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Taxation Through the Looking Glass: The Mirror Theory and the Income Tax System of the U.S. Virgin Islands Before and After the Tax Reform Act of 1986

by
Scott G. Chyatte†

INTRODUCTION

As a geographic entity, the United States Virgin Islands consists of approximately fifty islands, located 1,000 miles southeast of Miami and eighty miles east of Puerto Rico. As a political entity, the U.S. Virgin Islands is a possession or unincorporated territory of the United States, a body politic, with “attributes of autonomy similar to those of a sovereign government or state,”¹ but it is not sovereign in the true sense of the term. One attribute of sovereignty which the Virgin Islands clearly does not have is the authority to independently establish a system of taxation. Such authority was preempted by Congress, a little more than five years after the United States purchased the Virgin Islands from the King of Denmark in 1916, when it conferred the dubious bounty of the U.S. Internal Revenue Code [hereinafter I.R.C. or Code] onto the Virgin Islands.²

Generally, the I.R.C. is given effect in the Virgin Islands by a word substitution scheme known as the “mirror theory” or “mirror system.”³ The mirror theory essentially requires that the words “Virgin Islands” be substituted for the words “United States” wherever these terms appear in the

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1. In *Re Hooper's Estate*, 359 F.2d 569, 578 (3d Cir. 1966); Revised Organic Act of the Virgin Islands, 48 U.S.C. § 1541 (1954 & Supp. 1986) [hereinafter R.O.A.]; Thomas, *The U.S. Virgin Islands — “Foreign” Operations in a U.S. Possession*, in U.S. Tax. Int'l Operations: Tax Ideas ¶ 8511.1 (Prentice Hall 1984).

2. See Naval Service Appropriations Act of 1921, approved July 12, 1921, 48 U.S.C. § 1397 [hereinafter N.S.A.A.]; R.O.A., 48 U.S.C. §§ 1541, 1642 (1985).

3. *Great Cruz Bay, Inc., St. John Virgin Islands v. Wheatley*, 495 F.2d 301, 303 (3rd Cir. 1974); *Chicago Bridge and Iron Company v. Wheatley*, 430 F.2d 973, 975 (3rd Cir. 1970).

Code.⁴ The resulting tax system operates as if a foreign country had adopted the I.R.C. and enforced it against its own taxpayers in the same way the United States enforces the Code against U.S. taxpayers, except that the Virgin Islands is not a party to any of the tax treaties signed by the United States.⁵

While the concept can be simply stated, the tax system created by Congress for the Virgin Islands has produced particularly complex problems. When these inherent complexities are added to a pattern of inconsistent administration and judicial interpretation, the result is an uncertain regulatory scheme. The Tax Reform Act of 1986 has resolved many of the technical issues relating to the V.I. tax system, but fundamental problems remain. This article will trace the evolution of income taxation in the Virgin Islands by examining the administrative, judicial, and legislative measures that have been taken to answer the problems created by this unique system of taxation. This article demonstrates that such measures have had limited success in resolving the tensions created by the peculiar political status of the Virgin Islands and the resulting need for its tax system to operate independently from, yet in conjunction with, the United States tax system.

I.

STATUTORY OUTLINE

A. Governmental Powers

The federal statutory framework governing the Virgin Islands is detailed in the 1954 Revised Organic Act of the Virgin Islands, found in Chapter 12 Title 48 of the United States Code.⁶ Under the Act, the Virgin Islands is declared to be an unincorporated territory of the United States of America having only those governmental powers set forth in Chapter 12.⁷ This chapter provides for a local government with carefully circumscribed legislative, judicial, and executive powers.

4. I.T. 2946, XIV-2 C.B. 109 (1935), declared obsolete by Rev. Rul. 69-45, 1969-1 C.B. 313, reinstated by Rev. Rul. 73-315, 1973-2 C.B. 226.

5. Danielson, *Business Operations in the U.S. Virgin Islands*, Tax Management Portfolio, 336-2d, at A-4, A-81 (1978); See also *Operation and Effect of the Possessions Corporation System of Taxation*, Fourth Report, Dep't of the Treasury, Appendix A: Possessions Corporation System of Taxation in American Samoa, Guam, and the Virgin Islands (1983), reprinted in 9 INT'L TAX J. 343, 349.

6. R.O.A., 48 U.S.C. §§ 1541-1645 (1985). From 1917 to 1931, immediately after the United States acquired possession of the Islands, the Virgin Islands was under the administration of the United States Navy. In 1931, Herbert Hoover transferred administrative responsibility for the Islands to the Department of the Interior. Local civil government was established in 1936 by the Organic Act for the Virgin Islands. The Organic Act was then replaced by the more detailed provisions of the Revised Organic Act of the Virgin Islands in 1956. See *Smith v. Government of Virgin Islands*, 375 F.2d 714, 719 (3rd Cir. 1967).

7. R.O.A., 48 U.S.C. § 1541(b) (1985). The distinction between an unincorporated, as opposed to an incorporated, territory is discussed in *Smith*, 375 F.2d at 714, 719. According to the court in *Smith*, the significance of incorporation is that it is an important step leading to statehood which is only bestowed by Congress when it has already determined that the territory is destined for statehood. By expressly stating in the Revised Organic Act that the Virgin Islands

Legislative power in the Virgin Islands is housed in a unicameral body composed of fifteen locally elected senators.⁸ Legislative authority is explicitly limited to "rightful subjects of legislation" that are not inconsistent with the Revised Organic Act, the laws of the United States made applicable to the Virgin Islands, or any treaty or international agreement entered into by the United States.⁹ Moreover, the United States Congress retains the absolute power to disapprove, modify, supersede, or annul any and all acts of the Virgin Islands Legislature.¹⁰ The Islands are represented in Congress by a non-voting delegate to the House of Representatives.¹¹

Judicial power is vested in the District Court of the Virgin Islands and in lower local courts established by local law.¹² The District Court has jurisdiction equivalent to a U.S. federal district court, including exclusive jurisdiction over all proceedings in the Virgin Islands with respect to the income tax laws applicable there.¹³ Final decisions by the District Court may be appealed to the United States Court of Appeals for the Third Circuit.¹⁴

Executive power is vested in the Governor of the Virgin Islands. The Governor is elected locally and holds veto power over bills passed by the V.I. Legislature.¹⁵ In general, relations between the Virgin Islands government and the United States government are under the administrative supervision of the Department of the Interior.¹⁶

At the close of each fiscal year, the Governor must submit a comprehensive annual financial report to Congress and the Secretary of the Interior.¹⁷ Prior to 1982, a local comptroller had audit authority over all revenue and receipts accounts of the V.I. government. Since 1982, however, the Inspector General of the U.S. Department of the Interior has assumed these functions

is an unincorporated territory, Congress "made it clear that, although it was providing a detailed frame of government for the Islands, this was not to be taken as an indication that it had destined the territory for statehood." *Smith*, 375 F.2d at 718. This distinction had tax implications under former Internal Revenue Code [hereinafter I.R.C.] § 7701(a)(4) (1954), which defined a domestic corporation as one created or organized in the United States or under the law of the United States or of any state or territory. Under Treasury Regulation § 301.7701-5, the term "Territory" was defined to include only incorporated territories, such as Alaska and Hawaii. See *Chicago Bridge*, 430 F.2d at 974.

8. R.O.A., 48 U.S.C. § 1571 (1985).

9. *Id.* § 1574.

10. *Id.* § 1596.

11. *Id.* § 1547(c); *Port Construction Co. v. Government of Virgin Islands*, 359 F.2d 663, 667 n.2 (3rd Cir. 1966).

12. R.O.A., 48 U.S.C. § 1611(a) (1985).

13. *Id.* § 1612(a). The District Court of the Virgin Islands is not, however, a "constitutional court" (denoting one created under the authority and within the guidelines of Article III of the U.S. Constitution). *Government of Virgin Islands v. Bell*, 392 F.2d 207 (3rd Cir. 1968).

14. R.O.A., 48 U.S.C. § 1613 (1985).

15. *Id.* § 1591.

16. *Id.* § 1541(c).

17. *Id.* § 1591.

in order to provide a "satisfactory level of independent audit oversight," including authority to report to the Secretary of the Interior all failures to collect amounts due the V.I. government.¹⁸

B. Taxing Authority

Because the Virgin Islands is not a sovereign state but a territory of the United States, Congress must grant it the power to tax.¹⁹ The Naval Service Appropriations Act of 1922 and section 28(a) of the Revised Organic Act provide this grant of taxing authority.²⁰ According to the Naval Service Appropriations Act,

[t]he income-tax laws in force in the United States of America and those which may hereafter be enacted shall be held to be likewise in force in the Virgin Islands of the United States, except that the proceeds of such taxes shall be paid into the treasuries of said islands.²¹

With this simple pronouncement, Congress "introduced modern income taxation into the U.S. Virgin Islands."²² While doing so, however, Congress failed to provide any guidance as to how the income tax laws of the United States were to be applied and administered in the Islands. Furthermore, the V.I. legislature has little or no power to redefine or modify the provisions of the I.R.C. in their application to the territory.²³ Ironically, the simple, concise language of the Naval Appropriations Act "created what may well be the world's most confusing tax system."²⁴

The 1954 Revised Organic Act of the Virgin Islands resolved many of the questions left unanswered by the 1922 Act.²⁵ Section 28(a) of the Act states three basic principles.²⁶ First, the proceeds of the U.S. income tax levied on the inhabitants of the Virgin Islands and the proceeds of any other taxes levied by Congress on the inhabitants of the Virgin Islands 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. Second, inhabitants of the Virgin Islands shall satisfy their income tax obligations to the United States by paying their taxes on income derived from all sources both within and without the Virgin Islands to the V.I. Treasury. Third, the term "inhabitants of the Virgin Islands" includes all U.S. citizens whose permanent residence is in the Virgin Islands.²⁷

18. *Id.* § 1599.

19. *H.I. Hettinger & Co. v. Municipality of St. Thomas and St. John*, 187 F.2d 774, 776 (3rd Cir. 1951).

20. N.S.A.A., 48 U.S.C. § 1397 (1985); R.O.A., 48 U.S.C. § 1642 (1985).

21. N.S.A.A., 48 U.S.C. § 1397 (1985).

22. Danielson, *supra* note 5, at A-1.

23. *Chicago Bridge*, 430 F.2d at 975; *Danbury, Inc. v. Olive*, 627 F. Supp. 513, 518 (D.V.I. 1986).

24. Danielson, *supra* note 5, at A-1.

25. R.O.A., 48 U.S.C. § 1642 (1985).

26. *Id.* R.O.A. section 28(a) is 48 U.S.C. section 1642 (1985).

27. *Id.*

II. INTERPRETATION AND ADMINISTRATION

The statutory scheme outlined above illustrates the intriguing ambiguity underlying the relationship between the United States and the Virgin Islands. This ambiguity revolves around the fundamental issue of whether the Virgin Islands should be viewed as a political subdivision of the United States, similar to a state, or as a separate political entity. The aforementioned statutes address this issue only to the extent of delineating the general boundaries of local political authority. This legislative deficiency has given those responsible for administering and interpreting the tax laws of the Virgin Islands little operational guidance when applying these laws, particularly where the tax systems of the United States and the U.S. Virgin Islands overlap. Specifically, both the courts and the tax authorities have had difficulty handling the concepts of "foreign" and "domestic" when U.S. persons who are nonresidents of the Virgin Islands, come within the ambit of the V.I. taxing authority. This difficulty manifests itself in the treatment of both individuals and corporations.

