

February–March 2012

Journal of  
**TAX PRACTICE  
& PROCEDURE**

Published Bimonthly by CCH, a Wolters Kluwer business

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# No Good Deed Goes Unpunished— The Limitations and Pitfalls of Tax Code Driven Investment in the U.S. Virgin Islands

*By Jason B. Freeman*

Jason B. Freeman examines the limitations and pitfalls of Tax Code driven investment in the U.S. Virgin Islands.

## Introduction

Congress giveth, and the taxman taketh away. Trite euphemisms such as these have not found an enduring place in our tax-law lexicon without a few seeds of truth behind them. Indeed, if one looks hard enough, there are enough such seeds scattered about to fill a veritable treasure trove of witticisms directed at the IRS's expense. Unfortunately, the U.S. Virgin Islands may prove to be a hotbed for the germination of a few such seedlings.

The IRS has taken a controversial position regarding the applicability of the statute of limitations to certain USVI taxpayers—a position that is an integral part of its continuing effort to strip taxpayers who invested in the USVI through its Economic Development Program (“EDP”) of benefits they believed to be provided by that program. The benefits were made available, taxpayers believed, through a congressionally sanctioned tax credit that was supposed to incentivize them to make just such investments. For taxpayers who participated in the EDP, the IRS maintains that the three-year statute of limitations under Code Sec. 6501(a) was never triggered for certain years where the taxpayer claimed resident-of-the-United-States-Virgin-Islands status and filed tax returns with the USVI's Bureau of Internal Revenue (“BIR”). The IRS has opened many, if not most, such taxpayers up to audit, often going back some 10-plus years and

seeking enormous assessments—an unsettling reality for taxpayers who long ago settled into a false lull of repose. In addition to reinforcing the time-tested truism that “the taxman taketh away,” the IRS's position, if upheld, may just introduce yet another hackneyed expression into the practitioner's list of quotable quotes: No good deed goes unpunished.

## Background and Overview

Decades ago, the United States Congress, in an effort to stimulate the economic and fiscal independence of the Virgin Islands, authorized the USVI government to offer tax benefits to qualifying investors on certain USVI-connected income. Congress sought to attract businesses to the USVI and promote investment in its lackluster economy—an economy that trailed all 50 states and the District of Columbia in poverty metrics and per capita income.<sup>1</sup> Under this authority, a qualifying bona fide resident of the Virgin Islands was eligible, to the extent provided by the USVI government, for reduced income tax on USVI-sourced income and income effectively connected with the conduct of a trade or business within the Virgin Islands.

It was under this authority that the USVI established the EDP. The EDP currently provides qualifying taxpayers with a 90-percent reduction of income tax on income to which benefits are extended<sup>2</sup>—an effective tax rate of approximately four-percent on such income.<sup>3</sup> First introduced in the 1960s under the auspices of the Industrial Incentive Program, the

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USVI revamped and reorganized the EDP in 2001, breathing new life into its economy. In the process, it extended benefits to a significantly expanded category of businesses, including “service businesses” such as “investment managers,” “business and management consultants,” and “any other businesses serving clients located outside the Virgin Islands.”<sup>4</sup>

Attracted by the 90-percent credit—that was, after all, the point, was is not?—many taxpayers relocated or established operations in the USVI and attempted to take up residency there. The initiative was indeed quite successful: A 2005 study conducted by PricewaterhouseCoopers concluded that, during 2004 alone, the influx of EDP businesses created an additional 3,000 jobs, providing direct and indirect wages and benefits of more than \$150 million.<sup>5</sup> These businesses, the study concluded, accounted for nearly eight-percent of total USVI employment and almost 20-percent of the USVI government’s revenues.<sup>6</sup>

The U.S. government, for its part, actively touted the program’s tax benefits. Even into late 2003, the Office of Insular Affairs of the U.S. Department of the Interior—the U.S. governmental agency that oversees the federal administration of the USVI—was actively promoting the tax benefits available to U.S. citizens under the EDP.<sup>7</sup> Indeed, the government’s efforts led commentators in 2004 to conclude that: “[T]his tax benefit [was] actively sanctioned and promoted by current U.S. government policy to encourage investment in the Virgin Islands.”<sup>8</sup>

Congressional support for such an initiative is and was nothing new or unusual. The Legislature has long used the Tax Code as a mechanism to further its public policy goals, dangling carrots here and there to incentivize taxpayers to do this, that, and the other—and silently directing investment dollars as it sees fit. Its efforts have not always been successful. But sometimes they have—and sometimes they have, in retrospect, been viewed as a little too successful. In the eyes of the IRS, the EDP was one such instance.

