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December 18, 2008

David M. Zumwalt, Executive Director
University of the Virgin Islands Research and Technology Park Corporation
UVI St. Croix Campus
RR1 Box 10000
Kingshill, VI 00850-9781

Re: Tax Opinion Regarding E-Commerce in the U.S. Virgin Islands

Dear Mr. Zumwalt:

In our capacity as counsel to the University of the Virgin Islands Research and Technology Park ("RTPark"), we have participated in several key activities which have resulted in modifications of the U.S. Income Tax Code ("I.R.C." or "Code") and U.S. Treasury Regulations ("Regulations") there under relating to the U.S. Virgin Islands. In particular, our efforts on your part culminated in the issuance by the U.S. Treasury Department and the Internal Revenue Service ("I.R.S.") of final Regulations under I.R.C. Section 937(b) (TD 9391, 73 FR 19350) which define several e-commerce business models which will, in essence, qualify under U.S. rules which otherwise might restrict income tax reduction benefits offered by the U.S. Virgin Islands. As part of our ongoing capacity as your counsel, we hereby provide you with this U.S. federal tax opinion relating to this topic.

Tax Regime of the U.S. Virgin Islands and I.R.C. Section 934

In general, the income tax structure of the U.S. Virgin Islands follows a "mirror code system" with the U.S. Under this approach, the tax laws of the possession are generally identical to those of the U.S., except that residents of the U.S. Virgin Islands remit their tax liabilities to the possession rather than the U.S.

One key exception to the mirror code system is that, pursuant to I.R.C. Section 934(a) and (b), the law of the U.S. Virgin Islands is permitted to reduce income taxes in certain circumstances, in order to provide an incentive to locate business there. However, under Section 934, tax reductions are permissible only for "income derived from sources within the Virgin Islands or income effectively connected with the conduct of a trade or business within the Virgin Islands." The U.S. Virgin Islands has implemented a regime which provides for a 90% reduction in its corporate tax rate for certain activities meeting the approval of the Virgin Islands Economic Development Authority or the RTPark.

For many years prior to 2004, the determination of whether income was U.S. Virgin Island source income or was effectively connected with a U.S. Virgin Island trade or business was not well defined under the U.S. code, despite the fact that the U.S. Treasury was given express authority to write Regulations on the topic.

In 2004, the I.R.S. issued Notice 2004-45, which stated that the proper interpretation of the provisions of Section 934 was to follow the definitions of "source" and "effectively connected" existing within the various statutory provisions of the U.S. Code. The Notice also stated that any other contrary interpretation would be without merit. The Notice also expressed a concern over reports that some taxpayers were erroneously taking positions that they were U.S. Virgin Islands residents when they neither lived nor worked in the possession.



David M. Zumwalt, Executive Director
December 18, 2008
Page Two

Section 937 and The American Jobs Creation Act of 2004

Following the general tax rule framework of Notice 2004-45, Congress soon thereafter enacted Section 908 of the American Jobs Creation Act of 2004 in order to clarify the residency, source, and effectively connected income rules related to the U.S. Virgin Islands. This clarification was added as new I.R.C. Section 937.

Section 937(b)(1) now requires that rules similar to the rules for determining whether income is from sources within the U.S. or is effectively connected with the conduct of a trade or business in the U.S. will apply when making similar determinations for U.S. Virgin Islands purposes. Section 937(b)(2) provides that, except as provided in Regulations, income that is either from U.S. sources or is effectively connected with the conduct of a trade or business in the U.S. will be treated as neither from U.S. Virgin Islands sources nor effectively connected with a U.S. Virgin Islands trade or business. This rule is effectively an "all or nothing" rule, so that any U.S. source or connected income cannot be U.S. Virgin Islands source or connected income.

Under U.S. tax law, the source of income is determined from statutory rules which require an analysis of various underlying factors, depending upon what type of income is involved. See I.R.C. Sections 861 through 865. For example, the source of income for the sale of inventory generally depends upon the place at which title to the inventory passes. For another example, the source of services income depends upon the place where the services are performed. Other unique source rules exist for income from dividends, royalties, interest, rents, etc. Accordingly, any enterprise seeking tax reduction benefits of the U.S. Virgin Islands must closely scrutinize its revenue business model through the framework of the source rules of the I.R.C. to ensure that it is generating U.S. Virgin Islands source income, and not U.S. source income.

The legislative history and Section 937(b) itself allows Treasury to provide exceptions to the U.S. source rules, where necessary for the continuing economic development of the U.S. Virgin Islands.

In making the determination of whether a trade or business is effectively connected to the U.S. or U.S. Virgin Islands, the rules of I.R.C. Section 864 apply. The Regulations under that Section provide some guidance on how to make that determination, although that guidance is not extensive.

The Temporary Regulations under Section 937

On April 11, 2005, Treasury published temporary and proposed Regulations concerning Section 937. In large part, these Regulations re-stated the basic rules of the statute, which provide that the U.S. tax rules will provide the framework for determining source and effectively connected determinations. The Temporary Regulations requested comments from taxpayers.

Treasury did provide one exception to the general U.S. source and effectively connected income rules, which is found at Regulation section 1.937-3T(c) and section 1.937-3T(d). This exception provides, in essence, that a manufacturer of goods located in the U.S. Virgin Islands may pass title to inventory goods in the U.S. and still qualify for the tax reductions of Section 934. We do not analyze this area any further in this letter.