The first authoritative interpretation of the tax structure established by the Naval Appropriations Act, Treasury Ruling I.T. 1454 (1922), dealt with the problem by refusing to recognize it.²⁸ Under that ruling, the provisions of the U.S. revenue laws which apply to a resident of the United States were declared applicable to residents of the Virgin Islands for the purpose of collecting income tax in the Virgin Islands.²⁹ In effect, this ruling treated the Virgin Islands as a collection district of the United States rather than as a separate tax jurisdiction.³⁰

I.T. 1454 was revoked in 1935 by I.T. 2946.³¹ I.T. 2946 faced the foreign/domestic issue directly and set forth what continue to be the ground rules of V.I. taxation. First, the ruling held that the Virgin Islands and the United States are separate and distinct taxing jurisdictions, even though their income tax laws are derived from an identical statute.³² Under this ruling, the Naval Appropriations Act created a local, locally collectible income tax in the Virgin Islands.³³ This concept was initially given judicial approval in *Dudley v. Commissioner of Internal Revenue*,³⁴ and has since been reiterated as dogma by the Third Circuit.³⁵

28. I.T. 1454 I-2 C.B. 180 (1922), revoked by I.T. 2946, *supra* note 4.

29. *Id.*

30. See Danielson, *supra* note 5, at A-4.

31. See *supra* note 4.

32. *Id.*

33. *Dudley v. Commissioner of Internal Revenue*, 258 F.2d 182 (3rd Cir. 1958).

34. *Id.* at 185.

35. *Id. Chicago Bridge*, 430 F.2d at 973; *Great Cruz*, 495 F.2d at 303; *Vitco, Inc. v. Government of Virgin Islands*, 560 F.2d 180, 181-82 (3rd Cir. 1977), *cert. denied*, 435 U.S. 980 (1978).

Second, I.T. 2946 formulated the substitution scheme which is the basis of the mirror theory, replacing the collection district theory of I.T. 1454. As stated in the ruling, it is necessary in some sections of the Code to substitute the words "Virgin Islands" for the words "United States," in order to construe the I.R.C. as it operates in the Virgin Islands.³⁶ Third, I.T. 2946 applied the substitution technique to I.R.C. section 7701(a)(4). This means that citizens of the United States, other than permanent residents of the Virgin Islands, are considered aliens for V.I. tax purposes; U.S. citizens temporarily residing in the Islands are treated as resident aliens and U.S. citizens not residing in the Islands are treated as nonresident aliens.³⁷ Although deemed obsolete in 1969 and not reinstated until 1973,³⁸ since its issue I.T. 2946 has been cited as the foundation of the mirror theory.³⁹

The next significant ruling, Revenue Ruling 60-291, built on this foundation and at the same time eroded it by holding that under the Revised Organic Act, a U.S. citizen domiciled in the Virgin Islands may qualify as a V.I. inhabitant if that person meets the bona fide residence test set forth in I.R.C. section 911(a)(1).⁴⁰ Having established this status, as of the last day of the taxpayer's taxable year, such U.S. citizens will completely satisfy their U.S. income tax obligations by paying tax on all sources of income to the Virgin Islands.⁴¹ Curiously, this aspect of the V.I. tax system both reinforces and diminishes its separate and distinct character. On the one hand, the Internal Revenue Service [hereinafter IRS] treats the Virgin Islands as a foreign tax jurisdiction. It recognizes that the Virgin Islands collects its own taxes and that U.S. citizens residing in the Islands, like other U.S. citizens living

36. I.T. 2946, *supra* note 4, at 110.

37. *Id.* One aspect of the specific ruling is somewhat questionable since the legal nature of citizenship in the Virgin Islands appears to be based on residency. All persons born in the Virgin Islands are citizens of the United States by birth.

Presumably these persons are also citizens of the Virgin Islands so long as they permanently reside there. We see no basis for thinking that other citizens of the United States who came to make their permanent residence in the Virgin Islands do not thereby also become citizens of the Virgin Islands From these considerations it would seem to follow that in applying the Internal Revenue Code to the Virgin Islands, citizens of the United States residing in the Virgin Islands are, while they permanently reside there, citizens of the Virgin Islands as well, and are, therefore, to be regarded for income tax purposes as resident citizens of the Virgin Islands, rather than as resident aliens.

Great Cruz, 495 F.2d at 306 n.7.

38. I.T. 2946 was declared obsolete by Revenue Ruling 69-45, 1969-1 C.B. 313, which listed I.T. 2946 among "rulings which, although not specifically revoked or superceded, are not considered to be determinative with respect to future transactions." This obsolescence, however, was withdrawn by Revenue Ruling 73-315, 1973-2 C.B. 225, which reaffirmed the ruling of I.T. 2946.

39. See *supra* note 35 and accompanying text.

40. Rev. Rul. 60-291, 1960-2 C.B. 407. This test is not met if an individual, who has earned income from sources within a foreign country, submits a statement to the authorities of that country declaring that he is not a resident of that country, and is subsequently held by the authorities of that country not to be subject to tax liability. I.R.C. § 911(d)(5) (1986) (former § 911 (a)(1)).

41. *Id.*; see also R.O.A. § 28(a), 48 U.S.C. § 1642 (1985).

abroad, will be given special treatment if they qualify under section 911 as bona fide residents. On the other hand, allowing U.S. citizens to satisfy their entire U.S. tax liability, including their liability for U.S. source income, by payments to the V.I. Treasury, renders these payments equivalent to payments to the U.S. Treasury. The Virgin Islands tax jurisdiction is thus accorded a unique status which cannot be described as either completely foreign or domestic to the United States.

These early efforts by the U.S. tax administration to delineate the details of the V.I. tax system had little actual impact on the local authorities. Rather than slogging through the practical difficulties created by the mirror theory, the V.I. authorities chose a more pragmatic approach based on "a course of West Indian applied philosophy."⁴²

Smiling agreement with the Washington declarations, it [the V.I. government] ignored those doctrines and followed a simpler course of applying the law as if the Virgin Islands were a part of the United States. This was neither the collection district theory nor the mirror theory; it was an informal admixture of the two without definitive limits or rules. Situations were solved as the circumstances dictated.⁴³

This ad hoc procedure persisted until 1968, when the mirror theory was actually accepted by the local administration as the law of the Virgin Islands for the first time.⁴⁴ The first judicial test of the mirror theory as applied to the Islands did not occur until the Third Circuit Court of Appeals decided *Chicago Bridge and Iron Co. v. Wheatley* in 1970.⁴⁵

The central issue in *Chicago Bridge* was whether a Delaware corporation which derived ninety-five percent of its income from V.I. operations was entitled to use the Western Hemisphere trade corporation deduction to reduce its income tax liability.⁴⁶ At the time of the decision, section 922 defined a Western Hemisphere trade corporation as a domestic corporation, which conducts its business entirely in North, South, or Central America, and which satisfied certain percentage income conditions.⁴⁷ The controversy in the case surrounded the proper interpretation or "construction" of the term "domestic corporation" in this context.

The Virgin Islands Commissioner of Finance argued that for these purposes a "domestic corporation" was a corporation created or organized in the Virgin Islands.⁴⁸ Although the Virgin Islands District Court agreed, the Third Circuit did not.⁴⁹ Holding that the corporation was entitled to the

42. Danielson, *supra* note 5, at A-18.

43. *Id.*

44. *Id.*

45. *Chicago Bridge*, 430 F.2d at 975; Hoff, *U.S. Federal Tax Policy Towards the Territories: Past, Present and Future*, 37 TAX L. REV. 53, 69 (1981).

46. *Chicago Bridge*, 430 F.2d at 973.

47. *Id.* at 974. For purposes of V.I. taxation, I.R.C. §§ 921, 922, relating to Western Hemisphere trade corporations, were rendered inapplicable by Pub. L. No. 92-178 in 1971. The sections were subsequently repealed for U.S. tax purposes by Pub. L. No. 98-369 in 1984.

48. *Chicago Bridge*, 430 F.2d at 974-75.

49. *Id.* at 975, 977.

deduction, the court relied heavily on the rationale, if not the holding, of *Sayre v. Riddell*, a Ninth Circuit Court of Appeals case interpreting the tax system created by the Organic Act of Guam.⁵⁰

The Organic Act of Guam provides that the income tax laws in force in the United States shall likewise be in force in Guam.⁵¹ As interpreted by the Ninth Circuit in *Sayre*, this section established a separate territorial tax system for Guam, comparable to that provided for the Virgin Islands.⁵² The *Sayre* court described the tax structure created by Congress, first for the Virgin Islands, and later for Guam, as an arrangement whereby each territory would apply a separate income tax system within its geographical jurisdiction that has the same basic structure as the income tax system used by the United States within its geographical jurisdiction.⁵³ According to the Ninth Circuit, the tax system of Guam is designed to imitate the U.S. tax system in all substantive particulars. Therefore, Guam should apply the I.R.C. to persons and income within its territory just as the United States applies the Code to persons and income within its territory, and the tax imposed by Guam should be "that which the taxpayer would pay to the United States if residing there."⁵⁴

The Third Circuit ostensibly applied these concepts to the situation in *Chicago Bridge*. The court stated first that the purpose of the Western Hemisphere deduction was to serve as an equalizing benefit granted by the United States to American corporations doing most of their business outside the United States, but in the Western Hemisphere.⁵⁵ The court then reasoned that if the United States was the only taxing jurisdiction involved, the corporation would be entitled to the deduction on its Virgin Islands source income. In contrast, substituting "Virgin Islands" for "United States" results in *Chicago Bridge & Iron*, a U.S. corporation, being characterized as a foreign corporation for V.I. tax purposes. The effect of this substitution would be to disqualify the taxpayer from claiming the deduction against its V.I. tax liability because from the V.I. tax perspective, it was not "domestic." This result, as viewed by the court, "would substantially alter and distort the Western Hemisphere trade corporation deduction."⁵⁶

However, close analysis and comparison of the decisions in *Chicago Bridge* and *Sayre* reveals that *Chicago Bridge* is a misapplication of the principles enunciated by *Sayre*. In *Sayre*, the government of Guam sought to apply the withholding tax of section 881 to interest and commissions received by a Hawaii corporation from a Guam sole proprietorship.⁵⁷ A failure to collect the section 881 tax would result in the complete escape of this income from

50. *Id.* at 976; *Sayre & Co. v. Riddell*, 395 F.2d 407 (9th Cir. 1968).

51. Organic Act of Guam, 48 U.S.C. § 1421i(a) (1985).

52. *Sayre*, 395 F.2d at 410.

53. *Id.* at 412-13.

54. *Id.* at 410, 412; *Chicago Bridge*, 430 F.2d at 976.

55. *Chicago Bridge*, 430 F.2d at 976-77.

56. *Id.* at 977.

57. *Sayre*, 395 F.2d at 408-09.

Guamian tax, because the payments were deductible as a business expense to the Guam proprietorship. The Hawaii corporation contended that it qualified as a domestic corporation of Guam under the Ninth Circuit's interpretation of section 7701(a)(4) in *Atkins-Kroll v. Government of Guam*, and therefore, was not subject to the tax.⁵⁸ The court agreed with the government of Guam and allowed it to apply the withholding tax.

The mirror theory is difficult to apply to section 7701(a)(4). Prior to its amendment in 1977, the section defined "domestic corporation" as one created or organized in the United States, or under the law of the United States, or of any state or [incorporated] territory.⁵⁹ Mirrored literally, the section would define a V.I. domestic corporation as one created or organized in the Virgin Islands, or under the law of the Virgin Islands or of any State or Territory. The issue is whether the words "or of any State or Territory" are applicable in the mirrored codes of unincorporated territorial possessions such as the Virgin Islands and Guam. The *Sayre* court held they are not.

The *Chicago Bridge* court posited that the statutory scheme governing Virgin Islands income taxation required that the tax liability in the Virgin Islands be equivalent to what the United States could collect on the same income but for the mirror system. According to that court, Congress intended to provide the Virgin Islands with the same tax revenues, but not more, than the United States would otherwise collect from V.I. taxpayers. Thus, "substantive equality of treatment" in applying the mirror theory precluded the Virgin Islands from disallowing a claimed deduction which would have resulted in the receipt of a larger tax than the United States would have collected in the absence of the mirror system.⁶⁰ In the eyes of the court, nothing in this application of section 922 was "so manifestly incompatible with the concept of an equivalent separate tax imposed by the Virgin Islands as to require modifications altering the substance of the provision."⁶¹

The foreign/domestic issue in the corporate context was first considered (for U.S. tax purposes) in Revenue Ruling 56-616.⁶² This ruling examined the withholding tax of I.R.C. section 1442 as applied to interest income derived from U.S. sources by a corporation organized in a U.S. possession which was not engaged in a trade or business in the United States. According to the ruling, corporations organized in any possession of the United States are deemed foreign corporations for U.S. tax purposes under section 7701(a)(4) and therefore subject to the withholding provisions of section 1442.⁶³

Although the logical implication of Revenue Ruling 56-616 in a mirrored system would seem to be that U.S. corporations should likewise be

58. *Id.*; *Atkins-Kroll, Ltd. v. Government of Guam*, 367 F.2d 127 (9th Cir. 1966).

