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TAXATION

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TAXATION IN THE UNITED STATES VIRGIN ISLANDS*

GUSTAV A. DANIELSON**

GENERAL CONDITIONS

The United States Virgin Islands (named by Columbus after St. Ursula and her 11,000 virgins) were purchased from Denmark in 1917. What has happened to her tax system since should not be visited upon the most hardened harlot. To cope with the system one must be adept in "Alice in Wonderland" logic. The "Through the Looking Glass" concept which exists has been adequately rewarded with the sobriquet "mirror theory" being attached to its tax system. The Internal Revenue Code is applied with its full force in a manner not so predictable as in the continental United States. These waters are uncharted and infested with sharks and hidden reefs. Disastrous results are inflicted upon the unwary, who to their dismay learn that the whole trick was done with mirrors. For tax

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purposes, they may not be citizens under the American flag despite United States citizenship. Legitimacy of a well born taxpayer's birth has not yet been questioned, but equally strange interpretations are advanced by the Service under the mirror theory.

Despite the uncertainties of taxation, economic growth of the Virgin Islands has exceeded that of any other Caribbean area. Since the mid-1950's, the population more than doubled, and per capita income rose above \$2,500. Exports increased by 65 times those of 1955, eight major banking institutions maintain full services, and firms such as Martin Marietta (Harvey Alumina) and Hess Oil support industrial complexes. Holiday Inns, Sheraton, and Inter Continental Hotels have either existing or planned operations. Light industries and tourism businesses have found that the high standard of living in the politically stable sphere of a United States Territory provides a significant, advantageous business atmosphere. Manufacturing and assembly operations using foreign raw materials may export their products to the United States market with little or no customs duties applied. Tax incentives, outlined below, do exist and continue to attract business.

Unlike many developing areas, the Virgin Islands have experienced a "trickle-down" effect, benefitting most sectors of the economy. Unemployment has not been a serious consideration, and the high standard of living has created a substantial consumer class. The principal reasons for this growth and concurrent distribution of wealth fall without the subject matter of this paper. However, certain aspects of Virgin Islands economics should be brought to the attention of any prospective investor. The largest island industry is that of government. If this institution has failed to provide the services reasonably expected, it has been instrumental in distributing wealth.

In a grossly oversimplified statement, the scheme of things is roughly as follows: U.S. income taxes of residents (from all sources) and income tax on Virgin Islands source income of nonresidents are paid into the treasury of the Virgin Islands. Certain local taxes provide additional revenues, and the United States Government matches some specific funds. Taxes on sales of Virgin Island rum in the United States are returned to the Island's treasury. The Virgin Islands Government thereby becomes a comparatively wealthy entity with an operating budget of approximately \$130 million to provide services to a community of 95,000 inhabitants. Capital expenditures are met from completely different funds and federal grab-bags. The largesse is spread by hiring most who apply. With few

exceptions, native-born Virgin Islanders of all classes are government employees, and continental Americans and aliens have found government service to be rewarding. To fill jobs in the private sector, aliens from other Caribbean Islands have entered the Virgin Islands and may now outnumber the native-born population. Additional labor force has migrated from Puerto Rico, especially from the island of Vieques. The United States Department of Labor, upset over seasonal unemployment and mistakenly believing that a Spanish-speaking Puerto Rican labor market can supply the Virgin Islands' demand, has closed down the alien bonding program, with the result that there is little labor supply for private industries dependent upon human resources. The recession in the United States affects the Virgin Islands, and the labor shortage is not presently so severe as in normal times.

INCOME TAXATION AND THE MIRROR THEORY

History

Shortly after the purchase of the Virgin Islands by the United States, they were placed under a Naval Administration. No federal tax laws (or other federal laws, for that matter) are in effect in a possession unless Congress specifically so provides. *Fairchild v. Comm.*¹ Subsequently, the laws of income taxation were enacted by the Naval Appropriations Act of 1921.² This provided that the income tax laws in effect in the United States and those enacted thereafter should be in force in the Virgin Islands, except that the proceeds be paid into the treasury of the Virgin Islands. The Virgin Islands Code states that the Virgin Islands Income Tax Law means so much of the United States Internal Revenue Code as was made applicable by the above mentioned Naval Appropriations Act.³ Section 28(a) of the Revised Organic Act of 1954 expanded this by providing that the inhabitants of the Virgin Islands are required to pay taxes on income from all sources (including U.S. source income) into the Virgin Islands treasury.⁴ Thus, taxes which previously had been paid by permanent V. I. residents to the United States on United States source income were made payable to the Virgin Islands. As a corollary, Virgin Islands inhabitants have no obligation either to report or to pay taxes to the Federal Government on any income, whatever the source.⁵ On the other hand, United States persons (including corporations) are required to file a Virgin Islands Tax return as regards any portion of income derived from Virgin Islands sources. I.R.C. Sections 871 and 881-882

purportedly govern United States persons as well as persons of other "foreign" countries, and I.R.S. Sections 1441-42 provide the withholding obligations on payments made to such persons.

The Nature of the Tax

The nature of this income tax system is best explained by the *Jennings* cases in Guam. Until December 31, 1972, Section 31 of the Organic Act of Guam provided for a tax law similar to that of the Virgin Islands, by providing for insular application of the United States Internal Revenue Code. Thereby, Guam cases are persuasive authority. For taxable years beginning after 1972, Guam is given special treatment under amended Section 932 and new Section 935 of the Code.

In *Jennings v. U.S.*, 52 AFTR 927 (1957), the plaintiff argued that Section 252 of the 1939 Internal Revenue Code exempted Guamanians from payment of U. S. income taxes. Since the entire Code was in effect in Guam, it should follow that Guamanians should pay no income tax to the insular or any other treasury. The Court of Claims refused the plaintiff's motion for summary judgment and defendant's motion for dismissal, holding that the tax was *not* a separate territorial income tax but, instead, a *United States Income Tax* imposed in Guam and covered into Guam's treasury. Guam had administered and collected its income taxes for years, and the decision threatened the entire system.

The United States Congress responded quickly by passing Public Law 85-688, August 20, 1958, which stated that the tax was a separate, territorial tax, and that Guam was authorized to administer and collect such tax. No mention was made of the Virgin Islands and its similar tax system.

Trial on the merits followed the legislation. *Jennings v. U.S.*, AFTR 2d 6207. There the Court of Claims vacated its prior position and held that Guam's tax was a separate territorial income tax, stating that the plaintiff's position would support the absurdity that Congress imposed an income tax Code in Guam which was of no effect because of the terms of the Code itself. It held that Public Law 85-688, which had been passed so hastily following the first decision, merely re-enacted and clarified Guam's Organic Act. Therefore, the Court was not acting on an *ex post facto* law.

Although the Virgin Islands have no Public Law 85-688 to support the separate taxing jurisdiction theory, it has its *Dudley* to parallel

Jennings. The United States and the Virgin Islands are distinct taxing jurisdictions although their respective income tax laws arise from an identical statute applicable to each. *Dudley v. Commissioner*, 258 F.2d 182.

In *Dudley*, a Virgin Islands resident had a deficiency imposed by the Tax Division of the Department of Finance of the Government of the Virgin Islands, which in its 90-day letter stated that the "District Court is apparently the Court of jurisdiction in the case of an appeal from the decision of this office." The petitioner timely filed in the Tax Court of the United States (instead of the District Court) a petition "for redetermination of the deficiency claimed by the Commissioner of Internal Revenue." The Tax Court decided that it had no jurisdiction, and the Third Circuit agreed, saying that only the Secretary of the Treasury of the United States or his delegate is authorized to mail a notice of deficiency which will invoke the limited authority of the Tax Court, and that the tax in dispute was not a tax of the United States, but a territorial income tax. The *Dudley* court while doing violence to the language of the Organic Act of 1954, excused itself on the grounds of past usage and practice.

The Organic Act of 1954 takes precedence over other laws which designate the nature of the Virgin Islands income tax structure, and no inconsistent local laws may be enacted. The Naval Appropriations Act was explained in Congress as a means to assist the Islands in becoming self supporting.⁶ It only imposes the provisions of the Internal Revenue Code upon the Islands without specifying whose tax is being applied or who is to administer it. This is little aid in determining the nature of the tax. The Organic Act of 1954, on the other hand, does not hedge or speak in ambiguous terms. Section 28(a) states:

The proceeds of customs duties, the proceeds of the *United States Income Tax*, the proceeds of any taxes levied by the Congress on the inhabitants of the Virgin Islands, and the proceeds of all quarantine, passport, immigration, and naturalization fees collected in the Virgin Islands, less the cost of collecting all of said duties, taxes, and fees, shall be covered into the treasury of the Virgin Islands, and shall be available for expenditure as the Legislature of the Virgin Islands may provide (*Emphasis supplied.*)

Nothing there points toward a territorial tax. "United States" Income tax is specified, and the Act clearly anticipates federal administration, costs of which are to be deducted from the proceeds into the Virgin

Islands treasury. In the same sentence, separated by a comma, similar provision is made for customs duties which actually are administered by a federal agency. Nevertheless, the Virgin Islands have set up their own agency and are recognized as competent to administer and collect the tax. The *Dudley* case (and following cases citing it) provides direct authority for usurpation or delegation of federal administration. *Jennings* and Public Law 85-688 are supportive by analogy. Also by indirect inference, I.R.C. Section 7651 provisions (extending U.S. government enforcement of tax liability against persons and property in possessions) makes the exception "as otherwise provided in Section 28(a) of the Revised Organic Act of the Virgin Islands." Notwithstanding any such authority, it is in opposition to the precise language of the Organic Act.

In discussing the nature of the tax, it must be recognized that the Naval Appropriations Act and the Revised Organic Act of the Virgin Islands (1954) are both in effect and the provisions of each do not duplicate one another. Both assign the proceeds of the income tax to the Virgin Islands' treasury. There the similarity stops. The Naval Appropriations Act imposes the United States income tax laws upon the Virgin Islands with payment to be made into the Virgin Islands treasury. The source rules of I.R.C. Sections 861-864 come into play, and the Virgin Islands are able to tax a U. S. citizen or entity upon his Virgin Islands source income whether or not he be resident in the Virgin Islands.⁷ The law is geographic in nature and presumes that only taxes on Virgin Islands source income will be paid into the insular treasury just as the Internal Revenue Code provides that only U.S. source income shall be taxable to nonresident aliens and foreign corporations.⁸ The status of the persons taxed (citizen, resident, non-resident alien, domestic or foreign corporation) is left to the definitions of the Code. Prior to the 1954 Revised Organic Act, taxes on non-Virgin Islands source income of the U.S. citizens and resident aliens in the Virgin Islands were paid into the Federal treasury, not the Virgin Islands treasury.

Section 28(a) of the Revised Organic Act is person oriented and not geographic. It assigns the proceeds of the United States income tax of Virgin Islands inhabitants to the insular treasury. No authority is provided for the Virgin Islands to reap the tax benefits of non-inhabitants regardless of source. Just as in the U.S., it brings the world-wide income (including U.S. source income) of Virgin Islands inhabitants within the realm of Virgin Islands taxation. Congress has decreed that the U. S. treasury will bow to the claims of the Virgin Islands treasury on the taxes to be paid by Virgin Islands inhabitants even though they be U. S. citizens or U. S.

domestic corporations, and even though their income has sources within the continental United States.

Taken together, the Naval Appropriations Act renders tax on Virgin Islands source income (regardless of the taxpayer's status) into the Virgin Islands coffers, while the Revised Organic Act dictates that income tax on the worldwide income of Virgin Islands inhabitants (regardless of source) shall become funds placed at the discretion of the officials of this tropic glade.

The term "inhabitants of the Virgin Islands" is described by the Revised Organic Act as including all persons whose permanent residence is in the Virgin Islands as of the last day of their taxable year. A "person" under I.R.C. 7701(a)(1) includes partnerships and corporations, as well as trusts, estates, and individuals. The Regulations under Section 871 of the Internal Revenue Code are used to determine permanent residence. No extraordinary problems are presented for individuals, however, questions arise regarding corporations.

