Joint Committee on Taxation
September 14, 1982
JCX-37-82

H.R. 7093

REDUCTION OF CERTAIN WITHHOLDING TAXES PAID TO THE VIRGIN ISLANDS

I. SUMMARY

The Treasury and the Government of the Virgin Islands take the position that present law imposes a 30-percent tax on the non-Virgin Islands recipient of certain Virgin Islands source passive investment income, and that present law also imposes withholding at the source by the V.I. payor of such income. The bill would reduce this tax to 10 percent when the recipient is a U.S. individual or corporation and impose a corresponding withholding obligation on the V.I. payor of such income. The bill would allow the V.I. Government further to reduce this 10-percent rate in its discretion. The bill would not affect payments of V.I. source passive income to non-U.S. persons.

II. DESCRIPTION OF BILL

Present Law

Virgin Islands taxation in general

Under the Revised Organic Act, in the Virgin Islands, the U.S. Internal Revenue Code is generally applied as a local territorial tax code, except that tax proceeds are paid into the treasury of the Virgin Islands. This system has been interpreted to require that in applying the Internal Revenue Code in the Virgin Islands, the name "Virgin Islands" is generally substituted for the name "United States" wherever it appears in the U.S. Code (the so-called "mirror image" system).

Corporate and individual "inhabitants" of the Virgin Islands are taxed on their worldwide income by the Virgin Islands and are exempt from any income tax liability to the Federal Treasury, even on their U.S.-source income. All corporations chartered in the Virgin Islands are considered to be inhabitants of the Virgin Islands. In certain circumstances, a United States corporation may also qualify as an inhabitant of the Virgin Islands.

The U.S. Internal Revenue Code limits the power of the Virgin Islands government to reduce its income tax (sec. 934). The Virgin Islands may not reduce its taxes attributable to income derived from sources within the United States. With respect to non-U.S. source income, the Virgin Islands may not reduce its corporate tax except to U.S. and V.I. corporations that meet a so-called "80-50 test." This test allows the Virgin Islands to reduce taxes only for those U.S. and V.I. corporations that have derived for the past three taxable years (or applicable part thereof) at least 80 percent of their gross income from V.I. sources and at least 50 percent of their gross income from the active conduct of a trade or business within the Virgin Islands. Acting within the constraint of the 80-50 test, the Government of the Virgin Islands has established further criteria for tax reductions, such as a $50,000 minimum investment and certain employment criteria.

Taxation of passive income in the Virgin Islands

U.S. law generally imposes a 30-percent tax on the gross amount of dividends, interest, royalties, and other passive investment income paid by U.S. persons to non-resident aliens and foreign corporations when that income is not effectively connected with the conduct of a U.S. trade or business by the foreign person. This 30-percent rate is often reduced, or eliminated, by income tax treaties. U.S. law also generally imposes on the payor of such passive investment income a duty to withhold the tax due (secs. 1441 and 1442).

Under the mirror system, the Virgin Islands imposes a similar 30-percent tax on passive investment income paid by V.I. persons to non-V.I. persons, including U.S. persons. The Virgin Islands cannot now forgive this tax, since the tax is upon the recipient and not upon the company operating in the Virgin Islands. A U.S. recipient of passive income from the Virgin Islands may generally take a foreign tax credit for any such tax (subject to limits) against its U.S. tax liability. Although there is some dispute about the underlying tax liability of the recipient of passive investment income from the Virgin Islands, it is the Internal Revenue Service's position that the recipient is liable for the tax (Rev. Rul. 78-327, 1978-2 C.B. 196).1/

In addition, there is a dispute about the authority of the Virgin Islands to require withholding of this tax (as opposed to the authority to impose the underlying tax). This dispute has been the subject of litigation. The U.S. Court of Appeals for the Third Circuit held that the Virgin Islands did not have the power to impose withholding.2/ The basis of this decision was a Treasury Regulation that provided that U.S. persons were not required to withhold on payments of passive investment income to V.I. persons: the Third Circuit mirrored that Regulation to hold that V.I. persons did not have to withhold on payments to U.S. persons. The Treasury Department has since revoked the underlying Regulation. Therefore, according to the IRS, V.I. persons who pay passive income to U.S. persons must withhold tax at a 30-percent rate.

1/ No inference should be drawn from this discussion as to the correctness of the view of either party about this dispute or about the dispute as to the related withholding obligation.

2/ Vitco v. Government of the Virgin Islands, 560 F.2d 180 (3d Cir. 1977), cert. denied, 435 U.S. 180 (1978).

However, some persons have questioned the validity of the IRS revocation of that underlying Regulation. The revocation occurred simultaneously with 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. It is understood that these issues are again in controversy.

Guamanian taxation of passive income

Like the Virgin Islands, Guam is a possession of the United States and has a tax system generally mirroring the Internal Revenue Code. Until 1972, passive investment income paid by Guamanian persons to U.S. persons was subject to a 30-percent Guamanian tax. As is the case with V.I. taxes today, this tax was creditable (subject to limits) against U.S. tax liability through the foreign tax credit mechanism. In 1972, finding that the effect of the Guamanian passive income tax had been to discourage U.S. investment in Guam, Congress repealed the tax.3/

Explanation of Provisions

The bill would generally limit the Virgin Islands tax on certain passive investment-type income, including interest, dividends and rents, which is not effectively connected with the conduct of a trade or business in the Virgin Islands, that is received by U.S. citizens, resident aliens of the United States, and U.S. corporations from sources within the Virgin Islands to 10 percent of the gross amount received. The bill would continue the current 30-percent rate for dividends paid to such persons out of earnings and profits accumulated during taxable years beginning before the effective date (the day after the date of enactment). It would treat post-effective date dividends as first coming out of earnings and profits accumulated during taxable years beginning before the effective date.

3/ Congress' method of repealing the Guamanian tax was to repeal the 30-percent U.S. tax on passive investment income paid by U.S. persons to Guamanian persons. Repeal of the Guamanian tax thus occurred through "mirroring" of repeal of the U.S. tax.

The bill would allow the Government of the Virgin Islands, in its discretion, further to reduce this 10 percent rate (or to eliminate the tax altogether). The Government of the Virgin Islands would have the discretion to reduce (or eliminate) the tax on the basis of criteria it chose. The bill would also limit the complementary withholding tax on such income to the reduced 10 percent (or lower) rate.

The purpose of the bill is to encourage investment in the U.S. Virgin Islands by U.S. persons. Therefore, the reduced rate of tax is available only to U.S. citizens, resident aliens and corporations. The bill would not affect the tax treatment of payments by V.I. persons to non-U.S. persons, to U.S. trusts, estates, or partnerships, or to V.I. inhabitants. Also, the bill is not intended to enable foreign persons to use the Virgin Islands as a conduit to make investments in the United States.

The bill would make clear the Virgin Islands' right both to impose the tax and to collect it by requiring withholding.

Effective Date

The reduction in Virgin Islands tax rates would generally apply to amounts received after the date of enactment. However, the withholding obligation would apply to payments made after the date of enactment.

Revenue Effect

A revenue estimate is not available at this time.