59. I.R.C. § 7701(a)(4), amended by Act § 1906(c)(3), Pub. L. No. 94-455 (1976).

60. *Chicago Bridge*, 430 F.2d at 977-78.

61. *Id.* at 978.

62. Rev. Rul. 56-616, 1956-2 C.B. 589, superceded by Rev. Rul. 82-114, 1982-1 C.B. 104.

63. *Id.*

treated under section 7701(a)(4) as foreign to the possessions. The Ninth Circuit initially rejected this view. *Atkins-Kroll* held that the words "of any State or Territory" were to be given their full effect, so that Guam was to treat a corporation incorporated in California as a domestic corporation.⁶⁴ The rationale for this decision was that if the California corporation was treated as a foreign corporation, the resulting increased tax burden would constitute "a manifest and substantial inequity."⁶⁵ In this respect, the court in *Atkins-Kroll* held a view similar to that of the court in *Chicago Bridge*.

In *Sayre*, the court reversed this holding, arguing that Congress did not intend that either Guam tax officials or the courts should have the power to vary the statutory definitions of foreign and domestic corporations in accordance with their notion of what would and would not be equitable in a given situation. Citing I.T. 2946, the court held that any corporation organized outside of Guam is a foreign corporation for purposes of applying the terms of the I.R.C. in Guam. Since a corporation organized in Hawaii is a foreign corporation for Guam tax purposes, it is subject to the section 881 withholding tax.⁶⁶

The *Sayre* court derived support for this conclusion from the 1958 amendments to the Organic Act of Guam and from its previous decision in *Guam v. Koster*.⁶⁷ As amended in 1958, section 1421i(d) of the Act provides that the income tax laws in force in Guam, pursuant to 1421i(a) include the I.R.C., except that inclusion is limited to provisions which are not manifestly inapplicable or incompatible with the intent of this section.⁶⁸ Subsection (e) further provides that "Guam" is to be substituted for "United States" in the applicable provisions of the Code except where it is manifestly otherwise required.⁶⁹ According to the court in *Koster*, subsection (d) expressly authorizes Guam's taxing authority to set aside or modify provisions of the income tax laws of the United States which are "manifestly inapplicable or incompatible with the intent of the Act to create a separate territorial tax system for Guam."⁷⁰ Applying this concept in *Sayre*, the Ninth Circuit found that the construction of *Atkins-Kroll* was an impermissible deviation from the separate tax structure contemplated by the Act.⁷¹

The statutes creating the Virgin Islands tax structure do not include any provisions comparable with 1421i(d) or (e). The court in *Koster*, however, claimed that "by necessary intentment, this same authority was impliedly conferred by the initial enactment" of section 1421i(a), which is essentially

64. *Atkins-Kroll*, 367 F.2d at 129.

65. *Id.*

66. *Sayre*, 395 F.2d at 409, 412.

67. *Id.* at 408, 412; *Guam v. Koster*, 362 F.2d 248 (9th Cir. 1966); Organic Act of Guam, *supra* note 51.

68. *Sayre*, 395 F.2d at 408; Organic Act of Guam, *supra* note 51, § 1421i(a).

69. *Id.*

70. *Koster*, 362 F.2d at 251.

71. *Sayre*, 395 F.2d at 412.

identical to the analogous section in the Naval Appropriations Act.⁷² This reasoning, along with the important issue of how to apply section 7701(a)(4) to the Virgin Islands, was essentially ignored by the Third Circuit in *Chicago Bridge*. In fact, *Chicago Bridge* seems to disregard the holdings of *Sayre* and I.T. 2946 (both of which it cites as authority) to the effect that the integrity of the separate territorial tax systems created by Congress for the Virgin Islands and Guam required that U.S. persons not residents in these territories be deemed alien to them.

The Third Circuit's reliance on *Sayre* as authority to disregard the mirror theory in *Chicago Bridge* in favor of a "but for" test based on tax burden equivalency is unwarranted. The *Sayre* decision stands for the following principles: (1) "Guam" must be substituted for "United States" for the purposes of section 7701(a)(4); (2) the words "or of any State or Territory" are inapplicable to Guam for purposes of mirroring this section of the I.R.C.; and (3) the court could not adopt a different construction simply because it considered the result more equitable.⁷³ *Chicago Bridge*, on the other hand, completely avoided the technical questions raised by the mirror theory. Instead, the Third Circuit focused exclusively on the fact that if it applied the substitution required by the mirror theory, the taxpayer would be subject to a greater tax than if it did not. The decision thus reduces itself to the exact type of equitable determination rejected by the Ninth Circuit in *Sayre*. By violating the concept of a separate territorial tax in order to achieve "substantive equality of treatment," *Chicago Bridge* grafted a new and potentially broad limitation onto the mirror theory.⁷⁴

Curiously, the Third Circuit virtually ignored its three-year-old decision in *Chicago Bridge* when deciding *Great Cruz Bay, Inc. v. Wheatley* in 1973.⁷⁵ In *Great Cruz*, the question presented was whether a V.I. corporation was entitled to elect V.I. tax treatment as a subchapter S corporation where three of its shareholders were U.S. citizens not residing in the Virgin Islands.⁷⁶ Citing I.T. 2946, the court held that under the mirror theory U.S. citizens who were nonresidents of the Virgin Islands were to be treated as nonresident alien shareholders of the corporation. As a result, the corporation could not be taxed as a subchapter S corporation.⁷⁷ The court stated that under the mirror theory, the Government of the Virgin Islands must apply the provisions of the Code *mutatis mutandis*, meaning generally the same but with necessary changes in points of detail. Therefore, the V.I. government was to treat persons and income within the V.I. taxing jurisdiction just as the U.S.

72. *Koster*, 362 F.2d at 250.

73. *Sayre*, 395 F.2d at 412-13.

74. *Chicago Bridge*, 430 F.2d at 977; Hoff, *supra* note 45, at 70.

75. *Great Cruz*, 495 F.2d at 303.

76. *Id.* at 302.

77. *Id.* at 307, 308.

federal government treats persons and income within its own taxing jurisdiction.⁷⁸

The taxpayer argued, on the authority of *Chicago Bridge*, that such treatment would violate the principle of equivalency since it would result in the Virgin Islands receiving a larger tax than the United States would have collected in the absence of the mirror system.⁷⁹ The court ruled that *Chicago Bridge* did not require a contrary result. Citing *Sayre*, the court argued that if its construction of the mirror system resulted in some inequity to the taxpayer the remedy must be sought from Congress, not from the courts.⁸⁰ *Chicago Bridge* was distinguished as having "involved a wholly different provision of the Code."⁸¹

Great Cruz and *Chicago Bridge* are extremely difficult to reconcile. The critical determination in both cases involved the domestic or foreign status of U.S. persons for V.I. tax purposes. The implication of *Great Cruz* is that a strict mirroring approach is to be followed regardless of the amount of tax which may be owed as a result. *Chicago Bridge* is authority for the opposite conclusion.

After *Great Cruz*, the Third Circuit's next opportunity to interpret the mirror theory arose in *Vitco, Inc. v. Government of Virgin Islands*.⁸² The case involved a New York corporation, Chase Instruments Corporation, and its wholly owned V.I. subsidiary, Vitco. Vitco's only contact with the Virgin Islands consisted of a post office box.⁸³ From 1970-72, all of Vitco's income was derived from U.S. sources and the company, although filing income tax returns in both the United States and the Virgin Islands, paid all taxes to the United States while claiming a foreign tax credit for these amounts on its V.I. return. The V.I. Commissioner of Finance brought a deficiency action against Vitco. The Virgin Islands District Court held that Vitco was required to pay taxes on all its income to the Virgin Islands, rather than the United States, and that under section 1442 Vitco was also in arrears for failure to pay a thirty percent withholding tax on dividends paid by Vitco to Chase.⁸⁴ Vitco presented the court with two basic issues. The first issue was whether a V.I. corporation which had no V.I. source income and minimal contacts with the Islands was still obligated to pay taxes on all its income to the V.I. government. The second issue was whether a Virgin Islands corporation must pay a withholding tax on dividends paid to a U.S. parent.⁸⁵

78. *Id.* at 305-08.

79. *Id.*

80. *Id.* at 308.

81. *Id.* at 307.

82. *Vitco*, 560 F.2d at 181-82.

83. *Id.* at 181.

84. *Id.* at 183.

85. *Id.* at 181.

The Third Circuit began its analysis of the first issue by noting that the congressional policy behind the Revised Organic Act mandated that the Virgin Islands collect the tax on all income of V.I. residents, including U.S. source income, and that V.I. residents were thereby required to pay all such income tax to the Virgin Islands. Although Vitco had no employees, bank accounts, offices, property, or business in the islands, it was nonetheless chartered in the Virgin Islands, which in fact qualified it as a domestic corporation, thus a resident of that jurisdiction. As a result, the court held that Vitco must pay tax on all of its income to the Virgin Islands.⁸⁶

With regard to the second issue, the court recognized that, under the mirror theory, section 1442 provided for a thirty percent withholding tax on dividend income received by foreign corporations from sources within the Virgin Islands.⁸⁷ Read alone, this section would clearly require Vitco to withhold a thirty percent tax on dividends paid to Chase. The court, however, held that section 1442 must be read in conjunction with Treasury Regulation section 1.1441-4(d), which, if read according to the mirror theory, exempts from withholding "any item of income paid to any person who at the time of payment reasonably expects to satisfy his income tax obligations with respect to that item under section 28(a) of the Revised Organic Act of the Virgin Islands." The court reasoned that since the regulation precluded withholding on dividends paid by a U.S. domestic corporation to a V.I. corporation, a proper application of the mirror theory, as "guided by the equality principle for which *Chicago Bridge and Iron* stands," required that there can be no withholding on dividend income paid by a V.I. corporation to a U.S. corporation.⁸⁸ According to the court, both the I.R.C. and the regulations modifying these statutes must be mirrored. When this was done "the implication of Regulation 1.1441-4(d) allows no other conclusion" than that Vitco was exempt from withholding.⁸⁹

In order to make this regulation applicable to the Virgin Islands, the regulation had to operate in reverse over the objection of the V.I. government. *Vitco* established the principle that the mirror theory is a two-way street. Under this two-way substitution scheme, not only is "Virgin Islands" substituted for "United States" but "United States" must be substituted for "Virgin Islands" wherever these terms appear in the Code.⁹⁰ In support of the two-way mirror approach, the court pointed out that when Congress acted to prevent Guam from taxing a U.S. corporation's passive income, it did

86. *Id.* at 183.

87. *Id.* at 184.

88. *Id.* at 184-85. The court's cavalier assertion that Treasury Regulations must be mirrored along with the Code is somewhat at odds with its previous comments in *Dudley v. Commissioner* to the effect that "Congress understood that the provisions of the internal revenue laws of the United States relating to tax administration and enforcement . . . were without application to the Virgin Islands." *Dudley*, 258 F.2d at 187.

89. *Id.*

90. *Id.* at 184.

so by amending sections 881 and 1442 so that Guam corporations were not to be treated as foreign corporations for U.S. tax purposes. Congress changed the policy by inserting language in the U.S. tax law, knowing that the mirror effect would change Guamanian law.⁹¹ Thus, by application of the mirror system, U.S. corporations became domestic to Guam for the purposes of sections 881 and 1442. Since Congress chose to amend the I.R.C. in this manner rather than revising the Organic Act of Guam, Congress "obviously . . . intended a two-way mirroring."⁹²

Two-way mirroring could have been justified as a logical extension of the strict mirror theory expressed in *Sayre* and *Great Cruz*, yet the court chose to base its holding on the equivalency principle of *Chicago Bridge*.⁹³ It distinguished *Great Cruz* as pertaining to a different statutory provision that required a narrow construction and which had no special treasury regulation such as 1.1441-4(d).⁹⁴ The *Vitco* decision stands as a landmark in the development of the V.I. tax system, redefining the ground rules of that system on several different levels. At its broadest level, *Vitco* enshrined the *Chicago Bridge* view of the equivalency principle as the underlying theme of V.I. taxation. The Third Circuit replaced the relatively straightforward word substitution scheme articulated in I.T. 2946 with a potentially unadministrable test of "substantive equality" based on its judicially-manufactured policy of reciprocity. At the same time, the court severely curtailed the ability of the V.I. government to autonomously administer its tax system by holding that U.S. treasury regulations govern V.I. tax administration. This situation is further complicated by the court's two-way mirroring approach, which, when combined with the equality principle, requires the Virgin Islands to reciprocate any special tax provisions enacted by Congress to promote the economic development and financial independence of the Islands. *Vitco*, consequently, leads to the possibility that the Virgin Islands will be forced by Congress to provide tax subsidies for investment in the United States by virtue of legislation designed to encourage investment in the Islands. *Vitco* marks the nadir of the Virgin Islands' status as a distinct and separate tax jurisdiction.

