

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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to: Paula A. Martin Acting Chief, Partnerships, Trusts & International Section
S:CAS:SP:PP:P

from: W. EDWARD WILLIAMS
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subject: Virgin Islands Bureau of Internal Revenue (BIR) Cover Over Residency Issue

This memorandum is in response to your request for advice, dated 6/17/2003, for purposes of revising the Internal Revenue Manual. According to your request, during the processing of Virgin Islands ("VI") coverovers by the Philadelphia Accounts Management Center ("PAMC"), there are instances where information on returns submitted by the BIR indicates that certain taxpayers are not bona fide residents of the VI.

Issues:

1. Whether the IRS should decline to coverover net tax collections, attributable to individuals who may not be residents of the VI, and the returns forwarded back to the BIR with the issue clearly identified?
2. Alternatively, whether the PAMC should process the coverover, even though the bona fide residency is in question, and then send a copy of the return along with PAMC comments to the BIR and request that the BIR verify the bona fide residency of the taxpayer?
3. In instances where a return was filed with and processed by the IRS prior to receipt of a return for that taxpayer to be covered over, the cover over return causes a duplicate filing condition. Would the initial filing constitute the filer to be a United States taxpayer, and the

PAMC would therefore not cover over the return, or should the issue of residency be forwarded to the BIR as in #2 above?

4. Whether the PAMC should allow all Virgin Islands coverovers as submitted by the BIR without addressing the bona fide residency issue even if residency is deemed questionable?

Conclusions:

1. Under IRC sections 7654 and 932, the IRS is only authorized to cover over to the BIR taxes withheld on "bona fide residents of the Virgin Islands". Therefore, returns with questionable bona fide residence issues should not be covered over to the BIR. However, these income tax returns should not be sent to the BIR for a determination of the residency issue. Rather, the IRS should resolve the issue, since a U.S. citizen or resident who improperly claims to be a VI resident must report and pay tax on worldwide income to the IRS. Under IRC 7651(1), all administrative provisions in Title 26 relating to assessment and collection of tax, including the authority to issue summonses, apply in the U.S. Virgin Islands. Normal IRS procedures for selecting returns/taxpayers for examination, including IRS resource considerations, should apply to these situations.
2. As above, where it is questionable that an individual is a bona fide resident of the Virgin Islands, the return should be examined under normal IRS audit procedures. The appropriate IRS examination office may resolve the residency issue.
3. As above, the issue of residency should be resolved by the IRS examination office with jurisdiction over the individual under normal IRS procedures used to select returns for examination.
4. Under IRC sections 7654 and 932, in cases where there is an issue of whether the individual is a bona fide resident of the Virgin Islands, the IRS may examine a return or taxpayer under normal procedures used to select returns for examination.

Analysis:

The Virgin Islands Organic Act imposes the income tax sections of the Internal Revenue Code, as well as necessary procedural sections, as the local income tax law of the Virgin Islands:

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 (2003). See also, Chase Manhattan Bank, N.S. v. Government of the Virgin Islands, Bureau of Internal Revenue, 300 F.3d 320, 323 (3d Cir. 2002) (discussing the rules of construction of the Virgin Islands mirror code).

Section 7654(a) (Coordination of United States and certain possession individual income taxes.) provides as follows:

The net collection of taxes imposed by chapter 1 for each taxable year with respect to an individual to whom section 931 or 932(c) applies shall be covered into the Treasury of the specified possession of which such individual is a bona fide resident.¹ (Emphasis added.)

Section 931 describes the tax liability of bona fide residents of Guam, American Samoa, and the Northern Mariana Islands. Section 932(c) describes the tax liability of bona fide residents of the Virgin Islands. Section 932(c)(2) provides that an individual who is a bona fide resident of the Virgin Islands at the close of the taxable year must file a single tax return with the BIR in the Virgin Islands. This return must report the individual's worldwide income. Section 932(c)(3). An individual who is a bona fide resident of the Virgin Islands at the close of the tax year satisfies his or her United States income tax liability if on the return filed with the BIR, such individual reports income from all sources, identifies the source of each item shown, and "fully pays his tax liability referred to in section 934(a)^[2] to the Virgin Islands with respect to such income...". Section 932(c)(4). Thus, the United States imposes a residual tax liability on VI residents in the event they do not pay tax to the VI on their worldwide income.

Both section 7654 and section 932 were substantially amended by the Tax Reform Act of 1986, P.L. 99-514, 1986-3 C.B. 1, (A1986 TRA@). The House Report that accompanies the 1986 TRA provides the following:

An individual qualifying as a bona fide Virgin Islands resident as of the last day of the taxable year will pay tax to the Virgin Islands under the mirror system on his or her worldwide income. He or she will have no final tax

1 The regulations under section 7654 have not been amended to reflect the changes made by the Tax Reform Act of 1986, P.L. 99-514, 1986-3 C.B. 1, (A1986 TRA@).

