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**Guam Society Of Certified Public Accountants**  
**P.O. Box 1**  
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August 7, 2014

The Honorable Donna Christensen  
Virgin Islands Delegate to Congress  
1510 Longworth House Office Building  
Washington, DC 20515

The Honorable Madeleine Z. Bordallo  
Guam Delegate to Congress  
2441 Rayburn House Office Building  
Washington, DC 20515

The Honorable Gregorio Kilili Camacho Sablan  
Commonwealth of the Northern Mariana Islands  
Delegate to Congress  
423 Cannon House Office Building  
Washington, DC 20515

RE: Request for Clarification on Application of Net Investment Income Tax to Bona Fide Residents of the U.S. Territories

Dear Representatives Christensen, Bordallo, and Sablan:

The American Institute of Certified Public Accountants (AICPA), the Virgin Islands Society of Certified Public Accountants (VISCPA), and the Guam Society of Certified Public Accountants (GSCPA) would like your assistance with requesting clarification from

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the Virgin Islands Bureau of Internal Revenue ([VIBIR](#)), the Guam Department of Revenue and Taxation ([GDRT](#)), the Commonwealth of the Northern Mariana Islands Division of Revenue and Taxation (CNMIDRT), the U.S. Department of the Treasury (“Treasury”), and the Internal Revenue Service (IRS) regarding the applicability of Internal Revenue Code (IRC or “Code”) section<sup>1</sup> 1411 net investment income tax (NIIT) to bona fide residents of the U.S. Virgin Islands, Guam, and Commonwealth of the Northern Mariana Islands (CNMI) (referred to as “U.S. Territories”). Specifically, we would like clarification as to whether or not the NIIT is a mirrored tax to be collected by the VIBIR, GDRT, and CNMIDRT. In addition, clarity on the application of NIIT to U.S. Territory estates and trusts is necessary.

The AICPA is the world’s largest member association representing the accounting profession, with more than 394,000 members in 128 countries and a 125-year heritage of serving the public interest. Our members advise clients on federal, state and international tax matters, and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized business, as well as America’s largest businesses.

The VISCPA and GSCPA are associations representing the accounting profession, with more than 50 and 100 members, respectively, serving the public interest. These members advise clients on tax matters regarding Virgin Islands and Guam and international tax matters, and prepare income and other tax returns for taxpayers. These members provide services to individuals, not-for-profit organizations, small and medium-sized business, as well as large businesses. There also are CPAs in the Commonwealth of the Northern Mariana Islands who prepare income and other tax returns for taxpayers.

## **Background**

### **Net Investment Income Tax**

As part of the Patient Protection and Affordable Care Act (ACA) ([P.L. 111-148](#)) and Health Care and Education Reconciliation Act of 2010 ([P.L. 111-152](#)),<sup>2</sup> effective for taxable years beginning after December 31, 2012, IRC section 1411 imposes an excise tax of 3.8% on the lesser of net investment income or the excess of modified adjusted gross income over a threshold amount.

The IRS and Treasury issued NIIT proposed regulations ([REG-130507-11](#), December 5, 2012) (referred to as “2012 proposed regulations”) and another set of proposed regulations

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<sup>1</sup> All references herein to “section” or “§” are to the IRC of 1986, as amended, or the Treasury Regulations promulgated thereunder.

<sup>2</sup> Section 1402(a)(1) of the Health Care and Education Reconciliation Act of 2010 (Pub. L. 111–152) added section 1411 to a new chapter 2A of subtitle A (Income Taxes) of the Code effective for taxable years beginning after December 31, 2012.

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([REG-130843-13](#), December 16, 2013) (referred to as “2013 proposed regulations”) and final regulations ([T.D. 9644](#), December 16, 2013).

### **Mirror Code**

As detailed in the attached letter from tax attorney Marjorie Rawls Roberts, the income tax laws of the U.S. Virgin Islands (USVI) were established by the Naval Services Appropriation Act of 1922 (NSAA), which was enacted after the U.S. acquired the USVI from Denmark in 1917. The NSAA 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 to the treasuries of such islands.”<sup>3</sup> Under this arrangement, commonly referred to as the “mirror code” system of taxation, the substantive provisions of the IRC, as well as “any changes to, interpretations of, regulations and revenue rulings on and court interpretations of [such provisions]”<sup>4</sup> are applicable as the income tax laws of the USVI and Guam by substituting the words “Virgin Islands” and “Guam” for the words “United States” wherever they appear.

Similar to the USVI, Guam is also a “mirror code” jurisdiction. The [Guam Organic Act of 1950](#) (Organic Act) placed [Guam](#) under the administrative jurisdiction of the [United States Department of the Interior](#) as an unincorporated territory; the ultimate laws that govern Guam are still those of the U.S. Congress.<sup>5</sup>

For the Northern Mariana Islands, a covenant to establish political union with the United States was signed in 1975 and came into full effect in 1986, pursuant to Presidential Proclamation no. 5564, which conferred United States citizenship on legally qualified CNMI residents. Under the Covenant, in general, United States federal law applies to CNMI. Although the Internal Revenue Code does apply in the form of a local income tax, the income tax system is largely locally determined. The CNMI employs a mirror system of taxation and was adopted from the systems used in both U.S. Virgin Islands and Guam. References in the Code to Guam are deemed to also refer to the Northern Mariana Islands. Thus, the mirror Code of the Northern Marianas is linked to the Guamanian mirror code. Also, the CNMI has the authority to rebate the tax imposed by its mirror code with respect to Northern Marianas-source income. The CNMI rebate a significant amount of this tax, but impose three separate taxes that cover most of the same types of income at lower rates.