In 2004, believing the EDP to be rife with abuse by taxpayers attempting to avoid and evade U.S. taxation, the IRS issued a notice warning taxpayers that it intended to challenge certain claims of entitlement to the benefits of the EDP.<sup>9</sup> Such taxpayers, it alleged, were taking positions that were “highly questionable, and in most cases meritless.”<sup>10</sup>

Certainly there were some instances of taxpayer abuse. But many, if not most, taxpayers were simply doing their best to comply with unclear guidance

and ill-defined statutory and regulatory concepts in an effort to qualify for the congressionally sanctioned tax benefits available through the EDP. Often, these taxpayers relied upon so-called “experts” for guidance. The situation was not helped by the fact that there was no bright-line guidance for much of the period at issue defining some very central concepts, such as “bona fide resident of the Virgin Islands.”<sup>11</sup> Taxpayers were left to muddle through ambiguous principles and structure their affairs without the aid of clear and precise IRS guidance.

Many of these taxpayers filed a form with the IRS providing notification of a change of address or their change to “bona fide resident of the Virgin Islands” status during the tax years at issue,<sup>12</sup> as well as tax returns with the BIR reporting their worldwide income. Nonetheless, the IRS has taken the position that tax years ending before December 31, 2006—an arguably arbitrary cutoff date—are open to audit and assessment where the taxpayer took the position that he or she was a bona fide resident of the Virgin Islands and, consistent with that position, filed a return only with the BIR. In other words, the three-year statute of limitations provided by Code Sec. 6501(a) is not applicable; EDP beneficiaries who previously paid tax on their worldwide income to the BIR—tax for which the limitations period to claim a refund with the BIR has expired—are exposed to IRS assessment, possibly some 10-plus years after the fact in some cases.

For the practitioner confronted with an IRS challenge, this area can present a dizzyingly complex set of procedural and substantive issues, including (though by no means exclusively): the applicability of the economic substance doctrine; establishment of residency; income sourcing; whether income is effectively connected with the USVI; the reasonableness of compensation; the status of a USVI entity under Code Sec. 7701; the availability of foreign tax credits; the applicability of anti-deferment regimes on foreign outbound transactions; whether any dividends paid by a USVI entity to a U.S. citizen are qualified dividends under Section 1(h)(11); whether TEFRA procedures or traditional procedures applicable to foreign corporations are applicable where an assessment is proposed or a refund is sought; and the prospect of double taxation, as well as the applicability of mitigation provisions or use of competent authority procedures to relieve that double taxation. The most fundamental and important issue at hand, however, is whether a tax return filed with the BIR triggers the three-year statute of limitations

contained in Code Sec. 6501(a). The issue merits such preeminent status for one simple reason: A taxpayer-friendly answer would render the foregoing list of issues largely moot.

## Foreign Tax Framework

The United States administers an extraterritorial system of taxation. Its taxing jurisdiction flows, in theory at least, from the residence or citizenship of the taxpayer or source/type of the taxpayer's income. U.S. citizens and corporations are, therefore, generally subject to tax on their worldwide income, regardless of source. International double taxation is mitigated through a foreign tax credit for income taxes paid to foreign governments on foreign-source income.

Under U.S. law, foreign corporations and subsidiaries are generally recognized as separate taxpayers from their domestic shareholders and parent corporations. Thus, where a U.S. person conducts business through a foreign corporation, or a U.S. corporation conducts business through a foreign subsidiary, generally no U.S. income tax is owed unless and until such income is repatriated through a distribution or the taxpayer disposes of the foreign corporation's stock. This general regime provides taxpayers with significant flexibility to structure their affairs to defer tax on earnings until the earnings are repatriated to the United States. Of course, this general rule is not without exceptions. Congress has crafted several anti-deferral regimes that require immediate recognition of income or payment of interest on deferred income where it views deferral as abusive or unfair. The most important of these regimes are the controlled foreign corporation ("CFC") provisions of Subpart F and the passive foreign investment company provisions ("PFIC").

The USVI is generally considered a foreign jurisdiction for purposes of administering the United States Tax Code.<sup>13</sup> For instance, a USVI C Corp. is considered a foreign corporation for US tax purposes, potentially subjecting its shareholders to the CFC and Subpart F provisions of the Code.<sup>14</sup> U.S. taxpayers investing in the USVI would, therefore, generally have an alternative tax benefit to the EDP credit available: deferment of income recognition in the United States under general deferral principles—at least to the extent they do not run afoul of an anti-deferral regime.

In like manner, the United States is generally considered a foreign jurisdiction for purposes of administering the USVI's Tax Code (referred to as the "Mirror Code" and discussed below).<sup>15</sup> Although the United States

and USVI have not entered into a tax treaty, they have entered into information-exchange agreements.<sup>16</sup>

Currently, a U.S. resident who is not a bona fide resident of the Virgin Islands but who has income from the USVI must file two tax returns—one with the IRS and one with the BIR.<sup>17</sup> The taxpayer pays a pro rata amount of tax to each tax jurisdiction, with tax on USVI source income being paid to the BIR and tax on non-USVI source income being paid to the IRS.<sup>18</sup>

On the other hand, a bona fide resident of the USVI is only required to file a tax return with the BIR so long as it reports income from all sources and identifies the source of each item shown on the return.<sup>19</sup> The taxpayer, by paying tax on worldwide income to the BIR, is relieved of any income tax liability to the United States—even with respect to its non-USVI source income.<sup>20</sup>

## History of the Territory

Some background on the unique political status and history of the USVI provides a helpful basis for understanding the interaction between its tax system and that of the United States, as well as gaining an appreciation for the nature of the subtle legal implications that can result from USVI-related issues.

