THE TAX FREE ENTITY UNDER THE U.S. FLAG:
A UNITED STATES VIRGIN ISLANDS EXEMPT COMPANY

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It will come as a surprise to many practitioners that the Internal Revenue Code provides an international tax planning tool with one very unusual feature: a corporate entity which enjoys all the non-tax advantages of incorporation in a United States jurisdiction, but without any federal or local income tax. The entity, known as a United States Virgin Islands exempt company, was authorized by the 1986 amendments to Section 934(b) of the Internal Revenue Code. Implementing legislation was thereafter adopted by the Legislature of the Virgin Islands. This article discusses generally how territorial tax policy is formulated, the historical and policy background of the exempt company provisions, their technical application and requirements, and their practical application as a tax planning mechanism for selected non-United States owners.

I. Historical, Policy and Legislative Background

Formulation of Territorial Policy and Territorial Tax Policy

The United States has sovereignty over several offshore areas located in the Eastern Caribbean and in both the North and South Pacific Ocean. These offshore areas are usually referred to as territories or possessions. The most economically and politically important of these territories are Puerto Rico, the U.S. Virgin Islands, Guam, the Commonwealth of the Northern Mariana Islands, and American Samoa. Under the U.S. Constitution, Congress is responsible for enacting laws regarding the territories. For the most part, Congress has provided for each of the above territories to be self-governing: each has authority to elect its own governor and legislature; and each has the authority to enact its own laws except in the few areas where Congress has withheld, and retained for itself, such authority. Although rarely exercised, Congress also retains its Constitutional power to invalidate laws enacted by territories.

Congress also assists the territories in meeting their budgetary and fiscal needs. Generally there are three methods used to accomplish this: (1) continuing appropriations which are often tied to particular federal tax collections or other indicators; (2) annual appropriations that are either tied to specific projects or which may be applied by a territory to its general budget; and (3) participation in various federal programs which are specifically made applicable to the territories. While the levels of assistance in the second category were substantial historically, in the budget conscious years of the late seventies and eighties, the amount of assistance in this category has been steadily reduced and is now minimal. As the agency primarily responsible for holding the territorial purse strings, particularly in respect of the federal appropriations in the first two categories listed above, the Office of Territorial and International Affairs ("TIA") of the U.S. Department of Interior is generally responsible for most areas of territorial policy making and territorial-federal relations. TIA also has a separate budget for technical assistance grants to the territories which are typically used for such projects as computerization of territorial records or implementation of improvements to territorial government accounting systems and the like.

Aside from these direct responsibilities in overseeing federal expenditures for territorial projects,

TIA's role in territorial policy making also extends to advocating positions with other federal agencies, and with Congress, which are favorable to the territories. TIA's success in such efforts with other agencies usually depends on the significance of the issue involved and the relative political power of TIA or the Department of Interior as compared to that of the other agency involved. Of course, as the territories have gained political maturity, and particularly since they began electing governors in the 1970's, they have come to rely less and less on TIA's assistance with other agencies and have undertaken the responsibility to advocate their own positions directly with the agencies as well as with Congress. Again, the extent of a territory's self reliance (and success) in such areas can vary widely from issue to issue and from territory to territory.

In the area of territorial tax policy, however, the relatively powerful Department of the Treasury (specifically the Assistant Secretary for Tax Policy) usually has the final say on the administration position. As a result, neither TIA nor the territories themselves have had substantial influence in this area, at least with respect to influencing the administration position. TIA's views are rarely expressed on tax policy matters, and, if they are expressed, they generally do not differ substantially from those of Treasury. While the territories themselves have, particularly in recent years, conducted a dialogue on territorial tax policy issues with the Assistant Secretary for Tax Policy, as will be seen below, their success, where it has come at all, has usually resulted from their direct contact with Congress.

The Tax Reform Act of 1986

The Tax Reform Act of 1986 contained several provisions making significant changes in the income tax systems of the U.S. territories other than Puerto Rico. With a few exceptions, .934(b) being one of them, these provisions largely reflected the administration's tax policy toward the territories in the mid- 1970's to the mid-1980's, as expressed by the Treasury Department. This policy consisted of three main elements: maintaining or increasing territorial income tax revenues so as to reduce reliance on federal funding sources, elimination of fraud and abuse, and elimination of the so-called "mirror systems" of territorial taxation. All three of these elements are reflected in the Tax Reform Act of 1986 provisions relating to Guam, American Samoa, and the Northern Marianas, as well as the U.S. Virgin Islands, but the provisions relating to the U.S. Virgin Islands are substantially different from those which apply to the other three territories. In short, the Virgin Islands has retained the mirror system but has enacted special provisions allowing the elimination of tax on companies that meet certain relatively simple requirements, while the other territories are considering enactment of entirely new tax systems.

