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University of the Virgin Islands Research and Technology Park Corporation
2 John Brewer's Bay
St. Thomas, US Virgin Islands 00802-9990

Re: Virgin Islands Tax Incentives

Ladies and Gentlemen:

We have acted as special tax counsel to the University of the Virgin Islands Research and Technology Park Corporation (the "Technology Park Corporation") in connection with certain matters relating to the application of federal income tax law to individuals and entities with income effectively connected with the conduct of a trade or business in the United States Virgin Islands ("USVI") or with income from sources within the USVI. In that capacity we have been asked for our opinion as to certain federal income tax consequences of reductions of USVI income taxes, in the form of tax credits (the "Tax Reductions") granted under USVI law to certain entities located in and conducting business operations from the University of Virgin Islands Research and Technology Park (the "Technology Park"), all as described below.

SUMMARY

The Internal Revenue Code of 1986, as amended (the "Code") provides that the USVI may reduce or remit its territorial income tax, as implemented under the so-called "mirror code system" discussed below, only in certain defined cases. Under USVI tax law a tenant of the Technology Park that is a Protected Cell, as defined below, as well as certain owners of equity interests in a Protected Cell will be entitled to a 90% reduction of USVI territorial income tax with respect to defined classes of income. As discussed in detail below, we believe the Tax Reductions available to Protected Cells and their equity owners, if properly applied, will meet the requirements of the Code.

DISCUSSION

The Mirror Code System

The territorial income tax law of the Virgin Islands is established by federal law, which provides that

The income-tax laws in force in the United States of America and those which may hereafter be enacted shall be held to be likewise in force in the Virgin Islands of the United States, except that the proceeds of such taxes shall be paid into the treasuries of said islands.

48 U.S.C. § 1397. The effect of this provision is to create a so-called “mirror code system” of taxation, where the Code is applied in the USVI as a territorial income tax by substituting the term “Virgin Islands” for “United States” where appropriate. See, e.g., Chase Manhattan Bank, N.S. v. Government of the Virgin Islands, Bureau of Internal Revenue, 300 Fed. 3d 320 (3d Cir. 2002).

Application to Corporations. Under the mirror system a USVI corporation is treated generally as a domestic corporation for purposes of the USVI income tax law and as a foreign corporation for purposes of United States income tax law. As a USVI corporation it would be subject to income tax in the USVI on its worldwide income, but generally would be subject to tax in the United States only on its United States source income and its income effectively connected with the conduct of a trade or business (“effectively connected income”) in the United States. Similarly, a United States corporation (i.e., one incorporated in one of the 50 states or in the District of Columbia) is treated as a foreign corporation for USVI income tax purposes and thus would be subject to tax in the USVI only on USVI source income or effectively connected USVI income. In the case of either a USVI or United States corporation, taxes paid as a “foreign” corporation generally would be allowed as a foreign tax credit against its income tax liability as a domestic corporation. See Rev. Rul. 88-91, 1988-2 C.B. 257.¹

Application to Individuals. Federal law provides additional rules for coordinating the mirror code system in the case of individuals who are residents of the USVI. Under section 932(c) of the Code bona fide residents of the USVI are required to satisfy their income tax liability by paying tax to the USVI on their worldwide income. Temp. Treas. Reg. § 1.932-1T(c)(1).

In the case of a United States citizen who is not a bona fide resident of the USVI, but who has USVI source income or effectively connected USVI income, the taxpayer must file two returns, one with the United States and one with the USVI. Code § 932(a)(2); Temp. Treas. Reg. § 1.932-1T(b)(1). The payment to be made to the USVI is based on the ratio of the taxpayer’s USVI adjusted gross income to his or her overall adjusted gross income. Code § 932(b). The

¹ The USVI also has imposed a 10 percent surtax on corporations. In general the Code does not permit a credit for income taxes that exceed the income tax that would be paid on that same income under the Code. Thus, the 10% surtax cannot be credited against US income tax liability, although it may be deductible.

taxpayer generally receives a tax credit against his or her United States income tax liability equal to the amount of tax required to be paid to the USVI that is in fact paid. Code § 932(b)(3).