Residence was a concept in its application to corporations before I.R.C. Sections 881 and 882 were amended by the Foreign Investors Tax Act of 1966. Now the Internal Revenue Code treats corporations as being domestic or foreign without reference to residence, taxing foreign corporations on income effectively connected with trade or business. A domestic corporation is one created or organized under the laws of the United States or of any State or (incorporated) territory.⁹ A foreign corporation is any corporation which is not domestic.¹⁰ Section 875 I.R.C. does speak in terms of residency with reference to whether a partnership is "engaged in trade or business". Although I.R.C. Sections 1 and 61 are firm in dictating that U.S. citizens (individuals) are taxable by the U.S. on their worldwide income, Section 28(a) of the Revised Organic Act is a notable exception if the citizen is a Virgin Islands inhabitant. Likewise, I.R.C. Section 11 is adamant in taxing domestic corporations on their worldwide income. It appears that Section 11 is also frustrated by the Revised Organic Act if a U.S. domestic corporation is a Virgin Islands inhabitant. Thus, pre-1966 or United Kingdom concepts of residency may be required to determine if a corporation is a resident in the Virgin Islands and not subject to the United States taxation.

Two factors contribute heavily to the confusion which reigns in the nature of Virgin Islands income taxation. First, in establishing the system of U.S. taxation, Congress' main thrust was upon domestic income and domestic taxpayers. Foreign income and persons were a secondary con-

sideration. No attention was paid to special problems — characterizational, definitional, and conceptual — created by the application of essentially domestic rules to foreign persons.¹¹ Additionally the Internal Revenue Code is not designed to serve separate taxing jurisdictions. In some instances the perpetrators have recognized U.S. possessions and accounted for them in drafting U. S. tax legislation. For example, see I.R.C. Sections 170(c), 957(c), and 957(d). In most cases the possessions are ignored with no thought being given as to how a possession is to apply the law in dealing with U.S. persons.

For the law to have effect in the Virgin Islands, it is necessary that the United States and the Virgin Islands treat each other as foreign countries.¹² Where the term “possessions” is incorporated in the language of the Code, it is impossible to determine whether the Virgin Islands is to reciprocate by granting the same treatment to the U.S., or whether it should only apply this language to its own possessions, should it ever obtain any. Part of Sub-chapter N is delegated to protecting the fisc. This has no place in Virgin Islands taxation, since Congress has merely deigned to divert taxes on Virgin Islands source income and the taxes of Virgin Islands inhabitants into the treasury of the Virgin Islands. A Cadillac engine is being used to drive a Volkswagen chassis without provision being made for modifying the transmission. Secondly, the Revised Organic Act of 1954 applies the tax law to the islands in terms of “inhabitants” instead of “residents, citizens, domestic, foreign and alien” which is the language of the Internal Revenue Code.

One importance of the nature of the tax involves the freedom with which the Virgin Islands may treat an adoptive law. If it is a territorial tax, Treasury Regulations and Rulings may be optional. At present, a Virgin Islands Attorney General’s Opinion does accept the regulations and ruling of the I.R.S. as part of the adoptive law.¹³ Should it become more expedient to use a calypso dialect in reading the Code, anything might happen. Apparently nothing other than an Attorney General’s opinion stands in the way of a Virgin Islands’ administrative agency deciding that it can better serve the people with its own regulations. A Federal District Court Judge (although sitting as a Territorial Court jurist in tax cases) may see fit to recognize only federal standards. For those wealthy or interested enough to appeal, the United States Courts of Appeal and the United States Supreme Court are available.

Another problem involving the nature of the tax is in the collection of taxes from departed citizens. The Virgin Islands may be in a position

similar to that of the United States in attempting to collect taxes from a non-resident alien who has departed the friendly shores and is no longer within the jurisdiction of its courts. It is impossible to prevent flight of the U.S. taxpayer to a protective United States jurisdiction, demanding his prior payment of taxes. This constitutes one justification for the "mirror theory", and may explain why the courts have upheld such theory when dealing with Guam cases involving withholding taxes at the source.

Still, if the tax is "in lieu of" federal taxes and/or is imposed by federal law (the Organic Act of 1954 and the Naval Appropriations Act of 1921), it is difficult to understand why the tax collecting machinery of the Internal Revenue Service cannot be utilized and why Federal Courts could not be used for enforcement, despite the separate taxing jurisdictions. Furthermore, the U.S. Supreme Court has long recognized that tax codes are not penal and that state lines may be crossed to enforce them. In summary, the Virgin Islands are a separate taxing jurisdiction using the Internal Revenue Code as its law. He who does entangle himself, might not have the protection afforded in the continental United States. Just how is the Internal Revenue Code applied in the Virgin Islands? Read on.

The Mirror Theory

Mirror Theory v. Collection District Theory — General

Two major theories have been utilized in applying taxation in the Virgin Islands. The "Collection District" theory bespeaks that the Virgin Islands are to be treated in the same manner as the continental United States in interpreting the Code except that payment is to be made to the Virgin Islands Government. The effect of the "Collection District" theory is to create an early version of revenue sharing in which the Virgin Islands treasury receives the U.S. income tax imposed on its permanent residents and the income taxes applicable to Virgin Islands source income of non-inhabitants. This would seem to be the original intent without its folly — swaddles, just as Congress made it.

The Naval Appropriations Act of 1921 first states that the United States income tax shall be in force in the Virgin Islands. Without more, no problems would exist and Virgin Islands inhabitants would be taxed just as any other good U. S. person. The second phrase "except that the proceeds be paid into the treasury of the Virgin Islands" has confused the courts for better than a decade. The problem is one of allocation of

the proceeds of the tax to one treasury or the other. Section 28(a) of the Revised Organic Act supports the "Collection District" theory by stating:

inhabitants . . . shall satisfy their income tax obligations *under applicable taxing statutes of the United States* by paying their tax on income derived from all sources both within and outside the Virgin Islands into the treasury of the Virgin Islands.

The Second theory, known as the "Mirror Theory", says that to effect the law, the words "Virgin Islands" must be substituted for the words "United States" wherever the latter appears in the Code. This approach looks to the technical application of the Code in converting a U.S. taxing statute into a separate and distinct Virgin Islands territorial income tax. Such approach appears sensible until practical application is attempted. The principal effect is to convert United States citizens not residing in the Virgin Islands into non-resident aliens, and to treat state-side corporations as foreign in the Virgin Islands. The results of this interpretation are considerable since nonresident aliens and foreign corporations are taxed in a different manner and at different rates, than U.S. persons. The problem becomes one which drags the taxpayer (who couldn't care less which treasury receives his taxes) into disputes regarding the amount of tax he is to pay. The courts recognize the technical aspects of the Internal Revenue Code, forgetting the intent of allocating taxes on Virgin Islands source income to the Virgin Islands treasury. The Mirror Theory is presently in vogue. The effects are discussed below, but their validity is questionable.

Effect of the Mirror Theory

General

The mirror theory presumes that the Virgin Islands and the United States are jurisdictions foreign to one another, as if a foreign country adopted the United States Internal Revenue Code and enforced it against U.S. persons in the same manner as the U.S. enforces it toward foreign persons. The basic thrust is in determining the terms "citizenship, residence, foreign" and "domestic". After determining the status of the taxpayer, any given provision of the Code is interpreted in the light of the Code's language. This may be difficult since some sections of the Code extend the provisions to possessions. If mirrored, those provisions have no effect since the Virgin Islands have no possessions. Most certainly the U.S. is not a

Virgin Islands possession. On the other hand, it can be argued that the Code intends such provisions to be reciprocal between the U.S. and its possessions.¹⁴ Citations to the Internal Revenue Code are “mirrored” in the discussion below.

Citizenship, Residence, Foreign and Domestic Interpretation

I Individuals

- (1) Virgin Islands citizens are individuals born or naturalized in the Virgin Islands.¹⁵ All other individuals are aliens in the Virgin Islands.
 - (a) Virgin Islands citizens resident in the Virgin Islands are taxed by the Virgin Islands on their world-wide income in the same manner as U.S. citizens are taxed by the U.S. Such persons are not taxed by the U.S., even on U.S. source income.¹⁶ However, they will be nonresident aliens in applying the Code in the U.S. for purposes of substantive law.¹⁷ For example a Virgin Islands citizen not resident in the U.S. may not be a stockholder in a Subchapter “S” corporation.¹⁸
 - (b) Virgin Islands’ citizens resident in the U.S. are not taxed by the Virgin Islands, except as regards Virgin Islands source income, since they are not *inhabitants* of the Virgin Islands. These persons are taxed by the U.S. in the same manner as any other U.S. citizen because of their U.S. citizenship.¹⁹ A case may be made that the U.S. is imposing taxation on resident aliens rather than on citizens. Individuals born in the Virgin Islands certainly do not come within the definition of Reg. 1.1-1. Under I.R.C. §932 they are nonresident aliens unless resident in the U.S. Presumably, if such persons resided in the U.S., and have V.I. source income, their Virgin Islands tax liability arises from their having become nonresident aliens in the V.I. Otherwise, they would be taxed on worldwide income by virtue of their Virgin Islands citizenship.
 - (c) Virgin Islands citizens resident in foreign countries (neither the Virgin Islands nor the U.S.) are con-

sidered to be nonresident aliens for U.S. taxation.²⁰ It would appear that the Virgin Islands must also treat these individuals as non-resident aliens since they are not taxable as "inhabitants" under 28(a) of the Organic Act. Nevertheless, I.R.C. §932(b) states that nothing in that section shall be construed to defeat the Naval Appropriations Act of 1921. As explained above, that Act imposes the U.S. Internal Revenue Code on the Virgin Islands and is not person oriented. Therefore it may be argued that a Virgin Islands citizen is taxable by the Virgin Islands no matter where he may reside. This, however, would not agree with the principle that a V. I. citizen resident in the U.S. is subject to V.I. taxation only on his V.I. source income. It should also be noted that the *Flores* case, *infra*, held Section 932 to be an inappropriate subject of the mirror theory.

- (d) It is clear that the Virgin Islands citizen is certain of his status only so long as he remains resident in the Virgin Islands. If he moves to the U.S., it is uncertain whether he is being taxed as a citizen or as a resident alien by the U.S. Both are taxed in quite similar manners, however, questions may arise as to whether he is entitled to take exemptions for dependents resident in the Virgin Islands. As a U.S. resident he may still be taxable by the Virgin Islands on his world-wide income if his Virgin Islands citizenship is still in effect. As a resident of a foreign country, U.S. taxation is clear (he is a nonresident alien under I.R.C. §932), but Virgin Islands taxation may be nonexistent (he is not an inhabitant of the Virgin Islands) or Virgin Islands taxation may apply to his world-wide income since he is a Virgin Islands citizen. The statutes are silent and indefinite. No case law exists on the subject except by analogy, and those cases conflict with one another. Discussed below is an October 9, 1974 Revenue Procedure issued by the V. I. Tax Division which treats all individuals who do not reside in the V.I. as non-resident aliens. The Virgin Islands administration

thereby does not intend to tax the world-wide income of the V.I. citizens not resident in the Virgin Islands.

- (2) United States citizens resident in the Virgin Islands, but not born or naturalized there, are "resident aliens" for purposes of Virgin Islands taxation. Despite their U.S. citizenship, they are not liable for federal taxation. As Virgin Islands inhabitants they satisfy their U.S. income tax obligations by filing with the Virgin Islands government on all income including U.S. source income.²¹
- (3) United States citizens not resident in the Virgin Islands, are "nonresident aliens" for Virgin Islands taxation. Being citizens of the U.S., they are taxable by the U.S. on their worldwide income unless they are also Virgin Islands citizens not resident in the United States.²²
- (4) Non U.S. citizens resident in the Virgin Islands are "non-resident aliens" for purposes of applying the Code in the United States. They are "resident aliens" for purposes of applying the Code in the Virgin Islands. As "inhabitants" of the Virgin Islands (satisfying their U.S. tax obligations in the V.I.) the distinction is purely academic.
- (5) New taxpayers may adopt a fiscal year for filing their initial return without obtaining the Commissioner's approval. The fiscal year is adopted by keeping of books to compute income taxes. If no books are kept the taxpayer must use a calendar year.²³ By setting up a simple system of books, an individual may be able to adopt a fiscal year for the filing of his initial V.I. tax return, despite his having been on a calendar year in the U.S. This may be helpful to those who must be residents for the entire taxable year to qualify for provisions of the Code such as Sections 6013 and 934.