David M. Zumwalt, Executive Director
December 18, 2008
Page Three

The Temporary Regulations issued in 2005 did not provide any favorable examples of business operations qualifying under the basic U.S. tax framework for source and effectively connected income determinations. Accordingly, taxpayers were left somewhat confused by the new, highly technical tax rules. And as a result, several interested parties approached the Treasury and I.R.S. to comment upon the Temporary Regulations, with a hope towards obtaining taxpayer favorable revisions.

The May 12, 2006 Submission to Treasury

The law firm of DLA Piper US LLP, on behalf of RTPark, provided a several page memorandum ("DLA Piper Memo") to the Treasury Department and the I.R.S. on May 12, 2006, requesting that a number of examples be added to the Regulations under Section 937 to make clear that certain e-commerce business models would essentially qualify for the tax reductions provided by the U.S. Virgin Islands.

The DLA Piper Memo did not seek to obtain from Treasury any new exceptions to the framework of the U.S. tax rules relating to the source rules. Rather, the memorandum sought to have Treasury add examples of common e-commerce transactions which, under existing interpretations of U.S. tax rules relating to the source of income, would qualify for the U.S. Virgin Islands tax reductions. The examples were important because there were no Treasury or I.R.S. published rulings on these e-commerce business models for U.S. source rules to be found elsewhere, even outside the tax rules relating to the U.S. Virgin Islands.

I.R.S. Notice 2006-76

On September 18, 2006, the I.R.S. published Notice 2006-76, 2006-38 I.R.B. 459, stating that Treasury intended to modify the Temporary Regulations under Section 937, to add several favorable examples of software operations which would qualify as possession source income. The examples published in Notice 2006-76 were, in essence, the examples requested in the DLA Piper Memo. The two examples of Notice 2006-76 were then incorporated into final Regulations which were issued on April 9, 2008, and are analyzed below.

The DLA Piper Memo also requested specific guidance that a possession corporation could be wholly owned by a U.S. parent corporation, and that the possession corporation could have a variety of business connections with its parent. In particular, the DLA Piper Memo sought to confirm that a possession corporation could obtain its e-commerce content from its parent, provided that the subsidiary paid an arm's length price under normal U.S. transfer pricing rules for the content.

While this specific guidance was not incorporated into either Notice 2006-76 or the final Regulations, we believe that there was no dispute with the rules stated in the DLA Piper Memo. Rather, Treasury and I.R.S. apparently felt that there was no uncertainty on such issues, and there was no need to state the obvious in the Notice.

The Final Regulations under Section 937 and Conclusion

The Preamble to the final Regulations indicated that, "[c]ommentators responded positively to the publication of the examples in Notice 2006-76." As a result, the two examples in this Notice were included in the final Regulations under Section 937 published by the Treasury and I.R.S., effective on April 9, 2008. The two examples can be found at Regulation section 1.937-3(e) Example 4 and 5.



David M. Zumwalt, Executive Director
December 18, 2008
Page Four

The first example concerns software company A in possession X which develops software for sale. The software is either loaded onto CDs at the taxpayer's location in the possession, or downloaded by the customer from the Internet from the taxpayer's location in the possession. In either case, the taxpayer's contract provides that title passes to the customer in possession X. Since the type of income is sales income, it is sourced to the place where the title passes under the principles of Section 863(a), according to the final Regulations. Since title passes in the possession, the revenue qualifies as possession source income. The example also assumes that the income is effectively connected with the possession activities. Thus, the income should qualify for the tax reductions offered by the possession.

The clarity provided by this example is extremely beneficial for taxpayers seeking to set up e-commerce sales operations in the U.S. Virgin Islands, since the example shows that the positive result arises solely from the taxpayer's contractual stipulation of place of passage of title to the goods - even when the transaction is carried out over the internet. Accordingly, an e-commerce operation in the U.S. Virgin Islands seeking these benefits must pay key attention to its contractual terms and conditions relating to passage of title, even if this item is of little relevance for normal commercial purposes.

The second example concerns a company in possession X which has developed software which is provided to U.S. customers under an "application server provider" model. In this case, the taxpayer's customers submit their data to the company in the possession. There, the company processes the data, and in turn provides reports which are sent to the customers. The customers pay a monthly fee under a subscription agreement, and do not obtain title to the software itself.

This example assumes that the company is providing a service to the customer. Since the service is performed within the company's servers in the possession, the service is sourced to the possession, and not to the U.S. Thus, the final Regulations conclude this e-commerce model also qualifies for the tax reductions of the possession.

In this type of business model, care must be taken to ensure that the U.S. Virgin Islands enterprise actually owns, leases, or otherwise employs servers physically located there for the holding of its software, processing of data, and other essential computer activities. That is, it will be important to show that the service is being performed in a server located in the U.S. Virgin Islands.

Accordingly, it is our opinion that a U.S. Virgin Islands taxpayer whose business model fits within the two examples will have assurance that the source of income from that operation should not be sourced to or connected with the U.S. under I.R.C. Section 937(b), and accordingly such a taxpayer should qualify for the tax reductions provided by the U.S. Virgin Islands.



David M. Zumwalt, Executive Director
December 18, 2008
Page Five

Because each taxpayer's e-commerce business model and the determination of the jurisdiction to which the income is effectively connected are both highly factual matters, we strongly suggest that any taxpayer seeking to obtain U.S. Virgin Islands tax reduction benefits via RTPark consult with a qualified tax advisor on these topics.

Very truly yours,

DLA Piper LLP (US)

A handwritten signature in black ink, appearing to read 'Eric D. Ryan', written over the printed name.

Eric D. Ryan
Partner

Admitted to practice in California

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