Under the powers provided in the U.S. Constitution, Article IV, Section 3, Congress has power to make rules for the U.S Territories and, therefore, has the sole authority to establish the income tax laws of the U.S Territories by designating which taxes are applicable in the U.S Territories under the mirror code system of taxation. In addition, case law interpreting

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<sup>3</sup> 48 U.S.C. § 1397.

<sup>4</sup> *Chicago Bridge & Iron Co. v. Wheatley*, 7 VI 555, 562, 430 F.2d 973, 976 (3d Cir. 1970).

<sup>5</sup> [48 U.S.C. § 1421](#).

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the application of the mirror code system of taxation provides that the U.S. Territories have no power to determine which provisions of the IRC shall apply in the U.S. Territories, absent an express grant from Congress.<sup>6</sup>

According to 31 U.S.C. § 321, Congress has delegated part of its rulemaking authorities over the territories to Treasury. Therefore, the regulations that interpret the applicability of taxes to the U.S. Territories have the same authority as the Code.

As stated in a May 14, 2012 report by the U.S. Joint Committee on Taxation regarding federal tax law and issues related to the U.S. Territories:

Three territories, Guam, the Northern Mariana Islands, and the U.S. Virgin Islands, are referred to as mirror Code possessions because the Internal Revenue Code of 1986, as amended (the “Code”) serves as the internal tax law of those territories (substituting the particular territory for the United States wherever the Code refers to the United States). A resident of one of those territories generally files a single tax return only with the territory of which the individual is a resident, and not with the United States.... Federal tax rules apply to the territories in a manner that is different from their application in relation to both the States and foreign countries. Broadly, an individual resident of a territory is exempt from U.S. tax on income that has a source in that territory but is subject to U.S. tax on U.S.-source and non-possession-source income.<sup>7</sup>

The report also states:

While U.S. statutory laws apply to the U.S. possessions, and natives of U.S. possessions are U.S. citizens or nationals, for tax purposes the Code generally treats the U.S. possessions as foreign countries. When the Code uses the term in a geographical sense, the “United States” includes only the 50 states and the District of Columbia.... Taxes imposed by the Code in any possession are collected under the direction of the Secretary.... Three of the possessions employ a “mirror system” of taxation. In Guam, the Commonwealth of Northern Mariana Islands and the U.S. Virgin Islands, the United States Federal income tax laws are in effect (or “mirrored”) as the local territorial income tax. Proceeds of the mirror codes are generally paid to the treasuries of the possessions. Not all of the Code is mirrored; generally, only the income tax provisions of the Code are mirrored. In the tax statutes as in effect in each of these possessions,

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<sup>6</sup> Ibid.

<sup>7</sup> U.S. Joint Committee on Taxation Report on Federal Tax Law and Issues Related to the United States Territories, Scheduled for a Public Hearing Before the Senate Committee on Finance on May 15, 2012, [JCX-41-12](#), May 14, 2012, page 2.

the name of the possession is substituted for “United States,” and vice-versa. Although the reverse substitution is not explicitly described in any of the operative statutes for the possessions, two-way mirroring has been required to give effect to the intent of the mirroring requirement. To the extent that mirroring would produce a result manifestly incompatible with the Code or other provisions of the United States Code, mirroring is not required.<sup>8</sup>

### Analysis

The wording of proposed and final regulations regarding NIIT appears to exempt from the NIIT bona fide residents of the U.S. Territories; however, the VIBIR has issued a statement and the GDRT Deputy Tax Commissioner has stated that the NIIT applies to bona fide residents of the U.S. Territories, causing much confusion among taxpayers and practitioners. Clarity on the applicability of the NIIT to bona fide residents of the U.S. Territories is needed. Practitioners and taxpayers need clarity in order to file 2013 tax returns by the extended due date of October 15, 2014.

The 2012 proposed regulations state that the NIIT does not apply to bona fide residents of the U.S. Territories.

The 2012 proposed regulations, Preamble (Explanation of Provisions, 3. Application to Individuals, A. In General, p. 4) state:

The proposed regulations also clarify the treatment of (1) grantor trusts (see proposed §§ 1.1411-2(a)(2)(ii), 1.1411-3(b)(5), and part 4.B.ii of this preamble), (2) certain bankruptcy estates (see proposed §§ 1.1411-2(a)(2)(iii), 1.1411-3(d)(1), and part 4.D of this preamble), and (3) **bona fide residents of the U.S. territories** (see proposed § 1.1411-2(a)(2)(iv) and part 3.C of this preamble) (emphasis added).

The 2012 proposed regulations, Preamble (Explanation of Provisions, 3. Application to Individuals, C. Bona Fide Residents of U.S. Territories, pp. 4-5) state:

#### C. Bona Fide Residents of U.S. Territories

Proposed § 1.1411-2(a)(2)(iv) provides guidance on the application of section 1411 to individuals who are bona fide residents (within the meaning of section 937(a)) of possessions of the United States (U.S. territories) (namely, American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, and the United States Virgin Islands). An individual

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<sup>8</sup> Ibid, pages 7-8.

who is a citizen, resident, or nonresident alien with respect to the United States may qualify as a bona fide resident of a U.S. territory.

The application of the tax under section 1411 to a bona fide resident of a U.S. territory depends on whether the U.S. territory has a mirror code system of taxation, meaning the income tax laws are generally identical to the Code (except for the substitution of the name of the relevant territory for the term “United States” where appropriate). Three of the five U.S. territories (Guam, the Northern Mariana Islands, and the United States Virgin Islands) have a mirror code.