II Corporations and Partnerships

- (1) Corporations and partnerships created in the Virgin Islands are "domestic" in the Virgin Islands, but are "foreign" for purposes of applying the Internal Revenue Code in the continental United States.²⁴

- (2) Corporations and partnerships not created in the Virgin Islands are foreign in the Virgin Islands.²⁵
- (3) A U.S. corporation whose permanent residence is in the Virgin Islands appears to be an "inhabitant" of the Virgin Islands under §28(a) of the Organic Act. Thereby it should satisfy its U.S. tax liability on its world-wide income by paying the proceeds of the U.S. income tax into the Virgin Islands treasury. While resident alien individuals are taxable on their world-wide income,²⁶ foreign corporations are taxable only on income derived from sources within the Virgin Islands or effectively connected with a Virgin Islands trade or business.²⁷ Thus the Code makes no provision for mirror theory taxation of non Virgin Islands source income of U.S. corporations which are inhabitants of the Virgin Islands. The only means to tax this income is to treat the tax as a U.S. tax, thereby abandoning the "separate but identical tax statute" concept of *Dudley* and all other case law.

An exhaustive and complete survey of the implications of such cavalier treatment of citizenship is beyond the scope of this paper and would require a detailed analysis of the Code, section by section. However, some of the more blatant effects may be examined.

Western Hemisphere Trade Corporations

After the defeat in *Chicago Bridge and Iron, infra*, the Government of the Virgin Islands convinced Congress that the WHTC deductions should not be applicable to United States corporations doing business in the Virgin Islands. Consequently, the Revenue Act of 1971 deprives Virgin Islands corporations of the deduction and does not permit U.S. corporations the deduction in determining their V.I. tax liability. Despite this legislation, *Chicago Bridge* serves as an excellent study in application of the mirror theory. The mirror theory holds that a corporation created in the continental United States is a foreign corporation and thereby ineligible to qualify as a WHTC in reporting its Virgin Islands source income to the Virgin Islands government. The court rejected the mirror theory and held that the theory was applicable only to determine taxing jurisdiction, not to change substantive measures of the Code or the amount of taxes to be paid:

(S)ubstantive equality of treatment in determining the deduction under the Virgin Islands mirror system requires that the quoted language be given the same meaning.

This implies that the mirror theory is only applicable to give sense and effect to the law and in determining taxing jurisdiction. The implication was not so great as to have changed administrative thought on the matter. *Chicago Bridge* may be criticized on the grounds that the court permitted Virgin Islands source income to be taxed at a lesser rate by the Virgin Islands government. It certainly was not the intent of Congress to permit a U.S. tax reduction on U.S. source income. Neither should the Virgin Islands be forced to provide a tax reduction on income earned within its jurisdiction. The WHTC provisions were effected to encourage Latin American sales and investment by reducing U.S. tax rates. By court enforcement of those provisions, the Virgin Islands were compelled to honor a corporate tax reduction on income derived within its own boundaries.

Subchapter S Corporations

Stateside residents are considered to be nonresident aliens in the Virgin Islands. If they be stockholders in a corporation created in the Virgin Islands, the corporation does not qualify for Subchapter S status under the mirror theory. However, in March, 1973, the District Court of the Virgin Islands granted summary judgment in favor of the taxpayer where an Illinois resident was a stockholder in a Virgin Islands corporation which had elected Subchapter S treatment. In its memorandum opinion, the Court stated:

In the instant case we once again see an attempt on the Virgin Islands taxing authority to redefine terms of the Internal Revenue Code which manifestly it is powerless to do, opinions from high quarters to the contrary notwithstanding. Moreover, I cannot view the characterization of a United States citizen residing in any of the 50 states or of the other territories of the United States as a nonresident alien for this or any other taxing purpose, as a non-substantive change in nomenclature which one might regard as necessary to avoid confusion as to the taxing jurisdiction involved. To the contrary, to characterize a person so situated is to interject confusion where clarity is needed.

The Third Circuit did not agree, interjecting more confusion than any anticipated. Disregarding the 9th Circuit's *Manning, infra*, it held

that the mirror theory did apply, that U.S. residents are nonresident aliens in the Virgin Islands, and that these nonresident aliens cannot qualify as Subchapter S corporate stockholders. As discussed below, the Court permitted itself to be entranced with constitutional concepts of citizenship which Congress purposefully did not apply to the Virgin Islands. The wrong result was reached again. Substantive change in nomenclature was permitted with the result that the Virgin Islands received greater taxes than those to which the U.S. would have been entitled. It was not a case of reducing taxes in a manner that the U.S. would have refused. Equity was done only by evening the score for the *Chicago Bridge* case.

Even without this decision, a Congressional Committee Report (P.L. 92-606, 10-31-72) relating to Guam is not to be taken lightly. After permitting stateside stockholdership in Subchapter S corporations by new legislation, the Committee Report states:

It should be stressed that this provision has no effect on Subchapter S corporations themselves. Therefore, in determining whether an election of a Subchapter S corporation has been terminated because it derived more than 80 percent of its gross receipts from sources outside of its jurisdiction, income from sources within the other jurisdictions will continue to be classified as income from sources without the former jurisdiction. Similarly, in determining the sources of dividends and interest from a U.S. corporation, the source of the corporation's income will continue to be determined as provided in present law. For example, if less than 20 percent of the corporation's income is from U.S. sources, then the dividends and interest from it are treated as from sources without the United States.

Possessions Corporations

By definition the Virgin Islands are not a "possession of the United States" for purposes of I.R.C. Section 931.²⁸

Consolidated Returns

Of special importance to stateside corporations with subsidiaries in the Virgin Islands is the filing of consolidated returns. Under Section 1504(b)(3), a foreign corporation is not an "includible corporation" for filing a consolidated return. The mirror theory dictates that a Virgin Islands corporation is foreign for purposes of U.S. taxation and that a U.S. corporation is foreign for purposes of Virgin Islands taxation. No case can

be found which determines the matter, although those spoiling for a fight might be able to rely on *Chicago Bridge* and successfully argue the merits of consolidation.

Attention should be paid to the fact that brother-sister corporations are not accorded the privilege of filing consolidated returns. A common parent is required. Therefore, if the group has several Virgin Islands corporations and only one stateside corporation, care should be taken that a stateside corporation is not the common parent if the Virgin Islands group intends to file a consolidated return. Structure of the stockholder-ship becomes an important factor to be considered in planning for both U.S. and Virgin Islands taxation.

Joint Returns

Similar in nature are the rules for filing joint returns between man and wife. Section 6013(a)(1) prohibits the filing of a joint return if either the husband or wife at any time during the taxable year is a non-resident alien. Taken literally, under the mirror theory, this would mean in any year that both husband and wife are not residents of the Virgin Islands for a *full taxable year*, they will be disqualified from filing a joint return, since a stateside resident is considered to be a nonresident alien. A mitigating factor to this harsh treatment might be advanced by Rev. Rul. 60-291, C.B. 1960-2, 407, which provides that status as inhabitant in the Virgin Islands is determined as of the last day of the taxpayer's taxable year. This may be a strained interpretation since Rev. Rul. 60-291 merely designates the proper taxing authority while Section 6013(a)(1) specified the prohibition on joint returns if either spouse is a nonresident alien at any time during the taxable year. The Virgin Islands Revenue Procedure discussed below permits the filing of joint returns by stating that the residence of the wife is that of the husband. It would seem that the husband must be a resident of the Virgin Islands for the full taxable year, to qualify.

Dividend Exclusion and Deductions

The \$100 dividend exclusion under Section 116 applies only to dividends received from domestic corporations. Strict mirror theory precludes the deduction on dividends paid from U.S. corporations on Virgin Islands tax returns. The V. I. Revenue Procedure (October 9, 1974) cited below permits the deduction on dividends paid by U.S. corporations although the U.S. does not permit the deduction for V. I. source dividends.

Section 243 Dividends Received Deduction

Where a U.S. parent has a V. I. subsidiary, or vice versa, dividends paid to the parent will not qualify for the 85 or 100% dividends received deduction of Sections 243-244 I.R.C. Neither the U.S. nor the V. I. recognizes the deduction since the corporations are foreign to one another. The limited deduction of §245 is available. Additionally, the subsidiary will be required to withhold 30% on dividends paid to the parent (I.R.C. Sec. 1441-1442) although the 901-902 foreign tax credit will be available to the parent.

Controlled Foreign Corporations

If over 50% of a foreign corporation's voting stock is held by "U.S. shareholders", the corporation is a controlled foreign corporation under Sections 951 et. seq. I.R.C. A "U.S. shareholder" is a U.S. person (as defined by Sec. 7701(a)(30)) who holds 10% or more of the voting stock. Special provisions allow for treatment of corporations formed in possessions. Section 957(c) provides that corporations organized in U.S. possessions shall not be deemed controlled foreign corporations if 80% or more of its gross income for the preceding three years (or other applicable period) was derived from possession source income and 50% of the gross income was derived from the active conduct of trades or businesses constituting the manufacture or processing of goods, wares, merchandise, or other personal property; the processing of agricultural or horticultural products or commodities (including but not limited to livestock, poultry, or fur bearing animals); the catching or taking of any fish or the mining or extraction of natural resources (including processing of articles so obtained); or the ownership or operation of hotels. Thus if a V.I. corporation meets the source rules and actively engages in qualified activities, it will not be a controlled foreign corporation for U.S. taxation despite over 50% of its stock being held by U.S. persons with 10% ownership. 957(d) assigns the same meaning to "U.S. persons" as Section 7701(a)(30). An exception is made for V.I. inhabitants under 957(d)(2). Such persons are not U.S. persons with respect to a corporation organized under the laws of the Virgin Islands even though they may be categorized as such by 7701(a)(30). If a V. I. corporation engages in unqualified activities or fails to meet the requirements of the source rules of 957(c)(1) and (2), it still will not be a CFC providing not over 50% of its stock is held by U.S. persons each owning 10% or more of its voting stock. Furthermore, V.I. inhabitants will not be considered "U.S.

persons" even though defined as such under 7701. Neither will constructive ownership be applied to a U.S. person because of stock owned by a related V. I. inhabitant.²⁹

Suppose that a V. I. corporation is engaged in condominium development in the Virgin Islands. 60% is owned by two V. I. inhabitants, each owning 30%. Assume that both V. I. inhabitants are U.S. citizens who were born in the U.S., but now make their residence in the Virgin Islands. 35% is owned by a U.S. citizen resident in Guatemala and 5% is owned by a U.S. citizen resident in New York. Since the Virgin Island inhabitants are not counted as U.S. persons (and own 60% of the voting stock) the corporation is not a CFC. If one of the V. I. inhabitants moves to Chicago, the corporation becomes a CFC. The U.S. citizen residing in Guatemala and the ex-Virgin Islands inhabitant living in Chicago are both "U.S. persons" and own 65% of the voting stock between them. Should the corporation be liquidated, Section 1248 will come into play.

The flip side of the coin is not clear. Whether the "possession" provisions of §957 mean that the Virgin Islands is to give reciprocal treatment to the U.S. and its citizens in determining the CFC status of a U.S. corporation is uncertain. A literal mirror reading of the Code does not provide reciprocity. Since 957(c) and (d)(1) apply to Puerto Rico by designation, a literal reading would mean that the Virgin Islands extends these exceptions to Puerto Rico but not to the U.S. No case law exists on the matter, and, to date, the issue has not been raised.

The greatest cause for concern is in U.S. citizens who own over 50% of a U.S. corporation, moving to the V.I. Simply by changing their residence, they may have turned the U.S. corporation into a CFC for Virgin Islands taxation.

Tax planing possibilities exist in creating a CFC to obtain substantial Subchapter S results (for at least some of the stockholders) in cases including U.S. and V. I. stockholders.

