Meritless Filing Position Based on Sections 932(c) and 934(b)

Notice 2004–45

The Internal Revenue Service is aware that certain promoters are advising taxpayers to take highly questionable, and in most cases meritless, positions described below in order to avoid U.S. taxation and claim a tax benefit under the laws of the United States Virgin Islands (USVI). Promoters may also be advising taxpayers to take similar positions with respect to other U.S. possessions. This notice alerts taxpayers that the Service intends to challenge these positions in appropriate cases. The Service may impose civil penalties on taxpayers or persons who participated in the promotion or reporting of these positions. In addition to being subject to other penalties, any person who willfully attempts to evade or defeat tax by means of an arrangement such as the one described in this notice, or who willfully counsels or advises such evasion or defeat, may be guilty of a criminal offense under federal law.

Background

Section 934, which was enacted in 1960, provides that the USVI may reduce its territorial income tax only in certain limited cases. The USVI may not, however, reduce the tax liability of U.S. citizens or residents who are not *bona fide* residents of the USVI. In the case of U.S. citizens or residents who are *bona fide* residents of the USVI, it may reduce their tax liability only with respect to income from sources in the USVI or income effectively connected with the conduct of a trade or business within the USVI.

The legislative history of § 934 indicates that the statute was enacted in part because of concerns that certain local income tax programs, which were intended to provide incentives to corporations and USVI residents that made new investments in the USVI, were having the effect of reducing the tax liability attributable not only to income from sources within the USVI but also to income from sources within the United States. While recognizing the goal of encouraging economic development in the USVI through appropriate income tax reductions, the legislative history to § 934 indicates that

> in no case should this [goal] be attained by granting windfall gains to taxpayers with respect to income derived from investments in corporations in the continental United States, or with respect to income in any other manner derived from sources outside of the Virgin Islands.

S. Rep. No. 1767, 86th Cong., 2nd Sess. 4 (1960).

Typical Promotion

The highly questionable positions described in this notice may be promoted to taxpayers in a variety of forms. The Service is aware, however, that they have frequently been promoted in the following manner:

Promoters typically approach a taxpayer (Taxpayer) living and working in the United States and advise Taxpayer to (i) purport to become a USVI resident by establishing certain contacts with the USVI, (ii) purport to terminate his or her existing employment relationship with his or her employer (Employer) and (iii) purport to become a partner of a Virgin Islands limited liability partnership ("V.I.LLP") that is treated as a partnership for U.S. tax purposes. V.I.LLP then purports to enter into a contract with Employer to provide Employer with substantially the same services that were provided by Taxpayer prior to the creation of this arrangement. Typically, after entering into the arrangement, Taxpayer continues to provide substantially the same services for Employer that he or she provided before entering into the arrangement, but Taxpayer is nominally a partner of V.I.LLP instead of an employee of Employer.

Under this arrangement, Employer makes payments to V.I.LLP for Taxpayer's services and no longer treats the payments as wages paid to Taxpayer subject to the withholding and payment of employment taxes and reporting on Taxpayer's Form W–2. V.I.LLP, in turn, makes payments to Taxpayer for his or her services to Employer. V.I.LLP typically treats these payments for tax accounting purposes either as guaranteed payments for services or as distributions of Taxpayer's allocable share of partnership income. Under this arrangement, the promoter may be a general partner in V.I.LLP and may retain a percentage of the fees received from Employer.

V.I.LLP either has or secures a reduction, up to 90 percent, in USVI income tax liability under the Economic Development Program (EDP) of the USVI. Taxpayer takes the position that the EDP benefits granted to V.I.LLP provide a corresponding reduction in the income tax liability that Taxpayer reports on his or her USVI income tax return with respect to guaranteed payments from the partnership or distributive shares of the partnership's net income, or both. Taxpayer pays tax to the USVI in an amount approximately equal to 10% of the U.S. income tax liability that otherwise would be imposed on Taxpayer's income from performing the services. Taxpayer claims that, for purposes of computing his or her U.S. income tax liability, gross income does not include guaranteed payments received from V.I.LLP or Taxpayer's distributive share, if any, of the partnership's net income, or both.

