

IFC Review

The US Virgin Islands' Economic Development Program

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The US Virgin Islands (USVI), an unincorporated territory of the United States, offers targeted tax incentives to attract certain types of businesses to establish and carry-out operations in the territory. Notably, these benefits, administered by the Economic Development Commission (EDC), are available for financial services companies, including investment managers and advisors, business and management consultants, international trading and distribution, and any other businesses serving clients outside the USVI.

The benefits also extend to the dividends or allocations received by their resident owners. To qualify for benefits, an applicant must meet the requirements of the territory's economic development program law as well as receive income that is eligible for tax incentives under the Internal Revenue Code of 1986, as amended (the Code) and the Treasury Regulations promulgated thereunder. This Article will first set out the local requirements and available benefits and then provide the Federal framework for the territory's grant of benefits.

USVI Legal Requirements for Tax Incentives

Background

The USVI has had an economic development program providing tax credits or subsidies for 50 years. Until the mid-1990s, however, most beneficiaries were in either the hotel and tourism or the manufacturing sectors. Beginning, however, with legislative changes enacted in December 1986 and amendments enacted in February, 2001, followed by the advent of sophisticated technology and telecommunication infrastructure in the 1990s and early 2000s, the USVI started attracting service-oriented businesses. In the past 15 years, many of the new businesses approved under the territory's Economic Development Program (the 'Program') have been service businesses such as investment managers, also known as 'designated service businesses' or 'Category IIA' businesses.

Benefits

The Program benefits include a credit equal to 90 per cent of the otherwise applicable income tax, which applies both to the business receiving the benefits on income from the benefitted business, and to USVI resident owners on their allocations or dividends. In addition, every Program beneficiary can receive benefits for income from loans in excess of US\$1 million made to USVI borrowers meeting certain statutory criteria and on income from capital contributions in excess of US\$1 million made to USVI business entities or business entities in the USVI. Although beneficiaries are permitted to make such capital contributions without modifying their certificates, they must promptly advise the EDC in writing of such investments. Salaries and other forms of compensation such as guaranteed payments are fully taxable.

No withholding tax is imposed on payments to US corporations. Further, beneficiaries with foreign corporate owners are exempt from withholding tax on interest payments and are subject to a reduced withholding tax rate of 4.4 per cent on dividend payments. Similarly, no income tax is payable on

interest paid to nonresident alien individuals, and the tax rate on dividends paid to nonresident individuals is four per cent. The withholding tax is paid by the withholding agent to the USVI Bureau of Internal Revenue ('BIR') on Form 8109 and then reconciled annually on Form 1042.

Beneficiaries are also exempt from the territory's four per cent tax on gross receipts and on property tax if they own the building where their business is located. The personal homes of the owners of a beneficiary do not receive the property tax exemption, even if the respective owners maintain home offices. Moreover, if a beneficiary rents an office, the property tax exemption does not pass through to its landlord.

Requirements

Both before and after the expansion of the Program to service businesses, the Program's focus has been on direct and indirect job creation in the USVI. This objective is met through several requirements that every beneficiary must meet unless a waiver is granted.

First, each beneficiary must have a minimum of 10 full-time employees, defined as working at least 32 hours a week, within a year after the certificate granting the tax benefits is signed by the Chair of the EDC. At least 80 per cent of the employees must be USVI residents unless a waiver is granted. A USVI resident for EDC purposes is defined as: (1) any US citizen currently domiciled in the USVI for one year or more; (2) a person who has attended a school in the USVI for at least six years or is a high school graduate (presumably from a USVI high school) or a University of the Virgin Islands graduate and who is registered to vote in the USVI; or (3) the holder of an alien registration receipt card domiciled in the USVI for one year or more.

Second, each beneficiary must agree to (and make) a minimum capital investment of at least US\$100,000, typically including build-out costs, office furniture and fixtures, and computers. A beneficiary must purchase goods and services locally when available, must make certain contributions to scholarships and public education, must provide a plan for civic participation, and must meet the requirements imposed by the territory's coastal zone management and building codes for all construction. Program beneficiaries must provide certain employee benefits, including medical insurance, a pension benefit plan, and vacation and sick leave or paid time off. Beneficiaries must also provide employees with a management training program and must commit to provide educational assistance in the territory.