The United States Virgin Islands are made up of 68 Caribbean islands, although only four are actually inhabited—Saint Thomas, Saint Croix, Saint John, and Water Island. Originally named by Christopher Columbus, the islands have passed through the hands of various colonial powers since the days of the early European explorers, including the United Kingdom, Holland, France, and Denmark.

It was not until 1917, following Denmark's cession of the islands by treaty, that the Virgin Islands officially became a territory of the United States—a unique political status that, unlike a state, is not recognized as a separate sovereign, but that effectively "exercise[s] nearly all the powers of government, under what are generally called 'organic acts,' passed by Congress"<sup>21</sup> pursuant to its authority under the Territorial Clause of the United States Constitution.<sup>22</sup>

After being acquired from Denmark, the islands were initially governed by the U.S. Navy. Civil administration over the islands was eventually transferred to the Department of Interior in 1931 and the USVI's local government was largely established and organized through the 1936 Virgin Islands Organic Act and the Revised Organic Act of 1954. The Virgin Islands

were organized as, and remain, an unincorporated territory of the United States.<sup>23</sup>

This political status carries some subtle and not-so-subtle legal implications—some of which have, and some of which have not, been vetted by the courts. In its seminal jurisprudence on the status of U.S. territories, known as the *Insular* cases, the Supreme Court established the doctrine of territorial incorporation, a doctrine based on the concept that “the United States [can] acquire territory without incorporating it into the Nation, and that unincorporated territory [is] not subject to all the provisions of the Constitution.”<sup>24</sup> While the Constitution does not apply in full force in an unincorporated territory, under this doctrine, inhabitants of unincorporated territories are nonetheless entitled to “guaranties of certain fundamental personal rights declared in the Constitution.”<sup>25</sup>

One of the more not-so-subtle implications of this doctrine is that USVI native-born inhabitants are not constitutionally entitled to U.S. citizenship. Nonetheless, Congress has seen fit to statutorily extend that status upon native-born USVI inhabitants under its authority over naturalization found in Article I of the Constitution. One of the more subtle implications, however, is the fact that while Congress has installed a United States District Court in the USVI, that court is technically an article 4—not an article 3—court.<sup>26</sup> Technical distinctions such as these can have significant, and often difficult-to-see, implications on legal proceedings—particularly when complex substantive rules such as the CFC regime or procedural provisions such as those contained in TEFRA come into the picture.

## The Mirror System

It was against this historical and political backdrop that the income tax laws of the USVI evolved. Their evolution was an outgrowth of policy concerns and considerations unique to the islands.

The USVI tax regime operates within the so-called “mirror tax” system.<sup>27</sup> Under that system, Congress made the Internal Revenue Code applicable to the USVI, though it is read with modification: The phrase

“Virgin Islands” is substituted for “United States,” and vice versa, except where to do so would be manifestly incompatible with such a separate tax structure.<sup>28</sup> Proceeds from the “mirror” laws are to be paid into the treasury of the USVI rather than the U.S. treasury.<sup>29</sup>

The key event in the evolution of the USVI’s mirror code system was the enactment of the Naval Appropriations Act of 1921 (“Appropriations Act”). The U.S. Navy, largely concerned with fostering investment in the islands’ infrastructure to help make it into a viable naval port, was an animating force behind the act.<sup>30</sup> The congressionally stated purpose behind the act, however, was to assist the islands

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in becoming self-supporting.<sup>31</sup> The Appropriations Act recognized the USVI as a distinct tax jurisdiction and established the “mirror code” that largely remains in use to this day. In doing so, Congress provided that the income tax laws of the United States would also constitute the income tax laws of the USVI (with the terms interchanged) and that taxes imposed under these laws were payable to the treasury of the USVI.<sup>32</sup>

Despite the 1921 statute, however, the IRS did not immediately implement the mirror system that it envisioned.<sup>33</sup> Instead, it treated the USVI not as a distinct tax jurisdiction, but as a “collection district” for United States taxes, requiring that taxpayers with ties to both file only one return.<sup>34</sup> The return was to be filed in either the United States or USVI, dependent on where the taxpayer resided on the final day of the tax year.<sup>35</sup>

It was not until 1935 that the IRS actually implemented the “mirror system” contemplated by the Appropriations Act.<sup>36</sup> Treating the U.S. and USVI as two separate taxing jurisdictions, that system required some taxpayers to file two returns—one with the IRS and one with the BIR. United States citizens and domestic corporations that earned USVI-sourced income were required to file a return with the BIR and pay tax on USVI-source income, and also to file a return with the IRS and pay tax on worldwide income with an offsetting foreign tax credit for taxes paid to the USVI.<sup>37</sup>

The administration of the mirror tax system was modified and simplified in the 1950’s. The 1954 Revised Organic Act of the Virgin Islands provided that permanent residents of the USVI could satisfy their U.S.

income tax obligations by paying income tax on worldwide income to the BIR.<sup>38</sup> The USVI's Legislature was left free to determine how such taxes would be spent.