Limitation on Tax Reduction. Section 934(a) of the Code provides that the USVI may not reduce or remit the tax imposed by the mirror code system in any way, except as provided in section 934(b). Section 934(b)(1) provides, in turn, that the limitation in section 934(a) will not apply to tax on income that either is from USVI sources or is effectively connected USVI income. Temp. Treas. Reg. § 1.932-1T(b)(1). Section 934(b)(2) provides, in effect, that in the case of an individual who is a United States citizen the tax abatement permitted by section 934(b)(1) applies only to a bona fide resident of the USVI. Temp. Treas. Reg. § 1.932-1T(b)(2). Finally, in the case of a “qualified foreign corporation” section 934(b)(3) provides that the USVI is permitted to reduce or remit taxes on income that is neither from United States sources nor effectively connected with the conduct of a trade or business in the United States. For this purpose, a “qualified foreign corporation” is defined generally as a foreign corporation in which United States persons do not hold more than 10 percent of either the total voting in the corporation or the value of its outstanding stock. Temp. Treas. Reg. § 1.932-1T(c).

In sum, section 934 of the Code permits the USVI to reduce or remit otherwise applicable territorial income tax in the case of (i) USVI corporations with USVI source income or effectively connected USVI income,² (ii) bona fide residents of the USVI with USVI source income or effectively connected USVI income, and (iii) qualified foreign corporations with income that is not from United States sources or United States effectively connected income. The determination of whether income is USVI source income or is effectively connected with a USVI trade or business is made under the rules set forth in Temp. Treas. Reg. §§ 1.937-2T and -3T, respectively (see discussion below).

Residence Rules – Section 937(a). Section 937 of the Code, enacted as part of the American Jobs Creation Act of 2004, provides new rules (i) for determining whether an individual is a bona fide resident of a possession including the USVI (section 937(a)), and (ii) relating to the determination of whether income is sourced in or effectively connected with the conduct of a trade or business in the United States or a possession (section 937(b)). These rules generally will be applicable for purposes of determining the eligibility for and application of tax reductions provided by the USVI under the authority of section 934 of Code.

Section 937(a) and the temporary Treasury regulations promulgated thereunder provide revised rules for determining whether an individual will be considered a bona fide resident of the USVI. In general, these rules are more stringent than prior law and are intended to address concerns that individuals were inappropriately claiming to be bona fide residents in the USVI. Under these rules, which are subject to effective date transition rules, an individual will be

² Technically section 934 also would permit the USVI to reduce taxes of a United States corporation with USVI source income or income effectively connected with the conduct of a trade or business in the USVI. Such a reduction would not result in a reduction of income tax liability. A United States corporation is subject to United States tax on its world-wide income. Thus a reduction in the amount of USVI tax actually paid would lead to a corresponding reduction in the corporation’s foreign tax credit claimed against its United States tax liability, but the total tax paid would not be reduced.

treated as a bona fide resident of the USVI if he or she meets three tests: a presence test, a tax home test and a closer connection test. *See* Temp. Treas. Reg. § 1.937-1T(b).

The presence test is met for a tax year, in the case of a United States citizen or resident alien, if the individual (i) was physically present in the USVI for 183 days, (ii) was not present in the United States for more than 90 days, (iii) was present in the USVI for more days than in the United States and had no earned income from the United States, or (iv) had no “permanent connection” in the United States (e.g., a dependant spouse living there or a home in the United States available for full time use). *See* Temp. Treas. Reg. § 1.937-1T(c)(1). In the case of a nonresident alien individual (e.g., an alien living in the United States or the USVI under a nonresident visa) the presence test is met if the individual meets the “substantial presence” test described in Treas. Reg. § 1.301-7701(b)-1(c).

The tax home test looks to the taxpayer’s regular or principal place of business while the closer connection test looks to whether the individual had a closer connection to the USVI than to the United States, another United States possession or a foreign country. *See* Temp. Treas. Reg. §§ 1.937-1T(d) and -1T(e).

Source Rules – Section 937(b). Section 937(b) provides statutory rules for determining whether income is from sources within the USVI or is effectively connected USVI income. Section 937(b)(1) provides generally that rules similar to the rules for determining whether income is from sources within the United States or is effectively connected with the conduct of a trade of business in the United States will apply for purposes of making the equivalent determinations with respect to the USVI. Thus, except as discussed below, the principles of sections 861 through 865 of the Code will be used to determine whether income is from USVI sources or is effectively connected with the conduct of a trade or business in the USVI. *See* Temp. Treas. Reg. § 1.937-2T(b) (determining the source of income) and Temp. Treas. Reg. § 1.937-3T(b) (determining whether income is effectively connected with a USVI trade or business). This provision effectively codifies the existing regulatory source of income rules, subject to a limitation imposed by section 937(b)(2) as discussed below.