The Application Process

An applicant is required to provide a substantial amount of information, including detailed formation and good standing documents for the applicant and any subsidiaries and parent entities, legal structure and internal organizational diagrams, a detailed business plan, information regarding anticipated principal revenue sources, employee job descriptions and salaries, and detailed financial information, including a five-year projection, profit and loss statements and balance sheets, income tax returns, and bank reference letters. An applicant must also specifically indicate how it will meet the various employment, capital investment, and other requirements. As a result of recent updates to the EDC's application form, applicants must provide verification of business financing.

The EDC conducts background checks on the owners of applicant businesses. Each beneficial owner must be identified with accompanying biographical

information and detailed ownership, financial and contact information. Background questions must also be answered for each beneficial owner.

For a fund management business, the application fee is US\$5,000. When the certificate is issued by the EDC after approval, an issuance fee of US\$2,500 applies. Finally, each year a fund management business must pay a compliance fee of US\$7,500.

Following submission of the EDC application, the application is presented at a public hearing. The seven EDC commissioners are appointed by the Governor and confirmed by the USVI Legislature and are composed of four cabinet-level government employees and private sector representatives from the islands of St Croix, St John and St Thomas. The EDC generally schedules six-to-eight public hearings annually at which it will consider the applications that have been deemed complete by the EDC. Following the public hearing, the EDC will approve or reject the application in an Executive Session. If the EDC recommends that benefits should be granted, then the EDC will notify the applicant's representative with a letter summarizing the EDC's conditions of approval and will forward the application to the USVI Governor for his review after the applicant signs off on the terms of the recommendation. (If benefits are not approved, the applicant can seek reconsideration.)

The Governor statutorily has 60 days (excluding Sundays and holidays) to approve or disapprove the issuance of an EDC certificate. Upon notice of the Governor's approval, the EDC will provide the applicant with a copy of the terms and conditions upon which the approval is based (which are the same as those recommended by the EDC unless the Governor has requested a change during the review process). The applicant must then advise the EDC of the date it would like to commence benefits. Once commencement dates have been chosen, the EDC will issue the certificate - which is a contract between the USVI Government and the beneficiary - setting out the various tax credits, exemptions, and the time period of the beneficiary's EDC benefits. A beneficiary business must activate its benefits within five years after it commences doing business in the territory.

Ongoing Program Requirements

Beneficiaries are subject to certain ongoing compliance requirements including reporting of their ownership to the Lieutenant Governor, posting advertisements in local newspapers for items they need to acquire, and filing income tax and gross receipts returns with the USVI Bureau of Internal Revenue showing the value of their benefits.

Beneficiaries are also required to employ or contract with persons who are USVI residents and to purchase goods, materials, and services from local suppliers to the extent possible, unless an exemption applies. They must also require all contractors they retain to meet these local purchase requirements. In addition, beneficiaries are generally subject to certain competitive bidding and solicitation requirements and must maintain records showing compliance as well as justification for any non-solicitation of USVI suppliers and must describe any purchases the beneficiary believes are exempt from the procurement requirements.

Benefit Periods

Benefits are available for initial periods ranging from 10 to 30 years depending on where in the USVI the business is located. For example, benefits are available for 30 years for businesses located in the town of Frederiksted on the western end of St Croix and for 10 years in St Thomas

and St John. Benefits can be extended for businesses that are in compliance with the requirements of their certificates, although the EDC may request additional investment or employment as one of the conditions for extension. Benefits are extended in five year increments and are reduced by 10 per cent with an extension so the income tax credit is equal to 81 per cent of taxes rather than 90 per cent. Currently, as long as a beneficiary is in compliance until its surrender date, it can terminate its certificate before it expires with no 'cancellation' payment or repayment of any tax benefits.

Federal Legal Requirements for USVI Tax Incentives

The USVI offers economic incentives to businesses under a legislative mandate granted by the US Congress. Although the Congressional mandate has been amended several times, most recently in the Tax Reform Act of 1986 and the JOBS Act of 2004, the USVI's ongoing ability to provide incentives has greatly assisted the territory in diversifying its economy and developing jobs for its residents.