Section 1248

The doomsday provisions of I.R.C. §1248 generally will not be important where U.S.-V.I. relationships involve individual shareholders. 1248(b) places a limitation on tax applicable to individuals, based upon corporate tax rates. Since the V.I. and the U.S. charge the same tax rates, the only adverse effect to stockholders who are individuals is to impose the maximum capital gain on liquidation or sale of stock of a CFC. If the stock was owned for a continuous period of ten years or more,

no U.S. tax will be imposed on liquidation or sale of stock of a V. I. corporation since the Virgin Islands are designated as a Less Developed Country.³⁰

The United States as a Less Developed Country

A good case can be made under the mirror theory that the United States is a Less Developed Country in relation to the Virgin Islands. Under 955(c)(3), less developed countries are designated by Executive Order by the President of the United States. The mirror theory would convert that to "President of the Virgin Islands". Since the Virgin Islands have no President and since the mirror theory is to "give the law proper effect in those islands," the authority to designate less developed countries should remain with the United States President notwithstanding the mirror theory. The President has designated as "Less Developed Countries" all foreign countries in existence after 1962 except Australia, Canada, New Zealand, Japan, South Africa, the countries of Western Europe, and countries within the Sino-Soviet bloc, as well as all overseas areas (except Hong Kong) of any foreign countries outside the Sino-Soviet bloc, Puerto Rico and all United States (read "Virgin Islands" for mirror effect) possessions.³¹ The United States is not a possession of the Virgin Islands but it does not fall within any of the other exceptions; thereby it must be a less developed country so far as the Virgin Islands' taxing authorities are concerned.

Section 1491

The transfer of appreciated securities from a V.I. person to a U.S. entity presents an interesting problem. The tax on appreciated value of 1491 is deemed an excise tax. The I.R.S. does not consider it to be an income tax even though Section 1491 appears under Subtitle A.³² The only Federal taxes imposed upon a possession are those which Congress has specifically designated. Congress has never made Federal excise taxes applicable in the Virgin Islands. Thus the Interest Equalization Tax (when it was in effect) never applied to the Virgin Islands, as attested to by the proliferation of banks in the V.I. It would appear that 1491 transfers in the V.I. are not taxable. This provides great opportunity for one to become a V.I. inhabitant before making a transfer of appreciated securities to a foreign jurisdiction. In V.I.-U.S. transactions the risk is minimal. A 1491 transfer must be made with tax avoidance motive. Since the U.S. and the V.I. have similar tax rates, tax avoidance is rarely a motive in U.S.-V.I. transactions.

Section 367

Exchanges under I.R.C. §367 recognize gain on those corporate organizations and reorganizations which are normally nontaxable under Sections 332, 351, 354, 355, 356 or 361, if a foreign corporation is a party to the exchange, and if no ruling is obtained prior to the exchange. U.S. and V.I. corporations are foreign to each others jurisdiction. For example, if a U.S. citizen and resident owns V.I. situs appreciated property which he wishes to incorporate under a 351 nontaxable transaction, he must obtain a ruling from I.R.S. if a V.I. corporation is to be used. No ruling would be required from the V.I. Tax Division. If the U.S. resident decided to organize his corporation in the U.S. instead, no ruling would be required from I.R.S. Whether or not a V.I. ruling would be required depends upon the nature of the property. Normally, if the gain realized would be capital gain, no ruling is needed since the U.S. resident is a nonresident alien to the V.I. and as such, not normally taxable on his capital gains.³³ If the taxpayer is present in the V.I. for over 183 days of the year or otherwise has a taxable transaction resulting from the exchange, a V.I. ruling will be required to qualify for nontaxable status.

Corporate reorganizations can become a real frolic which may demand rulings from both I.R.S. and the V.I. Tax Division. Each transaction must be analyzed from the viewpoint of both tax jurisdictions to determine whether 367 is triggered and whose 367 is affecting the transaction. The rulings and toll charges will be decided by both jurisdictions under the usual regulations and revenue procedures. Since both jurisdictions' tax rates are similar, tax avoidance motive may be easier to disclaim.

Repatriation of Profits

There is no manner in which a U.S. parent may repatriate the profits of its V.I. subsidiary tax free. Section 367 blocks a 332 liquidation and the dividend route is inaccessible because of the inapplicability of Section 243. The Virgin Islands are excluded from Section 931 as possessions corporations. Additionally, the V.I. will withhold 30% of dividends paid out of V.I. source income to U.S. persons. The 901-902 tax credit may have severe limitations. I.R.C. §904.

Tax Treaties

The United States tax treaties do not extend to the Virgin Islands nor is there any treaty in effect between the two "countries". In interna-

tional tax planning the practitioner must take care that he does not mistakenly rely upon treaty provisions in applying the Code from the Virgin Islands standpoint.

Expatriation and Section 877

A U.S. citizen who expatriates himself, remains taxable on his U.S. source income as if he were still a citizen, unless no tax avoidance motive prompts his expatriation.³⁴ The application of this Code provision is almost impossible in the V.I. since the normal concepts of citizenship do not apply. "Inhabitancy" is the factor which gives the V.I. tax jurisdiction over citizens and resident aliens.

An interesting, but unreliable theory assumes that a U.S. born citizen, resident in the V.I., wishes to expatriate himself for tax avoidance motives. Since he satisfies his U.S. income tax under the similar but separate tax statutes in the Virgin Islands, the United States has no jurisdiction and he is not avoiding U.S. income taxation. In the V.I., he is taxed as a resident alien. Consequently, he has not "expatriated" himself from the V.I. and 877 does not apply. Although the V.I. would have no valid argument against this reasoning, the I.R.S. can take the position that by removing himself from the V.I., the expatriate becomes subject to U.S. tax jurisdiction. Any attempts to effect this scheme should pay heed to the chronology of the steps. Before expatriation, one should be certain that he is a V.I. inhabitant, not within the U.S. tax jurisdiction. After surrendering his U.S. citizenship and obtaining that of another country, he should remain an inhabitant of the V.I. for the tax year. The V.I. will continue to tax him as a resident alien, his having merely changed citizenship from one foreign country for another and he will not have subjected himself to the U.S. for jurisdiction. Visa arrangements will have to be settled with U.S. Immigration to permit the expatriate's continued residence in the V.I. After the end of the tax year, he may remove his residence from the V.I. Even with those steps, taken in order, success is questionable. If citizenship in a treaty country is adopted, the treaty provisions may make 877 of little effect. Section 984 gives treaty provisions precedence over 877.

Section 482 Allocations

Either I.R.S. or the V.I. Tax Division may institute an allocation of income and deductions between businesses controlled directly or indirectly by the same interests, in order to prevent evasion of taxes or to accurately

reflect their true taxable incomes. If the allocation is between V.I. and non-V.I. persons, there may be no correlative adjustment. The U.S. tax treaties do not extend to the Virgin Islands, and since there is no U.S.-V.I. treaty, no competent authority is available to consult on the issue. Economic double taxation may result.

Foreign Registration of Aircraft Under the FAA

Sections 883(a)(2) and 872(b)(2) of the Code permit exclusion of earnings derived from the operation of aircraft registered under the laws of a foreign country. If one assumes that the mirror theory converts United States registry to foreign registry, more strange results occur, however, this time in favor of the taxpayer. This point arose when a citizen and resident of the foreign island of Anguilla (which has no income tax) commenced an air taxi operation to the Virgin Islands. In order to obtain landing rights, he was required to maintain his aircraft under United States registry. Clearly, he would come under the 872(b)(2) exclusion if it were not for the United States registry. What's good for goose is good for the gander, so we polished up the brightest, shiniest looking glasses we could find in the 1040NR file, and daily sang a ditty (to the tune of "Mirror Mirror on the Wall") "The FAA is a foreign instrumentality staffed by nonresident aliens" went the lyrics. How wonderful when one stops resisting and joins the cosmic all. The issue was dropped at a later date for two reasons. First, the Virgin Islands Code provides that aircraft operating within the Virgin Islands must be registered with the United States government subject to certain exceptions. This in itself was not fatal to our position. However, the firm was operating at a loss and had incurred no tax liability. The only point at issue was whether there was a filing requirement.

Other Problems and Pitfalls

Virtually every section of the Code dealing with foreign corporations nonresident aliens, and foreign source income could produce unintended results under the mirror theory. Most situations have not yet been questioned by the Virgin Islands Government, but the Administration has made it clear that the mirror theory will be applied to all aspects of the Code in the future.

It is easy to overlook the filing of such forms as 4683, 926, 957, 958, 959, 2952, 3646 and 4790 for U.S.-V.I. transactions. In many cases forms need not be filed in the U.S. if the "foreign country" is a possession. But

need these forms be filed with the V.I. because the U.S. is not a possession? No U.S. withholding is required under Section 1441 from payments made to V.I. inhabitants,³⁵ yet the Virgin Islands administration does not extend the courtesy to U.S. residents. Foreign personal holding companies may be created inadvertently. In spite of the V.I. Tax Division's Revenue Procedure discussed below, one may find charitable deductions and personal exemptions disallowed if a new Commissioner or Technical Advisor determines his predecessor's interpretations to be erroneous.

The specific problems mentioned are only the tip of the iceberg. The entire Code could be analyzed with a view toward discovering fantastic results which startle the mind and shock the conscience. If tax planning is to embody these contingencies of interpretation, United States residents must look upon themselves as subject to nonresident alien regulations as regards their Virgin Islands holdings, and Virgin Islands residents must regard their stateside corporate holdings as they would those in any foreign country.

Mirror Theory v. Collection District Theory—Interpretation

General

The Collection District Theory and the Mirror Theory give different tax results. The former avoids the foreign-domestic problems inherent in the mirror theory, but makes no technical provisions for V.I. taxation of non-inhabitants on their V.I. source income.

Administrative Interpretation

Administratively, the two theories alternately have found favor in fashion like skirt lengths, the current vogue being two inches below the knee with all violators being prosecuted for indecent exposure to the mirror theory. Until 1935, the Collection District Theory prevailed, when I.T. 2946³⁶ proclaimed the mirror theory, stating:

It will be necessary in some sections of the law to substitute the words "Virgin Islands" for the words "United States" *in order to give the law proper effect* . . . citizens of the United States residing in the islands must be considered as resident aliens and citizens of the United States not residing in the Virgin Islands must be treated as nonresident aliens.

No mention was made of corporations, partnerships, trusts or estates.

Five years later, the Service and the Department of Interior agreed to return to the "collection district" theory, but in 1948, the Revenue Service reinstated I.T. 2946. Then in 1969, Revenue Ruling 69-420³⁷ declared I.T. 2946 to be obsolete. In July, 1973, Rev. Rul. 73-315, reinstated I.T. 2946. Strangely, this Revenue Ruling is entitled "Nonresident Aliens and Foreign Corporations," but like I.T. 2946 makes no mention of corporations in the text.

Rev. Rul. 56-616³⁸ which is still in effect, declares a territorial corporation to be "foreign" to the United States for purposes of taxation. The service has never abandoned the mirror theory altogether; but merely wavers at times.

Despite defeat in the *Chicago Bridge* case, *infra*, the Virgin Islands administration continued to apply the mirror theory to change substantive tax law. This led to the *Great Cruz Bay* case, *infra*, where the administration suffered at the hands of the trial court but was upheld by the 3rd Circuit Court of Appeals which reversed in March of 1974. In August, 1974 the administration held a seminar, inviting tax practitioners. It was made clear that the mirror theory would be applied literally whether or not substantive law was affected, whether individuals or corporations were in issue, and even though there results greater taxes than the United States would have received had the taxes been payable to the Federal treasury.

On October 9, 1974, the Virgin Islands Tax Division issued its own Revenue Procedure which mitigates the effects in some areas. It is not signed by the Commissioner of Finance, and is issued over the signature of the Technical Advisor. If past experience is indicative, this Revenue Procedure may not be relied upon. Introduced into evidence in the *Great Cruz Bay* case was a 1967 memorandum issued by the Technical Advisor stating Tax Division's position that "individuals who are not citizens of the Virgin Islands or the United States are considered aliens, either resident or nonresident". The 3rd Circuit in reversing the District Court did not mention this position formerly taken by the Tax Division, and fully rejected the concept. Reliance on Virgin Islands administrative positions is risky at best.

The October 9, 1974 Revenue Procedure states that the following guidelines are to be followed by agents:

1. Alimony payments from V.I. residents to U.S. residents under a final decree or judgment of a court of the United States, a State,

or political subdivision, will not be taxed as fixed or determinable payments under I.R.C. Sec. 871(a).

