income to the USVI and not to the United States. Under Section 934(b), the USVI is permitted to reduce its Mirror Code rate of tax on Virgin Islands source income, as well as Virgin Islands effectively connected income ("VI ECI"), regardless of source. Prior to enactment of the AJCA, Section 865(g)(2) had, as a practical matter, little, if any, material impact on the ability of the USVI to reduce the rate of tax on the capital gains of bona fide residents of the Virgin Islands participating in its tax incentive programs. With the enactment of the Section 937(b)(2) U.S. source limitation rule as part of the AJCA, however, capital gains income that also qualifies as VI ECI may now no longer be eligible for USVI tax incentive and economic development programs. The GVI submits that the interaction of Sections 865(g)(2) and 937(b)(2) thus creates an unintended adverse impact on USVI tax incentive and economic development programs and a competitive advantage in favor of Puerto Rico.

Accordingly, the GVI requests that Treasury exercise its regulatory authority under Section 937(b) to eliminate this disparate treatment. In particular, Section 937(b) grants the Treasury regulatory authority to issue regulations setting forth when income will be deemed from sources within a possession, generally using rules "similar to" rules for determining when income is from sources within the United States.

In 2008, the Treasury issued final regulations (T.D. 9391) generally applying the Section 861-865 sourcing rules for Section 937(b) purposes. In the preamble to T.D. 9391, the Treasury observed that the interaction of Section 937 and other Code Sections (*e.g.*, Section 865) requires a balance in implementing policies Congress intended in Section 937(b), while recognizing the possessions' efforts to attract and retain workers and businesses. Treasury expressly acknowledged that such need for balance and flexibility prompted the Treasury in Reg. § 1.937-2(f)(vi) to allow an individual who owns personal property prior to becoming a bona fide possession resident to elect to treat as possession source the portion of the gain from personal property accruing while the individual was a bona fide possession resident. In providing for this special election, in the preamble to T.D. 9391 Treasury invited further comments on the final regulations, and expressly anticipated that additional changes to the final regulations may be necessary to find the proper balance, departing when necessary and appropriate from the general U.S. source rules set forth in Sections 861-865.

Also, as acknowledged in the preamble to T.D. 9391, the Treasury has broad regulatory authority to modify the general U.S. source rules applicable to gain attributable to personal property owned by bona fide USVI (and other possession) residents. The enactment of Section 937(b)(2) makes Section 865(g)(2) newly relevant and important to bona fide residents of Mirror Code possessions such as the USVI, and to the GVI in its efforts to attract and retain workers and businesses.

We see no federal policy reason (tax or otherwise) to favor bona fide residents of delinked possessions (such as Puerto Rico) over bona fide residents of Mirror Code possessions (such as the USVI) with respect to the sourcing of possessions-based capital gains.

EXAMPLE (CURRENT LAW)

The following example is based on the apparent interaction of Sections 865, 932, 933, 934 and 937 of the Code, and illustrates the disparate sourcing of capital gains of bona fide residents of Puerto Rico vs. the USVI.

- (a) X is a U.S. citizen and a bona fide resident of Possession P for all relevant years. In year 1, X acquires asset A (which is a capital asset as defined in section 1221) for \$100. In Year 5, X sells asset A for \$300. Under the law of Possession P, the gain of \$200 is subject to tax at an effective rate of 4%.
- (b) Except as discussed below, the gain of \$200 is considered from income sources within Possession P under the principles of section 865 as applicable pursuant to section 937(b)(1) and Treas. Reg. § 1.937-2(b). For the purpose of applying those principles, X is considered a resident of Possession P due to X's status as a bona fide resident as determined under the rules of section 937(a) and Treas. Reg. § 1.937-1, rather than under the rules of section 865(g). See Treas. Reg. § 1.937-2(f)(2)(ii).
- (c) If Possession P is **Puerto Rico**, section 865(g)(2) does not apply. See Section 865(j)(3) and Notice 89-40. Accordingly, the gain is not considered U.S. source income under the rules of section 865, and the exception for U.S. source income under section 937(b)(2) and Treas. Reg. § 1.937-2(c) does not apply. As a result, the gain is considered income from sources within Puerto Rico for purposes of section 933, and not subject to tax under the Code.
- (d) If, alternatively, Possession P is the **USVI** (or a possession to which section 931 or section 935 applies), X is considered a "United States resident" for purposes of section 865 under section 865(g) due to the application of section 865(g)(2), because the income tax paid by X to Possession P was less than 10% of the gain. Accordingly, the gain is considered U.S. source income under section 865(a) and subject potentially to Mirror Code tax of 23.8% (the 20% long term capital gains tax rate under Mirror Code Section 1(h), plus the 3.8% Section 1411 tax). Pursuant to the exception for U.S. source income under section 937(b)(2) and Treas. Reg. § 1.937-2(c), the gain cannot be considered income from sources within Possession P for purposes of the Code (including sections 932 and 934).