III.

LEGISLATIVE ACTION PRIOR TO 1986

Prior to the 1986 Tax Reform Act, Congress attempted to reform many of the difficulties raised by the mirror theory by using a piecemeal approach, periodically enacting special rules in the Code applicable to the Virgin Islands. Perhaps the best example of this process is the protracted evolution of the withholding issue involved in *Vitco*. As noted above, the Third Circuit based its ultimate decision on the existence of regulation section 1.1441-4(d),

91. *Id.* at 184-85

92. *Id.*

93. *Id.* at 185.

94. *Id.*

which stated that no U.S. withholding tax will be imposed upon any item of income paid to any person who, at the time of the payment, reasonably expects to satisfy the U.S. income tax obligation with respect to that item of income under section 28(a) of the Revised Organic Act of the Virgin Islands.⁹⁵ This regulation, which the Third Circuit reformulated so as to operate in reverse via two-way mirroring, was revoked in 1981.⁹⁶ Although the effect of regulation section 1.1441-4(d) was simultaneously reinstated by Revenue Procedure 81-20, it is not clear, either from the language of the Procedure or under the broad scope of *Vitco*, that the mirror theory would continue to incorporate the rule into V.I. law.⁹⁷ As stated in the Procedure, *Vitco*:

held that not merely the Code but also the regulations under the Code, must be mirrored. Therefore, the Third Circuit mirrored section 1.1441-4(d) of the regulations to exempt from withholding payments from the Virgin Islands sources to United States payees. Section 1.1441-4(d) has been revoked.⁹⁸

Since 81-20 followed this rather cryptic statement with a restatement of the rule of section 1.1441-4(d) without also affirming the holding of *Vitco*, it could be inferred that the specific holding of *Vitco* was rejected by the Treasury. However, according to the Report of the House Ways and Means Committee on P.L. 97-455,

some persons have questioned the validity of the IRS revocation of that underlying Regulation. The revocation occurred simultaneously with the issuance of a Revenue Procedure that continued the rule that U.S. persons need not withhold on payments of passive investment income to V.I. persons. Therefore, some persons allege that the revocation of the Regulation was a sham and that the Virgin Islands does not have the power to require withholding of the tax.⁹⁹

This contention notwithstanding, both the V.I. government and the IRS took "the position that the mirror system imposes [a tax] withheld at source on the gross amount of passive investment income paid from Virgin Islands sources to non-Virgin Islands persons including U.S. persons."¹⁰⁰

Congress finally settled the issue in 1983 by enacting P.L. 97-455.¹⁰¹ This legislation added sections 934A and 1444 to the Code and included an explicit statement that the "bill makes clear the Virgin Islands' right both to impose the tax and to collect by requiring withholding."¹⁰² Prior to its repeal in 1986, section 934A held that for purposes of determining the tax liability to the Virgin Islands incurred by a corporation organized in the United States

95. *Id.* at 184; 26 C.F.R. § 1441-4(d) (1975), revoked by Rev. Proc. 81-20, 1981-1 C.B. 690.

96. Rev. Proc. 81-20, *supra* note 95.

97. *Id.*

98. *Id.*

99. Committee Reports on P.L. 97-455, *reprinted in* Stand. Fed. Tax Rep. (CCH) ¶ 4371L (1986).

100. *Operation and Effect of the Possessions Corporation System of Taxation*, Fifth Report, Dept. of Treasury, at 83 (1985).

101. *See* Committee Reports on P.L. 97-455, *supra* note 99.

102. *Id.*

with respect to amounts received from sources within the Virgin Islands, withholding taxes imposed by section 881 shall apply, except that "10 percent" shall be substituted for "30 percent."¹⁰³ According to section 1444, when determining the withholding tax liability incurred in the Virgin Islands in such situations the rate of withholding tax under section 1442 on income subject to tax under section 881 (as modified by section 934A) shall not exceed the rate of tax on such income under section 881.¹⁰⁴

Section 881 was itself amended in 1984 by P.L. 98-369 to read that a corporation created or organized in the Virgin Islands shall not be treated as a foreign corporation for purposes of section 881 in any year in which specific requirements are met.¹⁰⁵ P.L. 98-369 also amended section 1442(c) to exempt V.I. corporations from treatment as foreign corporations under that section if the corporations qualify according to the conditions of section 881(b).¹⁰⁶ Section 881(b), as amended in 1984, required the following conditions for corporations to qualify: (1) that at all times during the taxable year, foreign persons must own less than twenty-five percent in value of the corporation's stock; and (2) at least twenty percent of the gross income of the corporation must be derived from the Virgin Islands for the three year period ending with the close of the preceding taxable year, or for such part of the period as the corporation had been in existence.¹⁰⁷ "Foreign person" is defined for this section as any person other than a U.S. person or a person who would be a U.S. person if section 7701(a)(4) included references to a possession of the United States.¹⁰⁸

If this section were to be mirrored under *Vitco*, the definition of foreign person would allow a U.S. corporation which derived at least twenty percent of its income from the United States to escape V.I. withholding tax on income received from sources in the Virgin Islands. In fact, the equality principle would seem to demand such a result. However, P.L. 98-369, as reflected in

103. I.R.C. § 934A, repealed by Act § 1275(c)(3), Pub. L. No. 99-514 (1986).

104. I.R.C. § 1444, added by Act § 1(b), Pub. L. No. 97-455 (1983).

105. I.R.C. § 881(b), as amended by Act § 130(a), Pub. L. No. 98-369 (1984), subsequently amended by Act § 1273(b)(1), Pub. L. No. 99-514 (1986).

106. I.R.C. § 1442(c), as amended by Act § 130(b), Pub. L. No. 98-369 (1984), subsequently amended by Act § 1273(b)(2)(B) (1986).

107. I.R.C. § 881(b)(1) (1984), *supra* note 105.

108. I.R.C. § 881(b)(3) (1984), *supra* note 105 [now 881(b)(2)]. One of the purposes behind the 1984 amendment to § 881(b) was to prevent the use of the Virgin Islands as a conduit for foreign investors, who, using the exemption from U.S. taxation provided by the R.O.A., could receive tax-free payments of U.S. source income by creating a V.I. corporation to receive such payments. In order to allow the U.S. to collect tax on V.I. corporations which failed the 881(b) exemption tests, Congress had to amend I.R.C. § 7651(5)(B). This is because § 7651 stated that the R.O.A. was deemed to be effective as if it had been enacted after the enactment of the Code, and therefore prevailed over the Code in cases of conflict. To avoid the conflict created by § 7561, it was amended by the Act § 130(c), which created an exception to the R.O.A. override and thereby eliminated this particular abuse of the V.I. tax structure. See Committee Reports on P.L. 98-369, reprinted in Stand. Fed. Tax Rep. (CCH) ¶ 4171 (1986); Committee Report on P.L. 99-514, reprinted in Federal Taxes, ¶ 30,692.21 (Prentice-Hall 1987).

the Committee Report, "makes it clear that this [the 881(b)] rule is not mirrored."¹⁰⁹ The subsection "does not affect the tax imposed by . . . the Virgin Islands" on payments from V.I. sources to U.S. corporations.¹¹⁰

In summary, regulation section 1.1441-4(d) initially exempted U.S. source income paid to a V.I. inhabitant from U.S. withholding tax. *Vitco* read this regulation in reverse so as to preclude the Virgin Islands from imposing a withholding tax on Virgin Islands source income paid to a U.S. corporation. With the revocation of the regulation, the Virgin Islands were apparently left free to withhold the thirty percent tax, although the United States was still precluded from doing so due to Revenue Procedure 81-20. The withholding power of the V.I. government was subsequently limited to a ten percent tax by the addition of section 934A to the Code. Further amendments to the Code allowed the U.S. to regain the authority to withhold tax on payments to V.I. corporations which failed the tests of section 881(b).

Another example of pre-1986 legislation affecting the Virgin Islands is the amendment of the Foreign Investment in U.S. Real Property Tax Act [hereinafter FIRPTA]. FIRPTA added section 897 to the Code via P.L. 96-499 in 1980.¹¹¹ Under section 897, the gain or loss of a nonresident alien individual or foreign corporation from the disposition of a U.S. real property interest is treated as if the taxpayer were engaged in a trade or business within the United States and as if such gain or loss were effectively connected with such trade or business.¹¹² Due to Congress' failure to take into account the effect of the mirror theory and the unique treatment of V.I. inhabitants under the Revised Organic Act, FIRPTA created a tremendous loophole for V.I. corporations.¹¹³ For V.I. tax purposes, section 897, as mirrored, provides that the gain or loss of a foreign corporation from the disposition of a V.I. real property interest would be treated as effectively connected with a V.I. trade or business. A V.I. corporation holding a U.S. real property interest would thus not be covered by the V.I. version of 897 and would be exempt from U.S. taxation by virtue of section 28(a) of the Revised Organic Act. As a result, a V.I. corporation could be formed to hold U.S. real property interests, sell these interests, complete a tax-free liquidation under mirrored section 337, and ultimately distribute the proceeds free from both U.S. and V.I. taxation.¹¹⁴

To remedy this situation, P.L. 97-34 amended section 897(c) in 1981 so as to define the term "United States real property interest" to include an interest in real property located in the United States or the Virgin Islands.¹¹⁵

109. Committee Reports on P.L. 98-369, *supra* note 108.

110. *Id.*

111. I.R.C. § 897, added by Act § 1122(a), Pub. L. No. 96-499 (1980).

112. *Id.*

113. Hoff, *supra* note 45, at 85-87.

114. *Id.*

115. *Id.* I.R.C. § 871(1)(A)(i), as amended by Act § 831(a)(1), Pub. L. No. 97-34 (1981). Pub. L. No. 97-34 also added § 862(a)(8) which includes gains, profits, and income from the

A V.I. corporation, consequently, is subject to a mirrored section 897 tax on dispositions of either V.I. or U.S. real property interests. While this measure may have eliminated the loophole, it did so by blurring the distinction in one particular area between the territorial jurisdictions of the Virgin Islands and the United States.

While Congress was able to thus solve certain specific problems of the V.I. tax system by using special rules to modify the effect of the mirror theory, these isolated incursions into the field of V.I. taxation proved insufficient to solve the major problems in this area. A dramatic illustration of the inadequacy of the V.I. tax system as it existed at the time of the 1986 Tax Reform Act is provided by a 1986 case from the District Court of the Virgin Islands, *Danbury v. Olive*.¹¹⁶ The case involved Danbury, Inc., a corporation organized under Nevada law, which maintained its only office in the Virgin Islands and held its shareholder and directors meetings in the Virgin Islands, but whose income was wholly generated from U.S. sources. The corporation operated exclusively as a holding company for its shareholders' U.S. investments; its business was confined to acting as a receptacle for interest income and limited partnership distributions.¹¹⁷ Since Danbury was not organized under the laws of the Virgin Islands, it was a foreign corporation to the Virgin Islands under mirrored I.R.C. section 7701(a)(5).¹¹⁸ However, as a corporation whose permanent residence was in the Virgin Islands, Danbury also qualified under the Revised Organic Act as a V.I. inhabitant.¹¹⁹ Thus, Danbury was able to satisfy its U.S. tax liability by reporting its worldwide income on its tax return to the Virgin Islands.¹²⁰ As a foreign corporation to the Virgin Islands, Danbury's taxable V.I. income, under mirrored section 882, included only income derived from sources within the Virgin Islands or income effectively connected with the conduct of a trade or business within the Virgin Islands.¹²¹ By design, Danbury's income was neither derived from V.I. sources nor effectively connected with the conduct of a trade or business within the Virgin Islands.¹²² These facts created an unbelievable tax shelter whereby

Danbury is both a foreign corporation and an inhabitant of the Virgin Islands because it is not organized under the territory's laws but maintains its headquarters here. As an inhabitant it must pay tax on its world-wide income to the Virgin Islands' treasury. Foreign corporations, however, are taxed only on

disposition of a U.S. real property interest, as defined by § 897(c), as an item of income to be treated as income from sources outside the United States when the real property is located in the Virgin Islands.

