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HOUSE OF REPRESENTATIVES

REPORT
No. 97-833

REDUCTION IN RATE OF CERTAIN TAXES PAID TO VIRGIN ISLANDS

SEPTEMBER 16, 1982.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed.

Mr. ROSTENKOWSKI, from the Committee on Ways and Means, submitted the following

REPORT

[To accompany H.R. 7093]

The Committee on Ways and Means to whom was referred the bill (H.R. 7093) to amend the Internal Revenue Code of 1954 to reduce the rate of certain taxes paid to the Virgin Islands on Virgin Islands source income, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

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 will 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 will allow the V.I. Government further to reduce this 10-percent rate in its discretion. The bill will not affect payments of V.I. source passive income to non-U.S. persons.

II. EXPLANATION OF THE 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 the local territorial

89-006 O

tax law, 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, whenever appropriate, for the name "United States" where 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[1] 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 fixed or determinable annual or periodic income (hereinafter sometimes referred to as 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

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[1] Under the Tax Equity and Fiscal Responsibility Act of 1982, Public Law 97-248, the percentage of a corporation's gross income that must be derived from the active conduct of a trade or business in the Virgin Islands is increased from 50 percent to 65 percent. This increase will be phased in over three years. For taxable years beginning after Dec. 31, 1982, the percentage limitation will be 55 percent, for taxable years beginning after Dec. 31, 1983, the percentage limitation will be 60 percent, and thereafter the percentage limitation will be 65 percent.

That Act did not affect the percentage—80 percent—of gross income that must be derived from Virgin Islands sources.

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).[2]

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.[3] 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. 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.[4]

Reasons for Change

The current 30-percent tax on the gross amount of passive investment income paid by V.I. persons to U.S. persons discourages investment by U.S. persons in the Virgin Islands. Because no deductions are allowed, the tax on this income, in many cases, is higher than the regular corporate or individual tax would be if deductions were allowed. Although the United States allows a foreign tax credit for taxes paid to the Virgin Islands, such credits cannot offset U.S. tax on U.S. source income. Therefore, the 30-percent tax

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[2] 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.

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

[4] 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.

on gross V.I. source passive investment income frequently results in such income being taxed at a higher rate than similar income earned by U.S. persons in the United States. This disincentive has had the effect of retarding investments by U.S. persons in the Virgin Islands. The Committee has limited the effect of the bill to certain U.S. persons, because the Committee does not intend to enable foreign persons to use the Virgin Islands as a conduit to make investments in the United States.

Explanation of Provisions

The bill will generally limit the Virgin Islands tax on certain passive investment-type income from sources within the Virgin Islands that is not effectively connected with the conduct of a trade or business in the Virgin Islands and that is received by U.S. citizens, resident aliens of the United States, and U.S. corporations, to 10 percent of the gross amount received. The bill will 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 will treat post-effective date dividends as first coming out of earnings and profits accumulated during taxable years beginning before the effective date.

The bill will 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 will have the discretion to reduce (or eliminate) the tax on the basis of criteria it chooses. The bill will also limit the complementary withholding tax on such income to the reduced 10 percent (or lower) rate.

The reduced rate of tax is available only to U.S citizens, resident aliens and corporations. The bill will not effect 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.

The bill makes 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 will generally apply to amounts received after the date of enactment. However, the withholding obligation will apply to payments made after the date of enactment.

III. EFFECT OF THE BILL ON THE BUDGET AND VOTE OF THE COMMITTEE IN REPORTING THE BILL

Budget effects

In compliance with clause 7 or Rule XIII of the Rules of the House of Representatives, the following statement is made about the effect on the budget of this bill, H.R. 7093. The committee estimates that the provisions contained in the bill, H.R. 7093, will have a negligible revenue effect.

The Treasury Department agrees with this statement.

Vote of the committee

In compliance with clause 2(l)(2)(B) of Rule XI of the Rules of the House of Representatives, the following statement is made about the vote of the committee on the motion to report the bill, as amended. The bill, H.R. 7093, was ordered favorably reported by voice vote.

IV. OTHER MATTERS TO BE DISCUSSED UNDER HOUSE RULES

In compliance with clauses 3(l)(3) and 2(l)(4) of Rule XI of the Rules of the House of Representatives, the following statement are made with respect to the committee action on H.R. 7093.