REQUESTED ACTION

The GVI submits that Treasury has regulatory authority, and that sound tax policy commends Treasury to exercise such authority, to achieve parity of capital gain source treatment for bona fide residents of Puerto Rico and the USVI, especially for those individuals who participate in Congressionally authorized tax incentive programs offered by those possessions.

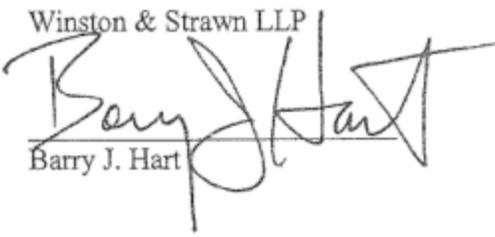
The GVI submits that Treasury should by regulation supplement Reg. § 1.937-2(c) and (f)(2) by providing that the Section 865(g)(2) 10% minimum tax rule does not apply when determining the source of gains recognized by a bona fide resident of any possession, including but not limited to the USVI. The GVI submits that Treasury's announced commitment in the preamble to T.D. 9391 to seek comments and make changes (clarifying and substantive) to the final regulations warrant careful consideration of this request.

Attached is a proposed Notice similar to Notice 89-40 giving effect to this requested Treasury action applicable to bona fide residents of the USVI. We defer to Treasury as to the application of the proposed Notice to other possessions.

After you and your staff have had an opportunity to consider this submission, we look forward to following up with you at your earliest convenience.

Respectfully submitted,

Winston & Strawn LLP


Barry J. Hart

cc: Governor John de Jongh, Jr.
United States Virgin Islands

Emily McMahon, Deputy Assistant Secretary
Robert Stack, Deputy Assistant Secretary
Danielle Rolfes, International Tax Counsel
Brenda Zent, Office of International Tax Counsel
[REDACTED], Associate Chief Counsel, International
[REDACTED], Deputy Associate Chief Counsel
[REDACTED], Branch VII Chief, International
[REDACTED], Branch VII, Senior Technical Reviewer

1. PURPOSE

This notice provides guidance under sections 937 and 865 of the Internal Revenue Code of 1986, as amended ("Code").

The rules contained in this notice will be incorporated in regulations to be promulgated under section 937(b) of the Code. This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or procedure. Any modification of the rules contained herein will be prospective only.

2. BACKGROUND

Section 865(g)(2) of the Code provides that gains of a U.S. citizen resident outside the United States are U.S. sourced unless a foreign income tax of at least ten percent is imposed. Section 1012(d)(6)(B) of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), 102 Stat. 3497, added section 865(j)(3) to the Code. Section 865(j)(3) authorizes the Secretary to prescribe regulations providing that, subject to certain conditions as may be provided in such regulations, section 865(g)(2) shall not apply for purposes of sections 931, 933, and 936.

Notice 89-40, 89-I CB 681 provides that regulations under section 865(j)(3) will provide that section 865(g)(2) shall not apply to a person who is a bona fide resident of Puerto Rico, and that the source of gains recognized by such a bona fide resident of Puerto Rico

shall be determined under section 865 without regard to section 865(g)(2), *i.e.*, such gains shall be subject to the general residence of the seller rule under section 865(a).

The American Jobs Creation Act of 2004 (AJCA), 118 Stat. 1418, added, *inter alia*, section 937 to the Code. Section 937(a) provides detailed rules in determining whether an individual is a bona fide resident of Puerto Rico, the United States Virgin Islands ("USVI"), or certain other possessions.