The mirror tax system was again modified by the Tax Reform Act of 1986, which enacted section 932 of the Code. Although subsequently modified in certain respects, section 932 provided the basic current framework for determining the tax filing and liability obligations of USVI taxpayers. It drew a distinction between individuals who were “bona fide” residents of the Virgin Islands “at the close of the taxable year,” and those that were not. Bona fide residents of the Virgin Islands that incurred tax obligations to both the United States and Virgin Islands could satisfy their tax reporting and payment responsibilities by filing a return with the USVI reporting worldwide income and fully paying tax to the BIR. Non-bona fide residents could not.

As part of its enactment, Congress contemplated that the BIR would provide the IRS with taxpayer information. Thus, the following year, the United States entered into an agreement with the USVI “for the exchange of information and mutual assistance with respect to taxes in order to prevent the evasion or avoidance of United States or Virgin Islands taxes.”<sup>39</sup> That agreement provided that the USVI would “routinely supply” the United States with “information about any taxpayer subject to Virgin Islands tax with non-Virgin Islands source income who files an income tax return with the Virgin Islands claiming for the first time to be a Virgin Islands resident.”<sup>40</sup>

In 2004, Section 932 was amended, removing the “at the close of the taxable year” provision and replacing it with the phrase, “during the entire taxable year”<sup>41</sup>—a notable change. The amendments also replaced the facts-and-circumstances residency test and implemented a new, multi-prong test for residence that, among other things, required that the taxpayer be present in the USVI for at least 183 days of the tax year, not have a tax home outside the USVI, and not have a closer connection to a U.S. state than to the USVI.<sup>42</sup> The term “bona fide resident of the Virgin Islands,” however, was not defined by the IRC.<sup>43</sup>

## Economic Development Program

In an effort to promote economic development and investment in the USVI, Congress authorized the Virgin Islands government to extend income tax benefits under the Mirror Code to qualifying investors. The

USVI is authorized to allow such benefits on certain income from USVI sources and income effectively connected with the USVI. Currently, the USVI implements this authority through the EDP, a program that largely finds its roots in the 1950s and 60s.

In 1957, the USVI enacted legislation designed to attract new business enterprises to the islands by providing qualifying taxpayers with a nontaxable subsidy equal to 75-percent of the income paid to the USVI's Treasury.<sup>44</sup> Without prior congressional authorization, however, the USVI basically jumped the gun by enacting this legislation and had to wait for Congressional approval to implement the subsidy; but Congress largely ratified the USVI's efforts in 1960.<sup>45</sup> However, harboring concerns that the Virgin Islands legislature sought to extend benefits “to the tax attributable both to income from sources within the Virgin Islands and from sources within the United States,” Congress amended Section 934 of the Code to restrict the scope of any tax benefits that the USVI might extend.<sup>46</sup> In doing so, it grafted a number of conditions into Section 934 that a taxpayer was required to satisfy in order to take advantage of any tax benefits the USVI might subsequently adopt.<sup>47</sup> The USVI took Congress up on this “invitation” and thereafter created several investment incentives, most notably an initiative originally known as the Virgin Islands Industrial Development Program.<sup>48</sup>

The program was, for the most part, historically limited to the hotel, tourism and manufacturing sectors.<sup>49</sup> However, with the advent of technology and extension of telecommunications infrastructure into the USVI in the 1990's and 2000's, along with certain benefits extended under the Tax Reform Act of 1986, the islands began attracting businesses engaged in various financial services industries.<sup>50</sup> This shift in economic infrastructure laid the groundwork for an extension of tax benefits to service-oriented businesses to help foster these budding industries.

In 2001, the program was given a face lift and renamed the Economic Development Program. The revamped program consolidated several initiatives and was the product of an effort to diversify the USVI's economy and spur development in a wider array of economic sectors, particularly the information-based service sector. Benefits were extended to “service businesses” such as “investment managers,” “business and management consultants,” and “any other businesses serving clients located outside the Virgin Islands.”<sup>51</sup>

Under the EDP, the USVI granted qualifying businesses a 90-percent reduction of income tax owed to the USVI<sup>52</sup>—resulting in an effective tax rate of approximately four-percent on qualifying income. Qualifying taxpayers also received an exemption from USVI property tax,<sup>53</sup> gross receipts tax,<sup>54</sup> and reductions in certain customs duties<sup>55</sup> and excise taxes.<sup>56</sup> To qualify, taxpayers were required to make sizeable capital investments in the USVI and provide full-time employment to a specified number of USVI residents.<sup>57</sup> As part of this employment, EDP beneficiaries were required to provide retirement pension plans and employee welfare benefits, including medical insurance, vacation, and sick leave to its USVI employees, as well as to use USVI service providers to administer these plans and benefits.<sup>58</sup>