2. The domicile or residence of a child is considered to be that of the parent, and the residence of the wife is to be treated as that of the husband. Where the husband becomes domiciled in the Virgin Islands, the wife is deemed to have changed her residence unless the facts clearly require another determination. This provision is important in determining eligibility of dependents and qualifications for filing joint returns.
3. Nonresident aliens are any individuals who do not reside in the Virgin Islands. Note that citizenship is bypassed in this definition with residence (meaning domicile) being the sole criteria.
4. Charitable contributions by V.I. persons to organizations appearing in the current Cumulative List of Organizations, U.S. Internal Revenue Service, Publication 78, shall not be disallowed because of the mirror theory distinction between foreign and domestic charities. This interpretation is subject to certain local criteria not found in the Code.
5. Fixed or determinable income under 871(a) and 881 of the Code is to be treated by agents in a strange manner. An exception is carved out for alimony as in 1. above. Thereafter, the rules are standard except for salaries and compensation. The standard 90 day, \$3,000 *de minimus* rule is to be applied,³⁹ however, the Revenue Procedure brings all other compensation under the 30% taxation of 871(a) and 881, despite the fact that remuneration paid an individual after December 31, 1966, for services rendered during the taxable year is taxed at graduated rates. Other than these exceptions, §871(a) is to be applied in the V.I. in the normal manner.
6. Investment Credit—the Revenue Procedure on Section 38 property is even stranger. Quoting §48(a)(7)(A), (disqualification of property manufactured outside of the U.S.), the administration magnanimously permits V.I. investment credit on U.S. manufactured property. As provided for in §48(a)(7)(c), §48(a)(7)(A) was rendered ineffective by Executive Order and has lain dormant since its inception in 1971.⁴⁰
7. The Revenue Procedure permits V.I. taxpayers to deduct losses (non-V.I.) suffered in years during which they are inhabitants

of the Virgin Islands. This author cannot imagine any reason why such losses would not be allowable. Not mentioned in the Revenue Procedure is the carryback and carry forward of capital and net operating losses suffered in years in which the taxpayer was not a V.I. person.

8. Dividends from corporations organized in the U.S. qualify in the V.I. for the dividend exclusion of Section 116 I.R.C., despite the source of such dividends being foreign.

With the above exceptions, the Virgin Islands administration has interpreted the mirror theory to be applied literally throughout the Code whether or not it is necessary to give the law proper effect. The principal bone of contention in most of the litigation to date is "What is giving the law the proper effect?"

The Courts

The courts did not favor the mirror theory until *Sayre and Co. v. Riddell*, 395 F.2d 407 (1968), when the theory struck the fancy of the Ninth Circuit interpreting a Guam case. Prior to the *Sayre* case, in *Wilson v. Kennedy*, D. Guam 1954, 123 F. Suppl. 156, 160 aff'g. Ninth Circuit 1956, 232 F.2d 153, the court recognized the mirror theory but limited it to the determination of the proper taxing jurisdiction, refusing to permit the amount of tax to be modified:

(t)he tax to be paid ordinarily is measured by the amount of income tax the taxpayer would be required to pay to the United States of America if the taxpayer were residing in the continental United States." The literal terms of the Internal Revenue Code should be modified only by "those non-substantive changes in nomenclature as are necessary to avoid confusion as to the taxing jurisdiction involved.

In *Atkins—Kroll v. Government of Guam*, 367 F.2d 127 (1966), the Ninth Circuit Court of Appeals refused to apply the mirror theory in ruling on the interpretation of the term "domestic" as applied to corporations under Section 7701(a)(4). Then the Ninth Circuit reversed itself, sitting en banc in 1968 in the *Sayre* case cited above, expressly upholding the mirror theory in that "Guam" must be substituted for "United States" giving effect to the holding that a corporation not organized in Guam is a foreign corporation within the meaning of the Code as applied in Guam. Undoubtedly *Sayre* controls corporate taxes in the Ninth Circuit.

The rule for individuals in Guam appears to be the opposite. The U.S. District Court for Guam was upheld by the Ninth Circuit Court of Appeals in a per curiam decision in *Manning v. Blaz*, 31 AFTR 2d 73-1088. It was held that a U.S. citizen, a non-resident of Guam, was not a non-resident alien for purposes of qualifying as a stockholder in a Guamanian Subchapter S corporation, for filing a joint return in Guam, and for purposes of the standard deduction. The court, relying heavily upon *Flores v. Govt. of Guam*, 28 AFTR 2d 71-5-58, distinguished the *Sayre* case as being applicable to corporations whereas this case and the *Flores* case concerned individuals. In *Flores*, the taxpayer was born in Guam and naturalized in the U.S. in 1922. In 1950, Guamanians became U.S. citizens by "collective naturalization" under the Organic Act of Guam.⁴¹ Rev. Rul. 56,⁴² declared that one who is a U.S. citizen solely by virtue of collective naturalization is a citizen of the possession. Since *Flores* had been naturalized prior to 1950, he had not become a "citizen of the possession" for income tax purposes. The court refused to "mirror" Section 932, the only section upon which the Service based the alleged nonresident alien status. No mention was made of mirroring Section 871 I.R.C. It held that Section 932 is not a valid part of the Guamanian territorial income tax and is manifestly inapplicable thereto. A 1958 amendment to Guam's Organic Act stated that the income tax laws shall include only those provisions of the Federal income tax code that are not "manifestly inapplicable or incompatible," specifically identifying (but not limiting to) two provisions. The Senate Report accompanying the 1958 amendments stated, "The specific mention of Chapter 2 and Section 931 of the 1954 Code . . . is not intended to exclude other provisions . . . from the category of provisions which are manifestly inapplicable or incompatible with that intent (for instance Section 932 . . . is also excluded even though not specifically singled out for mention)."⁴³

The *Flores* case dealt with one born in Guam. The *Manning* case extended the *Flores* rule to U.S. citizens not born in Guam, and distinguished the *Sayre* rule regarding corporations. Again only 932 was discussed, and Section 871 was ignored. Thus, the Ninth Circuit holds that corporations not created under the laws of Guam are "Foreign" corporations for purposes of the territorial income tax, but that U.S. citizens not resident in Guam are not nonresident aliens.

The Third Circuit maintains a contrary position for the Virgin Islands. In *Chicago Bridge & Iron Co. v. Wheatley*, 430 F.2d 973, a Delaware corporation was deemed to be "domestic" in applying the territorial income tax, while in *Great Cruz Bay Inc. v. Wheatley*, 33 AFTR 2d 74-1021, a

U.S. citizen was held to be a nonresident alien in determining whether he was a qualifying shareholder in a Subchapter S corporation. These cases, along with *Dudley, supra*, are the landmark cases in the Virgin Islands. In the eyes of the Third Circuit, it appears that the mirror theory applies to individuals but not to corporations. Nonetheless, both *Chicago Bridge* and *Great Cruz Bay* dealt with narrow operative sections of the Code (921-922 and 1371 et. seq.), and courts may not be consistent with such an across the board treatment. Furthermore, the Guam cases (holding opposite views) are freely cited in all Virgin Islands mirror theory opinions.

Several problems remain in relying upon judicial interpretation, especially on the issues of citizenship and constitutionality. Although the Code does not define the word "citizen", Reg. 1.1-1 undertakes this task: "Every person born or naturalized in the United States and subject to its jurisdiction is a citizen."

Reg. 1.871-2 defines the term nonresident alien as "(a)n individual whose residence is not within the United States, and who is not a citizen of the United States". As noted above, Section 871 is not mentioned by the Ninth Circuit in either the *Flores* or the *Manning* case, but a mirrored reading of the regulation will make a nonresident alien out of anyone whose residence is not within the Virgin Islands and who is not a citizen of the Virgin Islands.

No mirror theory case has been granted certiorari by the United States Supreme Court. Consequently, the mixed bag of contrary opinions is frequently challenged with success and new chapters are added, replete with lofty statements to perpetuate the confusion. Additionally, no taxpayer has ever challenged the mirror theory on constitutional grounds. The Ninth Circuit in *Flores* discussed the constitutional aspects in a footnote citing several tax cases:

Guam is undoubtedly entitled to great flexibility in fashioning classifications for the purpose of taxation so long as such classifications do not violate equal protection of the law . . . That a statute may discriminate in favor of a certain class does not render it arbitrary if the discrimination is founded upon a reasonable distinction, or difference in state policy . . . Although we do not reach the issue here, we feel compelled to mention that we are unable to hypothesize a rational basis for distinguishing between collectively naturalized and individually naturalized Guamanians for purposes of the Guam Income tax law.

In 1968, the Virgin Islands Revised Organic Act was amended to extend the second sentence of Section 1. of the 14th ammendment of the U.S. Constitution to the Virgin Islands with "the same force and effect as in the United States or in any State of the United States". The first sentence of Section 1. (which was *not* extended to the Virgin Islands) reads "All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside". Nevertheless the Third Circuit in *Great Cruz Bay* disregards the intentional Congressional exclusion of extending that Constitutional provision to the Virgin Islands. The Court, in footnote 7 of its opinion, provides a befuddling discussion of citizenship, confusing state with national citizenship and citing this nonapplicable Constitutional provision along with case law based thereon. On the other hand, the portion of the 14th Amendment which does apply in the Virgin Islands provides that "No State shall make *or enforce* any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, of property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws." Since the privileges and immunities and equal protection clauses do apply in the Virgin Islands, the remarks of the *Flores* court cited above are well taken, although ignored by the *Great Cruz Bay* court which made a non-applicable constitutional phrase the target of its unsolicited consideration.

Unless corrective legislation is effected, it is certain that the mirror theory will be fertile ground for litigation for some time to come. In tax planning, the practitioner should take heed of the pitfalls and structure the enterprise in a manner which will avoid adverse "mirrored" consequences. If faced with a *fait accompli*, he should realize that the administration's house is built on shifting sands. Litigation stands an excellent chance of success if the client is willing and able to withstand the economic risk. *Chicago Bridge* looked to the original Congressional intent in imposing the income tax laws of the Internal Revenue Code on the Virgin Islands and ruled that the amount of tax to be paid is to be measured by the amount which otherwise would be paid to the U.S. Treasury. *Great Cruz Bay* looked to the mirrored semantic aspects of the Internal Revenue Code with a view towards its application without regard to the amount of tax liability. The Court there said, "Our holding in the *Chicago Bridge* case . . . does not require a contrary result." Both cases are present Third Circuit law even though the administration refuses to

recognize the *Chicago Bridge* holdings and dicta. The Constitutional issues have yet to be tried, and the U.S. Supreme Court has never spoken.

Congressional Intent and Acceptance

The bodies interpreting the law generally make reference to Congressional intent and Congressional acceptance of the theories. The "intent" test favors the collection district theory. However, Congressional acceptance of the mirror theory can be found in explicit terms. The original tax imposed by the Naval Appropriations Act was explained in Congress as being to assist the islands in becoming self-supporting, thereby upholding the theory that the tax merely is to be allocated to the Virgin Islands. The language of the Revised Organic Act of 1954 refers to the "proceeds of the United States Income tax" being covered into the Virgin Islands treasury. The court in *Chicago Bridge* stated:

The scheme of the statute is to impose a tax obligation to the Virgin Islands equivalent to what the United States would collect on the same income . . . More basically, Congress has aided the Virgin Islands by giving them the same tax, not more, than the United States would otherwise collect on Virgin Islands businesses.

When we turn to Congressional acceptance of the mirror theory, another story unfolds. In the 1958 amendments to Guam's Organic Act, Section 31 (e) states that in order to obtain a "mirrored effect" between the federal and Guamanian tax laws, the word "Guam" is to be substituted for the words "United States", and other changes in language and nomenclature are to be made, including the omission of inapplicable language, when converting a federal tax provision for use as part of the Guamanian tax laws. In 1960, the Finance Committee Report accompanying H.R. 5547 explicitly referred to the "mirror system" of the Virgin Islands as being the law, although the Committee appears not to be aware of the inequities created if it be applied to substantive law. That awareness was not missing in 1972, however, when Section 932 was amended and Section 935 was added to the Code. The effect of these changes to the Code was to remove partially the burden of the mirror theory from the shoulders of Guamanian residents. Committee Report (P.L. 92-606, 10-31-72), House Explanation, not only recognizes the "mirror image tax system", but goes on to explain the nature of the problem:

Under present law (Sec. 932) certain non-resident U.S. citizens who are also citizens of a possession of the United States are treated as

nonresident aliens for purposes of the U.S. tax laws. This group consists of those persons who are born or naturalized in most possessions (including Guam) . . . your committee has provided that this provision is no longer to apply to Guamanians.