Section 937(b) provides that for purposes of the Code, except as provided in regulations, rules similar to the rules for determining whether income is from sources within the United States or is effectively connected with the conduct of a trade or business within the United States shall apply for purposes of determining whether income is from sources within a possession specified in section 937(a)(1), including the USVI, or effectively connected with the conduct of a trade or business within any such possession.

T.D. 9391 promulgated final regulations generally applying the principles of the source rules set forth in sections 861-865 for section 937(b) purposes. In the preamble to T.D. 9391 the Treasury and IRS acknowledged that the interaction of section 937 and other Code provisions, including but not limited to section 865, requires a balance between policies Congress intended in section 937(b), while recognizing other Congressional policies to support the possessions' efforts to attract and retain workers and businesses. Treasury and the IRS also acknowledged in the preamble to T.D. 9391 that changes may be needed to the final regulations to find the proper balance, and observed that Congress afforded the Treasury broad regulatory authority to make such changes.

3. PERSONS COVERED

This notice applies only to bona fide residents of the USVI as defined in section 937(a) of the Code and the regulations thereunder, and whose tax return filing obligations are governed by section 932(c) and the regulations thereunder.

4. SALES BY BONA FIDE RESIDENTS OF THE VIRGIN ISLANDS

Regulations issued under section 937(b) of the Code will provide that section 865(g)(2) shall not apply to a person who is a bona fide resident of the USVI for the entire taxable year. The source of income from the sale of personal property by such bona fide residents shall be determined under section 865 without regard to section 865(g)(2). Thus, for example, a bona fide USVI resident who sells stock (that does not constitute inventory) will not be subject to the ten percent tax payment rule of section 865(g)(2), but, instead, will be subject to the general residence of the seller rule under section 865(a). Therefore, regardless of whether a tax equal to 10 percent of the gain is paid to the USVI, the income from the stock sale will be treated as USVI source income.

5. EFFECTIVE DATE

This notice is effective for taxable years beginning after December 31, 2004.

External Memorandum

BARRY J. HART
Partner

To: Brenda Zent

From: Barry J. Hart
Peter N. Hiebert

Date: June 26, 2014

RE: Section 937(a): Liberalization of Presence Test

I. Introduction

As you know, our discussions about the need to liberalize the physical presence test for Virgin Islands (“V.I.”) residency have recently focused on creating a 30-day exemption for off-island travel (the “30 Day Off-Island Travel Exemption”).¹ You have asked the Government of the U.S. Virgin Islands (“GVI”) to explain why such a liberalization is necessary and appropriate—and in particular, to provide examples of persons who would benefit from it. This memorandum demonstrates the need for the 30 Day Off-Island Travel Exemption by different classes of V.I. residents for whom the existing physical presence test poses substantial business and personal disadvantages.

As we explain below, the proposed 30 Day Off-Island Travel Exemption is particularly critical for beneficiaries of the GVI’s Economic Development Commission Program (“EDC Program”). Because these beneficiaries are legally obligated to serve only clients located outside of the V.I., they are often required to travel extensively not only to the U.S. mainland, but also internationally. A travel exemption is also critical for many individual V.I. residents whose personal travel for medical and disaster-related reasons falls outside the exemptions that cover such travel.

¹ The GVI continues to support extension to U.S. citizens and residents of the Section 7701(b) 122 day/3 year weighted average test currently applicable to nonresident aliens—an extension that the GVI maintains is both appropriate and within Treasury’s regulatory authority. See, e.g., GVI March 31, 2011 Submission to Michael F. Mundaca, Assistant Secretary of Treasury for Tax Policy (copy enclosed). The GVI also supports the 30 Day Off-Island Travel Exemption discussed in this memorandum as an alternative to the extension of Section 7701(b).

II. Background: The Existing Statutory and Regulatory FrameworkA. Section 937(a)

Section 937(a) contains a three-part *conjunctive* test for an individual (U.S. citizen or resident, or a nonresident alien) to be considered a bona fide V.I. resident. The individual must:

- (1) be physically present in the V.I. for 183 days or more in the taxable year (*i.e.*, the “Presence Test”); **and**
- (2) not have a tax home outside the V.I. during the taxable year; (the “Tax Home Test”) **and**
- (3) not have a closer connection to the United States or a foreign country than to the V.I. (the “Closer Connection Test”).

Section 937(a) expressly grants Treasury the authority to modify the above statutory requirements by regulation—an authority it exercised in T.D. 9248 (1/31/06) and T.D. 9297 (11/14/06).

