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Memorandum

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From: Barry J. Hart
Peter Hiebert

Date: May 12, 2006

Re: U.S. Virgin Islands: eCommerce Activities

Background. At our April 7, 2006 meeting, we discussed certain business models representing various sectors in the U.S. Virgin Islands Economic Development Commission (“EDC”) Program, *i.e.*, (i) the U.S.V.I. Research and Technology Park (“R&T Park”), (ii) the U.S.V.I. Insurance/Reinsurance Sector, and (iii) U.S.V.I. Financing Company Sector.

Towards the close of our meeting Mr. Fields, representing the R&T Park, advised you of the need for urgent Treasury/IRS published guidance to “clarify” that income from certain proposed eCommerce activities to be conducted in the R&T Park would be V.I. source income within the meaning of Temp. Reg. § 1.937-2T(b). You advised that Treasury/IRS would be amenable to considering the issuance of published guidance, and suggested we submit a memorandum in support of such a proposed clarification.

Please find attached a memorandum prepared by DLA Piper Rudnick Gray Cary, counsel to the R&T Park, providing three (3) examples of eCommerce business models, two (2) involving sales of eCommerce goods (Examples 1 and 2), and one (1) involving the performance of eCommerce services (Example 3). The Government of the Virgin Islands (“GVI”) believes the eCommerce income of each model qualifies as wholly V.I. source income.

A. eCommerce Sales Income. While the principles of Section 861 through 865 should produce only V.I. source income in both Examples 1 and 2, the R&T Park has encountered significant U.S. business concerns that such outcome is unclear. The GVI therefore supports the R&T Park’s requested clarification of the source rules for eCommerce sales income.

GVI REQUEST: Confirmation, by way of one or more examples in the Section 937(b) regulations, that income from the sale of eCommerce goods produced in the Virgin Islands, as set forth in the examples in the attached memorandum, is wholly V.I. source income, and hence not subject to the U.S. income rules of Temp. Reg. § 1.937-2T(c)(1).

Such confirmation, the GVI submits, is suitable for a Notice or other published guidance on a time-urgent basis, and need not await the promulgation of final regulations under Section 937(b).

NB. Examples 1 and 2 assume that a sale of a copyrighted article, as defined in Reg. § 1.861-18, has occurred. The GVI understands that Treasury/IRS may not consider the determination of whether a transaction constitutes a sale for Reg. § 1.861-18 purposes germane to the Section 937(b) regulations, and therefore suggests the Section 937(b) regulations simply cross-reference Reg. § 1.861-18 and decisional law for this determination, as the attached Examples 1 and 2 provide. See, e.g., Temp. Reg. § 1.937-3T(e) Example 1. See also Notice 2005-14, § 3.04(7)(a), (d) regarding a similar Reg. § 1.861-18 cross reference relating to computer software under Section 199.

B. eCommerce Services Income. In addition, the attached memorandum provides in Example 3 the business model of an “application service provider” (“ASP”). The GVI believes the eCommerce services income provided by the ASP qualifies as wholly V.I. source income. As with the U.S. business response to the business models set forth in the R&T Parks’ Examples 1 and 2, however, U.S. businesses which are ASP’s have expressed concern that this outcome is not entirely clear.

GVI REQUEST: Confirmation, by way of an example in the Section 937(b) regulations, that income from the performance by an ASP of eCommerce services within the Virgin Islands, as set forth in the example in the attached memorandum, is wholly V.I. source income, and hence not subject to the U.S. income rule of Temp. Reg. § 1.937-2T(c).

Such confirmation, the GVI submits, is suitable for a Notice or other published guidance on a time-urgent basis, and need not await the promulgation of final regulations under Section 937(b).

Conclusion: The GVI's support of the R&T Park request for the above published Treasury/IRS guidance is without prejudice to the GVI's longstanding position that special sourcing and "effectively connected" Section 937(b) regulations are necessary to give effect to the Congressional two-pronged intent to promote V.I. fiscal autonomy through the EDC Program and prevent U.S. tax avoidance or evasion. The GVI position is more fully set forth in its formal submission in connection with the July 21, 2005 IRS hearing on the Temporary and Proposed Possessions Regulations.

The GVI looks forward to continuing to work collaboratively with the Treasury and IRS to achieve timely, fair and administrable rules consistent with Congressional intent.



MEMORANDUM

TO: U.S. Treasury Department
Internal Revenue Service

FROM: Eric Ryan

DATE: May 12, 2006

RE: **Request for IRS Notice of Clarification relating to eCommerce business models operating in the U.S. Territories**

I. Executive Summary

This memorandum has been prepared to provide the U.S. Treasury and Internal Revenue Service ("IRS") with justification to issue a notice of clarification of existing law and regulation. The following are specific examples, to be issued by the IRS in the form of a Notice or equivalent rulemaking, which demonstrate some common factual situations for United States Virgin Islands ("USVI") companies selling eCommerce products or providing services qualifying for income tax benefits under existing USVI programs, consistent with IRC section 937(b) and the existing Temporary and Proposed Regulations ("Regulations") there under.

The Regulations under IRC section 937(b) have provided general rules for sourcing, and a narrow exception for certain sales income from manufactured inventory property. Unfortunately, there are no examples in the Regulations which demonstrate a USVI trade or business continuing to qualify for tax benefits under established USVI programs, or of the exception. This is of significant importance to the creation of an eCommerce business sector in the USVI. Organizations such as the U.S. Virgin Islands' University of the Virgin Islands' Research and Technology Park ("R&T Park") have been created to take advantage of core assets of the USVI for global eCommerce. A central goal of the research and technology park is to stimulate social and economic development in the territory through small business job creation and workforce development. The combination of U.S. law for intellectual property protection, significant broadband accessibility and tax advantages have attracted the interest of companies to operate eCommerce from the R&T Park.

