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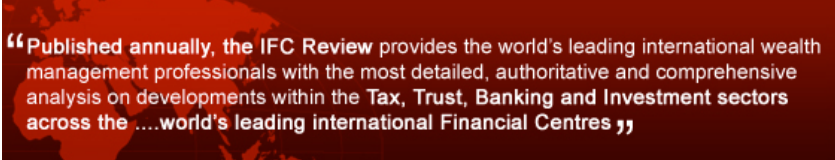
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Article



The USVI: Economic Incentives for Knowledge-Based Businesses

By Marjorie Rawls Roberts and Johanna Harrington, Marjorie Rawls Roberts PC, St. Thomas, USVI* (01/05/2011)

The US Virgin Islands (USVI), an unincorporated territory of the United States, offers targeted tax incentives to attract technology and other knowledge-based businesses to establish and carry-out their operations in the territory. These tax incentives are administered by the Research and Technology Park Protected Cell Corporation (RTPark-PC), a public corporation and an autonomous instrumentality of the USVI Government.

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

USVI Legal Requirements for Tax Incentives

Background

The USVI has had several economic development programs providing tax benefits to targeted types of businesses spanning more than 50 years. Recently, the USVI has focused on attracting knowledge-based businesses. In 2002, the USVI Government passed legislation creating the RTPark Corp, a public corporation and an autonomous instrumentality of the USVI government. The RTPark-PC is governed by the Board of Directors of the University of the Virgin Islands Research and Technology Park Corporation (RTPark), a separate public corporation and autonomous instrumentality of the USVI government that is the parent entity of RTPark-PC and affiliated with the University of the Virgin Islands (UVI). Businesses receiving benefits via the RTPark-PC are known as 'Protected Cells'.

A seven member Board of Directors administers the RTPark-PC. It is made up of the Chair of the UVI Board of Trustees, the President of the UVI, and two additional UVI trustees selected by their colleagues. The remaining three positions are appointed by the Governor.

Benefits

Benefits for Protected Cells include a credit equal to 90 percent of the otherwise applicable income tax, which applies to both the business receiving the benefits on income from the benefitted business and any USVI resident owners of the business on their allocations or dividends. Salaries and other forms of compensation such as guaranteed payments are fully taxable.

Protected Cells are also exempt from withholding tax on payments to US corporations, whether interest, dividends, royalties, or other types of passive income. Protected Cells with foreign corporate owners are exempt from withholding tax on interest payments and are subject to a reduced withholding tax rate of 4.4 percent on dividend and royalty payments. No income tax is payable on interest paid to nonresident alien individuals, and the withholding tax rate on dividends and royalties paid to nonresident individuals is four percent. The withholding tax is paid by the withholding agent to the Virgin Islands Bureau of Internal Revenue (BIR) on Form 8109 and then reconciled annually on Form 1042.



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Protected Cells are also exempt from the USVI gross receipts tax, which is otherwise imposed at a rate of 4.5 percent on the gross receipts of a business with no deductions. Materials and machinery used in the construction of a Protected Cell's facilities are exempt from the USVI excise tax, otherwise imposed at an effective rate of 4.2 percent on most items. Raw materials brought into the USVI by a Protected Cell to produce goods or articles are also exempt from the USVI excise tax. Protected Cells benefit from a reduction in the customs duties imposed on goods or components imported from outside the USVI or the United States – from six percent to one percent. Materials made in the United States are exempt from customs duty.

Finally, if real property is owned by the Protected Cell and used solely for the business, the Protected Cell receives an exemption from the USVI property tax. The personal homes of the owners of a Protected Cell do not receive the property tax exemption, even if the owners maintain home offices. Moreover, if a Protected Cell rents an office, the property tax exemption does not pass through to its landlord.

Requirements

Protected Cells must be a 'Knowledge-Based Business', which by definition includes an "e-Commerce Business." A 'Knowledge-Based Business' is statutorily defined to include any business that uses highly skilled or highly educated personnel and a high level of research and development to create intellectual assets and property. An 'e-Commerce Business' is defined to mean any business involving electronically based data transactions for digitally based commerce. Examples of an e-Commerce Business include web-based marketing, financial settlements, telemedicine, and electronic data interchange and other digital supply transactions.

The Protected Cell must provide the RTPark-PC with an equity interest in the Protected Cell entity. The equity interest is agreed upon between the RTPark-PC Board and the owners of the Protected Cell. Protected Cells also negotiate an initial fee to the RTPark and an ongoing payment which can be a set amount or a percentage of gross income.

Protected Cells must work closely with UVI to develop and offer such assistance and opportunities as scholarships, continuing education programs, consulting and research opportunities for faculty, guest lectures, and internship opportunities for UVI students. Such cooperation helps students gain the knowledge and training to obtain employment with technology based businesses.