Bona fide residents of U.S. territories that are mirror code jurisdictions have no income tax obligation (or related return filing requirement) with the United States provided, generally, that they properly report income and pay income tax to the tax administration of their respective U.S. territory. See generally sections 932, 934, and 935. Therefore, the tax imposed by section 1411(a) generally does not apply to bona fide residents of mirror code jurisdictions because they will not have an income tax liability to the United States if they fully comply with the tax laws of the relevant territory.

Bona fide residents of non-mirror code jurisdictions (American Samoa and Puerto Rico) generally exclude territory source income from U.S. Federal gross income under sections 931 and 933, respectively. (American Samoa currently is the only territory to which section 931 applies because it is the only territory that has entered into an implementing agreement under sections 1271(b) and 1277(b) of the Tax Reform Act of 1986.) Although territory-source income is excluded, these bona fide residents are subject to U.S. Federal income taxation, and have a related income tax return filing requirement with the United States to the extent they have U.S.-source or other non-territory source income or income from amounts paid for services performed as an employee of the United States or any agency thereof (collectively, U.S. reportable income). See section 931(a) and (d) and section 933. Furthermore, under section 876 and § 1.876-1, bona fide residents of non-mirror code jurisdictions who are nonresident aliens with respect to the United States are subject to net-basis U.S. taxation on U.S. reportable income under sections 1 and 55, rather than to gross-basis U.S. taxation with respect to U.S.-source income under sections 871 through 879 (provisions that otherwise generally apply to nonresident aliens with respect to U.S.-source income).

Therefore, the tax imposed under section 1411(a) is applicable to bona fide residents of non-mirror code jurisdictions if they have U.S. reportable

income that gives rise to both net investment income and modified adjusted gross income exceeding the threshold amount in section 1411. However, section 1411(a) does not apply if such bona fide residents are nonresident alien individuals with respect to the United States because section 1411(e)(1) and proposed § 1.1411-2(a)(1) exclude from section 1411(a) all nonresident alien individuals, which would include bona fide residents of any U.S. territory. However, nonresident alien individuals who are bona fide residents of non-mirror code jurisdictions remain subject to taxation under chapter 1 of subtitle A pursuant to section 876.

The final regulations published December 16, 2013 ([T.D. 9644](#)), in IRS Bulletin No. 2013-51, page 714, state:

(vi) *Bona fide residents of United States territories – (A) Applicability.* An individual who is a bona fide resident of a United States territory is subject to the tax imposed by section 1411(a)(1) only if the individual is required to file an income tax return with the United States upon application of 931, 932, 933, or 935 and the regulations thereunder.

Furthermore, regarding the NIIT applicability, we are concerned by the fact that the NIIT is part of a new Chapter 2A. It is not clear whether new Chapter 2A is part of Chapter 2 or not, and whether it is a mirrored income tax.

The NIIT was established as a Subtitle A, Chapter 2A tax. Whereas Chapter 1 income taxes are generally mirrored, under the Organic Act, Chapter 2 taxes are non-mirrored and collected solely by Treasury, not the local taxing authorities.

If the NIIT is part of Chapter 2, then Chapter 2 non-mirrored treatment should apply. We note that Organic Act section 1421(i)(d) says that Chapter 2 (26 USCA § 1401, et. seq.) is not to be “mirrored” on Guam. If Chapter 2A is a continuation or subparagraph Chapter 2 (26 USCA § 1401, et. seq.), then it would appear that it would also be excluded from Guam’s “mirror” tax code, similar to Chapter 2 (26 USCA § 1401, et. seq.).

In addition, it has been pointed out that the Chapter 2 tax revenues fund federal benefits to residents of mirror-code territories. We note that the NIIT is collected by Treasury to fund sections of the ACA. Since these benefits of the ACA are not available to bona fide residents of the U.S. Territories, many commentators believe that it was not intended and would not be appropriate to apply the Chapter 2A tax on bona fide residents of U.S. Territories who will see no benefits from the ACA.

The VIBIR issued a [press release](#) (revised March 13, 2014), stating:

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## **BIR REMINDS TAXPAYERS THAT THE NET INVESTMENT INCOME TAX APPLIES IN THE VIRGIN ISLANDS**

Claudette Watson-Anderson, CPA, Director of the Virgin Islands Bureau of Internal Revenue, reminds taxpayers that the net investment income tax applies to bona fide residents of the Virgin Islands. The tax went into effect on January 1, 2013. Bona fide residents of the Virgin Islands satisfy their tax obligation by filing income tax returns with the Bureau of Internal Revenue. This tax applies to bona fide residents based on the application of the mirror income tax laws that apply in the Virgin Islands.

The net investment act is 3.8% of certain net investment income of individuals, estates and trust that have income above certain thresholds. Net investment includes, among other things, interest, dividends, capital gains, rental and royalty income. Taxpayers are encouraged to consult their financial advisors and accountants to ensure that the correct estimated tax payments are made throughout the year.

Taxpayers with questions about the net investment income tax can contact Tamarah Parson-Small at (340) 715-1040, ext. 2249.

The GDRT Deputy Tax Commissioner has informally stated that the NIIT applies to bona fide residents of Guam who file with the GDRT. In an email on April 11, 2014, to a tax practitioner, the Director of the Deputy Tax Commissioner of the GDRT stated:

... After additional consideration, DRT maintains the position that the Net Investment Income Tax is mirrored under the Guam Territorial Income Tax laws. Chapter 2A is a new chapter and is not specifically exempted by the Organic Act. Although the regulations state that it generally does not apply to mirror code jurisdictions, it qualifies it by saying they will not have an income tax liability to the United States if they fully comply with the tax laws of the relevant territory....