Section 937(b)(2) provides that, except as provided in regulations, income that is either from United States sources or is effectively connected with the conduct of a trade or business in the United States will be treated as neither from USVI sources nor as effectively connected USVI income. *See* Temp. Treas. Reg. §§ 1.937-2T(c) and -3(c). As in the case of the new residency rules in section 937(a), this rule was intended to address perceived abuses. As described below, however, the application of this rule has been limited somewhat by the recently adopted temporary regulations.

Treas. Reg. §§ 1.937-3T(c) and -3T(d) provide, in effect, that the rule in section 937(b)(2) does not apply to “income from the sales of inventory property described in [Treas. Reg.] § 1.863-(3)(f),” which regulation governs the allocation of income between United States and possessions sources in the case of inventory produced in a possession and sold in the United States, or vice versa. The effect of this exception, stated somewhat differently, is that in the case

of sales of inventory³ described in section 1.863-3(f) of the regulations, the source of income and whether the income is effectively connected to the conduct of a trade or business will be determined without regard to the exception set forth in section 937(b)(2) of the Code. Cf. Temp. Treas. Reg. § 1.937-3T(e) Example 1.

The Technology Park and the Protected Cell Corporation

The Technology Park. In 2002 the legislature of the USVI adopted the University of the Virgin Islands Research and Technology Park Corporation Act, 17 V.I.C. § 480 et seq. (the “Research Park Act”) to spur the development of a technology sector within the USVI economy and to attract United States and other non-USVI businesses considering the relocation of facilities or business activities to off-shore locations. To this end the Research Park Act established both the Technology Park Corporation, to be owned by the University of the Virgin Islands, and the Technology Park, located in St. Croix.

The Protected Cell Corporation. At the same time that it established the Technology Park the USVI legislature enacted the Research and Technology Park Protected Cell Corporation Act, 17 V.I.C. § 800 et seq. as amended by 2005 VI Sess. Laws 6726, (the “Cell Corporation Act”), which created the Research and Technology Park Protected Cell Corporation (the “Protected Cell Corporation”). Pursuant to section 800 of the Cell Corporation Act, the Protected Cell Corporation is a public corporation and an autonomous instrumentality of the government of the USVI and is governed by the Board of Directors of the Technology Park Corporation. The purpose of the Protected Cell Corporation is to provide a vehicle through which businesses can set up operations as tenants of the Technology Park and through which the Tax Incentives can be administered.

Under the Cell Corporation Act a Protected Cell is a separate legal entity affiliated with the Protected Cell Corporation. Under section 802(d) of the Protected Cell Act a Protected Cell must (1) be an “Electronic Commerce Business,” an “e-Commerce Business” or a Knowledge-Based Business” as defined in 17 V.I.C. § 482, (2) be a tenant of the Technology Park and (3) have the Protected Cell Corporation as a shareholder, partner, member or other equity owner at all times with an agreed minimum percentage of the total equity interests in the Protected Cell entity.

The Tax Reductions

A tenant of the Technology Park⁴ that has been designated as a Protected Cell under section 802 is entitled to certain tax benefits pursuant to section 806, including the right effectively to reduce the income tax liability shown on its USVI income tax return for the taxable

³ Treas. Reg. § 1.861-18 contains a detailed analysis for classifying the transfer of computer programming as a sale or license arrangement. This classification is relevant for applying the general sourcing rules under sections 861 through 865 of the Code.

⁴ Four primary types of tenants are permitted in the Technology Park: a Protected Cell, a beneficiary of the Economic Development Program (29 V.I.C. § 701), a Knowledge-Based Business that is not a Protected Cell and a Research and Technology Park Support Business that is not a Protected Cell.

year by 90%. Pursuant to section 934(b)(1) of the Code, the USVI is authorized to grant this reduction only for USVI income tax on (i) income from USVI sources and (ii) income that is effectively connected with the conduct of a USVI trade or business. There is also a corresponding reduction in a Protected Cell's estimated tax payments.