While this is an accurate interpretation of Section 932, the Committee Report proceeds to give examples of U.S. individuals subject to Guamanian taxes including the filing of joint returns, stockholdership in Subchapter S corporations and the \$100 dividend exclusion for dividends received from domestic corporations. The Committee expressly believes the mirror theory to be the law in Guam before passage of the accompanying legislation, and that the mirror theory is unaffected except to the extent of the new legislation. Courts are proclaiming that the mirror theory as applied to substantive law was not within the intent of Congress while a subsequent congressional body is passing laws based upon the belief that the mirror theory is law as regards substantive tax statutes.

The Congressional Report refers solely to Guamanian law, nevertheless, the report is couched in general terms which probably include the Virgin Islands. If this interpretation is correct, Congress has relieved Guamanians of some of the more onerous features of the mirror theory while giving its blessing to those sanctions being visited upon the tax system of the Virgin Islands. Even in Guam, the statute (Section 935) corrects the mirror theory problems of individuals, but, with the exception of withholding taxes under Section 881, leaves corporations to fend for themselves in the reflections cast by this amusement park speculum.

The Administration in the Virgin Islands is catholic in its views and the mirror theory is its dogma. The administration in Washington maintains more agnostic views and is unsettled on whether to take the holidays or not. Despite conversion, periodically it backslides and advocates the "collection district" theory. When declaring I.T. 2946 to be obsolete, it continued to pay homage to Revenue Ruling 56-616 declaring a territorial corporation to be foreign for purposes of United States taxation. The Ninth Circuit holds the mirror theory to be applicable to corporations but not to individuals while the Third Circuit applies the mirror theory to individuals but not to corporations. The District Court of the Virgin Islands merely speaks disrespectfully of sin and refuses to characterize a United States citizen as a nonresident alien, but is reversed by the Third Circuit. Congressional intent originally did not contemplate the mirror theory, but subsequent Congressional Reports have embraced its concepts.

Straws in the Wind

A bill is being prepared for the 1975 Congress, which will relieve individuals taxpayers of much of the inequitable treatment of the mirror theory. The bill purportedly contains many of the provisions of Section 935 I.R.C. which gave Guamanian individuals relief from the vagaries of the mirror theory. Work is then to start on a bill affecting corporate taxpayers. The mood in Washington reflects a desire to provide the Virgin Islands with a tax system *similar* to that in the U.S., as was the original intent of Congress. In the Virgin Islands, only the Tax Division seems to balk at the idea of legislation now. Spokesmen state that they are in favor of legislation, but that the enactment should come only after prolonged studies are made. The outgoing Governor favors legislation at this time and late in December, 1974, the Virgin Islands Senate passed a resolution requesting the Governor and the Delegate to Congress to urge Congress to effect legislation eliminating the mirror theory. The Resolution cites the detrimental effect of the mirror theory on business, investment and tax revenues in the Virgin Islands and that the Legislature is in favor of “. . . eliminating the mirror system of taxation in all instances which result in any United States resident or Virgin Islands resident being denied any deduction, credit, or election under the Internal Revenue Code of 1954 by reason of the existence of two separate taxing jurisdictions . . . is in favor of limiting the amount of income taxes paid to the Virgin Islands Treasury by any taxpayer, to an amount equivalent to that which would be paid in the United States Treasury were the Virgin Islands a State of the United States.” Hopefully, the Tax Division will be unsuccessful in its efforts to stymie or delay much needed legislation.

SECTION 934 AND THE INDUSTRIAL INCENTIVE ACT*

History

Anyone engaged in analyzing the Code sections relating to taxation of foreign income probably will be puzzled as he reads through Section 934. It is a simple enough section to understand. The bewilderment arises as to its purpose. It is as if the Rules of Federal Procedure were found imbedded in a treatise on famous sporting houses. The problem encountered is not understanding the history of the Virgin Islands Industrial Incentive Program.

*The terms “Tax Incentive Act and “Industrial Incentive Act” are used interchangeably for purposes of this article.

Although origins of the Virgin Islands Industrial Incentive Program go back to ordinances of the municipal councils which preceded the creation of the Virgin Islands legislature, the real impetus came after World War II. During the post-World War II period, many underdeveloped countries and areas enacted tax incentive programs to encourage investment. The Virgin Islands were no exception and in 1948, its original Tax Incentive Act was passed. Since that time it has been amended several times. It appears there was little restriction on the content of such acts. However, it was recognized that a Washington administration had the power to demand changes or repeal of such legislation at any time. As a consequence, the principal tax advantages were placed in terms of a Virgin Islands government subsidy, granted under a binding contract with the recipient.

The 1957 Act got a little out of hand, its drafters felt obliged to grant certain tax-free benefits on the sale of marketable securities. This was more than the Treasury was accustomed to accepting, especially if securities purchased in the United States could find a tax haven upon their sale through a Virgin Islands broker or bank.

Section 934, Internal Revenue Code

Since 1960, I.R.C. Section 934 has limited the Virgin Islands Government's power to make grants or subsidies which directly or indirectly reduce income taxes payable to it. Subsidies may apply only to those who are bona fide residents of the Virgin Islands for the entire tax year, and then only to Virgin Island sources income. Not surprisingly, Regulations Section 1.934-1(c)(5) specifies that gain on the sale of securities is not Virgin Islands' source income. Perhaps there was a little overkill in this provision since there would appear to be no objection to Virgin Islands residents escaping tax on the sale of securities of Virgin Islands corporations if the local government saw fit to grant such exemption. It also appears to prevent the granting of tax exemption to stockholders on liquidating dividends of an exempt corporation. See I.R.C. Sec. 165(g)(2) for definition of a "security."

It must be recognized that Section 934 is not the Industrial Incentive Act itself, nor does it purport to grant any benefits to taxpayers. The sole purpose of the section is to limit the zeal of the Virgin Islands government in spreading glad tidings to deserving recipients. The section speaks in terms of a general prohibition with exceptions:

Tax liability incurred to the Virgin Islands . . . shall not be reduced . . . directly or indirectly, whether by grant, subsidy or other similar payment, by any law enacted in the Virgin Islands, except to the extent provided (below).

Exceptions are made for domestic and Virgin Islands corporations to the extent that the tax liability is derived from sources without the United States, if

- (1) 80 percent or more of the gross income for the three-year period preceding the close of the taxable year was derived from sources within the Virgin Islands and
- (2) 50 percent or more of the gross income was derived from the active conduct of a trade or business within the Virgin Islands.

The regulations then provide formulas for computation of tax liability attributable to income derived from sources without the United States. If the subject corporation is a United States domestic corporation required to file both United States and Virgin Islands tax returns, the formula is not applied, and the actual tax liability to the Virgin Islands is used. In determining the source of gross income, the principles of Section 861-864 govern.

Under 934, *all amounts received by a corporation in the United States are considered as being derived from sources within the United States!* This can be a fatal trap for those who may sell manufactured goods from a Virgin Islands tax-exempt corporation and deposit the proceeds directly in stateside banks. Despite there being no mention of this provision in the Virgin Islands Tax Incentive Act (except by incorporation of Section 934), it is a pitfall beyond the powers of the Virgin Islands to forgive, waive, or legislate out of existence. Likewise, the 80% and 50% rules above appear only by reference in the Tax Incentive Act. The Virgin Islands being a United States possession, there are no restrictions on transfer of capital or repatriation of profits. All proceeds of sales by tax-exempt firms should be first deposited directly into Virgin Islands bank accounts, and then transferred to the continent if so desired.

In addition to the exceptions to the general rule for domestic and Virgin Islands corporations, Section 934 permits grants and subsidies to be made to a United States citizen (individual) who is a bona fide resident of the Virgin Islands for the entire tax year, to the extent tax liability is attributable to income derived from sources within the Virgin Islands. The principles of Section 871 determine residence. Although one may find

the Virgin Islands to be the proper taxing jurisdiction by virtue of his being an "inhabitant" of the Virgin Islands on the last day of his taxable year, he may not qualify for benefits of grants or subsidies if he was not a bona fide resident for the entire tax year. Under the present Tax Incentive Act, the 934 provision may be academic since under one interpretation qualified individuals must be domiciled in the Virgin Islands for at least three years. This interpretation is open to question. Section 934 also makes specific reference to amounts received as an employee of the United States government not being considered Virgin Islands source income.

Section 934 rings down the curtain by specifying the information which tax-exempt firms must attach to their Virgin Islands tax return. Normally, the I.R.S. will conduct a tax examination, limited in scope to ascertain whether Section 934 has been complied with. Naturally, Virgin Islands tax examiners will not so limit the scope if the firm's return is selected for examination.

Before introducing the present Industrial Incentive Act, it is emphasized that it must be read together with Section 934. The provisions of 934 are not spelled out in the Industrial Incentive Act. Nevertheless, they must be complied with. Furthermore, 934 supersedes the Industrial Incentive Act, and limits such legislation.

Virgin Islands Industrial Incentive Act

The present act known as the Virgin Islands Industrial Incentive Act,⁴⁴ became effective July 1, 1972. A consulting firm was retained by the Virgin Islands Government to compare the bill to other areas' industrial incentive acts and to make suggestions to improve it. Most recommendations are sensible, but no indication of their being implemented is evident.

The 1972 Act has the aura of having been designed by social scientists to curry the favor of monopolistic laborites, without taking into consideration the realities of the situation. Rather than supplying an incentive to investment, it seems to say, "If you're so greedy as to seek tax benefits, we'll make an honest man out of you." The costs are simply too great to support the benefits for the small investor. Larger firms may find it worthwhile.

One of the problems is that the original Act and those which have followed were patterned on those of other areas such as Puerto Rico's successful "Operation Bootstrap" and the Pioneer Industries laws of other

islands. These areas are attempting to relieve high unemployment rates and utilize a large labor potential. The Virgin Islands enjoy a low unemployment rate and suffer a labor shortage. However, the 1972 Industrial Incentive Act is aimed at an unusually severe demand that local labor be used. As has been noted in studies prior to the one mentioned above, no overall economic plan or objectives have ever been formulated.⁴⁵ In addition, all social problems are blamed (by government) on the hot economic climate which demands an increasingly greater labor force, and the resultant population explosion, rather than to the inefficiency of wealthy government in conducting its business.

The Act has general provisions with the express intent that benefits be determined through a process of bargaining. No detailed benefits can be supplied to a tentative investor. The benefits detailed below are the maximum permitted. Among other general provisions are the incorporation of Section 934 by reference and the definitional sections which describe a resident as “. . . any United States citizen, or the holder of an alien registration receipt card, . . . who has been domiciled in the Virgin Islands for any period of three consecutive years, or more.” The language of the statute makes it impossible to determine whether the 3-year domicile rule is applied only to holders of alien registration cards or if three years of domicile is also required of U.S. citizens. Also, constitutional issues are inherent in such discriminatory definitions. This definition is to be applied both as to beneficiaries and to employment restrictions.

Beneficiaries must meet nine standards to qualify:

- (1) Their business must be one which advances the economic and social well-being of the Virgin Islands.
- (2) If a natural person, he must be a resident of the Virgin Islands as defined above; if incorporated, he must be incorporated in the Virgin Islands. Corporations are more restricted than under Section 934, since United States domestic corporations do not qualify.
- (3) Beneficiaries must meet the requirements of Section 934 of the Internal Revenue Code. The Act itself does not spell out the requirements.
- (4) The beneficiary must be the actual investor and not a mere nominee or agent.
- (5) Ecological standards, not yet established, must be met.

- (6) Subject to exceptions below, only Virgin Islands residents may be employed.
- (7) Despite the foregoing employment restrictions, beneficiaries must establish and abide by nondiscriminatory employment policies.
- (8) A written agreement must be signed, whereby the beneficiary binds himself to use Virgin Islands goods and services unless bids exceed nonresident bids by 15 percent.
- (9) Perpetual easements must be granted to the Virgin Islands government, to any beaches or shorelines and provide free and unrestricted access thereto to the public.