116. 627 F. Supp. 513 (1986). For a discussion of the *Danbury* opinion, see Estes, *U.S. Virgin Islands—The Ultimate Tax Shelter*, 15 TAX MGMT. INT'L J. 155 (1986).

117. *Danbury*, 627 F. Supp. at 515.

118. *Id.* at 515 n.2.

119. *Id.* at 516.

120. *Id.*

121. *Id.*

122. *Id.* at 517.

income derived in the Virgin Islands. Since Danbury's income is wholly generated from foreign sources, it owes no tax to the Virgin Islands. And because its United States obligations are satisfied under the Virgin Islands tax code, it owes no tax to the federal government.¹²³

On this basis, Danbury moved for a summary judgment invalidating the deficiencies assessed by the V.I. government.

The Government countered with its own motion for summary judgment on the grounds that Danbury should be treated as domestic to the Virgin Islands and taxed on its world-wide income because, according to the Government, section 28(a) of the Revised Organic Act authorized the Virgin Islands "to dispense with the source distinction of section 882 and tax a foreign corporation as if it were domestic."¹²⁴

In support of this position, the Government put forth two theories. First, the language of the Revised Organic Act "indicates that it is a taxing statute, separate from the I.R.C., which allows the territory to alter the mirror of [section] 882."¹²⁵ As authority for this theory, the Government relied upon Revenue Ruling 80-40.¹²⁶ Revenue Ruling 80-40 involved a U.S. corporation which, like Danbury, had established a permanent residence in the Virgin Islands. In relevant part, the Ruling held that a U.S. corporation can qualify as an inhabitant of the Virgin Islands and that by virtue of sections 881 and 882,

under an exact mirror system, non-Virgin Islands source income that is not effectively connected with a United States corporate inhabitant's conduct of a Virgin Islands trade or business would escape territorial income tax since the inhabitant is considered a foreign corporation by the Virgin Islands. However, Congress, in section 28(a) of the R.O.A., made it clear that such income of inhabitants of the Virgin Islands would not escape taxation by using the words "paying their tax on *income derived from all sources both within and outside the Virgin Islands* into the Treasury of the Virgin Islands." (emphasis added) Thus, in effect, [the corporation] is taxed as if it were a Virgin Islands corporation If [the corporation] fails to file a return or pay tax on its income from all sources to the Virgin Islands, then [the corporation] does not satisfy its U.S. tax obligation.¹²⁷

The District Court dismissed the Revenue Ruling as merely stating a conclusion and rejected the Government's theory as being based on a faulty premise.¹²⁸ Citing *Chicago Bridge*, the court stated that "[b]y limiting the Government's income taxing authority to the execution of non-substantive

123. *Id.* at 515-16.

124. *Id.* at 517-18.

125. *Id.* at 517.

126. *Id.* at 518; Rev. Rul. 80-40, 1980-1 C.B. 175.

127. Rev. Rul. 80-40, *supra* note 126. The Ruling also held that such a corporation was still entitled to the dividend received deduction, as a domestic corporation, under I.R.C. § 243. Assuming that this aspect of the Ruling survived the *Danbury* opinion, a U.S. corporation could form a Danbury-type subsidiary which not only could act as a tax-exempt holding company, but could also repatriate these profits tax-free to its U.S. parent.

128. *Danbury*, 627 F. Supp. at 518.

changes in nomenclature, the Third Circuit has implicitly held that . . . [section 28(a)] is not a taxing statute.”¹²⁹ Therefore, the V.I. government is not authorized under the Revised Organic Act to alter the definition of a domestic corporation so as to tailor the provisions of the I.R.C. to suit the situation “even where the alternative is the ultimate tax shelter.”¹³⁰

The Government’s second theory proposed that the source distinctions of section 882 were inapplicable because the Revised Organic Act gives the Islands the authority to tax income derived from all sources.¹³¹ The court viewed this argument as a claim that the R.O.A. precluded the mirroring of all I.R.C. provisions which constrained the Government’s ability to tax anything less than all income, thus allowing the Government to “pick and choose which sections of the I.R.C. it will honor.”¹³² Such a rule would “invite the opening of a Pandora’s box as to all of the I.R.C.’s tax reducing provisions”¹³³ As the court pointed out, the critical flaw in the Government’s case was that it ignored the key words of the statute on which it relied. Section 28(a) of the R.O.A. requires V.I. inhabitants to satisfy their tax obligations under the applicable tax statutes of the United States by paying their tax to the V.I. treasury. The meaning of this section is “nothing more than that the I.R.C. is the tax code of the Virgin Islands”; section 28(a) provides the basic tax procedure for territorial inhabitants, but “has no independent effect on the provisions of the I.R.C.”¹³⁴ Being a general rule of inclusion, the statute incorporates all exceptions, including section 882.¹³⁵

Although the court recognized that Danbury was organized specifically to exploit “the ultimate tax shelter” created by this loophole in the V.I. tax structure,

there is nothing to suggest that Congress intended to allow the Virgin Islands to chip away at the mirror theory so carefully retained over all these years. Rather, it appears that the effect of [section] 882 in favor of a foreign corporation inhabitant filing in the Virgin Islands was overlooked. We cannot legislate the closing of this loophole by judicial fiat We are certain that Congress did not intend to create this aperture in the tax laws. But where one occurs it is the exclusive province of Congress and the federal chief executive to close it. And until this is accomplished, a corporation may pursue the Danbury route.¹³⁶

Apparently, many corporations were actively pursuing such a course at the time of the *Danbury* decision. As noted in the opinion, the “income from hundreds of millions of dollars of corporate assets is currently being sheltered under the Danbury loophole,” despite the fact that the federal and territorial

129. *Id.*

130. *Id.*

131. *Id.*

132. *Id.*

133. *Id.*

134. *Id.* at 518-19.

135. *Id.* at 518.

136. *Id.* at 519.

governments had known of the loophole for several years.¹³⁷ Congress, which had considered elimination of "this quirk in the law" several times, had simply failed to deal with the problem.¹³⁸ Perhaps the reason for this failure is that the *Danbury* loophole is inextricably intertwined with the cornerstones of V.I. taxation: the mirror theory and the Revised Organic Act. Congress was not presented with a mere technical problem which could be resolved by a special rule for an isolated situation, but rather, with a flaw striking at the very foundation of the system. Unwilling to undertake a major overhaul of this system, Congress stood by, unable to eliminate the loophole.

IV. THE 1986 TAX REFORM ACT

The 1986 Tax Reform Act marks a significant departure from the previous congressional approach to the problems of the Virgin Islands tax system. While P.L. 99-514 did retain most of the special rules applying to V.I. situations, the legislation attempted to effect change on a more comprehensive level. The most sweeping of these changes was the amendment of section 7651. Previously, section 7651(5)(B) stated that section 28(a) of the Revised Organic Act of the Virgin Islands shall be effective as if such section had been enacted after the Code.¹³⁹ Therefore, the R.O.A. superceded the I.R.C. when the U.S. and V.I. taxing jurisdictions overlapped, and as a result, a U.S. entity such as *Danbury, Inc.* could avoid all U.S. tax by becoming a V.I. inhabitant.¹⁴⁰ As amended, section 7651(5)(B) provides that section 28(a) of the Revised Organic Act of the Virgin Islands shall be effective as if such section 28(a) had been enacted before the enactment of this title and that such section 28(a) shall have no effect on the amount of income tax liability required to be paid by any person to the United States.¹⁴¹ By specifying that the R.O.A. will have no effect on any person's U.S. tax liability, Congress repealed the inhabitancy rule of section 28(a) and eliminated the *Danbury* loophole.¹⁴²

137. *Id.* at 516 n.5; see also Danielson, *supra* note 5, at A-90, A-91.

138. *Danbury*, 627 F. Supp. at 516 n.5. For example, the Conference Committee Report on P.L. 98-369 states that

[t]he conferees believe that the relationship between the tax systems of the United States and those U.S. territories whose tax systems depend on the U.S. Tax Code has created great uncertainty and possible opportunities for taxpayers to take positions that, if sustained, would result in tax avoidance. The conferees did not address this problem in the conference report because neither House of Congress addressed the problem in the legislation that the Congress considered.

Committee Reports on P.L. 98-369, *supra* note 108.

139. I.R.C. § 7651(5)(B), as amended by Act § 130(c), Pub. L. No. 98-369 (1984), see *supra* note 108.

140. See Stand. Fed. Tax Rep. (CCH) ¶ 4371H.10 (1986).

141. I.R.C. § 7651(5)(B), as amended by Act § 1275(b), Pub. L. No. 99-514 (1986).

142. The repeal of the inhabitancy rule applies to taxable years beginning after 1986. With respect to income other than income from V.I. sources or income effectively connected with a V.I. trade or business, it applies to any income derived in any pre-1987 "open year," meaning any taxable year for which the assessment of a deficiency is not barred by any law or rule of law.

According to the Committee Report on P.L. 99-514, "even if a person is treated as an 'inhabitant' of the Virgin Islands under the Revised Organic Act, that person will be fully subject to U.S. tax."¹⁴³ The Report also states that the Secretary of the Treasury is to be given authority to provide by regulation the extent to which provisions in the I.R.C. will not be mirrored into V.I. law.¹⁴⁴ In particular, the Report expresses the Committee's expectation that references to possessions of the United States will not be mirrored. More generally, the Report anticipates that the Secretary will use the authority granted to prevent abuse of the V.I. tax structure.¹⁴⁵

With respect to individuals, P.L. 99-514 filled the gap left by the repeal of the inhabitancy rule with a new section 932, providing for the coordination of U.S. and V.I. income taxes.¹⁴⁶ Under subsection 932(a), an individual citizen or resident of the United States who has income derived from sources in the Virgin Islands, but who is not a resident of the Virgin Islands, now must file a tax return with both the U.S. and V.I. tax authorities.¹⁴⁷ In determining the U.S. tax liability of such a person, her United States income includes all income sourced in the Virgin Islands. In addition, under subsection 932(b), that person must pay tax upon the V.I. source income to the Virgin Islands.¹⁴⁸ An amount equal to the taxes paid to the Virgin Islands is allowed as a credit against that person's U.S. tax liability.¹⁴⁹ That portion of the person's U.S. tax liability which must be paid to the Virgin Islands is termed the "applicable percentage" which is defined as the percentage which Virgin Islands adjusted gross income bears to total adjusted gross income (determined without regard to the credit provided for V.I. taxes paid).¹⁵⁰ "Virgin Islands adjusted gross income" is defined as "adjusted gross income, determined by taking into account only income derived from sources within

Committee Report on 99-514, *supra* note 108; Act § 1277(c)(2)(A)-(E), Pub. L. No. 99-514 (1986).

143. Committee Report on 99-514, *supra* note 108.

144. *Id.*

145. *Id.* Towards this end, the Report provides specific indications of the type of situations where Congress anticipates regulations will be required. For example, "the committee does not believe that a mainland resident who moves to the Virgin Islands while owning appreciated personal property such as corporate stock or precious metals and who sells that property in the Virgin Islands should escape all tax, both in the United States and the Virgin Islands, on that appreciation. Similarly, the committee does not believe that a resident of the Virgin Islands who owns financial assets such as stocks or debt of companies organized in the Virgin Islands, the underlying value of which is primarily attributable to activities performed outside the Virgin Islands, should escape tax on the income from those assets. The Secretary should treat such income as sourced outside the Virgin Islands. Similarly, when appropriate, the Secretary may treat an individual as not a bona fide resident of the Virgin Islands." Such regulations could be patterned on Revenue Ruling 82-179, 1982-2 C.B. 87, which precludes taxpayers from changing residence from either the United States to the Virgin Islands (or the other way around) and from switching accounting methods so as to reduce tax.