B. Treasury Regulations1. Presence Test

Current Treas. Reg. § 1.937-1(c) provides a five-part *disjunctive* test for a U.S. citizen (or resident alien) to meet the Presence Test for a taxable year. A U.S. citizen (or resident alien) will meet the Presence Test if he or she —

- (a) was present in the V.I. (or another possession) for at least 183 days during the taxable year (the “183 Day Test”); **or**
- (b) was present in the V.I. for at least 549 days in the three (3) year period consisting of the taxable year and the two immediately preceding taxable years, provided that the individual was also present in the V.I. for at least 60 days during each taxable year of the period (effectively, a 183 day non-weighted averaging test, the “183 Day/3 Year Test”); **or**
- (c) was present in the United States for no more than 90 days during the taxable year (the “90 Day Test”); **or**
- (d) During the taxable year had earned income (as defined in § 1.911-3(b)) in the United States, if any, not exceeding in the aggregate the amount specified in Section 861(a)(3)(B) [currently \$3,000] and was present for more days in the V.I. than in the United States (the “Earned Income Test”); **or**

- (e) Had no significant connection to the United States during the taxable year (the "No Significant Connection Test").

Treasury added the 183 Day/3 Year Test described in paragraph (b) above in T.D. 9297 (11/14/06). When creating the more flexible three-year average presence test, Treasury determined that liberalizing the strict 183 Day Test was unlikely to lead to abuse because a V.I. taxpayer seeking to satisfy it must still also meet both the Tax Home Test and the Closer Connection Test.

2. Days of V.I. Presence

For purposes of the Presence Test, an individual (U.S. citizen, resident alien, or nonresident alien) is considered to be present in the V.I. on:

- (a) any day that the individual is physically present at any time;
- (b) any day that an individual is outside the V.I. to receive or to accompany on a full time basis, a parent, spouse or a child who is receiving "qualifying medical treatment" (*i.e.*, medically documented care on an inpatient basis) (the "Medical Treatment Rule"); and
- (c) any day that an individual is outside the V.I. because the individual leaves, or is unable to return, to the V.I. during (i) a 14-day period within which FEMA has issued a Presidential declaration of a major disaster in the possession, or (ii) any period for which a mandatory evacuation order is in effect for the geographic area in the V.I. in which the individual's place of abode is located (the "Disaster Rule").

3. Days of U.S. Presence

Reciprocally, an individual is considered to be present in the United States on any day that the individual is physically present in the United States at any time. Important exceptions to days of U.S. presence include days in which the individual is temporarily present in the United States due to either the Medical Treatment Rule or the Disaster Rule. In such cases days of U.S. presence will not count as such under the Presence Test.

III. GVI Proposal: The 30 Day Off-Island Travel Exemption

To resolve difficulties posed by the existing physical presence requirements, the GVI proposes that Treasury enact the 30 day Off-Island Travel Exemption. As we have discussed, the exemption would permit a bona fide V.I. resident to travel outside the V.I. for 30 days annually, while still counting those travel days as days of presence in the V.I.

Thus, for any taxable year, V.I. residents could satisfy the Physical Presence Test by showing (i) actual or constructive V.I. presence of no fewer than 153 days (the current standard

of 183 days, less 30 days) under the 183 Day Test or (ii) a potentially somewhat lesser number of days of V.I. presence under the 183 Day/3 Year Test, with the important proviso that, in the latter case, there be at least 60 days of actual V.I. presence in each taxable year. In addition, under the 30 Day Off-Island Travel Exemption up to 30 days of U.S. presence attributable to Off-Island travel would be counted as days of V.I. presence and, conversely, not be counted as days of U.S. presence, under both the 90 Day Test and the Earned Income Test.

The GVI submits that the 30 Day Off-Island Travel Exemption is a natural extension of the 183 Day/3 Year Test, which the IRS adopted recognizing the realities of life in the V.I., including the need for frequent travel outside the V.I. for business and personal reasons. The existing physical presence regime is unnecessarily rigid, and fails to provide exemptions for legitimate business travel by bona fide V.I. businesses and personal travel that falls well within the spirit of the existing exemptions for medical and disaster-related absences from the V.I. The 30 Day Off-Island Travel Exemption offers businesses and individuals the flexibility to undertake legitimate business and personal travel without suffering potentially adverse tax consequences.