An applicant for Protected Cell status must be formed under the laws of the USVI (if the applicant is an entity). If the applicant is a natural person, then the person must be a USVI resident. If the owners of the Protected Cell entity want their distributions or allocations to qualify for the available tax credit of up to 90 percent, they must be bona fide residents of the USVI. The RTPark has established strategic relationships with several e-commerce partners in the areas of co-location services and financial transaction financing so that Protected Cells have these services readily available from the commencement of operations.

Protected Cells pay franchise tax to the Office of the Lieutenant Governor with the rate depending on initial capital used in the business and the type of entity. For example, a limited liability company pays a minimum annual franchise tax of US\$300. Protected Cells are also required to pay an annual franchise tax to the Department of Finance depending on annual gross receipts.

Applying for Protected Cell status

The application process involves submission of an application and a due diligence questionnaire and the negotiation of the specific terms for benefits. The applicant's negotiations with the RTPark regarding the specific terms for benefits include the collaboration with UVI, the RTPark-PC's equity interest in the applicant's business, and the Protected Cell's additional financial commitment to the RTPark. Typically, the financial terms are finalized before the applicant proceeds with the due diligence questionnaire. The due diligence questionnaire requests biographical information on the applicant's owners, including information on prior lawsuits and arrests, and requires a US\$5,000 background check fee. No separate application fee exists for businesses seeking approval as Protected Cells as long as the applicant is represented by USVI counsel. The application process also requires an explanation of how the business will be structured, including the sources of any financing and an operating plan that includes pro-forma financial statements. Finally, each applicant must provide information regarding all bank accounts and current bank balances.

Applications are discussed and either approved or disapproved by the RTPark Board members during their periodic meetings. Although RTPark board meetings are generally open to the public, no public hearing is required for the RTPark Board

members to make a decision regarding any applicant. Once an applicant is approved by the Board, the terms of the approval are memorialised in the Protected Cell's Park Tenant Agreement.

Ongoing Program Requirements

Once approved, the Protected Cell is subject to various requirements. The RTPark will conduct annual reviews of the Protected Cell to ensure that the Protected Cell fulfills its responsibilities and obligations as set forth in the Protected Cell's Park Tenant Agreement. The Protected Cell must also provide audited financial reports on a yearly basis. Finally, Protected Cells must provide an annually updated three-year plan of operations, together with employment projections for USVI-based employees and associated skill requirements.

Benefit Periods

Benefits for Protected Cells are available for a 15-year period regardless of where the Protected Cell conducts its operations within the USVI. Benefits may generally be renewed for a period of 10 years. Subsequent renewals are for periods of five years. The renewal of benefits is subject to rules to be developed by the Board.

Federal Legal Requirements for USVI Tax Incentives

The USVI offers economic incentives to businesses under a legislative mandate granted by the US Congress. The Congressional mandate has been amended several times, most recently in the Tax Reform Act of 1986 and the American Jobs Creation Act of 2004.[i] The USVI's ongoing ability to provide incentives has greatly assisted the USVI in diversifying its economy and developing jobs for its residents. Specifically, the addition of the RTPark and its Protected Cells serves to assist UVI in providing scholarship and internship opportunities and faculty development and to assist the USVI by broadening its economic base.

The Internal Revenue Code of 1986, as amended (the "Code") applies in the USVI under a 'mirror' system whereby "the Virgin Islands" 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. USVI source income includes fees or compensation income for services provided in the USVI. Capital gains derived by a USVI business may also be eligible if certain requirements are met, although certain gains from the sale of assets contributed by a US resident who then moves to the USVI must typically be allocated. Further, certain dividend and interest income from a USVI payor is USVI source income. Finally, foreign source income earned by a Protected Cell may be effectively connected with a USVI trade or business if it consists of certain specific types of income, such as royalties or rents from intangibles or income from sales of inventory made in the USVI.

The IRS issued Notice 2006-76 on September 18, 2006, which provided examples to illustrate the application of the applicable source rules to the USVI, and specifically to the RTPark. The IRS included similar examples in Final Regulations, issued on April 4, 2008 and effective April 9, 2008, that set out rules for determining whether income is sourced in or effectively connected to a trade or business in a US possession.

The examples in Notice 2006-76 and the Final Regulations provide guidance as to the types of income that will satisfy the Federal source and effectively connected income rules and thus be eligible for benefits under the RTPark-PC program.

Example 4 in Treasury Regulation § 1.937-3(e) (which is almost identical to **Example 1** in Notice 2006-76) gives guidance on the sourcing of income from the sale of computer software:

- (i) Corporation A, a corporation organised in Possession X, is engaged in a business consisting of the development of computer software and the sale of that software. Corporation A has its sole place of business in Possession X and is not engaged in the conduct of a trade or business in the United States. Corporation A receives orders for its software from customers in the United States and around the world. After orders are accepted, Corporation A's software is either loaded onto compact discs at Corporation A's Possession X facility and shipped via common carrier, or downloaded from Corporation A's server in Possession X. The sales contract provides that the rights, title, and interest in the product will

pass from Corporation A to the customer either at Corporation A's place of business in Possession X (if shipped in compact disc form) or at Corporation A's server in Possession X (if electronically downloaded). Assume for purposes of this example that each transaction is classified as a sale of a copyrighted article under § 1.861-18(c)(1)(ii) and (f)(2).