The tax reduction described above reduces the income tax liability of the Protected Cell directly in the case of a corporation that is not a United States corporation. If the Protected Cell is a pass through entity such as a partnership, or a limited liability company treated as a partnership, or in the case of dividends or distributions paid to shareholders, members, partners, grantors, beneficiaries or other owners by the Protected Cell, the reduction would apply to such partner or beneficial owner that either (i) was established in the USVI (e.g., a USVI corporation) or, (ii) in the case of an individual, is a bona fide resident of the USVI under sections 932(c) and 937(a) of the Code.

Example.

Assume the facts in the following example:

A United States corporation (Acme US) wishes to establish an internet based e-commerce business operation in the USVI using a protected cell structure. Acme forms a wholly owned USVI subsidiary (Acme VI) which in turn creates a limited liability corporation (Acme LLC) under USVI law. Acme VI owns X percent of Acme LLC, with the remaining Y percent being owned by the Protected Cell Corporation.

Acme LLC is designated as a Protected Cell (Acme Cell) and it sets up a business operation in the Technology Park. Acme VI's X percent share of Acme Cell's income is \$1,000,000, all of which is effectively connected with the conduct of a trade or business in the USVI. For purposes of this illustration, assume that the USVI income tax on Acme VI's share of Acme Cell's income, before taking into account the Protected Cell reduction, is \$350,000. After the 90 percent reduction (technically, a 90 percent credit against the tax otherwise owed) Acme VI's USVI income tax liability on its share of Acme Cell's income is 10% of \$350,000, or \$35,000.

Assume that Acme Cell distributes to Acme VI all of its share of Acme Cell's income, with ACME VI receiving \$1,000,000. After Acme VI pays the \$35,000 of tax to the USVI it would have \$965,000 of cash remaining. Acme VI generally would not be subject to United States income tax on its share of Acme Cell's income until that income is distributed by Acme VI to Acme US.⁵

⁵ Acme VI would be a controlled foreign corporation within the meaning of section 957 of the Code. For purposes of the example we have assumed that the income attributable to Acme LLC's activities in the Technology Park would not be subpart F income within the meaning of section 951 of the Code.

CONCLUSION

In light of the foregoing, we believe that a tax reduction provided under section 806 of the Cell Corporation Act to a Protected Cell with respect to either USVI source income or effectively connected USVI income will be authorized under section 934(b) of the Code.

For the purposes of this opinion we have assumed that (i) after taking into effect the requirements of section 937(b)(2) of the Code and the regulations promulgated thereunder, the income earned by each Protected Cell of the Technology Park with respect to which a tax reduction is granted will be derived from sources within the USVI or will be effectively connected with the conduct of a trade or business in the USVI, and that such income will not be treated either as from United States sources or as income effectively connected with the conduct of a business in the United States, (ii) the designation by the Cell Corporation of a business entity as a Protected Cell and the granting of a tax reduction pursuant to section 806 of the Cell Corporation Act is legal and valid under USVI law, and (iii) each Protected Cell thus designated meets all applicable requirements of the Cell Corporation Act.

We call to your attention that the issue of whether income is from USVI sources or is effectively connected with the conduct of a trade or business in the Virgin depends on the specific facts of each case. We offer no opinion as to whether any item or category of income earned by a Protected Cell would be treated as income from USVI sources or as income that is effectively connected with the conduct of a trade or business in the USVI.

We also call to your attention that, while we believe the views expressed in this opinion are supported by an analysis of the Internal Revenue Code and applicable case law, there is no reported controlling judicial precedent directly on point and there is no assurance that a court of appropriate jurisdiction, the Internal Revenue Service or the Virgin Islands Bureau of Internal Revenue would adopt our analysis. In addition, except as specifically set forth above we offer no opinion as to the income tax consequences of any activity or transaction under either United States or USVI income tax law, including particularly the formation and operation of a Protected Cell.

The above opinion speaks as of its date. We do not undertake to advise you or anyone else of any changes in the opinions expressed herein resulting from changes in law, changes in facts or any other matters that hereafter might occur or be brought to our attention.

Any business entity that is contemplating creating a Protected Cell and becoming a tenant in the Research Park to obtain the benefits of the Tax Incentives should consult with its own tax advisors.

Very Truly Yours,

Ballard Spahr Andrews & Ingham, LLP