146. I.R.C. § 932, added by Act § 1274(a), Pub. L. No. 99-514 (1986).

147. *Id.* §§ 932(a)(1) and (a)(2).

148. *Id.* § 932(b)(1).

149. *Id.* § 932(b)(3).

150. *Id.* §§ 932(b)(1) and 932(b)(2)(A).

the Virgin Islands and deductions properly apportioned or allocable thereto."¹⁵¹

Under subsection 932(c), an individual who is a bona fide resident of the Virgin Islands at the close of the taxable year files his or her tax return for that year with the Virgin Islands.¹⁵² In determining the tax liability of such person, her Virgin Islands income includes her U.S. source income.¹⁵³ Any amount reported by V.I. residents on their V.I. tax returns is not included as gross income for purposes of calculating any potential U.S. tax liability.¹⁵⁴ Thus, a bona fide V.I. resident will have no U.S. tax liability as long as he or she reports all income from all sources and identifies each source of income on the return filed with the Virgin Islands.¹⁵⁵ In order "to facilitate enforcement assistance," the information contained on the V.I. returns will be transmitted to the I.R.S.¹⁵⁶ Any taxes withheld in the United States from payments to a V.I. resident and any estimated tax payments made by such an individual to the United States will be covered over to the V.I. Treasury and will be credited against the individual's V.I. tax liability.¹⁵⁷

Section 932 also establishes a special rule for cases where spouses file a joint return and only one spouse qualifies as a resident of the Virgin Islands. According to subsection 932(d), the residency status of both spouses depends on the residence of the spouse who has the greater adjusted gross income for the taxable year.¹⁵⁸ This determination is made without regard to community property laws.¹⁵⁹

Finally, subsection 932(e) provides that section 932 "shall not apply for purposes of determining income tax liability incurred to the Virgin Islands."¹⁶⁰ Absent such a provision, section 932 would, under *Vitco*, be mirrored into V.I. law. This would allow a V.I. resident to exclude his or her U.S. source income from V.I. tax by paying tax on such income to the United States. In addition, a U.S. resident could avoid V.I. taxation on V.I. source income by reporting such income on his or her U.S. tax return.¹⁶¹ Subsection 932(e) precludes two-way mirroring of this section, and thereby shifts the

151. *Id.* § 932(b)(2)(B).

152. *Id.* §§ 932(c)(1) and 932(c)(2).

153. *Id.* § 932(c)(3).

154. *Id.* § 932(c)(4).

155. *Id.* § 932(c)(4); see also Committee Report on P.L. 99-514, *supra* note 108. Any taxes collected by the United States on the income of such an individual will be covered over into the V.I. Treasury. Section 7654(a), as amended by Act § 1276(a), Pub. L. No. 99-514 (1986). This section of the Act also amended I.R.C. § 7654(e) to provide that the Secretary shall prescribe regulations to carry out the provisions of § 932. These regulations shall prohibit the rebate of taxes covered over which are allocable to U.S. source income and prescribe the information which the individuals to whom § 932 applies shall furnish to the Secretary.

156. Committee Report on P.L. 99-514, *supra* note 108.

157. *Id.*

158. I.R.C. §§ 932(d), 932(a)(1)(B) and 932(c)(1)(B) (1986).

159. *Id.* § 932(d).

160. *Id.* § 932(e).

161. *Id.* §§ 932(a)-(c).

balance of the statute, channeling all tax receipts from V.I. source income to the V.I. Treasury, and not to the U.S. Treasury.

With respect to corporations, the repeal of the inhabitancy rule leaves section 7701(a)(4) as the only relevant statute for determining the status of a corporation for V.I. tax purposes. Consequently, only corporations created under V.I. law will be treated as domestic corporations under the Virgin Islands mirrored Code.¹⁶² U.S. corporations, even those which establish a permanent residence in the Virgin Islands, will continue to be subject to U.S. tax on their global income and will also be subject, as foreign corporations, to V.I. taxation on their V.I. source income. Double taxation is avoided by the foreign tax credit or, for those corporations which qualify, by the possession tax credit of section 936, made available to corporations operating in the Virgin Islands by P.L. 99-514.¹⁶³

In addition to these macro changes in the V.I. tax system, the 1986 Act contained several specific amendments to sections of the Code relating to the Virgin Islands. The sections affected by these amendments include sections 934A and 881(b), which set the guidelines for withholding tax on V.I. corporations receiving income from U.S. sources, and section 934, which limits the authority of the Virgin Islands to reduce or rebate V.I. taxes.¹⁶⁴ As discussed above, the withholding area has been the focus of continued congressional, judicial, and administrative attention.¹⁶⁵ This pattern was continued by P.L. 99-514's repeal of section 934A, which had reduced the rate of V.I. tax withheld on payments of V.I. source passive income to U.S. persons from thirty percent to ten percent.¹⁶⁶ The Virgin Islands now imposes a thirty percent withholding tax on corporations which receive payments from V.I. sources.¹⁶⁷ Moreover, subsection 881(b) was amended yet again so as to revise the tests which a V.I. corporation must satisfy to escape U.S. withholding tax. Subsection 881(b) now states that a V.I. corporation will be exempt from U.S. withholding on payments of U.S. source income if (1) less than twenty-five percent in value of the corporation's stock is owned by foreign persons [defined as any person other than a U.S. person if the United States was defined in section 7701(a)(9) to include U.S. possessions]; (2) at least sixty-five (previously twenty) percent of the corporation's income is effectively connected with the conduct of a trade or business in a U.S. possession or in the United States; and (3) no substantial part of the income of the corporation is used (directly or indirectly) to satisfy obligations to persons who are

162. *Id.* § 7701(a)(4).

163. I.R.C. § 936(d)(1), as amended by Act § 1275(a)(1), Pub. L. No. 99-514 (1986), now defines the term "possession of the United States" to include the Virgin Islands as well as Puerto Rico for purposes of the possessions tax credit.

164. See Committee Report on P.L. 99-514, *supra* note 108.

165. See *supra* notes 95-110 and accompanying text.

166. See *supra* note 103.

167. *Id.*

not bona fide residents of a possession or the United States.¹⁶⁸ As a result of these changes, the Virgin Islands has unfettered authority to withhold tax on Virgin Islands source income paid to U.S. corporations, while the United States has limited authority to withhold tax on U.S. source payments to a V.I. corporation.

Another specific change relates to the substantial reformulation of section 934. Under prior law, subsections 934(b)-(g) provided corporations operating in the Virgin Islands similar tax benefits to those provided for corporations operating in Puerto Rico by section 936, discussed *infra*.¹⁶⁹ However, when a subsidiary of a U.S. corporation became an inhabitant of the Virgin Islands and qualified for the benefits of section 934, the U.S. parent corporation often enjoyed tax benefits more favorable than those enjoyed by a U.S. parent of a section 936 corporation.¹⁷⁰ Congress eliminated this imbalance by striking out the applicable provisions of section 934 and redefining "possession" for purposes of section 936 so as to include the Virgin Islands.¹⁷¹ Section 934(b), as amended by section 1275(c) of P.L. 99-514, delimits the conditions under which V.I. tax incentive programs are available to investors in the Virgin Islands. These changes are expressly predicated on the signing of an implementing agreement between the United States and the Virgin Islands creating rules under which the evasion or avoidance of U.S. income tax shall not be permitted or facilitated by the Virgin Islands.¹⁷² Such an agreement was signed on February 24, 1987.¹⁷³ In general, the agreement provides for the exchange of tax information and mutual assistance in tax matters.¹⁷⁴ With the signing of this agreement, the amendments to section 934(b) are now in effect. Both the section 936 possession tax credit and the operation of the Virgin Islands Industrial Development Program under section 934(b) will be discussed in detail below.

Finally, the 1986 Act gave the Virgin Islands the authority to enact and collect nondiscriminatory local income taxes in addition to those imposed under the mirror Code.¹⁷⁵ In this regard, the Virgin Islands is forbidden to discriminate against U.S. citizens and corporations, or similar persons from other possessions.¹⁷⁶ For U.S. purposes, these taxes will be treated in the same manner as state or local income taxes.¹⁷⁷

168. I.R.C. § 881(b), as amended by Act § 1273(b)(1), Pub. L. No. 99-514 (1986).

169. For a comparison of §§ 934 and 936, see *Operation and Effect of the Possessions Corporation System of Taxation*, Third Annual Report, Dept. of the Treasury, 117-21 (1980).

170. *Id.*

171. See *supra* note 163.

172. Committee Report on P.L. 99-514, *supra* note 108; Act § 1277(c)(1), Pub. L. No. 99-514 (1986).

173. Treasury News, March 2, 1987.

174. *Id.*

175. Committee Report on P.L. 99-514, *supra* note 108; Act § 1274(b), Pub. L. No. 99-514 (1986).

176. *Id.*

177. *Id.*

V.

SELECTED PROVISIONS OF THE REFORM

A. *The Possessions Tax Credit*

Section 936 is an elective provision which forces the taxpayer to choose between the special possessions tax credit it provides and the foreign tax credit available under section 901.¹⁷⁸ The two credits are rendered mutually exclusive by subsection 936(c).¹⁷⁹ To qualify for the section 936 election, the corporation must be a U.S. domestic corporation and must satisfy the conditions of subsection 936(a)(2).¹⁸⁰ That subsection requires that at least eighty percent of the gross income of the corporation for the previous three years (or applicable part of such period) has been derived from sources within a U.S. possession and that at least sixty-five percent of the gross income of the corporation for this period has been derived from the active conduct of a trade or business within a U.S. possession.¹⁸¹

Having satisfied these conditions, an electing corporation qualifies for a credit calculated under subsection 936(a)(1).¹⁸² According to this subsection, the credit will be equal to the portion of the corporation's U.S. tax liability attributable to its taxable income from its operations in a possession.¹⁸³ Specifically, the corporation's taxable income from either the active conduct of a trade or business within a U.S. possession, or the sale or exchange of substantially all of the assets used by the taxpayer in the active conduct of such trade or business, is added to the corporation's "qualified possession source investment income."¹⁸⁴ For purposes of determining the taxable income of the corporation under subsection 936(a), any income received by the corporation within the United States, whether derived from sources within or without the United States, will not be taken into account as income from sources without the United States under section 936.¹⁸⁵

178. I.R.C. §§ 936(a)(1) and 936(c) (1986).

179. *Id.* § 936(c).

180. *Id.* §§ 936(a)(1) and 936(a)(2).

181. *Id.* §§ 936(a)(2)(A) and 936(a)(2)(B).

182. *Id.* § 936(a)(1). The possession tax credit is not, however, available to a corporation for any taxable year in which it is a Domestic International Sales Corporation (DISC), a former DISC, or in which it owns stock in a DISC, former DISC, Foreign Sales Corporation (FSC), or former FSC. *Id.* § 936(f). In addition, the credit does not offset the environmental tax imposed by § 59A, the tax on accumulated earnings imposed by § 531, the personal holding company tax imposed by § 541, or taxes relating to recoveries of foreign expropriation losses imposed by § 1351. *Id.* § 936(a)(3).

183. *Id.*

184. *Id.* §§ 936(a)(1)(A) and 936(a)(1)(B). Subsection 936(d)(2) defines qualified possession source investment income as investment income from sources within a possession in which the corporation actively conducts a trade or business. *Id.* § 936(d)(2)(A). The corporation must establish that the income is attributable to the investment in the possession of funds derived from active conduct of a trade or business in the possession. *Id.* § 936(d)(2)(B).