(ii) Under the principles of section 863(a), as applied pursuant to § 1.937-2(b), because Corporation A passes the rights, title, and interest to the copyrighted articles in Possession X, Corporation A's sales income is sourced to Possession X. Corporation A's sales income is also effectively connected with the conduct of a trade or business in Possession X, under the principles of section 864(c)(3) as applied pursuant to § 1.937-3(b). Corporation A's income is not from sources within the United States, nor is it effectively connected with the conduct of a trade or business in the United States. Accordingly, the US income rule of section 937(b)(2), § 1.937-2(c)(1), and paragraph (c)(1) of this section does not operate to prevent Corporation A's sales income from being Possession X source and Possession X effectively connected income under section 937(b)(1).

Further, **Example 5** of Treasury Regulation § 1.937-3(e) (which is almost identical to **Example 2** in Notice 2006-76) gives guidance on the sourcing of income from the use of specialised software housed in the USVI by customers around the world:

(i) Corporation B, a corporation organised in Possession X, has its sole place of business in Possession X and is not engaged in the conduct of a trade or business in the United States. Corporation B employs a software business model generally referred to as an application service provider. Employees of Corporation B in Possession X develop software and maintain it on Corporation B's server in Possession X. Corporation B's customers in the United States and around the world transmit detailed data about their own customers to Corporation B's server and electronic storage facility in Possession X. The customers pay a monthly fee to Corporation B under a Subscription Agreement, and they can use the software to generate reports analysing the data at any time but do not receive a copy of the software. Corporation B's software allows its customers to generate the reports from their location and to keep track of their relationships with their own customers. Assume for purposes of this example that Corporation B's income from these transactions is derived from the provision of services.

(ii) Under the principles of section 861(a)(3) and § 1.861-4(a), as applied pursuant to § 1.937-2(b), because Corporation B performs personal services wholly within Possession X, the compensation Corporation B receives for services is sourced to Possession X. Corporation B's services income is also effectively connected with the conduct of a trade or business in Possession X, under the principles of section 864(c)(3) as applied pursuant to § 1.937-3(b). Corporation B's income is not from sources within the United States, nor is it effectively connected with the conduct of a trade or business in the United States. Accordingly, the US income rule of section 937(b)(2), § 1.937-2(c)(1), and paragraph (c)(1) of this section does not operate to prevent Corporation B's services income from being Territory X source or Possession X effectively connected income within the meaning of section 937(b)(1).

It is important to note that the USVI cannot reduce or exempt tax on income from US sources except for sales of inventory manufactured or purchased in the USVI where title passes in the United States. Of course, in any case the income must also be eligible for benefits under the RTPark-PC program and earned in the activities described in the Park Tenant Agreement.

Types of Entity Structure

Protected Cells can be 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 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 percent of the tax otherwise due on the allocation from the entity. (Bona fide residents must meet specific physical presence, closer connection, and tax home requirements.) This structure results in an effective tax rate on the tax-benefitted income of 10 percent of the otherwise applicable rate. If one or

more of the owners is not going to be bona fide USVI residents, however, then the preferred business entity may be a 'C' corporation. A tax-benefitted USVI C corporation pays tax to the BIR at an effective rate of 3.85 percent on eligible income.[ii] As previously discussed, 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 percent rate on the dividends under current dividend rates.

USVI C corporations are foreign corporations for US tax purposes and thus may be subject to the controlled foreign corporation (CFC) and subpart F provisions of the Code for Federal income tax purposes. Furthermore, a US citizen/USVI bona fide resident shareholder of a USVI corporation owning at least 10 percent 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 percent, 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. If the beneficiary receives other types of income, it must determine whether each type of income falls within a subpart F exemption or exclusion as well whether the income is from USVI sources or effectively connected with a USVI trade or business.

Other Considerations for Protected Cells

The USVI is not covered by any US income tax treaties (nor are the other US territories).

Further, although the USVI is for most income tax purposes 'foreign' such 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[iii] and Notice 2007-31,[iv], governing the exchange of information and other matters.

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[i] P.L. 108-357, 118 Stat. 1418.

[ii] V.I. CODE ANN. tit. 33, § 581, imposes a surcharge of ten percent of each corporation's total liability on all corporations that have a liability to pay USVI income tax. Since the "regular" corporate rate is 35 percent, the surcharge of 10 percent of 35 percent, or 3.5 percent, results in a tax rate of 38.5 percent.

[iii] Tax Implementation Agreement Between the United States of America and the Virgin Islands (Feb. 24, 1987).

[iv] 2007-1 C.B. 971.a

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