Oversight findings

With respect to subdivision (A) of clause 2(l)(3) (relating to oversight findings), the committee advises that it was as a result of the committee's oversight activities with respect to taxation of income from sources within the Virgin Islands that the committee concluded that it is appropriate to enact the provisions contained in the bill.

The Subcommittee on Select Revenues Measures of the Committee on Ways and Means held a hearing on the subject (H.R. 6985) on July 12, 1982.

New budget authority and tax expenditures

With respect to subdivision (B) of clause 2(l)(3), after consultation with the Director of the Congressinal Budget Office, the committee states that the changes made to existing law by this bill involve no new budget authority or new or increased tax expenditures.

Consultation with congressional budget officials on budget estimates

With respect to subdivision (C) of clause 2(l)(3), the committee advises that the Director of the Congressional Budget Office has examined the committee's budget estimates (as indicated in part III of this report) and agrees with the committee's budget estimates.

Oversight by Committee on Government Operations

With respect to subdivision (D) of clause 2(l)(3), the committee advises that no oversight findings or recommendations have been submitted to the committee by the Committee on Government Operations regarding the subject matter of this bill.

Inflationary impact

In compliance with clause 2(l)(4), the committee states that the enactment of this bill is not expected to have an inflationary impact on prices and costs in the operation of the national economy.

V. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3 of Rule XIII of the Rules of the House of Representtives, changes in existing law made by the bill, as reported, are shown as follows (new matter is printed in italics, existing law in which no change is proposed is shown in roman):

INTERNAL REVENUE CODE OF 1954

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Subtitle A—Income Taxes

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CHAPTER 1—NORMAL TAXES AND SURTAXES

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Subchapter N—Tax Based on Income From Sources Within or Without the United States

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PART III—INCOME FROM SOURCES WITHOUT THE UNITED STATES

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Subpart D—Possessions of the United States

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SEC. 934. LIMITATION ON REDUCTION IN INCOME TAX LIABILITY INCURRED TO THE VIRGIN ISLANDS.

(a) GENERAL RULE.—Tax liability incurred to the Virgin Islands pursuant to this subtitle, as made applicable in the Virgin Islands by the Act entitled "An Act making appropriations for the naval service for the fiscal year ending June 30, 1922, and for other purposes", approved July 12, 1921 (48 U. S. C. 1397), or pursuant to section 28(a) of the Revised Organic Act of the Virgin Islands, approved July 22, 1954 (48 U. S. C. 1642), 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 Island, except to the extent provided in subsection (b) or (c) *or in section 934A.*

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SEC. 934A. REDUCTION IN INCOME TAX RATE ON VIRGIN ISLANDS SOURCE INCOME.

(a) GENERAL RULE.—For purposes of determining the tax liability incurred by citizens and resident alien individuals of the United States, and corporations organized in the United States, to the

Virgin Islands pursuant to this title with respect to amounts received from sources within the Virgin Islands—

(1) the rate of the taxes imposed by sections 871(a)(1) and 881 shall not exceed 10 percent, and

(2) subsection (a) of section 934 shall not apply to such taxes.

(b) REDUCED RATES NOT TO APPLY TO PRE-EFFECTIVE DATE EARNINGS.—

(1) IN GENERAL.—The reduction under subsection (a)(1), and any reduction under section 934 pursuant to subsection (a)(2), in a rate of tax imposed by section 871(a)(1) or 881 shall not apply to dividends paid out of earnings and profits accumulated for taxable years beginning before the effective date of the reduction.

(2) ORDERING RULE.—For purposes of paragraph (1), dividends shall be treated as first being paid out of earnings and profits accumulated for taxable years beginning before the effective date of the reduction (to the extent thereof).

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CHAPTER 3—WITHHOLDING OF TAX ON NONRESIDENT

ALIENS AND FOREIGN CORPORATIONS AND TAX-FREE COVENANT BONDS

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Subchapter A—Nonresident Aliens and Foreign Corporations

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SEC. 1444. WITHHOLDING ON VIRGIN ISLANDS SOURCE INCOME.

For purposes of determining the withholding tax liability incurred to the Virgin Islands pursuant to this title with respect to amounts received from sources within the Virgin Islands by citizens and resident alien individuals of the United States, and corporations organized in the United States, the rate of withhholding tax under sections 1441 and 1442 on income subject to tax under section 871(a)(1) or 881 shall not exceed the rate of tax on such income under section 871(a)(1) or 881; as the case may be.

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