185. *Id.* § 936(b). This limitation does not apply to any amount of income derived from the active conduct of a trade or business within a U.S. possession which is received from a person who is not a "related person" with respect to the corporation. The term "related person" is

The possessions credit is available in the first taxable year in which the election is made and in which the corporation satisfies the specified conditions.¹⁸⁶ The election continues in force for each taxable year thereafter until the election is revoked. Before the expiration of the ninth taxable year following the year of election, revocation is available only with the consent of the Secretary. After the ninth taxable year, the election may be revoked for any taxable year by the taxpayer.¹⁸⁷ Following revocation, the taxpayer may make a subsequent election for any taxable year in which it qualifies, subject to the same terms for revocation as the first election.¹⁸⁸

The section 936 credit is generally more favorable to taxpayers than the foreign tax credit available under sections 901-904. The section 936 credit essentially offsets U.S. tax in an amount equaling what the U.S. tax would have been on that income. The foreign tax credit, on the other hand, is a limited credit against U.S. tax liability. It equals the amount of tax assessed by either the U.S. or foreign jurisdiction, which has the lower rate of tax.

Section 936 also provides detailed rules governing the tax treatment of the intangible property income of possessions corporations. Historically, U.S. corporations have employed techniques to shelter the income produced by intangible property developed or acquired in the United States by transferring ownership of such property to possessions corporations.¹⁸⁹ Section 936(h) was enacted in order to prevent the possessions corporation from becoming a vehicle for abuse.¹⁹⁰ Intangible property income is defined in subsection 936(h) as the income of a possessions corporation attributable to any intangible property, e.g. patents, copyrights, trademarks, contracts, programs, or technical data, which has a substantial value independent of the services of any individual.¹⁹¹ In general, the intangible property income of a corporation making the section 936 election is included on a pro rata basis in the gross income of all shareholders of the corporation as U.S. source income.¹⁹² Income not included in the gross income of a shareholder of the electing corporation will be treated as income of the corporation derived from sources

defined in § 936(h)(3)(D) as a person who is a member of the same controlled group of corporations as the electing corporation.

186. *Id.* § 936(e).

187. *Id.*

188. *Id.*

189. See Committee Report on P.L. 99-514, *reprinted in* Federal Taxes ¶ 30,686 (Prentice-Hall 1987).

190. *Id.*

191. I.R.C. § 936(h)(3)(B) includes any patent, invention, formula, process, pattern, know-how, copyright, artistic composition, trademark, trade name, brand name, franchise, license, contract, method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, technical data, or any similar item which has substantial value independent of the services of any individual. This definition is limited so as to not include income from the disposition of a product or rendering of services by a possessions corporation which is determined by the Secretary to be a reasonable profit on the costs incurred by the corporation attributable to the income. *Id.* § 936(h)(3)(C).

192. *Id.* § 936(h)(1)(A).

within the United States, and will not be taken into account for purposes of calculating the possession's tax credit.¹⁹³ This result could disqualify the corporation from the section 936 election.¹⁹⁴

If a corporation is disqualified by virtue of its failure to reallocate its intangible property income, the corporation may still meet the conditions for the credit if it makes a pro rata distribution of property to its shareholders after the close of the taxable year. Such a distribution must be designated as a distribution to meet qualification requirements. It also must equal that portion of the corporation's income which exceeds the amount of income for such period necessary for the corporation to satisfy the conditions of subsection 936(a)(2).¹⁹⁵ However, this distribution will not satisfy the conditions if there is a finding of intent to evade tax or willful neglect on the part of the corporation.¹⁹⁶

A possessions corporation which maintains a significant business presence in a possession by providing a particular product or type of service, as defined in subsection 936(h)(5)(B), may avoid application of the aforementioned rules governing the treatment of the income from such product or service if it makes an election to compute the taxable income derived therefrom according to one of the methods specified in subsection 936(h)(5)(C).¹⁹⁷ This subsection allows the corporation to derive some intangible property income tax-free by either reallocating costs, under the cost sharing method, or reallocating profits, under the profit split method, among the members of the affiliated group, including both U.S. and foreign persons, which were involved in developing the product or service.¹⁹⁸

B. I.R.C. Section 934 and the Virgin Islands Industrial Development Program

According to the general rule of subsection 934(a), V.I. tax liability "shall not be reduced or remitted in any way, directly or indirectly, whether by grant, subsidy, or other similar payment, by any law enacted in the Virgin Islands, except to the extent provided in subsection (b)."¹⁹⁹ By negative implication, the subsection thus authorizes the Virgin Islands to enact tax incentive legislation. Under subsection 934(b), the prohibition of subsection 934(a) is deemed not to apply to tax liability attributable to income derived from sources within the Virgin Islands or income effectively connected with the

193. *Id.* § 936(h)(1)(B).

194. *Id.* § 936(h)(2)(B).

195. *Id.* § 936(h)(4)(A).

196. *Id.* § 936(h)(4)(C).

197. *Id.* § 936(h)(5).

198. *Id.* § 936(h)(5)(C); see also *Federal Taxes* ¶ 30,686 (Prentice-Hall 1987).

199. I.R.C. § 934(a). A new § 934(b) was added by Act § 1275(c)(2)(B), Pub. L. No. 99-514 (1986).

conduct of a trade or business within the Islands.²⁰⁰ This exception, however, is limited with respect to U.S. citizens and foreign corporations. Subsection 934(b)(2) specifically disallows any reduction in the V.I. tax liability, of U.S. citizens who are not residents of the Virgin Islands determined under subsection 932(b).²⁰¹

Subsection 934(b)(3) established a special rule extending the authority of the Virgin Islands to reduce or rebate V.I. tax liability arising from the non-U.S. income of certain foreign corporations.²⁰² As stated in that subsection, the tax liability of a "qualified foreign corporation," defined as a corporation in which less than ten percent of the total value and voting power of the corporation's stock is owned by any U.S. person, will not be subject to the prohibition of subsection 934(a) if the tax liability is attributable to income derived from sources outside the United States and not effectively connected with the conduct of a trade or business within the United States.²⁰³

Operating within these restrictions, the Virgin Islands Industrial Development Program, found in Chapter 12, Title 29 of the V.I. Code, provides for a rebate of territorial taxes paid by qualifying corporations operating in the Virgin Islands.²⁰⁴ The principal qualifying requirements of the program include a minimum investment of \$50,000, an agreement to give a hiring preference to V.I. residents, compliance with ecological regulation, and approval by the Industrial Development Commission.²⁰⁵ Corporations which are beneficiaries of the program generally receive rebates, continuing over a ten year period, of seventy-five to ninety percent of V.I. income taxes paid each year.²⁰⁶ The corporation has the option of commencing the benefit period any time within the first five years of business operations in the Virgin Islands, and may be granted a renewal of benefits at the end of the period. The average effective rate of corporate income tax in the Virgin Islands for corporations which qualify for a rebate is generally no more than ten percent.²⁰⁷

In the past, the program has been criticized as a rather "inefficient and costly system of tax incentives" which does not relate the tax foregone to the benefits received by the Virgin Islands.²⁰⁸ For example, in 1977 the average amount of tax foregone per employee of the U.S. subsidiaries receiving tax

200. *Id.* § 934(b)(1).

201. *Id.* § 934(b)(2).

202. *Id.* § 934(b)(3).

203. *Id.*

204. 33 Virgin Islands Code § 4109.

205. See *Territorial Income Tax Systems; Income Taxation in the Virgin Islands, Guam, the Northern Mariana Islands and American Samoa*, Dep't of the Treasury, 18-20 (1979).

206. *Operation and Effect of the Possessions Corporation System of Taxation*, Fifth Report, Dep't of the Treasury, 83 (1985).

207. *Territorial Income Tax Systems*, *supra* note 205, at 83.

208. *Id.* at 4.

rebates under the program equaled thirty-six percent of the average compensation of those employees.²⁰⁹ In one case, the income tax foregone per employee was five times larger than average employee compensation.²¹⁰ A 1980 study revealed that the size of tax benefits per employee of the participating commercial entities equaled 49.8 percent of the compensation paid to the employees.²¹¹ Moreover, the four corporations which received 94.2 percent of the total tax benefits provided jobs for only 29.3 percent of the total workers employed by participating corporations.²¹² The tax benefits received by these corporations equaled 79.5 percent of compensation paid to employees.²¹³

VI.

CRITICISM AND PROPOSALS FOR CHANGE

The Tax Reform Act of 1986 is clearly a major landmark in the development of Virgin Islands taxation. To determine the extent to which the Act improves the V.I. tax system, it is useful to consider the basic purposes for which it was enacted. In general, these purposes are expressed in three criteria used by a 1979 Treasury Report to evaluate the tax systems then operating in the U.S. possessions.²¹⁴ The report states that these criteria are: "(A) raising revenue, (B) equitable treatment of territorial versus stateside residents, and (C) simplicity of interpretation, administration, and compliance."²¹⁵ Although the Report noted that in principle the mirror theory (now applicable only to the Virgin Islands)²¹⁶ is well suited to meeting these objectives, it observed that in actual practice the tax systems operating under the mirror theory were not successful under any of the criteria used.²¹⁷ As a result, the Report concluded that the mirror systems were "functioning poorly and should be overhauled."²¹⁸ The remainder of this Article will analyze and discuss, using the criteria employed by the Treasury Report, how well the reforms embodied in the 1986 Act have addressed the fundamental defects in the V.I. tax system.

The primary function of any tax system is to raise revenue. As the Treasury Report pointed out, the most obvious failure of the mirror systems is that they have been deficient in the amount of income tax revenues collected.²¹⁹ With respect to the Virgin Islands, the failure of the system to raise a reasonable amount of revenues is attributable to several factors. One

209. *Id.* at 20.

210. *Id.*

211. *Operation and Effect of the Possessions Corporation System of Taxation*, Fourth Report, *supra* note 5, at 354, 356.

212. *Id.*

213. *Id.*

214. *Territorial Income Tax Systems*, *supra* note 205.

215. *Id.* at 31.

216. *See infra* note 256 and accompanying text.

217. *Id.* at 2-4.

218. *Id.* at 2.

219. *Id.*

factor, which at one time was put forth by the V.I. government as the major cause of the problem, is that under the mirror theory the rate of tax in the Virgin Islands is not under the control of the V.I. legislature and thus is not determined according to local condition. Instead the tax rate is controlled by decisions made in the United States on the basis of U.S. domestic considerations.²²⁰ Accordingly, the amount of V.I. tax revenue directly results at least in part, from U.S. policy choices. Declining tax rates in the United States produce declining tax revenues in the Virgin Islands.²²¹ Another contributing factor has been the judicially created limitations on the amount of tax the Virgin Islands may collect which have deprived the Virgin Islands of sources of revenues. These limitations are represented generally by the equality principle.²²² A third factor is the enforcement problems faced by the Virgin Islands government, which has limited ability to pursue recalcitrant taxpayers who leave the Islands and own no property there.²²³ As noted in the Report, the V.I. system is "easily abused by persons wishing to avoid and evade Federal taxes."²²⁴ The predominant cause of the poor performance of the V.I. tax system as a revenue producer, however, is the unwillingness of the local authorities to aggressively enforce the tax laws and the lack of any real motivation for them to do so.²²⁵ Historically, the Virgin Islands has relied on transfer payments in various forms to fund its deficits.²²⁶ Consequently, as a study by the Virgin Islands Legislature Committee on Finance concluded, "it appears that a policy has been established to forego enforcement of the Virgin Islands internal revenue laws, and to seek, instead, to subsidize the resulting shortfalls of revenues by incursions into the U.S. Treasury."²²⁷

The 1986 Act, building on legislation enacted over the past several years, should aid in the development of a more efficient tax collection mechanism for the Virgin Islands. One of the most significant steps in this regard was the 1982 amendment of the R.O.A. which transferred the functions of the government comptroller for the Virgin Islands to the Inspector General of the U.S. Department of the Interior.²²⁸ As a result of this action, the Inspector General has the authority to audit all accounts pertaining to the revenue and receipts of the V.I. government and to report to the Governor of the Virgin Islands and the Secretary of the Interior all failures to collect amounts due the government.²²⁹ In line with this approach to the problem, the 1986 Act

220. See Hoff, *supra* note 45, at 91.

221. *Id.*

222. *Territorial Income Tax Systems, supra* note 205, at 34-35.

223. See Danielson, *supra* note 5, at A-17.

224. *Territorial Income Tax Systems, supra* note 205, at 40.

225. See generally Hoff, *supra* note 45, at 88-93.

226. *Id.*

227. COMMITTEE ON FINANCE, VIRGIN ISLANDS LEGISLATURE, A STUDY OF THE COLLECTION OF REVENUES IN THE VIRGIN ISLANDS FOR 1978 (June 1979), *quoted in* Hoff, *supra* note 45, at 93.