The program was quite successful. A 2005 study conducted by PricewaterhouseCoopers recognized that the reorganized program, through its skillful use of tax incentives, had attracted a number of new businesses that had led to the creation of at least 3,000 new jobs by the end of 2004 alone.<sup>59</sup> These jobs translated into approximately \$150 million in total direct and indirect wages and benefits.<sup>60</sup> Program beneficiaries, the study concluded, accounted for almost twenty percent of the USVI government's total revenues during 2004.<sup>61</sup>

This success, however, led the IRS to question whether EDP participants were abusing the tax credit. Prompted by such concerns, the IRS began aggressively auditing many, if not most, program participants.<sup>62</sup> In its effort to combat the perceived abuse, the IRS adopted a controversial and hard-line stance on a very critical issue—the statute of limitations. Its position was that for certain tax years, the statute of limitations that generally prohibits the IRS from assessing tax more than three years after a return is filed remains open with respect to taxpayers that claimed to be bona fide residents of the Virgin Islands and who, consistent with that position, filed returns with only the BIR. Such taxpayers are effectively treated as though they never filed a return at all. Put bluntly, this policy undermines the congressional authority given to the USVI government to implement tax-incentive policies, as well as the ability of the EDP to accomplish its goals of fostering economic development and diversification—goals that, it should not be forgotten, ultimately benefit the United States.

## Statute of Limitations

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The IRS's current position is that, for tax years ending on or *after* December 31, 2006, filing an USVI Form 1040 with the BIR sets the statute of limitations running. For tax years ending *before* that date, however, whether a BIR-filed Form 1040 triggers the limitations period hinges on the taxpayer's income level. Taxpayers with less than \$75,000 of gross income can set the section 6501(a) period running by filing a Form 1040 with the BIR. Those taxpayers earning gross income above this threshold, however, cannot—they must file a return with the IRS as well. Not surprisingly, the vast majority of EDP participants surpass this threshold, rendering it relatively meaningless.

The IRS's position is controversial. It seems to undercut the very goal of the tax incentive legislation, a fact not lost on the Taxpayer Advocate's Office, which addressed this point in its 2009 Report to Congress:

[T]he IRS has singled out a small group of USVI taxpayers for special treatment – the very types of high income taxpayers that federal tax incentives [we]re seeking to attract to the USVI – by effectively eliminating the [statute of limitations] applicable to them but not the [statute of limitations] applicable to other similarly situated taxpayers.<sup>63</sup>

Evidently recognizing that the \$75,000 monetary threshold on which the application of the statute of limitations hinges seems a bit arbitrary, the Taxpayer Advocate went on to conclude that the IRS's position:

sends the message that the IRS might arbitrarily eliminate the benefit of any SOL by singling out those who take advantage of legitimate tax incentives<sup>64</sup> [and that] ... the IRS ha[d], without legislation, upset longstanding expectations by singling out for special treatment those taxpayers with gross incomes of more than \$75,000 who are claiming USVI residency.<sup>65</sup>

Throughout the years, the IRS's position on this issue has been anything but stagnant; it has gone through several iterations, which, in a sense, serves to underscore the arbitrary nature of its position. Prior to the 1986 Tax Reform Act, a U.S. citizen who was an inhabitant of the VI could satisfy his or her U.S. tax obligations by filing an income tax return with the VI and start the limitations period.<sup>66</sup> According to

the IRS, however, this “single-filing procedure [known as the VI inhabitant rule] was prescribed in the Revised Organic Act of the VI,” but “was retroactively repealed by ... the Tax Reform Act of 1986.”<sup>67</sup> “[T]he requirement that a US citizen file a return with the IRS that reports his worldwide income was made to supersede the VI inhabitant rule... ”<sup>68</sup>

In 1992, following the Third Circuit’s decision in *Danbury, Inc. v. Olive*, 820 F.2d 618 (1987), in which it held that the U.S. limitations period indeed began running upon the filing of a Virgin Islands’ return, the IRS issued a Field Service Advice Memorandum disagreeing with the court and setting forth its position on the issue.<sup>69</sup> The IRS made it clear that, in its view, simply filing a return with the USVI was not sufficient to set the 6501(a) limitations period running. “[T]he requirement that a US citizen file a return with the IRS that reports his worldwide income was,” again in the view of the IRS, “made to supersede the VI Inhabitant Rule.”<sup>70</sup>

Not long thereafter, however, the IRS issued another memorandum reaching a conclusion that seemed to conflict with this position.<sup>71</sup> In a 1999 Field Service Advice Memorandum, the IRS concluded that “[s]ince more than three years ha[d] passed since the taxpayer filed a USVI return ... the IRS [could] not assess additional tax, despite that [the taxpayer] failed to report on that return gross income from U.S. sources... ”<sup>72</sup> “Therefore,” the memorandum concluded, “the limitation period imposed by Code section 6501(a) ha[d] expired, unless an exception [was] appli[cable].”<sup>73</sup>

Several years later, however, the IRS again pulled an about-face. In 2006, it issued a Chief Counsel Advice Memorandum, concluding that if an “individual claims to be a bona fide resident of the USVI but fails to meet a condition under 26 U.S.C. § 932(c)(4), he or she must file a Form 1040 with the IRS” as well as with the USVI.<sup>74</sup> Merely filing a return with the BIR would not suffice to set the limitations period running.<sup>75</sup>