Positions Promoted

In situations such as those described above, as well as in other situations, the following highly questionable positions are being promoted:

—"You can continue to live and work in the United States and, nevertheless, be a *bona fide* resident of the USVI." The concept of a "*bona fide* resident of the Virgin Islands" was an integral part of the predecessor to § 934(b), and as such, its meaning has been well established. *See* § 934(c) as enacted by P.L. 86–779, §4(a) (1960). When Congress enacted the current versions of §§ 932 and 934(b), it retained this concept, but noted that Treasury has the authority to modify its meaning when necessary to prevent abuse. *See* H.R. Rep. No. 99–426 (1985) and General Explanation of the Tax Reform Act of 1986, JCS–10–87 (1987) ("Similarly, where appropriate, the Secretary may treat an individual as not

a *bona fide* resident of the Virgin Islands.") The determination of whether an individual is a *bona fide* resident of the USVI turns on the facts and circumstances and, specifically, on an individual's intentions with respect to the length and nature of his or her stay in the USVI. *See* § 1.934–1(c)(2) (generally applying the principles of §§ 1.871–2 through –5). Promoters typically represent that a taxpayer need not make major lifestyle changes in order to become a *bona fide* resident of the USVI, and may represent that the taxpayer need only spend a few weeks or less out of the year in the USVI to become a resident for income tax purposes. These representations, however, have no basis in the well-established meaning of the term "*bona fide* resident of the Virgin Islands." Accordingly, a claim of USVI residency for income tax purposes may be considered without merit or fraudulent when the taxpayer continues to live and work in the United States.

—"USVI source income includes income from services performed in the United States." The principles that generally apply for determining gross and taxable income from sources within and without the United States (in particular, the rules of §§ 1.861–1 through 1.863–5) also generally apply in determining gross and taxable income from sources within and without a possession of the United States. *See* § 1.863–6 and *Francisco v. Commissioner*, 119 T.C. 317 (2002) *aff'd*, No. 03–1210 (D.C. Cir. June 18, 2004). With certain limited exceptions, compensation for labor or personal services performed in the United States is gross income from sources within the United States. *See* § 861(a)(3) and § 1.861–4(a)(1). The result does not change if the compensation is received in the form of a guaranteed payment from a partnership rather than in the form of a fee for services under an employment contract. *See Miller v. Commissioner*, 52 T.C. 752 (1969), *acq.* 1972–2 C.B. 2. Promoters typically claim that taxpayers are free to argue, under a variety of theories, that income from services performed in the United States constitutes income from USVI sources because "no rules exist under section 934" for determining whether income is from USVI sources. Based on the foregoing discussion, however, such arguments are without merit.

—"For purposes of determining the source of income, USVI includes the United States." Section 932 provides coordination rules for filing of returns for U.S. and USVI income taxes by *bona fide* residents of the USVI and U.S. citizens and residents who have income derived from sources within the USVI or income effectively connected with the conduct of a trade or business within the USVI. To facilitate this coordination, § 932(c)(3) states that the USVI includes the United States for certain tax purposes. Section 932(c)(3) was modeled after § 935(c), which was enacted fourteen years earlier and which provides an equivalent rule with respect to Guam. For an illustration of the types of purposes for which these provisions apply, *see* § 1.935–1(c)(1)(ii). Notably, these provisions do not apply for purposes of determining the source of income. *See* H.R. Rep. No. 92–1479, 92d Cong., 2d Sess. 5 (Oct. 2, 1972) ("In determining the source of income for purposes of the special tax system provided in the bill (new code sec. 935), the principles contained in secs. 861–863 are to be applied without reference to sec. 935(c).") Based on an incorrect reading of § 932(c)(3), promoters may claim that compensation for services performed in the United States is considered for tax purposes to be compensation for services performed in the USVI. This claim is without merit. Section 932 does not apply to determine the source of income on which the USVI tax liability of *bona fide* residents may be reduced under § 934(b)(1). Thus, § 932(c)(3) does not operate to transform compensation from the performance of personal services in the United States into income from sources in the USVI.