IV. The Need For A More Liberal Travel Exemption

The existing physical presence requirements are unduly onerous for at least three important V.I. constituencies: (i) certain businesses that by law must serve only non-V.I. clients, and so must travel extensively to serve their clients in the ordinary course of business; (ii) for individuals who travel outside the V.I. for legitimate medical reasons, but whose travel falls outside the extremely narrow Medical Treatment Rule; and (iii) for individuals whose absence from the V.I. is a result of a natural disaster that occurs outside the V.I. but that prevents them from returning.

A. EDC Program Service Businesses Require Unusually Extensive Travel

The V.I. remains a developing economy historically dependent on tourism and a diminishing legacy of manufacturing and agricultural business. The GVI has for many years committed itself to developing a high-value service sector based on entrepreneurship and intellectual capital. To that end, the GVI created the EDC Program, relying upon tax incentives authorized by Congress in Section 934(b) to attract and retain high-value service businesses.

Services companies eligible for EDC benefits (known as "Designated Service Businesses," or "DSBs") include, among many others, public relations firms, consulting companies, news syndicates, mail-order businesses, computer service centers, investment managers and advisers, other financial services firms, software developers, call centers, and e-commerce businesses. Critically, regardless of the kind of business a DSB engages in, the EDC Program requires all EDC beneficiaries to service only clients and customers who are located *outside* the V.I., so as not to compete unfairly with local V.I. companies subject to general Mirror Code taxation. *See generally* 29 V.I. Code Ch 12.

Because DSBs can only have clients based outside the V.I., DSB status *necessarily* requires extensive travel outside the V.I. in order to meet with current and prospective clients and customers—a key function of any services business. That client-service travel is in addition to all the travel normally associated with an operating business, including travel necessary to attend professional conferences, meet with government and regulatory officials, deal with lawsuits, recruit employees and consultants, and deal with general business and professional exigencies.

The burden of the existing regime is particularly harsh for financial-services firms, which generate enormous value and which have been a particular focus of the EDC Program. The travel restrictions of the existing physical presence test pose a substantial obstacle to successful operations in the V.I. As one former EDC beneficiary—a hedge-fund management company—explained to the GVI, its business includes three principal tasks: (1) soliciting investors; (2) investing raised capital; and (3) conducting due diligence on their investments. Each of these tasks necessitates significant off-island travel because “[s]oliciting and managing investors[’] money invariably requires intensely personal relationships and communication that cannot be satisfactorily effected from the USVI.” And “due diligence often requires meeting face-to-face with the management of the targeted investment.” That company, which previously employed 10 or more V.I. residents and generated millions of dollars of economic activity in the V.I., recently concluded that the current physical presence requirements were incompatible with its business model, and was “compelled to relocate to the U.S.” Moreover, because “no substantial hedge industry conferences are held in the USVI[,]” “[i]f hedge fund managers want to engage in the formal and informal information sharing that occurs at such conferences, they must be absent from the USVI.”

Even where the physical-presence requirements do not force viable businesses to leave the V.I., they can have significant and deleterious effects on business operations. In two instances, V.I. entrepreneurs were forced to return to the U.S. mainland to help repair “critical problems” in their family-owned business. These problems represented a “life or death situation” for their businesses, but under the current Treasury Regulations, the V.I. entrepreneurs were at risk of not satisfying the Presence Test. In another example, V.I.-based real estate consultants faced difficulty in satisfying the Presence Test because their business frequently required them to attend meetings in a variety of jurisdictions, notwithstanding that the base of operations existed in the V.I.

Because the costs of the existing physical-presence requirements on their ability to successfully operate in the V.I. are real and substantial, many DSBs struggle to both comply with the rules and remain competitive. The 30 Day Off-Island Travel Exemption would give DSBs needed flexibility to operate their businesses without fear of incurring potentially adverse tax consequences.

B. Medical Patients and Disaster Victims Also Suffer From Unnecessarily Rigid Physical Presence Requirements

It is not only businesses that would benefit from a liberalized travel exception to the physical presence rules. Individual Virgin Islanders, too—including medical patients and disaster victims, who are in difficult personal circumstances and are most in need of the ability to travel freely—suffer unnecessarily under the existing regime.