In 2007, the IRS added an interesting element into the analysis. In Notice 2007-19, the IRS advised that now the applicability of the statute of limitations would hinge on the taxpayer’s income level.<sup>76</sup> An income tax return filed by a U.S. citizen

with the BIR would trigger the statute of limitations, provided the taxpayer met the definition of a “covered person.”<sup>77</sup> A “covered person” was defined as a “U.S. citizen or resident alien who t[ook] the position that he or she [wa]s a bona fide resident of the U.S. Virgin Islands, file[d] a USVI Form 1040 with the U.S. Virgin Islands, and ha[d] less than \$75,000 of gross income for the taxable year.”<sup>78</sup>

The following month, the IRS once again veered slightly off course, issuing another Notice amending and supplementing Notice 2007-19. For tax

years ending on or after December 31, 2006, the IRS announced, an income tax return filed by an individual with the BIR would indeed trigger the statute of limitations.<sup>79</sup> The Notice did not, however, affect returns for prior tax years.<sup>80</sup> Those prior years would become the subject of much of the ongoing litigation in this area.

As this “concise” background illustrates, the USVI statute-of-limitations issue implicates a number of complex considerations, many of which cannot be laid out in a digestible format here and therefore, by default, find themselves beyond the scope of this article. There are clearly competing views on where the law should come down on this issue, none of which are without proponents or support. The real rub with the IRS’s current position, however, lies in its egregiousness: Many of the challenges to EDP beneficiaries languished for years and are just now—some eight, nine, even ten or more years later—coming to fruition in the form of proposed assessments, long after many such taxpayers had settled into a lull of repose.

This seems, at the very least, inconsistent with the purposes Courts have identified behind statutes of limitation. Such statutes, it is said, are primarily designed to assure fairness to defendants and promote justice by preventing unfair surprises years after the fact—after evidence has been lost, memories have faded, and witnesses have disappeared.<sup>81</sup> In time, the right to be free from stale claims simply comes to prevail over the right to prosecute them.<sup>82</sup> The Supreme Court, early in the nation’s history, offered an insightful and instruc-

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tive commentary in this regard, the sentiment of which, even though expressed in a different context, rings true some 200-plus years later: “In a country where not even treason can be prosecuted after a lapse of three years, it could scarcely be supposed that an individual would remain forever liable for a pecuniary forfeiture.”<sup>83</sup>

Applying the statute of limitations in the income-tax-specific context, the court thereafter recognized that, as a matter of policy:

It probably would be all but intolerable ... to have an income tax system under which there never would come a day of final settlement and which required both the taxpayer and the Government to stand ready forever and a day to produce vouchers, prove events, establish values and recall details of all that goes into an income tax contest.<sup>84</sup>

Indeed, “a statute of limitation is an almost indispensable element of fairness as well as of practical administration of an income tax policy.”<sup>85</sup> While such statutes “are by definition arbitrary,”<sup>86</sup> they are all but necessary to administering our complex tax system. “As statutes of limitation are applied in the field of taxation, the taxpayer sometimes gets advantages and at other times the Government gets them”<sup>87</sup>—those are the breaks.

Beyond its seeming inconsistency with the purpose of a statute of limitations, the IRS’s position is particularly troublesome for other reasons as well. During the periods at issue, the IRS Form 1040 instructed Virgin Islands residents to file their Forms 1040 with the BIR, in part because the United States and USVI were parties to a Tax Implementation Agreement and agreement to share taxpayer information. What is more, many taxpayers filed

Forms 8822 or 8898 directly with the IRS notifying it that they were changing addresses and/or taking the position that they were a bona fide resident of the Virgin Islands. In light of these factors, it is difficult to support the notion that the IRS was not, at least constructively, on notice of such taxpayers’ position or that such taxpayers were attempting to keep this information from the IRS. On balance, it seems that the legal, equitable and policy factors at play come down in favor of applying the three-year period of limitations in the absence of fraud or some other exception.<sup>88</sup>

## Conclusion

The outcome remains to be seen. In the end, if the IRS gets its way, many disaffected taxpayers may very well find themselves nodding to a familiar refrain: No good deed does in fact go unpunished. Their investments in the USVI, which helped to further the congressional goals of infusing the Virgin Islands economy and increasing its fiscal autonomy, may have been commendable on several levels. Certainly, VI inhabitants saw real, tangible benefits from them. However, the investments were, of course, not purely altruistic. They were made with an expectation, usually in good faith, of receiving corresponding tax benefits. That is, Congress did not rely upon the awesome power of wishful thinking to bring about these capital infusions; they were Tax Code driven investments prompted by congressionally sanctioned incentives. While taxpayer compliance with the often vague, ambiguous and changing technical provisions governing their qualification for the benefits may be an area for legitimate disputes, putting those types of disputes to bed after the passage of many years is precisely the point of a statute of limitations.