The restrictions on employment are subject to exceptions, and temporary permits to employ nonresidents may be granted for three months (one year in the case of high managerial, supervisory personnel or skilled technicians). The sole purpose of these permits is to allow beneficiaries the necessary time for training Virgin Islands residents. One must agree to establish and conduct vocational training classes for resident applicants to fill nonresident held positions, or agree to pay the cost of training preselected resident employees in a school or other facility. During training, the trainee must be paid at least the minimum wage prescribed by law. Granting of the permits requires adequate notice and public hearing.

If the Commissioner of Labor finds that a training program should be undertaken, even though only resident employees are hired, the applicant must submit a comprehensive plan for establishing and conducting such training program. The program is also subject to review and approval of the Virgin Islands Board of Vocational Education.

A page has been torn from the Bahamian work permit statute and found its way into Virgin Islands law. Unless it is administered with laxity, only large firms will be able to comply.

Specific minimum dollar investments are required, the amount being determined by the type of business or industry seeking the tax benefits. Ten separate classifications are given:

- (1) Non-polluting light industry—\$25,000.
- (2) Guest house of at least five transient rooms—\$50,000
- (3) Government sponsored housing—\$100,000.

- (4) Eighteen-hole golf course with hotel—\$1,500,000. Without hotel—\$500,000.
- (5) Regularly scheduled water transportation, including sight seeing tours—\$40,000.
- (6) Air transportation between U.S. Virgin Islands and British Virgin Islands or Puerto Rico—\$500,000.
- (7) Hotel of 50 rooms or over—\$500,000.
- (8) Harvesting and processing agricultural products, seafood or dairy products—\$25,000.
- (9) Shopping Center—\$5,000,000.
- (10) Any other industry—\$100,000.

Two types of benefits (exemptions and subsidies) are offered, all of which are permissible but not mandatory. The spirit of the Act being founded in negotiated benefits, any combination is possible. Those listed below are the maximum permitted.

The exemptions are taxes which need not be paid by the successful applicant and consist of the following:

- (1) Taxes on real property. 100 percent for the first three years; 50 percent for the following three years. No renewals are permitted on the same property.
- (2) Gross receipts taxes (See "Other Taxes" section in this article). 100 percent for five years. It has been the practice of the Board in its discretion, not to grant any exemption for Gross Receipt taxes.
- (3) Excise taxes (See "Other Taxes" section in this article) on goods imported to build facilities. One hundred percent exempt for five years.

Exemptions are not nontaxable. By virtue of being exempt from payment, no deduction accrues for the amount which nonexempt firms must pay.

The subsidies require that the tax be paid in full. The government then returns a portion of such tax as a nontaxable subsidy. Such subsidies are available for:

- (1) Custom duties on raw material—90 percent for five years.
- (2) Income taxes—75 percent for five years; 50 percent for additional five years. Subsidies will be paid to stockholders of Subchapter S corporations, who are bona fide residents of the Virgin Islands. The subsidy does not apply to income earned from sources without the Virgin Islands.

A single beneficiary may not receive benefits for more than two enterprises. Furthermore, each of the two enterprises must either qualify under different categories or be located on separate islands. No definition of the word "Enterprise" is given and there is question as to whether it means taxpaying entity or separate location of operations.

The nontaxable aspect of subsidies has been the subject of attack by the Virgin Islands Tax Division. In *HMW Industries Inc. v. Wheatley*, 34 AFTR 2d 74-5921 (3rd Cir. 1974) a Virgin Islands subsidiary was liquidated by its U.S. parent in a §332 transaction, and continued operations as a branch of the parent. Under I.R.C. §334(b)(1), the parent took the basis of the subsidiaries' assets (entirely inventory) as its own. The Virgin Islands Commissioner of Finance contended that subsidies paid to the subsidiary were "non-shareholder contribution to capital" subject to the provisions of §362(c)(2) I.R.C., that the subsidies were used to purchase inventory, and that the inventory should therefore have a zero basis. The 3rd Circuit upheld the District Court in determining that the subsidy was not a non-shareholder contribution to capital, but was a refund of income taxes, and that §362(c)(2) did not apply. For good measure the court added:

. . . the subsidy legislation . . . was designed to reduce income tax liability . . . by refunding a portion of the tax paid. Sec. 33 V.I.C. §§4108(b), 4071(a)(2). Nothing appears . . . to indicate that a deferment of tax liability was intended rather than an exemption from liability. . . . If a subsidy is treated as the Commissioner contends . . . the subsidy would in effect be rendered taxable, albeit at a later date.

Additionally, the Court did not reach the Commissioner's original contention that the V.I. legislature did not have the authority to enact the tax (exemption-subsidy) law.

The *HMW* case actually begged the question and had the wrong tormentor. Unless *HMW* applied for a 367 ruling, the liquidation of their subsidy did not qualify for 332 treatment and was taxable by the U.S.

It is the intent of the Tax Division to scuttle any tax incentive legislation whenever possible. Unlike their more sophisticated neighbors in Puerto Rico, the V.I. Tax Division, with tunnel vision, looks toward immediate revenues rather than long term fiscal advantages. Despite one industry after another leaving the V.I. for more hospitable climes, they continue in engaging newcomers into expensive litigation. Recently the Technical Advisor of the Tax Division held that litigation would be necessary if a firm wished to maintain its position that the subsidy was a refund of taxes and therefore subject to the statute of limitations. The *HMW Industries* holding that subsidies are tax refunds was recent and firm in his mind.

Attacks on V.I. tax incentive corporations have not always been denied. The grant of exemption and subsidy may not be worth the paper it is written on. In an obvious abuse of the incentive privileges, the taxpayer was not permitted to enjoy the benefits. *In re Hooper's Estate*, 359 F.2d 569, 577 (3rd Cir. 1966) it was stated that "the Government is neither estopped by acts of its officers or agents in entering into an arrangement or agreement to do or cause to be done what the law does not sanction or permit." But even where the taxpayer acted in good faith and was induced by a tax incentive grant to place his capital at risk in the Virgin Islands condominium market, he found himself holding an empty bag. *Tracy Leigh Development Corporation v. Govt. of the Virgin Islands* (3rd Cir. 1974). In that case it was the U.S. Comptroller of the Virgin Islands who played the heavy by declaring that the exemption and subsidy were available only for the ownership of condominiums and not for the construction thereof.

Today, the Tax Division is attacking the inclusion in cost of sales, of customs duties paid on raw materials where 90% of the duties are refundable as nontaxable subsidies. To deny the deduction would be to transform a nontaxable subsidy into a taxable subsidy.

The procedure to be followed in seeking these tax benefits commences with an application being filed with the Director. Under the provisions of the statute, the Director then submits the application to a Commission Chairman along with his recommendation. Within twenty working days thereafter, the statute tells us, the Commission is to meet and consider the application. Thereafter, the Commission is to hold public hearings. No time limits is designated. Thirty days after the public hearing, reports are to be submitted to the Governor, who makes the final decision. Again, no time period is specified for the Governor's due consideration.

Assuming that the application has been successful, the certificate still may be revoked or modified under certain conditions. Two years and \$2,500 awaits the submitter of false or fraudulent claims.

The investor who carefully analyzes the income tax benefits of the V.I. Industrial Incentive Act, will soon discover that the U.S. Treasury is the major beneficiary of his time and expense to qualify. Since there is no means to repatriate V.I. earnings taxfree, the following example assumes that a U.S. parent has a V.I. subsidiary with the subsidy benefits, and that the subsidiary's profits are paid out annually as dividends:

Subsidiaries Net Income	\$100.00
V.I. Tax (48% less 36% tax subsidy refund)	12.00
	<u>\$ 88.00</u>
V.I. Withholding Tax on Dividend Paid—30%	26.40
Net dividend paid to U.S. parent	<u>\$ 61.60</u>
U.S. 48% tax on parent's dividend	42.24
	<u>\$ 19.36</u>
901-902 Foreign Tax Credit	36.96
Net Repatriated Earnings	<u>\$ 56.32</u>
Taxes Generated by V.I. Government	<u>\$ 38.40</u>
Taxes Generated by U.S. Government	\$ 5.28

Were it not for the incentive subsidy, the foreign tax credit limitation would result in the U.S. collecting no income taxes on the V.I. source income. The parent benefits by 4.32 points over income generated by its less risky domestic investments. The U.S. Treasury walks off with the lion's share of \$5.28. In the Ways and Means Committee Report on the Energy Tax and Individual Relief Act of 1974 (which did not pass) is the following quote regarding Puerto Rico and possessions corporations:

. . . without significant local tax incentives that are not nullified by U.S. taxes, the possessions would find it quite difficult to attract investments by U.S. corporations.

The Virgin Islands Industrial Incentive Act provides that the salary of the Director is to be equal to that of the highest salary paid to a head of any other executive department. It does not state whether he is to be supplied with a desk or a hammock.

It is fortunate that the Director appears to be genuinely dedicated to the development of the Virgin Islands. With such a legislative framework, we wish him good luck; especially since the final decisions lie within the arbitrary judgment of the Governor and his advisors, whosoever may constitute that lot.

In 1974, an attempt was made to set up an Industrial Incentive Authority which would operate along the lines of Puerto Rico's Fomento. It would have had the power to issue revenue bonds and to operate independently. Hearings on the matter found the V.I. Legislature in great confusion as to the difference between revenue bonds and general obligation bonds, resulting in its rejection by the V.I. solons.

The truth is that while an industrial incentive program can aid the islands immensely through economic development and diversification, the fate of its people has never hung on this thread. The population is small enough that a beneficent Federal Government fulfills its financial needs. The population and life or death elements which entered into Puerto Rican problems do not exist in the Virgin Islands. The horn of plenty provided by federal programs during the 1930's (Bluebeard's Castle, a luxury hotel, was partially built as a WPA project) was never understood. Economic depression had been a way of life for decades. The Islands were surprised to find that the Federal Government deemed depression to be an emergency, and never quite recovered from the shock of that discovery. Ever since, it has been assumed that the government will provide. A bucolic panic that the intruder may enjoy a tax benefit permeates the atmosphere. A provincial ignorance fails to recognize the benefits conferred upon the Islands by outside investment.

Infiltration of the Islands by active and vocal continentals has also taken its toll. Many wish to retain the sleepy, tropical island atmosphere while living from stateside investment income, rather than permit insular economic development along with concomitant population growth. This group has difficulty in determining who was supposed to be the last guy permitted off the plane.

The consequence is an incentive program which is more defiant than inviting to investors. Large corporate entities can live within the restrictions of the present law. However, industrial giants more often negotiate their own deals with the government, leading to the enactment of special legislation. The smaller investor will have to submit to arbitrary government demands or forego the industrial incentive benefits.

CUSTOMS DUTIES AND SECTION 301 OF THE UNITED STATES TARIFF ACT

Customs Duties

Customs duties are based on the treaty made with Denmark in 1917, when the islands were purchased by the United States. The gist of the treaty is that such duties would never be increased, and that the "free port" status would be maintained. Actually the Virgin Islands are not a free port, since a 6% across-the-board duty is imposed on all non-U.S. imports. This duty is collected and administered by United States Customs, and not by any local agency. The proceeds, however, are paid into the Virgin Islands treasury after deduction for collection costs. Under the investment incentive law, qualifying firms may be entitled to rebates of up to 90% of such duties paid on raw materials.

Since the duty rates of the Virgin Islands differ from those of the United States mainland, any import of such goods into the continental United States from the Virgin Islands requires full payment of duties, except as to manufactured goods under Section 301 of the Tariff Act, discussed below. For this reason, one must go through Customs when going from the Virgin Islands to the United States or Puerto Rico, although the converse does not apply.

Exemptions for foreign goods purchased by United States travelers is generally \$100. The Virgin Islands have been favored, and a \$200 exemption is granted to travelers for foreign merchandise purchased in the U.S. Virgin Islands. Since federal excise taxes do not apply in the Virgin Islands, liquor and cigarettes are especially good buys. One gallon of liquor per person may be returned to the mainland without paying duties. Several years ago the law was amended to rectify a longstanding abuse. Visiting infants are no longer entitled to their liquor quota, although resident tipping toddlers are still permitted their gallon once every six months.

Section 301 of the United States Tariff Act

Although now incorporated under a different section, the most promising incentive to manufacturing investors is found in what is popularly known as "Section 301" or "Headnote 3a". It is this federal program which provides benefits most attractive to risk capital. Section 301 provides for duty-free import into the United States of goods manufactured in the

Virgin Islands, if the cost of raw materials from foreign sources is no more than 50% of the sale value of the finished goods in the United States.