We have been informed that GRDT says Chapter 2A is not part of a Chapter 2 (26 USCA § 1401, et. seq.), but is instead a new Chapter of 26 USCA §1401, not mentioned in the Organic Act.

The CNMIDRT has not issued any statement about whether the NIIT is a mirror tax.

We take no position on whether the Chapter 2A NIIT applies to bona fide residents of the U.S. Virgin Islands, Guam, CNMI, or any other U.S. Territory.



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The AICPA, VISCPA, and GSCPA believe, as a matter of clarity and fair interpretation and application of Congressional intent, Congress should request that Treasury provide clarification on whether the NIIT applies to bona fide residents of the mirror code U.S. Territories. In addition, if bona fide residents of mirror code U.S. Territories are exempt from the NIIT, the extension of this exemption to mirror code U.S. Territories estates and trusts should be clarified as well.

### **Conclusion/Recommendations**

The U.S. Territories do not have the authority to determine which provisions of the IRC are mirrored. This authority is held by Congress, which has delegated this authority to Treasury.<sup>9</sup> Interpretations of Code application, therefore, lie with Treasury regulations, IRS notices, and revenue procedures. A Congressional statement, or Treasury, or IRS announcement or notice on this matter is needed.

It is not clear whether Congress or Treasury intended to make the NIIT a mirrored income tax.

Treasury should provide clarity to bona fide residents of mirror code U.S. Territories as to when and how the NIIT applies. If bona fide residents of mirror code U.S. Territories are exempt from the NIIT, we additionally request clarification as to whether or not U.S. Territory estates and trusts are exempt from the NIIT as well.

We kindly request your assistance with the issue by initiating contact with Treasury on behalf of taxpayers and tax preparers in your constituency. An authoritative statement from the U.S. Congress or Treasury is needed as soon as possible for taxpayers to correctly complete their 2013 income tax filings.

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We thank you for your consideration of this request for clarification. Please feel free to contact any of the following: Jeffrey A. Porter, Chair of the AICPA Tax Executive Committee at (304) 522-2553, or [jporter@portercpa.com](mailto:jporter@portercpa.com); Rob Upson, President of the VISCPA, at (340) 776-1852, or [admin@viscpa.org](mailto:admin@viscpa.org); Sean Phillips, President of the Guam Society of CPAs, at (671) 649-5050, or [sean@babacorp.net](mailto:sean@babacorp.net); or Eileen R. Sherr, AICPA Senior Technical Manager, at (202) 434-9256, or [esherr@aicpa.org](mailto:esherr@aicpa.org) to discuss the above comments or if you require any additional information.

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<sup>9</sup> 31 U.S.C. § 321.

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Sincerely,



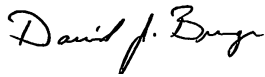
Jeffrey A. Porter, CPA  
Chair, AICPA Tax Executive Committee



Robert Upson, CPA  
President, VISCPA



Sean Phillips, CPA  
President, GSCPA



David Burger, CPA  
Chairman of the CNMI Board of Accountancy

cc: Mark Mazur, Assistant Secretary for Tax Policy, Department of the Treasury  
Brenda Zent, Office of International Tax Counsel, Department of the Treasury  
Catherine Veihmeyer Hughes, Estate and Gift Tax Attorney Advisor, Office of Tax Policy,  
Department of the Treasury  
William J. Wilkins, Chief Counsel, Internal Revenue Service  
Adrienne Mikolashek, Office of Chief Counsel for Passthroughs and Special Industries,  
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May 13, 2014

## VIA: FEDERAL EXPRESS

Ms. Brenda Zent  
U.S. Department of Treasury  
Office of International Tax Counsel  
1500 Pennsylvania Avenue, NW, Room 3058  
Washington, DC 20220

### **Re: Net Investment Income Tax as applicable in the United States Virgin Islands**

Dear Ms. Zent:

We are writing to request guidance concerning the Net Investment Income Tax ("NIIT") which became effective on January 1, 2013.<sup>1</sup> Specifically, we are requesting confirmation that the NIIT is not a mirrored tax to be collected by the U.S. Virgin Islands ("USVI") Bureau of Internal Revenue (the "BIR").

By way of background, the income tax laws of the USVI were established by the Naval Services Appropriation Act of 1922, which was enacted after the United States acquired the USVI from Denmark in 1917. The Naval Services Appropriation Act 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."<sup>2</sup> Under this arrangement, commonly referred to as the "mirror code" system of taxation, the substantive tax provisions of the Internal Revenue Code of 1986, as amended (the "Code"), as well as "any changes to, interpretations of, regulations and revenue rulings on and court interpretations of [such provisions]"<sup>3</sup> are applicable as the income tax laws of the USVI by substituting the words "Virgin Islands" for the words "United States" wherever they appear.

Congress has the sole authority to establish the income tax laws of the USVI by designating which taxes are applicable in the USVI under the mirror code system of taxation. Specifically, Article IV, section 3 of the U.S. Constitution provides in pertinent part that:

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<sup>1</sup> 26 U.S.C. § 1411.

<sup>2</sup> 48 U.S.C. § 1397. "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."

<sup>3</sup> *Chicago Bridge & Iron Co. v. Wheatley*, 7 V.I. 555, 562, 430 F.2d 973, 976 (3d Cir. 1970).

The Congress shall have power to dispose of and make all needful rules and regulations respecting the territory or other property belonging to the United States; and nothing in this Constitution shall be so construed as to prejudice any claims of the United States, or of any particular state.