## ENDNOTES

<sup>1</sup> See [http://www.statemaster.com/graph/eco\\_gdp\\_percap-product-current-dollars-per-capita](http://www.statemaster.com/graph/eco_gdp_percap-product-current-dollars-per-capita), last accessed March 3, 2012.  
<sup>2</sup> 29 V.I.C. § 713b(b).  
<sup>3</sup> Roberts, Marjorie Rawls, *U.S. Virgin Islands Enacts Expanded Tax Incentives for Businesses Owned by Long-Term Residents*, 2001 WTD 113-13 (2001).  
<sup>4</sup> Feb. 1, 2001 Act of Virgin Islands Legislature, No. 6390, §§ 1, 4, 11, Sess. L. 2000, p. 402, 404, 407. 29 V.I.C. § 708(a).  
<sup>5</sup> *Appleton*, Tax Court No. 7717-10, Mot. Of the Gov’t of the United States Virgin Islands

to Intervene and Mem. In Supp. Of Intervention, pp. 4-5 (filed June 18, 2010).  
<sup>6</sup> *Id.* at 5.  
<sup>7</sup> Schumann, Paul, *U.S. Virgin Islands Economic Development Program and the Internal Revenue Code: Happy Together*, 15 JITAX 34, 36 (2004).  
<sup>8</sup> *Id.* at 37.  
<sup>9</sup> Notice 2004-45, 2004-2 CB 33 (June 24, 2004).  
<sup>10</sup> *Id.*  
<sup>11</sup> *G.C. Huff*, 135 TC 222, 226-27, Dec. 58,309, n. 1 (2010).  
<sup>12</sup> See e.g., Code Sec. 937(c)(1), (2); IRS Forms

8822 and 8898.  
<sup>13</sup> See *Danbury, Inc. v. Olive*, CA-3, 87-1 ustrc ¶ 9349, 820 F2d 618, 622.  
<sup>14</sup> Roberts, Marjorie Rawls, *The U.S. Virgin Islands’ Economic Development Program*, IFC Review 2011.  
<sup>15</sup> *Danbury, Inc. v. Olive*, CA-3, 87-1 ustrc ¶ 9349, 820 F2d 618, 622.  
<sup>16</sup> Roberts, Marjorie Rawls, *The U.S. Virgin Islands’ Economic Development Program*, IFC Review 2011.  
<sup>17</sup> Code Sec. 932(a).  
<sup>18</sup> Code Sec. 932(b).