Obvious manipulations could be practiced in pricing of the finished goods as well as figuring cost of foreign raw materials. This is policed by United States Customs whose regulations govern calculation of cost, sales value, and determine whether the process applied in the Virgin Islands is a qualifying manufacturing process. The latter determination has been made in a liberal fashion and includes assembly of cigarette lighters, inserting the bolt which joins two imported scissor halves, and the marking, calibrating, and etching of Japanese thermometer blanks.

The obvious advantage of using Section 301 is in manufacturing items which use foreign raw materials having a high duty rate for United States entry. The across-the-board 6% duty in the Virgin Islands is paid with possibility of 90% refund under the Industrial Incentive Act. If such refund is in effect, the net duty paid is .6%, and no further duty is charged when the finished goods are imported into the United States mainland.

This is a federal law over which no local control is exercised, administratively or otherwise. It is implemented by federal agency which can severely restrict the benefits as it sees fit. Consequently, restrictions and quotas have been imposed in cases where volume imports into the United States have created unfair advantage and hardship to United States manufacturers and importers. A large watch assembly industry grew quickly, only to find quotas imposed when the volume threatened stateside interests. Similar quotas were imposed when Italian fabrics were imported into the Virgin Islands, where they were unrolled through a waterproofing bath, dried, rerolled, and re-exported to the United States as waterproof fabrics, duty free.

The great Panamanian orange juice scheme was something else again. It never got off the ground. It simply wouldn't fly. Back in the 1930's, the Federal Government formed a wholly-owned corporation, devised to revitalize the sugar industry. As part of the program, this corporation acquired substantial acreage on the island of St. Croix. By the mid 1960's the efforts were an acknowledged failure, and the governmentally owned corporation was dismantled. The then Governor of the Virgin Islands encouraged outside interests to acquire the St. Croix lands to grow oranges. At first, the sanity of those involved was questioned. Oranges do not grow well in the Virgin Islands, and, at first glance a ski lodge would stand a better chance of success. Then the rest of the plan was revealed.

Tankers would bring Panamanian orange juice to St. Croix, where the meager product of the Cruzan orchards would be added. This would increase the value of the juice by 100% (presumably because of the high quality and distinctive flavor of oranges grown on sugar lands), the "cost" of foreign raw materials would be within 50% limitation, and the whole mixture could be sloshed into the United States duty-free. Florida fruit growers were yet to be reckoned with. Rumor has it that a strong lobby reached the President of the United States. The promoters gave a groan, the air was rent with a final spastic cough, the scheme rolled over and has not been heard from since.

The lesson to be learned is that Section 301 is a very viable tax benefit, but care must be taken not to get greedy by swamping the United States market with low-duty goods or to devise plans which would outrage United States competitors.

Federal free trade legislation also affects the viability of Section 301. The lower the duties and the greater the trade preferences granted by the U.S., the lesser the advantages to be gained by manufacturing in the Virgin Islands. From the Virgin Islands standpoint, this incentive is not a long range advantage over other competitors for the investor's dollar.

OTHER TAXES IN THE VIRGIN ISLANDS

Excise Tax (Local Import Tax)

An import tax is imposed on all imports of goods for business use without regard to the country of shipment. As separate from a customs duty, which applies only to imports from foreign countries, this excise tax is placed on island imports from the United States and its possessions. Where practicable, the tax may be avoided by taking delivery outside of the Virgin Islands. A local pleasure boat sales firm makes delivery of boats in Puerto Rico. The buyer then sails the boat into the Virgin Islands as a non-business asset, thereby avoiding the tax the seller otherwise would have had to pay.

Two things present problems with this plan. The delivery, so made, may subject the sale to unknown Puerto Rican taxes; also, there is contradiction between two sections of the Virgin Islands law. The first section imposes the tax on all goods including those for personal use, however, the provisions of the act relating to valuation of the taxed articles refers only to those for "disposition in the course of trade or business."⁴⁶

The excise tax rate is between 2 and 10%, depending upon the nature of the goods imported. The tax does not apply to goods disposed of in the course of export trade to purchasers who shall take delivery and actual possession outside of the Virgin Islands. No court interpretation has been made as to the exclusion under this clause, of raw materials imported where the finished goods are to be disposed of outside the Virgin Islands. Administrative procedure seems to favor the taxability of raw materials, excluding only goods brought in for direct trans-shipment. Prior industrial incentive acts have provided for exemptions and subsidies for excise taxes on raw materials, without making reference to the place of disposal of the finished goods.

Gross Receipts Tax

The gross receipts tax is imposed upon the vendor of goods or services. It is not a sales tax which is collectible from the consumer and held in trust for the government. It may be added on to the selling price, thereby recovered from the purchaser, but is not collected and held in trust.

A bill approved July 13, 1973, amended the prior acts, eliminating certain exclusions previously existing. Receipts from services rendered on a personal basis (professions) are now subject to the tax, which is at a rate of 2%. Unfortunately, the Act did not eliminate an ambiguity of the old law which states that gross receipts means "all receipts cash or accrued." Although the law seems to give the taxpayer a choice of reporting on either a cash or accrual basis without reference to other tax reporting requirements, administrative authority rules that the accounting method of reporting must be consistent with that used for income tax reporting. Administrative convenience appears to be the basis for this rule, as it is the habit of the authorities to compare the income reported on gross receipts tax returns with that reported on income tax returns. No court has ever decided the issue. "Gross Receipts" is defined as being without deduction for any expenses whatsoever. Since bad debts are an expense to an accrual basis taxpayer, but are never brought into income by a cash basis taxpayer, the latter is taxed at a lower rate than the former.

Property Taxes

No personal property tax is imposed in the Virgin Islands, but real property is assessed and annual tax bills rendered. Assessment rates are approximately 60% of market value to which a 1 $\frac{1}{4}$ % tax rate is applied.

Payroll Taxes

Withholding of income taxes is the same as in the continental United States, except that they are paid into the Virgin Islands treasury instead of the federal treasury. Payments are made quarterly and no depository receipts are required on a monthly basis. Social Security is under the federal program with exactly the same requirements as in the United States. Self-employment returns must be filed with the U.S., separate and apart from the income tax return filed with the Virgin Islands government. The Virgin Islands are exempt from the Federal Unemployment Contributions Act, but has its own system which requires employers to pay a rate of 1½% of each employee's first \$4,200 annual earnings. It is compulsory for employers to provide Workmen's Compensation Insurance through the government operated Government Insurance Fund.

Estate, Gift, and Inheritance Taxes

Under prior federal estate tax law, a United States citizen domiciled in the Virgin Islands at the date of his death was not a citizen of the United States within the meaning of the Code.⁴⁷ In 1958, Section 2208 was added to the Code which brought estates of persons not born or naturalized in the Virgin Islands under federal estate and gift tax provisions. Estates of resident persons born in the Virgin Islands, or naturalized in a court of the Virgin Islands after qualifying for citizenship by virtue of Virgin Islands residency, are subject to federal estate taxation as non-resident aliens.⁴⁸ These persons are exempt from federal gift tax, even as to transfers of intangible property situated in the United States; and the Foreign Investors Act of 1966 extends the exemption to such persons who are also engaged in business in the United States. The exemption for Federal estate taxes is not so broad. U.S. situs property is taxable as if the Virgin Islands citizen were a nonresident alien.

In October, 1973, the Virgin Islands Legislature passed a bill "To Establish a Virgin Islands Gift Tax and to Amend the Inheritance Tax." The new gift tax imposes taxes on all gifts over \$3,000 made to any person in a calendar year. No lifetime exemption is in effect, nor is there provision for election of split gifts. The rates are not progressive, but differ depending upon the relationship between donor and donee as follows:

Between spouses or lineal ascendants and descendants	5%
Between brothers, sisters or their issue	10%
Between all others	15%

Deductions are permitted for gifts to charities and to the Virgin Islands for exclusively public purposes, but the charitable deduction appears to have erroneously been omitted from the inheritance tax provisions. The tax applies to gifts of all property which has its situs in the Virgin Islands whether the donor be resident or nonresident.

This imposed an especially heavy burden on taxpayers who are also liable for federal gift taxes since neither the Virgin Islands nor the federal law provides for credit of the other's gift tax.

The amendment to the inheritance tax merely raised the rate, which now corresponds to those in the newly enacted gift tax, above, as well as to provide for "Estate Tax Pickup". In the event a federal estate tax is payable to the United States, the Virgin Islands inheritance tax will be raised to an amount equal to the maximum credit allowed for payment of inheritance taxes to a state, territory or possession of the United States. The language of the statute indicates that the drafter was under the impression that a Virgin Islands inheritance tax qualifies for credit under I.R.C. 2011. It does not. The Virgin Islands fall under I.R.C. 2014 and only the foreign tax credit is available.

In this summary of taxes in the United States Virgin Islands, each tax has been discussed to the extent and depth which the writer considers to be of interest to the planner of international tax and business transactions. Some of the material is sketchy, and my own biases are apparent throughout. Despite care having been taken to avoid error, undoubtedly sins of omission and commission both exist. The author welcomes commentary, corrections, and questions which should be addressed to Post Office Box 1015, St. Thomas, U.S. Virgin Islands 00801.

NOTES

¹24 T.C. 408 (1955)

²42 Stat. 123, 48 U.S.C. §1397

³33 V.I.C. §1931(15)

⁴48 U.S.C. §1642

⁵Rev. Rul. 60-291

⁶61 Cong. Record, Part 2, p. 1724; 61 Cong. Record, Part 3, p. 3173

⁷I.R.C. Sections 871 and 881-882

⁸I.R.C. Sections 872(a) and 882(b)

⁹Sec. 7701(a)(4), I.R.C.

- ¹⁰Sec. 7701(a)(5), I.R.C.
- ¹¹Mulraoney, T.M. 197 3rd, *Foreign Partners, Partnerships, Trusts, Estates, and Beneficiaries*
- ¹²See Rev. Rul. 73-315, I.T. 2946, and Rev. Rul. 56-616
- ¹³4 V.I. Op. A.G. 292
- ¹⁴I.R.C. §38, 170, and 957 (examples)
- ¹⁵I.R.C. Reg. §1.1-1(c)
- ¹⁶Section 28(a) Organic Act of 1954
- ¹⁷Sec. 932, I.R.C.
- ¹⁸I.R.C. 1371(a)(3)
- ¹⁹I.R.C. §932
- ²⁰*ibid*
- ²¹Section 28(a) Organic Act of 1954
- ²²I.R.C. Sec. 932
- ²³I.R.C. §441(g)
- ²⁴I.R.C. §7701(a)(4) & (5), Rev. Rul. 56-616
- ²⁵*ibid*
- ²⁶I.R.C. §1
- ²⁷I.R.C. §882(b)
- ²⁸I.R.C. 931(c)
- ²⁹I.R.C. §958(b)(4)
- ³⁰I.R.C. §1248(d)(3)
- ³¹Executive Order 11071, C.B. 1963-1, 137
- ³²Rev. Rul. 72-29
- ³³I.R.C. §871
- ³⁴I.R.C. §877
- ³⁵I.R.C. Reg. §1.1441-4(d)
- ³⁶C.B. XIV-2, 109 (1935)
- ³⁷I.R.C. 1969-31, 18
- ³⁸C.B. 589-90
- ³⁹I.R.C. §864(b)(1)
- ⁴⁰Proc. 4098 (12-20-71), 36 Fed. Register 24201 (12-22-71)
- ⁴¹64 Stat. 384
- ⁴²1953-1 C.B. 303
- ⁴³2 U.S. Cong. & Admin. News 1958 p. 3649
- ⁴⁴Bill 5518, Act. No. 3263
- ⁴⁵*Tax Incentives For Economic Growth in the U.S. Virgin Islands*, Oldman and Taylor, Caribbean Studies, Vol. 10, No. 3 (1969), at 184, 191
- ⁴⁶Title 33, Virgin Islands Code, Section 42(b)
- ⁴⁷*Estate of Fairchild v. Comm'r*, U.S.T.C. 1955, 24 T.C. 408
- ⁴⁸I.R.C. §2209