Consistent with Congress' constitutional authority to make rules for the territories, case law interpreting the application of the mirror code system provides that the USVI has no power to determine which provisions of the Internal Revenue Code shall apply in the USVI, absent an express grant from Congress.<sup>4</sup> Specifically, the Third Circuit has determined that:

[The USVI is] not... a sovereign state but... a territory. The power to tax, therefore, is not present as an attribute of sovereignty, but must come as a grant from Congress. In the case of the Virgin Islands such power to levy taxes comes from the Organic Act of June 22, 1936. *H. D. Hettinger & Co. v. Municipality of St. Thomas & St. John*, 187 F.2d 774, 776 (3d Cir. V.I. 1951).

Pursuant to 31 U.S.C. § 321, Congress has delegated part of its rule making authority over the territories to the U.S. Treasury Department. Therefore, the Treasury Regulations, IRS Notices and Revenue Procedures that interpret the applicability of certain taxes to the USVI speak with the same authority as the Code itself.

It appears clear that neither Congress nor the U.S. Treasury Department intended to make the NIIT part of the income tax laws of the USVI through the mirror code system of taxation for the following reasons:

1. The U.S. Treasury Department, exercising power delegated to it by Congress, has specifically stated in Treasury Regulations and Publication 570 that the NIIT does not apply to USVI taxpayers.
2. The U.S. Congressional Research Service has indicated to the U.S. Virgin Islands Delegate to Congress that the NIIT is not applicable in the USVI.
3. The NIIT is a tax that was enacted as part of the Affordable Care Act,<sup>5</sup> which is not generally applicable in the USVI. Therefore it would be a justifiable use of the U.S. Treasury Department's delegation of authority to provide that the NIIT not be mirrored to the USVI. To the contrary, imposing a tax on the USVI to collect revenues for a program

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<sup>4</sup> See *Chi. Bridge & Iron Co. v. Wheatley*, 430 F.2d 973, 978 (3d Cir. 1970). (“[T]he Virgin Islands may not at its option effectively disallow the deductions provided in the Internal Revenue Code... Congress has aided the Virgin Islands by giving them the same tax, not more, than the United States would otherwise collect on Virgin Islands business.”) Citations omitted.

<sup>5</sup> Pub.L. 111-152, Title I, § 1402(a)(1).

that is not generally applicable to the USVI would seem to be an unreasonable use of the U.S. Treasury Department's authority.

Additionally, the USVI Legislature has not enacted the NIIT in the USVI despite clearly having the power to enact local income taxes. By way of background, Code section 934(b)(1) permits the USVI to reduce or rebate tax on USVI source or effectively connected income – but not the power to raise taxes on such income. Further, a 1976 amendment to the Naval Service Appropriations Act<sup>6</sup> inserted language permitting the USVI to enact local income tax surcharges of up to 10 percent on the Federal income tax liability of both corporations and individuals. The USVI's unicameral legislature has enacted an income tax surcharge for corporations starting in 1985<sup>7</sup> but has not done so for individuals. Finally, the Tax Reform Act of 1986 gave the USVI the ability to enact a local income tax that would be treated as a state or local tax (which the surcharge is not) but the USVI has not enacted a local income tax.

However, the USVI does not have (and has never had) the power to determine which provisions of the Code are “mirrored” to the USVI. Further, except as a legislatively enacted local tax or surcharge of up to 10 percent, it does not have the power to increase taxes under the Code as applicable to the USVI on income that is neither sourced to the USVI nor effectively connected with a USVI trade or business. It is important to note that much of the income that would be subject to the NIIT (if applicable to the USVI) would likely consist of non-USVI source income such as dividends and interest from U.S payors.

**1. The U.S. Treasury Department, exercising power delegated to it by Congress, has specifically stated that the NIIT does not mirror to the USVI.**

Congress has delegated to the U.S. Treasury Department wide authority to administer the Code, including the authority to determine which income tax provisions “mirror” to the USVI. By way of example, the Senate Finance Committee Report, in describing the reasons for the changes in the USVI tax system enacted in the 1986 Tax Reform Act, indicated that the Secretary of the Treasury has the power to determine what provisions of the Code are mirrored:

The Secretary of the Treasury is given authority to provide by regulation the extent to which provisions in the Internal Revenue Code shall not apply for purposes of determining tax liability to the Virgin Islands (i.e. shall not be mirrored). It is anticipated that such regulations will provide that references to possessions of the United States will not be mirrored. Committee on Finance Report to accompany H.R. 3838, page 483.

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<sup>6</sup> Pub. L. 94-392.

<sup>7</sup> V.I. CODE ANN. tit. 33, § 581. See also *Abramson Enterprises, Inc. v. Gov't of the Virgin Islands, et al.*, 994 F.2d 140 (3d Cir. 1993) (holding that the 10% surtax is an extension of the corporation's Federal income tax liability and not a deductible state or local tax).

As stated above, the Senate Finance Committee Report indicated that the Secretary of the Treasury has the authority to provide by regulation the extent to which provisions in the Code shall not apply for purposes of determining tax liability to the Virgin Islands (i.e. shall not be mirrored). The Report further indicated that it was anticipated that such regulations would provide that references to possessions of the United States would not be mirrored. While it did not indicate that the only exception from the mirroring of the Code would be with regard to possession references, the clear implication was that provisions should not be mirrored where it did not make sense that they be mirrored.

Given that the U.S. Treasury Department has the authority to determine which provisions of the Code are mirrored, the following documents strongly indicate that the U.S. Treasury Department does not intend that the NIIT be mirrored to the USVI.

**A. The NIIT Treasury Regulations state that bona fide residents of the USVI are not subject to the NIIT.**

The pertinent Treasury Regulation states as follows:

An individual who is a bona fide resident of a United States territory is subject to the tax imposed by section 1411(a)(1) only if the individual is required to file an income tax return with the United States upon application of section 931, 932, 933, or 935 and the regulations thereunder. 26 CFR 1.1411-2(a)(2)(vi)(A).