1. The need for a travel exemption to supplement the Medical Treatment Rule

As noted, an individual is considered to be present in the V.I. on a particular day if he or she is physically present there at any time on that day. In T.D. 9248, however, Treasury created an exception to that rule for persons who are outside the V.I. to (i) receive, or (ii) accompany on a full-time basis a parent, spouse or child who is receiving, qualified medical treatment on an inpatient basis.

On its face, the Medical Treatment Rule exempts travel only in a highly limited set of circumstances. It applies only to medical care of the taxpayer and his or her parents, spouse, and children; only if that care constitutes “qualified medical treatment;” and only if that care occurs “on an inpatient basis.” As should be self-evident, the rule omits a large amount of legitimate medical travel, imposing on Virgin Islanders potentially adverse tax consequences for doing nothing more than caring for themselves and their loved ones.

For example, one Virgin Islander reported that his elderly and infirm parents lived at their home on the U.S. mainland, rather than a medical care facility, depriving him of the benefit of the Medical Treatment Rule even though his parents were under continuous supervision by medical professionals. Another V.I. resident reported receiving a course of cancer treatment that required travel to the U.S. mainland several times a year for specialized chemotherapy; but because the chemotherapy did not require hospitalization, the resident was unable to claim the benefit of the rule for any of his travel. Similarly, a V.I. resident had a rare cancer that required special, experimental treatment at a U.S. mainland hospital far away from the V.I. But again, because the treatment did not require hospitalization, the resident was not protected by the Medical Treatment Rule. The rule also does not apply to grandparents’ travel: one respondent reported traveling to the U.S. mainland for his granddaughter’s brain surgery, and being unable to claim the benefit of the rule because it applies only to travel for “a parent, spouse or child.”

These kinds of inequitable outcomes could be partially remedied by adoption of an expanded travel exemption. The 30 Day Off-Island Travel Exemption would permit (for example) a chemotherapy patient to travel to the US

for outpatient treatments, or a grandparent or grandchild to travel outside the V.I. to care for an ailing, but not hospitalized, grandparent or grandchild, as the case may be, without risking serious tax consequences.²

2. The need for a travel exemption to supplement the Disaster Rule

Like the Medical Treatment Rule, the Disaster Rule provides an exemption to the physical-presence rule for any day that an individual is outside the V.I. because the individual leaves, or is unable to return to, the V.I. during (i) a 14-day period within which FEMA has issued a Presidential declaration of a major disaster in the possession, or (ii) any period for which a mandatory evacuation order is in effect for the geographic area in the V.I. in which the individual's place of abode is located.

By its terms, the Disaster Rule exemption applies only to persons who travel outside the V.I. due to a disaster in the V.I. It does not apply to persons who are forced to remain outside the V.I. due to a disaster elsewhere in the United States. For example, the GVI is aware that V.I. residents were stranded in the United States due to Hurricane Sandy in November 2012, and severe winter storms in Atlanta, in 2014, and unable to return to the V.I. due to disruption of air travel in New York Atlanta, which are major travel hubs for flights to the V.I. These U.S. mainland disasters were as disruptive to the stranded V.I. residents as a V.I. natural disaster, but currently such U.S. mainland disasters do not qualify for the 14-day Disaster Rule.

A liberalized travel exemption like the one described above would provide the flexibility needed to assist Virgin Islanders who are temporarily stranded by a disaster outside the V.I. in the mainland United States.

V. Conclusion

The GVI respectfully submits that Treasury's adoption of the GVI's 30 Day Off-Island Travel Exemption is consistent with the Treasury's tradition of sympathetic consideration of the business and personal realities of life in the V.I. Taking into account the ongoing conjunctive need also to meet the Tax Home Test and Closer Connection Test, the GVI submits this further liberalized Presence Test is not susceptible to abuse.