The Code applies in the USVI under a 'mirror' system whereby "USVI" is effectively substituted for "the United States" wherever the latter appears. In addition, the Code contains several sections – notably sections 932, 934, and 937 – that deal specifically with the USVI and, more particularly, govern the extent to which the USVI can grant tax incentives and how USVI residents file their returns.

The USVI can grant tax benefits on any income that is from USVI sources and on certain income that is effectively connected with a USVI trade or business. In general, income earned by a beneficiary is USVI source income if it is fee or compensation income for services performed in the USVI and is reasonable for the services actually provided. Capital gains derived by a USVI business may also be eligible if certain requirements are met (other than certain gains from the sale of assets contributed by a US resident who then moves to the USVI, which must typically be allocated). In addition, certain dividend and interest income from a USVI payor is USVI source income. Finally, income earned by a beneficiary may be effectively connected income with a USVI trade or business if it consists of non-US source dividends or interest derived in the active conduct of a banking, financing, or similar business. The USVI can never reduce or rebate tax on income from US sources except for sales of inventory manufactured in the USVI where title passes in the United States. Of course, to be eligible in any case the income must also fall within the certificate granted to the business by the EDC.

Types of Beneficiaries

The USVI Program permits beneficiaries to be sole proprietorships, corporations, partnerships, limited liability companies, trusts, or similar entities. In determining the type of entity to choose, a business will consider both local and Federal law. The primary consideration may be whether the owners of the entity will be bona fide residents of the USVI for tax purposes, in which case a 'flow through' entity, such as an LLC or a partnership, may be preferable because no income tax is imposed at the entity level and the owner gets a credit equal to 90 per cent of the tax otherwise due on the allocation from the entity. (Bona fide residents must meet physical presence, closer connection, and tax home requirements that are beyond the scope of this article.) This structure results in an effective tax rate on the tax-benefitted income of 10 per cent of the otherwise applicable rate. If one or more of the owners are not going to be bona fide USVI residents, however, then the

preferred business entity may be a 'C' corporation. A USVI C corporation with tax benefits pays tax to the USVI Bureau of Internal Revenue at an effective rate of 3.85 per cent on eligible income. No USVI withholding tax is imposed on dividends paid to USVI residents, US citizens who reside elsewhere, or US corporations. US residents would be subject to tax at a 15 per cent rate on the dividends under current dividend rates.

USVI C corporations are foreign corporations for US tax purposes and subject to the controlled foreign corporation (CFC) and subpart F provisions for Federal income tax purposes. Furthermore, a US citizen/USVI bona fide resident shareholder of a USVI corporation owning at least 10 per cent of the total combined voting power of all classes of stock entitled to vote will be considered a US shareholder for purposes of the CFC rules, and if such ownership threshold exceeds 50 per cent, then the USVI corporation will be deemed a CFC for Federal income tax purposes. The subpart F regime will not currently tax the active business income of the USVI corporation and many fund managers receive all or most of their income in the form of management and performance fees which would be such income. If the beneficiary receives other types of income, it will be important to determine whether each type of income falls within a subpart F exemption or exclusion as well as whether the income is from USVI sources or effectively connected with a USVI trade or business.

Other Considerations for Financial Services Businesses

The USVI is not covered by any US income tax treaties (nor are the other US territories). Further, although the USVI is for most tax purposes 'foreign' so that the BIR and not the IRS administers the Code in the USVI, the two tax jurisdictions have entered into several agreements, including the Tax Implementation Agreement of 1987 and Notice 2007-31, governing the exchange of information and other matters. Finally, the Securities and Exchange Commission (SEC) does exercise oversight over fund managers in the USVI to the extent that it does so over fund managers elsewhere in the United States, and USVI fund managers can register with the SEC to be investment advisors and broker-dealers. The USVI also exercises oversight over local investment advisors and broker-dealers within the Office of the Lieutenant Governor, similar to any state regulatory office, and the level of oversight depends in part on whether the business is federally regulated.

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