## ENDNOTES

- <sup>19</sup> Code Sec. 932(c).
- <sup>20</sup> See *id.*
- <sup>21</sup> *New York ex rel. Kopel v. Bingham*, 211 US 468, 475 (1909) (quoting *In re Lane*, 135 US 443, 447 (1890)).
- <sup>22</sup> US CONST. art. IV, § 3, cl. 2.
- <sup>23</sup> Ciolli, Anthony, *The Power of United States Territories to Tax Interstate and Foreign Commerce: Why the Commerce and Import-Export Clauses Do Not Apply*, 63 TAX LAW 1223, 1233 (2010).
- <sup>24</sup> *Torres v. Puerto Rico*, 442 US 465, 469 (1979).
- <sup>25</sup> *Balzac v. Porto Rico*, 258 US 298, 312-13 (1922).
- <sup>26</sup> *Id.* at 312; see also *Glidden Co. v. Zdanok*, 370 US 530 (1962).
- <sup>27</sup> 48 USC. § 1397.
- <sup>28</sup> E.g., *Danbury v. Olive*, CA-3, 87-1 USTC ¶9349, 820 F2d 618, 622.
- <sup>29</sup> 48 USC § 1397.
- <sup>30</sup> *Historical Perspective—Origins of USVI Tax Incentives and Federal Support (Excerpted from V.I. Public Services Commission Docket 578 (2008))*, available at <http://www.uvirt-park.com/assets/Origins-of-USVI-Tax-Incentives.pdf> (last visited on Mar. 3, 2012).
- <sup>31</sup> *HMW Industries, Inc. v. Wheatley*, CA-3, 74-2 USTC ¶9726, 504 F2d 146, 150; *G.H. Dudley*, CA-3, 58-2 USTC ¶9749, 258 F2d 182, 185 (1958).
- <sup>32</sup> *Danbury v. Olive*, CA-3, 87-1 USTC ¶9349, 820 F2d 618, 622.
- <sup>33</sup> *Id.* at 621.
- <sup>34</sup> *Id.*
- <sup>35</sup> See I.T. 1454, I-2 C.B. 180 (1922), *revoked* by I.T. 2946, XIV-2 C.B. 109 (1935).
- <sup>36</sup> *Danbury*, 820 F2d, at 621.
- <sup>37</sup> *Id.*
- <sup>38</sup> Revised Organic Act of the Virgin Islands, ch. 558, §28(a), 68 Stat. 508 (1954) (codified as amended at 48 USC. § 1642).
- <sup>39</sup> Tax Implementation Agreement Between the United States of America and the Virgin Islands, p. 1 Feb. 24, 1987, 1989-1 C.B. 347.
- <sup>40</sup> *Id.* at art. 4, Section 2(b)(iii).
- <sup>41</sup> American Jobs Creation Act of 2004 (P.L. 108-357) Act Sec. 908(c)(2).
- <sup>42</sup> *Id.*, Act Sec. 908(a).
- <sup>43</sup> *Huff*, 135 TC 222, 226 (2010).
- <sup>44</sup> *HMW Industries, Inc. v. Wheatley*, CA-3, 74-2 USTC ¶9726, 504 F2d 146, 150-51 (citing Act No. 224, Virgin Islands Sessions Laws (1957)).
- <sup>45</sup> *Id.*; *Historical Perspective—Origins of USVI Tax Incentives and Federal Support (Excerpted from V.I. Public Services Commission Docket 578 (2008))*, available at <http://www.uvirt-park.com/assets/Origins-of-USVI-Tax-Incentives.pdf> (last visited on Mar. 3, 2012).
- <sup>46</sup> *HMW Industries, Inc. v. Wheatley*, CA-3, 74-2 USTC ¶9726, 504 F2d 146, 151.
- <sup>47</sup> *Id.*
- <sup>48</sup> *Id.*
- <sup>49</sup> Roberts, Marjorie Rawls, *The US Virgin Islands' Economic Development Program*, IFC Review 2011.
- <sup>50</sup> *Id.*
- <sup>51</sup> Feb. 1, 2001 Act of Virgin Islands Legislature, No. 6390, §§ 1, 4, 11, Sess. L. 2000, p. 402, 404, 407. 29 V.I.C. § 708(a).
- <sup>52</sup> 29 V.I.C. § 713b(b).
- <sup>53</sup> 29 V.I.C. § 713a(a)(1).
- <sup>54</sup> 29 V.I.C. § 713a(a)(2).
- <sup>55</sup> 29 V.I.C. § 713c.
- <sup>56</sup> 29 V.I.C. § 713a(3).
- <sup>57</sup> Roberts, Marjorie Rawls, *US Virgin Islands Expands Tax Benefits Under Economic Development Program*, 2002 WTD 197-1, *Worldwide Tax Daily* (Oct. 8, 2002).
- <sup>58</sup> *Id.*
- <sup>59</sup> *Appleton*, Tax Court No. 7717-10, Mot. Of the Gov't of the United States Virgin Islands to Intervene and Mem. In Supp. Of Intervention, pp. 4-5 (filed June 18, 2010).
- <sup>60</sup> *Id.*
- <sup>61</sup> *Id.*, at 5.
- <sup>62</sup> *Id.*
- <sup>63</sup> Taxpayer Advocate Service, 2009 Annual Report to Congress, Vol. I, Legislative Recommendation No. 10 at 391-92.
- <sup>64</sup> *Id.*, at 392.
- <sup>65</sup> *Id.*, at 397.
- <sup>66</sup> Field Service Advice 1992 WL 1354833 (July 21, 1992).
- <sup>67</sup> *Id.*
- <sup>68</sup> *Id.*
- <sup>69</sup> *Id.*
- <sup>70</sup> *Id.*
- <sup>71</sup> FSA 199906031 (Dec. 18, 1998).
- <sup>72</sup> *Id.*
- <sup>73</sup> *Id.*
- <sup>74</sup> CCA 200624002 (Feb. 16, 2005).
- <sup>75</sup> *Id.*
- <sup>76</sup> Notice 2007-19, 2007 IRB 689 (Feb. 21, 2007).
- <sup>77</sup> *Id.*
- <sup>78</sup> *Id.*
- <sup>79</sup> Notice 2007-31, 2007-16 IRB 971 (Mar. 30, 2007).
- <sup>80</sup> *Id.*
- <sup>81</sup> *Burnett v. N.Y. Cent. R.R. Co.*, 380 US 424, 428 (1965).
- <sup>82</sup> *Id.*
- <sup>83</sup> *Adams v. Woods*, 6 US (2 Cranch) 336, 342 (1805).
- <sup>84</sup> *Rothensies v. Electric Storage Battery Co.*, 329 US 296, 301 (1946).
- <sup>85</sup> *Id.*
- <sup>86</sup> *Id.* (citing *Chase Securities Corp. v. Donaldson*, 325 US 304, 314 (1945)).
- <sup>87</sup> *Id.* at 302 (1946).
- <sup>88</sup> It should be noted that as this article went to press, the United States Tax Court issued an opinion in *G.C. Huff*, 138 TC–, No. 11 (2012) that touched on issues potentially relevant to the statute of limitations analysis. While that decision did not address the statute of limitations issue directly, as recently noted by Josh O. Ungerman, a name partner and tax attorney at Meadows, Collier, Reed, Cousins, Crouch & Ungerman LLP in Dallas, Texas, the decision potentially “lays the groundwork for the Tax Court to disregard statute of limitations protections to taxpayers who filed in the U.S.V.I. in good faith pursuant to a U.S. federal government jobs program....” Jeremiah Coder, *Deficiency Notice to U.S.V.I. Resident Is Valid, Tax Court Holds*, Taxanalysts Doc. 2012-5752. The ramifications of the decision remain to be seen.

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