Although the nature of the eCommerce business models planned to be implemented in USVI should be acceptable under the Regulations, the uncertainty and complexity of these intricate tax rules, coupled with a wide array of both government notices and press reports, have created a negative view of the USVI tax policies as it relates to U.S. Treasury policy. Even though the current eCommerce strategy is solely focused on income from sales and services sourced in the USVI, and isn't affected by residency and

royalty source income issues, the current environment has made it virtually impossible to attract eCommerce business interests to the USVI without published clarification.

Accordingly, what is immediately needed for the Treasury or IRS to provide, such as by way of an IRS Notice, some positive examples of allowable business models which will qualify under a proper interpretation of the sourcing rules of IRC section 937(b). Our examples are focused on sales and services business models, and where relevant, transactions with related parties employ the arm's length standard of IRC section 482. Of course, companies will still have to qualify for USVI tax benefits based on sound accounting principles and specific USVI economic development requirements, such as training programs, hiring plans, local banking and use of local support services. Based upon our understanding, we believe the positive results in our examples do not create any new exceptions to the Regulations. This should not be interpreted, however, as any sort of belief or statement that further, substantial revisions to the existing Regulations are not warranted.

II. Examples Requested

Example 1

Business Model: Z, a USVI corporation, has its sole office and business in the USVI. Z's engineers develop business software. Z's marketing personnel occasionally travel to various cities in the U.S. to arrange for U.S. companies to carry Z's advertising. Z's personnel do not solicit or conclude contracts with any customers in the U.S. Z receives orders from consumers in the U.S. and around the world. Z's contract with its customers is entitled "End User Software License," which provides that the customer has the perpetual right to use the product, may make a back-up copy only, and that the customer has no right to further duplicate and sell copies of the software, which is copyrighted. All of the other terms and conditions of Z's arrangement with its customer are also consistent with a determination under Treas. Reg. sec. 1.861-18 that the transaction will be considered a sale of a copyrighted article. The contract also provides that title will pass to the products at the point where Z ships the products from its USVI site. After orders are accepted, Z's software is shipped either by:

1. Transmitting it from Z's servers located in the USVI directly to the customer; or
2. Loading it onto compact discs at USVI's facility, which then are shipped to the customer via common carrier.

Analysis: Under the principles of IRC section 864(c), Z has an office or fixed place of business in the USVI, and does not have an office or fixed place of business in the U.S. Z's business consists of sales income of copyrighted articles. Since title passes to the goods in the USVI, under the principles of IRC section 861 (a)(6) and IRC section 862(a)(6), Z's sales income is sourced to the USVI, and it will not be subject to the U.S. income rule of Treas. Reg. sec. 1.937-2T(c).

Example 2

Business Model: Assume the same facts as Example 1, except that in this case USVI corporation Y develops music videos for sale on compact discs or downloadable from the internet. Similar to Example 1, Y passes title to the goods in the USVI, and Y does not have any office or fixed place of business in the U.S. Y's artists and engineers perform substantial development activity at Y's USVI facility. However, Y must license some of the copyrights to various pieces of content from unrelated artists worldwide and from A, Y's U.S. parent corporation, for which Y pays arm's length consideration under IRC section 482. A does not assist in the sales activities of Y.

Analysis: Similar to Example 1, Y recognizes sales income of copyrighted articles. The mere fact that Y is wholly owned by A, a U.S. corporation, does not alter the analysis of example 1. Nor does the fact that Y pays a U.S. company for copyrights used in the development of Y's product. Since title passes to the

products in the USVI, Y's sales income is sourced to the USVI is sourced to the USVI, and it will not be subject to the U.S. income rule of Treas. Reg. sec. 1.937-2T(c).

Example 3

Business Model: V, a USVI corporation whose sole office and business is located in the USVI, employs a business model generally referred to as an "application service provider." V's employees develop computer software which is resident on V's servers in the USVI. V's software allows V's customers to keep track of their relationships with their own customers. V's customers transmit detailed data about their own customers to V's servers and other electronic storage facilities in the USVI. V's customers pay a monthly fee under V's "Subscription Agreement," and they can use the software at any time; however, V's customers do not receive a copy of the software. V's customers receive reports on a periodic basis via the internet, and they can also request special reports by interfacing with V's software via the internet. All such reports are generated by V's software and electronic storage facilities in the USVI.

Analysis: Under the principles of Treas. Reg. 1.861-18 and IRC section 7701 (e), V's business consists of services income. In this case, the essence of the service is the creation of periodic and special reports, which occurs in the USVI. The inputting of data by the customer and the receipt of the reports by the customer in the U.S. are not services performed by V. Accordingly, under the principles of IRC section 861(a)(3) and 862(a)(3), all of V's income will be sourced to the USVI, and it will not be subject to the U.S. income rule of Treas. Reg. sec. 1.937-2T(c).

III. Summary

The clarification of these sourcing rules for eCommerce has the potential of creating significant new employment within the USVI. Currently these jobs are going to non-U.S. countries that have favorable tax policies for eCommerce, such as Ireland, Qatar and India. However, even though companies can receive significant tax breaks in these jurisdictions, locating eCommerce off-shore can create compelling problems, such as:

- Legal rights management of their intellectual property in foreign jurisdictions.
- Different accounting rules and standards than the U.S.
- Capacity issues for significant telecommunications bandwidth for global eCommerce.

The USVI has the assets to compete with foreign locations on these issues, if we are able to clarify the tax code. This represents an opportunity to bring some of those positions back under the U.S. flag through operations such as the R&T Park. The R&T Park will be able to emerge as a global center for eCommerce and technology with a focus on providing an enabling environment for research and development, business incubation and technology-driven businesses.

Thank you for your consideration.