228. See R.O.A., 48 U.S.C. § 1599 (1985).

229. *Id.*

added a new section 932, with revised filing requirements, and mandated the signing of a tax implementation agreement between the U.S. and V.I. governments.²³⁰ Section 932 explicitly states that U.S. residents will only be able to take a credit for taxes incurred in the Islands if those taxes are actually paid.²³¹ Furthermore, a V.I. resident will only be able to avoid U.S. tax liability if that individual reports all income from all sources and identifies the source of each item of income on the return filed with the Virgin Islands.²³² To facilitate enforcement the information on these returns will be transmitted by the V.I. Bureau of Internal Revenue to the IRS.²³³ U.S. oversight will also be aided by the recently signed implementation agreement, which contains measures to coordinate the tax administrative functions of the IRS and the V.I. Bureau of Internal Revenue and establish procedures for exchanging tax information.²³⁴

The negative side of these measures is that while increased U.S. oversight will undoubtedly improve the efficiency of V.I. tax collection, it will have the concomitant effect of decreasing the autonomy of the V.I. tax system. True fiscal autonomy, which should be the ultimate goal of V.I. tax policy, requires not only the wherewithal to collect the revenue required to fund local governmental expenditures but also local authority and responsibility over the administration of the system. Moreover, the 1986 Act will not, and unless there is a radical change in U.S. policy, could not affect the inherent dynamics of the relationship between the United States and the Virgin Islands which undermine the motivation of the local government to strictly enforce the tax law. So long as the United States continues to subsidize the Virgin Islands government, this motivational problem will remain.

Other aspects of the 1986 Act should increase the flow of revenue to the V.I. Treasury. First, the Act granted authority to the Virgin Islands for the promulgation of a local income tax, similar to a state income tax. Second, the Act increased the rate of V.I. withholding tax on payments to the United States to thirty percent by repealing section 934A, which limited the rate to ten percent.²³⁵ Although this measure eliminates one of the specific holdings of *Vitco*, the Act did not directly address the more subtle problem of the equality principle. Indirectly, however, the Act does provide the means to ameliorate the undesirable consequences of this judicial concept by granting of authority to the Secretary of the Treasury to issue regulations which preclude mirroring of certain provisions of the Code.²³⁶ As noted previously, certain provisions of U.S. tax law have already been excluded from the V.I.

230. See *supra* notes 148-57, 172-74.

231. I.R.C. § 932(b)(3).

232. See *supra* note 155.

233. See *supra* note 156.

234. See *supra* notes 173-74.

235. See *supra* notes 166-67 and 175.

236. See *supra* note 144.

mirror Code, namely, section 881(b), according to the Committee Report on P.L. 98-369, and section 932, by virtue of subsection 932(e).²³⁷

The second criterion enumerated above is whether the V.I. tax system provides for equitable treatment of territorial versus stateside residents. Under prior law, it was clear that despite the fact that the income tax laws in force in the United States were likewise in force in the Virgin Islands, U.S. residents who derived income from the Virgin Islands were not subject to income taxes comparable to those of other U.S. citizens.²³⁸ This was because U.S. residents were treated as non-resident aliens for purposes of V.I. income taxation; consequently, these individuals were eligible for fewer deductions and possibly higher tax rates.²³⁹ On the other hand, corporations such as Danbury, Inc. could take advantage of gaps in the law so as to enjoy much more favorable tax treatment than other domestic corporations that derived V.I. income without establishing residency in the Islands. As a result, the V.I. tax system produced "unintended tax benefits for some and harsh consequences for others."²⁴⁰

The 1986 Act eliminated almost all of the discrepancies between the treatment of individual taxpayers who are U.S. residents and those who are V.I. residents by enacting section 932. Under this section, the United States will be deemed to include the Virgin Islands for purposes of determining the tax liability of V.I. residents.²⁴¹ As with the revenue raising aspects of the Act, the drawback of these reforms is that equity is accomplished by virtually incorporating the Virgin Islands into the territorial jurisdiction of the United States for purposes of section 932.

With respect to corporations, the amendment of section 7651 now prevents a corporation from using the Revised Organic Act to avoid U.S. tax.²⁴² On the other hand, U.S. corporations which do not establish a residence in the Islands will continue to be treated as foreign corporations for V.I. tax purposes and V.I. corporations will remain foreign to the United States.²⁴³ Discrepant treatment between such nonresident (foreign) corporations and resident (domestic) corporations will, consequently, likely continue.

The third standard used by the Treasury Report, and adopted here, is whether the system engenders simplicity of interpretation, administration, and compliance. As noted in the report, basing the V.I. income tax on the I.R.C. should have minimized the problems in achieving this result.²⁴⁴ In

237. See *supra* notes 109 and 160.

238. *Territorial Income Tax Systems*, *supra* note 205, at 38.

239. *Id.*

240. *Danbury*, 627 F. Supp. at 519 n.9, citing "The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity" (1985).

241. I.R.C. §§ 932(b)(1) and 932(c)(3) (1986).

242. See *supra* note 139.

243. *Id.*

244. *Territorial Income Tax Systems*, *supra* note 205, at 38.

application, this assumption was unfounded. The mirror theory is intertwined with the distinctions made in the Code between foreign and domestic persons.²⁴⁵ These areas of the Code, which relate to international transactions, are among the most complex sections in U.S. tax law.²⁴⁶ The unique provisions of the R.O.A., which exempted V.I. inhabitants from U.S. taxation, and thereby meshed the Federal and V.I. tax jurisdictions into a unique tax system, added new and unusual problems, which, when combined with inconsistent judicial decisions, poor administration, and the inherent difficulties of the mirror theory, produced an "unending series of technical problems which [could] not be resolved satisfactorily under existing statutory authority."²⁴⁷

Many of the worst technical problems will disappear along with the inhabitancy rule. More will probably be resolved as the regulations called for in the Committee Report on P.L. 99-514 are enacted. Nonetheless, the equality principle and the mirror theory remain a trap for the unwary, including Congress, the V.I. government, and taxpayers. All must carefully consider the mirrored effect of any new tax legislation and whether any such additions to the Code will be affected by the equality principle. Yet, according to the Treasury Report, a persistent feature of the system has been that both the V.I. government and its taxpayers have had difficulty keeping abreast of the incessant changes in the Federal revenue laws and how these changes are to be mirrored into the V.I. Code.²⁴⁸ As a result, administration and compliance practices have created a gap between the law in theory and the law actually enforced.²⁴⁹ This discrepancy between principle and practice, which is a matter of particular concern "in tax systems which depend as much on voluntary compliance as do the Federal and the territorial income tax systems" is likely to survive the Tax Reform Act of 1986.²⁵⁰

In sum, the 1986 Act has taken major strides towards addressing many of the problems concerning income taxation in the Virgin Islands. In fact, the Act has probably taken the mirror theory system as far as it can go, in terms of efficiency, equity and simplicity. What the Act does not appear to adequately address is the fact that the mirror theory itself is a primary source of the difficulties in the V.I. tax system. Any alternatives to the present system would require elimination of the mirror theory. Generally, such alternatives

245. Hoff, *supra* note 45, at 100.

246. *Id.*

247. *Territorial Income Tax Systems*, *supra* note 205, at 1.

248. For example, the V.I. tax authorities were unaware until 1979 that the Tax Reform Act of 1976 had amended § 6013(g) so as to allow a married couple, one of whom is resident of the U.S., and the other in the V.I., to file jointly in the Virgin Islands. In addition, U.S. corporations operating in the Virgin Islands generally appear to be unaware that they are foreign persons for V.I. tax purposes. As a result, they typically file returns as domestic corporations, often simply sending duplicates of their U.S. return and claiming no V.I. tax liability, apparently on the theory that they satisfied their obligation by paying taxes on the income in the U.S. *Id.* at 40-41.

249. *Id.* at 3.

250. *See id.* at 41.

would involve either providing for increased integration of the Virgin Islands into the U.S. tax system, or allowing for increased V.I. autonomy.²⁵¹

As the Treasury Report recognized, administering the V.I. tax system in order to achieve actual equivalency between the treatment of U.S. residents and V.I. residents would require the law to be changed to treat U.S. citizens, residents, and corporations as domestic to the Virgin Islands and V.I. residents and corporations as domestic to the United States.²⁵² This would entail amending the geographic definition of the United States in section 7701(a)(9) to include the Virgin Islands and redefining a domestic corporation to include corporations created under the laws of the Virgin Islands.²⁵³ The end result of such a revision in the Code would be to extend federal tax jurisdiction to the Virgin Islands as if it were one of the states, thus greatly simplifying the system and easing the burdens of administration and compliance.²⁵⁴ The obvious problem with this alternative is that it would also eliminate the Virgin Islands as a separate and distinct tax jurisdiction. Similar proposals in the past have met with severe opposition in the Virgin Islands as representing an extension of U.S. colonialism through usurpation of a basic attribute of V.I. self government.²⁵⁵

The second alternative would be to follow the recent changes in the tax systems of Guam, American Samoa, and the Northern Mariana Islands by granting the Virgin Islands autonomy over its local income tax laws.²⁵⁶ This alternative would also eliminate the mirror theory and its complications, and would have the additional advantage of allowing the local authorities to adapt the laws to local conditions and to assume the responsibility for administering those laws. Such a change would bring the Virgin Islands in line with the rest of the U.S. possessions, all of whom now have general authority over their local tax systems.

The 1986 Act can be seen as either the first step toward complete integration of the U.S. and V.I. tax systems, or as a compromise designed to resolve some of the specific inequities created by the structure of the system while preserving its separate character. On the one hand, the addition of section 932 and the information sharing arrangements included in the Act bring the U.S. and V.I. systems much closer to a unified tax structure. On the other hand, the repeal of the inhabitancy rule has to a certain extent reinforced the integrity of the Virgin Islands as a separate tax jurisdiction. This is especially true with respect to the treatment of U.S. corporations deriving

251. Hoff, *supra* note 45, at 94-102.

252. *Territorial Income Tax Systems*, *supra* note 205, at 16.

253. See I.R.C. § 7701(a)(4) (1986); Danielson, *supra* note 5, at A-3.

254. Hoff, *supra* note 45, at 94-96; Danielson, *supra* note 5, at A-3. Such a change in the law could also bring the Virgin Islands within the coverage of U.S. international tax treaties. At the present time, although persons born or naturalized in the Virgin Islands are U.S. citizens, they are excluded from the benefits of these treaties if they are residents of the Virgin Islands.

255. Hoff, *supra* note 45, at 94-96; Danielson, *supra* note 5, at A-3.

256. Act § 1271, Pub. L. No. 99-514 (1986).

income from the Islands, which now operate under provisions more closely analogous to corporations conducting business in a truly foreign jurisdiction. The presence of both these measures in the Act supports the conclusion that the Act is a political compromise aimed at solving specific problems without causing radical change to the system. As such, the Act is a qualified success.

CONCLUSION

From its inception, the income tax system of the U.S. Virgin Islands has undergone a continual evolution. Throughout this process, both stateside and local authorities have struggled with the semi-separate nature of the system and the need to balance the competing concerns created by it. Most of these difficulties were unavoidable in light of the inherent ambiguities of a political and legal system which is neither completely independent from nor completely integrated into a sovereign political entity. Yet the mere fact that the Virgin Islands is a U.S. possession does not account for all of the difficulties in V.I. taxation. The system has also been plagued by uncertainty caused by judicial inconsistency, administrative mismanagement, and legislative neglect. The most recent step in the evolution of the V.I. tax system, as enacted by the applicable provisions of the Tax Reform Act of 1986, stands as a distinct improvement over previous efforts to address the problems of V.I. taxation. Clearly, however, the process of reform is far from complete. Faced with the dilemma of either increasing the integration between the V.I. and the U.S. tax systems in order to achieve greater efficiency, or increasing the independence of the V.I. system to promote fiscal autonomy, Congress has opted to do a little of both. By finessing the problem in this manner, the 1986 Act has produced a more workable system, but it has left unresolved the underlying issues which have caused the most difficult and significant problems in Virgin Islands taxation.