Finally, the GVI believes that many V.I.-based individuals who clearly meet the Tax Home Test and the Closer Connection Test also under U.S. estate and gift tax principles constitute V.I. domiciliaries, a presumptively higher threshold of V.I. nexus than Section 937(a)

² For cases involving very lengthy health-related travel, the GVI submits that it would appropriate to modify the Medical Treatment Rule to permit otherwise qualifying medical care on other than an inpatient basis outside the V.I. to count as a day of V.I. presence and, conversely, be excluded as a day of U.S. presence in the event such outpatient medical care is in the United States. The GVI also supports expanding the rule to cover medical travel by the patient's grandparents or grandchildren.

residency. As the Third Circuit in *Vento v. Director of Virgin Islands Bureau of Internal Revenue*, noted, income tax residency requires “far less than domicile.” (715 F.3d 455 at 466). See Treas. Reg §§ 20.0-1(b)(1) & 25.2501(b) for a definition of domicile for U.S. estate and gift tax purposes. Liberalizing the Presence Test by adopting a 30 Day Off-Island Travel Exemption will tend to harmonize the related, albeit different, concepts of residency and domicile by minimizing the possible anomaly that a V.I.-based individual would be a V.I. domiciliary for U.S. estate and gift tax purposes, but not a V.I. resident for U.S. federal income tax purposes.

30-Day Travel Exception
to Physical Presence Test
for Bona Fide V.I. Residency

The current test for bona fide V.I. residency was established as part of the American Jobs Creation Act of 2004 ("Jobs Act"). The statute provides a three-part test for residency: the individual must (1) be physically present for 183 days or more in the taxable year (the "Physical Presence Test"), (2) not have a tax home outside of the Virgin Islands during the tax year (the "Tax Home Test"), and (3) not have a closer connection to the U.S. or foreign country than to the Virgin Islands (the "Closer Connection Test"). In regulations promulgated to implement the residency test, Treasury modified the Physical Presence Test by providing a number of alternative ways to meet the requirement, including allowing an individual to be physically present in the Virgin Islands an "average" the 183 days a year over a moving three-year period. Notwithstanding Treasury's stated efforts to provide flexibility for V.I. residents, the Physical Presence Test, as currently implemented, has had a substantial adverse impact on the Virgin Islands Economic Development Commission ("EDC") Program and consequently on the Virgin Islands economy.

The Government of the Virgin Islands ("GVI") has consistently maintained that the proper test for bona fide V.I. residency should be the test the IRS applies under Section 7701(b) of the Internal Revenue Code to determine whether a foreign individual residing in the United States has sufficient presence in the U.S. to justify subjecting that individual to U.S. taxing jurisdiction in the manner as U.S. citizens: *i.e.*, such foreign individual must be physically present at least 183 days in any one tax year, *or* an average of 122 days a year over any three year moving period. Treasury has taken the position that it lacks legislative authority to adopt the 122-day test.

However, as a result of a meeting that Governor de Jongh had with then Assistant Secretary of the Treasury Michael Mundaca in the Summer of 2010, Secretary Mundaca advised that Treasury would be willing to review the Jobs Act rules (both residency and sourcing) *ab initio*, and invited the GVI to submit a detailed memorandum in support of any requested changes. In response, the GVI submitted a detailed memorandum to Treasury on March 11, 2011 proposing changes to both the Jobs Act residency rules and sourcing rules. In September of that year, Assistant Secretary Mundaca advised the Governor that Treasury had reviewed the GVI memorandum and agreed that the current residency test required additional flexibility (Assistant Secretary Mundaca also advised that Treasury would consider changes to the sourcing rules after completing review of any changes to the residency rules). Assistant Secretary Mundaca advised that Treasury/IRS would soon thereafter propose a "30-day of travel exception" to the Physical Presence Test, whereby up to 30 days of travel outside of the Virgin Islands by an individual otherwise eligible for bona fide V.I. residency could be considered as "constructive presence" in the Virgin Islands for purposes of meeting the Physical Presence Test.

Unfortunately, Assistant Secretary Mundaca left Treasury shortly after advising the Governor, and the proposed rulemaking languished.

Earlier this year, Treasury advised the GVI that the proposal was still “live” and still on Treasury’s regulatory agenda, but asked that the GVI provide additional support, anecdotal and otherwise, for the proposed exception. The GVI provided that support, in the form of a memorandum on June 26, 2014. In September, Governor de Jongh met with the current Assistant Secretary for Tax Policy, Mark Mazur, to discuss the pending proposal for a 30-day travel exception (as well as the GVI petition on the treatment of V.I. capital gains). In November, Treasury advised the Governor that based on the additional analysis provided by the GVI, Treasury would initiate a notice of proposed rulemaking early in 2015 to implement a 30-day travel exception to the 183-day physical presence requirement to establish V.I. tax residency.