2 Section 934(a) provides that taxes imposed by the Virgin Islands mirror code shall not be reduced or remitted by any law enacted in the Virgin Islands, with an exception in 934(b) for VI source income or income effectively connected with the conduct of a trade or business within the Virgin Islands.

liability for such year to the United States, as long as he or she identifies the source of each item of income on the return. Any taxes withheld and deposited in the United States from payments to such an individual, and any estimated tax payments properly made by such an individual to the United States, will be covered over to the Virgin Islands Treasury, and will be credited against the individual's Virgin Islands tax liability. A Virgin Islands resident deriving gross income from sources outside the Virgin Islands will list all items of such income on an attachment to his or her Virgin Islands return. Information contained on these attachments will be compiled by the Virgin Islands Bureau of Internal Revenue and transmitted to the Internal Revenue Service to facilitate enforcement assistance.

H. Rep. No. 99-426; 1986-3 C.B. 2, at 490 (1986). (Emphasis added.) Therefore, it is clear from both the statute and the legislative history that the IRS is only authorized to cover over to the BIR, taxes withheld on “bona fide residents of the Virgin Islands”.

The United States does not “cover over” to the BIR income taxes collected by the United States attributable to individuals who are not bona fide residents of the Virgin Islands. Section 932(a) provides that individuals who are U.S. citizens or stateside residents (other than those who were bona fide residents of the Virgin Islands at the close of the taxable year) and who have income derived from sources in the Virgin Islands or income effectively connected to a trade or business in the Virgin Islands, must file an income tax return with both the Virgin Islands and the United States:

Each individual to whom this subsection applies for the taxable year shall file his income tax return for the taxable year with both the United States and the Virgin Islands.

Section 932(a)(2). Both income tax returns must report the individual's worldwide income. Section 932(a)(3).

Non-VI residents must pay an “applicable percentage” of their income taxes to the BIR. The applicable percentage is defined as “the percentage which Virgin Islands adjusted gross income bears to adjusted gross income”. Section 932(a)(2)(A). “Virgin Islands adjusted gross income” is defined as “adjusted gross income determined by taking into account only income derived from sources within the Virgin Islands and deductions properly apportioned or allocable thereto”. Section 932(b)(2)(B). Non-VI residents are permitted to take a tax credit in the United States for taxes paid to the BIR under section 932(a)(2). Section 932(b)(3).

Where a non-VI resident has income from sources in the Virgin Islands or income effectively connected with a business in the Virgin Islands, such an individual calculates the

“applicable percentage” using Form 8689 (Allocation of Individual Income Tax to the Virgin Islands). Form 8689 is attached to both copies of the individual’s Form 1040. The instructions accompanying Form 8689 explicitly state that in the case of non-VI residents, the United States will not pay excess taxes it collects to the BIR:

Amounts overpaid to the United States will not be applied to the amount you owe to the Virgin Islands. Similarly, amounts overpaid to the Virgin Islands will not be applied to the amount you owe to the United States.

Therefore, where there is a question concerning an individual’s bona fide residence in the Virgin Islands, the IRS is not authorized to coverover taxes to the BIR.

The IRS has jurisdiction to issue a summons under IRC section 7602 in a case where there are doubts concerning the individual’s residency in the Virgin Islands. A U.S. citizen or resident who improperly claims to be a VI resident is subject to a U.S. tax deficiency. Section 7651(1) provides the applicability of administrative provisions to the possessions in cases where U.S. tax liability is at issue:

All provisions of the laws of the United States applicable to the assessment and collection of any tax imposed by this title or of any other liability arising under this title (including penalties) shall, in respect of such tax or liability, extend to and be applicable in any possession of the United States in the same manner and to the same extent as if such possession were a State, and as if the term “United States” when used in a geographical sense included such possession.

Therefore, if information calls into question an individual’s claim of being a bona fide resident in the Virgin Islands, the IRS should determine whether the individual is a resident of the Virgin Islands pursuant to the normal procedures used by the IRS to select taxpayers/returns for examination.

In a case where the BIR asserts that the individual is a resident of the VI and the IRS also asserts that the same individual is a stateside U.S. resident, double taxation may arise because both authorities would be asserting primary taxing jurisdiction. In such a case, the Implementation Agreement Between the United States and the Virgin Islands (signed February 24, 1987) (“Agreement”) directs the competent authorities to “agree upon the facts and circumstances necessary to achieve consistent application of the tax laws of the respective Governments.” See Paragraph 6 of the Agreement. The determination of residency of a particular taxpayer is specifically listed as an example of what the competent authorities may “consult together to endeavor to agree” upon.

If you have any questions concerning this matter, please feel free to contact either myself or
of my staff at .