It specifically states that a bona fide resident of the USVI (and other territories) is only subject to the NIIT tax if he or she has a U.S. filing obligation. An individual must file a tax return with the United States if he or she is not a bona fide resident of the USVI.<sup>8</sup> An individual's filing obligation with the BIR is not the result of the mirror code, but rather the result of laws and regulations specifically enacted and issued by Congress and the U.S. Treasury Department, respectively, regarding USVI taxpayers. Like the laws and regulations discussing the filing requirements of bona fide residents of the USVI, the Treasury Regulation discussing the applicability of the NIIT to bona fide residents of the USVI specifically describes the tax's applicability to the USVI. Therefore that Treasury Regulation should apply to the USVI as its "plain text" – or clear language provides unambiguously.

The Treasury Regulation discusses who "is subject to" the tax. If a bona fide resident of the USVI is not "subject to" the tax, as the Treasury Regulation states, it should not matter which agency is collecting the tax. The annotations to the Treasury Regulation state:

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<sup>8</sup> See 26 USC § 932(c).

Bona fide residents of U.S. territories that are mirror code jurisdictions have no income tax obligation (or related return filing requirement) with the United States provided, generally, that they properly report income and pay income tax to the tax administration of their respective U.S. territory. See generally sections 932, 934, and 935. Therefore, the tax imposed by section 1411(a) generally does not apply to bona fide residents of mirror code jurisdictions because they will not have an income tax liability to the United States if they fully comply with the tax laws of the relevant territory. Full comments available at: <http://www.gpo.gov/fdsys/pkg/FR-2012-12-05/html/2012-29238.htm>

The annotations to the Treasury Regulation also indicate that the NIIT does not apply to bona fide residents of the USVI so long as they do not have an income tax liability to the United States. If the NIIT were mirrored, the specific language of the Treasury Regulation and the annotations thereof would be rendered meaningless. Because Congress and its authorized delegate the U.S. Treasury Department have power to determine which provisions are mirrored, the mirror code does not apply where Treasury Regulations that relate specifically to the USVI indicate that mirroring does not apply. Therefore, the Treasury Regulation dealing with Code Section 1411 clearly indicates that the NIIT is not mirrored to the USVI.

**B. Publication 570 also indicates that bona fide residents of the USVI are not subject to the NIIT.**

As discussed in detail above, the Secretary of the Treasury has the authority to determine if the NIIT is mirrored, and the Secretary has determined that it is not. Treasury Regulation sec. 1.1411-2(a)(2)(vi)(A) states that bona fide residents of the USVI who do not file an income tax return with the United States are not “subject to” the tax, and this Treasury Regulation does not differentiate between the IRS and the BIR.

Additionally, Publication 570, Tax Guide for Individuals with Income from U.S. Possessions, – the publication in which the IRS provides guidance to filing and payment requirements relating to each territory – states the following about the NIIT:

Bona fide residents of Puerto Rico and American Samoa who have a federal income tax return filing obligation may be liable for the NIIT if the taxpayer's modified adjusted gross income from non-territory sources exceeds a specified threshold amount. Pub. 570, page 1. February 26, 2014.

Puerto Rico and American Samoa are not “mirror code” jurisdictions. The publication specifies that the NIIT only applies to taxpayers in Puerto Rico and American Samoa if that taxpayer's modified adjusted gross income *from sources outside each territory* exceeds the NIIT threshold amount. The publication is silent as to the applicability of the NIIT to bona fide residents of the

mirror code jurisdictions – specifically the USVI, Guam and the Commonwealth of the Northern Marianas. It stands to reason that if the U.S. Treasury Department and the IRS intended for bona fide residents of the USVI to be “subject to” the NIIT, either directly or as mirrored to the USVI, it would have stated so in Publication 570 which is the IRS publication specifically directed to taxpayers in the U.S. possessions.

**2. The U.S. Congress has Indicated Informally that the NIIT is Not Mirrored to the USVI.**

On or about June 26, 2013, Thomas Brunet, who works for U.S. Virgin Islands Delegate to Congress, Dr. Donna Christensen, contacted the Congressional Research Service<sup>9</sup> to ask whether the 3.8 percent tax applies to the USVI. The response from the CRS is set out below and the email exchange is available upon request.

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1. Does the 3.8% tax and apply to the USVI?

Generally, no. The ACA’s 3.8% net investment tax does not apply to bona fide residents of the USVI according to the following guidance from the IRS (see the highlighted section). Keep in mind, however, that some taxpayers may have unique circumstances that would require more information to assess their tax position. The selected text below is from:

Federal Register / Vol. 77, No. 234 / Wednesday, December 5, 2012 /  
Proposed Rules, Page 72612

C. Bona Fide Residents of U.S. Territories

Proposed Sec. 1.1411-2(a)(2)(iv) provides guidance on the application of section 1411 to individuals who are bona fide residents (within the meaning of section 937(a)) of possessions of the United States (U.S. territories) (namely, American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, and the United States Virgin Islands). An individual who is a citizen, resident, or nonresident alien with respect to the United States may qualify as a bona fide resident of a U.S. territory.

The application of the tax under section 1411 to a bona fide resident of a U.S. territory depends on whether the U.S. territory has a mirror code system of taxation, meaning the income tax laws are generally identical to the Code (except for the substitution of the name of the relevant

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<sup>9</sup> The Congressional Research Service (“CRS”) is a public policy research arm of the United States Congress. As a legislative branch agency within the Library of Congress, CRS works primarily and directly for Members of Congress, their Committees and staff on a nonpartisan basis.



territory for the term "United States" where appropriate). Three of the five U.S. territories (Guam, the Northern Mariana Islands, and the United States Virgin Islands) have a mirror code.