—"Non-USVI source income can be treated as effectively connected with the conduct of a trade or business within the USVI even if, under equivalent circumstances, such income would not be considered effectively connected with the conduct of a trade or business within the United States." As noted above, § 934(b)(1) grants limited authority to the USVI to reduce the USVI tax liability with respect to income from USVI sources or income effectively connected with a trade or business within the USVI. The use of the term "effectively connected with the conduct of a trade or business" in § 934 indicates that Congress generally intended for the rules under § 934 to follow the well-established rules that apply for purposes of determining the taxation of nonresidents, such as the definition of effectively connected income under § 864(c). Section 934(b)(4), however, provides Treasury with the authority to issue regulations providing an alternative definition of the term. The legislative history of § 934 makes clear that this grant of regulatory authority was for the purpose of preventing abuse, and that Congress anticipated that it would be used to provide further limitations on the type of income that would be treated as from USVI sources or as effectively connected with the conduct of a trade or business within the USVI. S. Rep. No. 99–313, at 484, 1986–3 C.B. (vol. 3) 484. Taxpayers have no legal basis for claiming that the scope of the term "income effectively connected with the conduct of a trade or business" is broader under § 934 than it is under § 864. In particular, taxpayers have no legal basis for disregarding the rules of § 864(c)(4), which generally limit the amount of foreign source income that is treated as effectively connected with a U.S. trade or business to certain, very narrow categories of income. Accordingly, with the exception of those narrow categories, and in the absence of regulations to the contrary, income, gain, or loss from sources without the USVI cannot be treated as effectively connected with the conduct of a trade or business within the USVI for purposes of § 934. For example, income from the performance of personal services without the USVI cannot under any circumstances be treated as effectively connected with the conduct of a trade or business within the USVI. Promoters typically interpret the phrase "effectively connected to the conduct of a trade or business within the USVI" broadly, and inconsistently with § 864(c)(4), in order to claim a

tax reduction with respect to income from non-USVI sources. As indicated above, however, these interpretations have no merit.

The IRS intends to challenge these positions and other similar claims that disregard the statutory and regulatory provisions concerning the limitations on the reduction of USVI income tax. Where taxpayers in order to make these claims enter into arrangements such as the one described in this notice, the Internal Revenue Service may disregard such arrangements on the grounds that they lack economic substance or that they have no purpose other than tax avoidance or evasion. The Service also may assert that the arrangement does not serve to terminate the employment relationship between a taxpayer and Employer for federal employment tax purposes, with the result that Employer remains liable for employment taxes and applicable penalties and interest.

In addition to liability for tax due plus statutory interest, taxpayers that claim to have no requirement to file a federal income tax return or pay federal income tax liability based on the positions described herein may be subject to penalties including, but not limited to, the accuracy-related penalty under § 6662, failure to file or pay penalties under § 6651 and civil fraud penalties under § 6663. Further, persons who participate in the promoting or reporting of these positions may be subject to aiding and abetting penalties under § 6701. In addition to other penalties, any person who willfully attempts to evade or defeat tax by taking the positions described in this notice, or who willfully counsels or advises such evasion or defeat, may be guilty of a criminal offense under §§ 7201, 7203, 7206, or 7212(a) or other provisions of federal law. Promoters and others who assist taxpayers in taking these positions also may be enjoined from doing so under § 7408.

The principal author of this notice is W. Edward Williams of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact W. Edward Williams at (202) 622–3295 (not a toll-free call).