*Bona fide residents of U.S. territories that are mirror code jurisdictions have no income tax obligation (or related return filing requirement) with the United States provided, generally, that they properly report income and pay income tax to the tax administration of their respective U.S. territory. See generally sections 932, 934, and 935. Therefore, the tax imposed by section 1411(a) generally does not apply to bona fide residents of mirror code jurisdictions because they will not have an income tax liability to the United States if they fully comply with the tax laws of the relevant territory.*

Bona fide residents of non-mirror code jurisdictions (American Samoa and Puerto Rico) generally exclude territory-source income from U.S. Federal gross income under sections 931 and 933, respectively. (American Samoa currently is the only territory to which section 931 applies because it is the only territory that has entered into an implementing agreement under sections 1271(b) and 1277(b) of the Tax Reform Act of 1986.) Although territory-source income is excluded, these bona fide residents are subject to U.S. Federal income taxation, and have a related income tax return filing requirement with the United States to the extent they have U.S.-source or other non-territory source income or income from amounts paid for services performed as an employee of the United States or any agency thereof (collectively, U.S. reportable income). See section 931(a) and (d) and section 933.

Furthermore, under section 876 and Sec. 1.876-1, bona fide residents of non-mirror code jurisdictions who are nonresident aliens with respect to the United States are subject to net-basis U.S. taxation on U.S. reportable income under sections 1 and 55, rather than to gross-basis U.S. taxation with respect to U.S.-source income under sections 871 through 879 (provisions that otherwise generally apply to nonresident aliens with respect to U.S.-source income).

Therefore, the tax imposed under section 1411(a) is applicable to bona fide residents of non-mirror code jurisdictions if they have U.S. reportable income that gives rise to both net investment income and modified adjusted gross income exceeding the threshold amount in section 1411. However, section 1411(a) does not apply if such bona fide residents are nonresident alien individuals with respect to the United States because section 1411(e)(1) and proposed Sec. 1.1411-2(a)(1) exclude from section 1411(a) all nonresident alien individuals, which would include bona fide residents of any U.S. territory. However, nonresident alien individuals who are bona fide residents of non-mirror code jurisdictions remain subject to taxation under chapter 1 of subtitle A pursuant to section 876.

THOMAS G. BRUNET  
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It is clear from the above analysis that an unbiased and informed reading of the applicable Treasury Regulation by the Congressional Research Service – a nonpartisan body whose core mission is to provide guidance on such issues – resulted in a conclusion that the statute and regulations did not mirror to the USVI.

**3. The NIIT is a tax enacted as part of the Affordable Care Act, which is not applicable in the USVI, and therefore it would be an appropriate and justifiable use of the U.S. Treasury Department’s delegation of authority that the NIIT not be mirrored to the USVI.**

Generally, taxes collected for a specific Federal program that is administered by the United States are not mirrored in the USVI. The NIIT’s 3.8 percent surtax was enacted as part of the Health Care and Education Reconciliation Act of 2010 (“Affordable Care Act”)<sup>10</sup> and the legislation enacting this tax created a new section of the tax code entitled: “Chapter 2A – Unearned Income Medicare Contribution.” This section was a revenue-raiser enacted to pay for health care costs.<sup>11</sup> However, the Affordable Care Act does not mandate that all territorial residents buy plans nor does it provide subsidies to make coverage more affordable, as it does in the 50 states and the District of Columbia.<sup>12</sup> Hence the USVI (and other territories) do not benefit from the subsidies provided to the 50 states and DC. It is therefore reasonable that the IRS determined that such territories should not be required to pay a tax that was specifically enacted to offset the costs of the health care legislation in the 50 states and D.C. either directly to the IRS (similar to Medicare which does benefit the territory’s residents) or to the BIR under the “mirror code” (where it would not be used to offset the costs of health care legislation).

Moreover, as a Chapter 2A tax, the NIIT is more akin to non-mirrored payroll taxes under Chapter 2 of Subtitle A of the Code. While Chapter 1 taxes are generally mirrored to the USVI (unless the U.S. Treasury decides they should not be mirrored as discussed above), Chapter 2 taxes such as Federal Insurance Contribution Act (“FICA”) payments, Medicare, Medicaid, and the Federal Unemployment Tax (“FUTA”) are not mirrored to the USVI because they relate directly to programs funded by the United States. USVI residents benefit from these programs, however, and thus the United States collects the tax directly from USVI residents to fund these programs. Unlike FICA, FUTA and the hospital insurance taxes, the provisions of the Affordable Care Act funded by the NIIT do not apply to bona fide residents of the USVI. Thus, since the NIIT is a revenue raiser that was enacted to fund a specific piece of Congressional

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<sup>10</sup> Pub.L. 111-152, Title I, § 1402(a)(1).

<sup>11</sup> Jillian Berman, *Obamacare Investment Income Tax: Wealthy to Pay 3.8 Percent Surcharge on Capital Gains, Dividends*, HUFFINGTON POST, December 4, 2012.

<sup>12</sup> Sarah Kliff, *Think your state has Obamacare problems? They’re nothing compared to Guam*, WASHINGTON POST, December 19, 2013.

legislation that does not apply in the USVI, it would not be appropriate or reasonable to “mirror” the NIIT to the USVI or for the IRS to collect it from USVI bona fide residents.

**4. Only Congress (or its authorized delegee) may determine whether the NIIT provisions mirror to the USVI; the BIR and the USVI government have no authority to make such a determination.**

The mirror system exists to allow the USVI to become self-supporting. It does not allow for the BIR to make independent decisions about which taxes are mirrored and which are not.<sup>13</sup> Congress passed sweeping reforms to the USVI tax system, and the mirror code in the 1986 Tax Reform Act<sup>14</sup>, and under these reforms the USVI is free to enact additional taxes upon residents of the USVI through the USVI legislative process only to the extent such taxes do not conflict with the mirror code.<sup>15</sup> The Ways and Means Committee described this authority as follows in its report regarding the Tax Reform Act of 1986:

[T]he Virgin Islands is provided with the authority to enact nondiscriminatory local income taxes (which for US purposes would be treated as State or local income taxes) in addition to those imposed under the mirror system. Ways and Means Committee Report, Tax Reform Act of 1986, p. 488-489.

The USVI can also enact up to a ten percent surcharge on individuals. However, and as stated above, any such income tax laws – whether a surcharge or a local income tax – must be passed by the USVI legislature, and signed into law by the USVI governor.<sup>16</sup> The BIR, as an administrative agency of the USVI government, does not have any legal authority unilaterally to enact tax laws or to determine if a provision of the Code is applicable in the USVI (which would effectively be the same thing as enacting a local statute).

Yet this is exactly what the BIR is attempting to do. On or about June 24, 2013 the BIR issued the following statement, by way of a press release that provides, in relevant part: “Claudette Watson-Anderson, CPA, Director of the Virgin Islands Bureau of Internal Revenue reminds taxpayers that the net investment income tax applies to bona fide residents of the Virgin Islands. The tax went into effect in January 1, 2013.”

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<sup>13</sup> See *Chase Manhattan Bank, N.A. v. Gov't of the Virgin Islands*, 300 F.3d 320 (3d Cir. 2002) (holding that interest on the taxpayer's overpayment of USVI taxes accrued at the rate applicable under the Internal Revenue Code rather than at the rate applicable under the Virgin Islands Code).

<sup>14</sup> Pub. L. No. 99-514, 100 Stat. 2085.

<sup>15</sup> Pursuant to 26 U.S.C. § 934, the USVI legislature has authority to reduce income tax liability only on income that is USVI-source or on income that is effectively connected with a USVI trade or business and is not otherwise U.S. source. However, the USVI legislature has no authority to change the application of the mirrored Code with respect to the USVI.

<sup>16</sup> See, e.g. 48 USC §§ 1574 – 1599.

By applying the NIIT to the USVI in direct contrast to the clear language in the Treasury Regulations governing the NIIT and other guidance that specifically states that bona fide residents of the USVI are not “subject to” the NIIT, the BIR is usurping Congress’ (and by extension, the U.S. Treasury Department’s) authority to determine which taxes are mirrored to the USVI. Further, the BIR’s action creates a precedent for the USVI and other territories to make unilateral decisions with regard to the applicability of other provisions of the Code to the respective territory. Since there is no clear distinction between deciding that a provision is mirrored where Congress and the U.S. Treasury Department have indicated otherwise and not mirroring a provision of the Code, unilateral action by a territory with regard to the mirroring of certain Code provisions undermines Congress’ ability to determine which provisions should not be mirrored in the future. If in fact Congress and the U.S. Treasury Department are signaling a change in the application of the mirror code to the U.S. territories, it should be made directly with applicable notice in IRS publications and other relevant media.

### Conclusion

Congress has the sole authority to determine which income taxes apply to the USVI pursuant to the “mirror system” of taxation and may delegate such power to the U.S. Treasury Department. Congress has given specific authority to the USVI to enact a 10 percent surcharge on income, to enact local income taxes, and to reduce or remit taxes on USVI source and effectively connected income. These actions require passage by the Legislature of the USVI and Governor approval. Congress has not given the USVI’s tax administration agency, the BIR, the authority to decide unilaterally whether a tax is mirrored to the USVI – especially where the authority issued by the U.S. Treasury Department indicates otherwise. Based on the final Treasury Regulations promulgated under Code section 1411<sup>17</sup> and other administrative guidance produced by the U.S. Treasury Department, it is our belief – one shared by the Congressional Research Service as well as many USVI taxpayers – that the U.S. Treasury Department has already determined that the NIIT does not mirror to the USVI.<sup>18</sup>

However, the BIR has taken a contrary position to that of the U.S. Treasury Department. This position has caused confusion among taxpayers in both the USVI and in other U.S. territories that are subject to the “mirror” system of taxation in regard to the specific application of the NIIT and more broadly the authority of the USVI (and Guam and the Commonwealth of the Northern Mariana Islands) unilaterally to interpret and apply provisions of the Code. Therefore we specifically request confirmation to all parties involved that the tax is not applicable in the USVI. If you disagree with this analysis, we would appreciate specific details as to when and how the NIIT applies to USVI taxpayers and also guidance on when the BIR can and cannot make decisions regarding “mirroring” of the Code.

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<sup>17</sup> 26 CFR § 1.1411-2(a)(2)(vi)(A).

<sup>18</sup> See Joseph M. Erwin, “Business Operations in the Territories and Possessions of the United States (except Puerto Rico) — Additional Medicare Tax,” 995-2nd Tax Mgmt. (BNA) Foreign Income, at II.B.2.f (2014).

Ms. Brenda Zent  
Department of Treasury  
Office of International Tax Counsel  
Re: Net Investment Income Tax  
May 13, 2014  
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Thank you very much for your assistance in this matter. We would be glad to discuss any of the points raised in this letter in a telephone conference or in-person meeting if you believe it would be beneficial.

Very Truly Yours,



Marjorie Rawls Roberts