The 1986 legislation relating to Guam, American Samoa, and the Northern Marianas was almost solely a reflection of Treasury's tax policy toward the territories and was both proposed and enacted without a substantial amount of either support or objection from these territories. The difference in treatment for the Virgin Islands is primarily a result of that territory's mostly successful effort in the early 1980's to influence the federal formulation of territorial tax policy relating to the Virgin Islands. So that the Tax Reform Act of 1986 provisions relating Virgin Islands, and particularly to Virgin Islands exempt companies, may be put in the proper historical and policy context, a brief outline of the Tax Reform Act of 1986 provisions applying to the other three territories follows.

Guam, American Samoa, and the Northern Marianas:
No Quick End to the Mirror Systems

Very generally, for the purposes of United States taxation, the Tax Reform Act of 1986 treats corporations organized in Guam, American Samoa and the Northern Marianas as foreign corporations, while individual U.S. citizens resident in those jurisdictions are taxed by the United States on their worldwide income except that income from territorial sources is exempt. While not directly eliminating the mirror systems in these territories, this legislation clearly encouraged their elimination by suggesting that the respective territorial legislatures adopt new tax systems to replace them. To date, however, none has done so. Guam which has recently drafted a proposed new tax code which would replace the mirror system appears to be headed in that direction; American Samoa has locally adopted the mirror system as its tax law; and the Northern Marianas continues to use the mirror system along with a special rebate for residents.

The new rules contained in the Tax Reform Act of 1986, and any new tax law to be adopted by one of these territories, will not take effect until the effective date of an implementing agreement between the territory and the United States; in the meantime the mirror systems continue to operate. The implementing agreement is designed to facilitate the sharing of tax information and the elimination of double taxation, and to end any evasion or avoidance "permitted or facilitated" by a territory. Of the three territories to which these provisions apply, only one, American Samoa, has an implementing agreement that is in effect. The effective date of Guam's agreement has been indefinitely delayed to provide the Guam Government additional time for approving a new tax code, and the Northern Marianas has never approved an agreement.

In theory at least the 1986 legislation relating to Guam, American Samoa, and the Northern Marianas was to have encouraged these territories to move significantly toward Treasury's goal of disentangling them from the perceived problems and abuses of the mirror system. In so doing these territories and their taxpayers would be treated for U.S. tax purposes almost identically to foreign countries and foreign persons, respectively. Whether or not the mirror systems actually caused territorial revenue shortfalls or abuse problems, or whether perhaps their elimination was proposed for these territories so that Treasury could avoid the need to deal with several recurring mirror system administrative problems, the mirror systems certainly have not yet been eliminated, notwithstanding Treasury policy and the Tax Reform Act of 1986. In the meantime, the details of any new tax systems for these three territories has not yet been determined.

U.S. Virgin Islands: Mirror System "Repair" and New Opportunities

For a variety of reasons, during the consideration of the Tax Reform Act of 1986, the Virgin Islands took a more pro-active stand than did its sister territories. First, the Virgin Islands wanted to ensure that a politically significant local policy, that of maintaining substantial local control over the administration of the Virgin Islands tax system, was not abrogated in the federal legislation. The Treasury Department, on the other hand, was very concerned that a well-publicized loophole, known as a "Section 28(a) company", would be legislatively eliminated; the Virgin Islands Government had no objection to this, but was concerned that its views as to accomplishment of this goal be given consideration. Third, as a policy matter, the Virgin Islands took the position that, so long as federal authorization was in place to allow

elimination of certain inequities and administrative problems, the mirror system ought to continue as the territory's tax system. Finally, the Virgin Islands viewed the Tax Reform Act as a vehicle for the expansion of its financial services industry -- specifically, that it should contain provisions authorizing the establishment of tax exempt companies in the territory.

The Tax Reform Act of 1986 contained three major substantive changes relating to the Virgin Islands: the loophole closing provisions referred to above, a new code section substantially eliminating most of the adverse effects of the mirror system on individuals, while retaining the mirror system generally, and the provision authorizing the establishment of the U.S. Virgin Islands exempt company. Of major importance to the Virgin Islands Government was the fact that it would be permitted to continue to administer its own tax system without federal interference, and that the system would still be the mirror, but now an "improved" mirror. Unlike the treatment accorded the other territories, the maintenance of the mirror system was seen by the Virgin Islands as a means of continuing a familiar (albeit admittedly complex) system, with familiar forms, regulations, and rulings, and without the need to endure the political and economic upheaval that could be wrought by having to write a new tax code.

The first mirror improvement is that for the purposes of individual taxation, the United States is deemed to include the Virgin Islands and the Virgin Islands is deemed to include the United States. This change alone eliminated a substantial portion of the administrative and interpretative headaches for both taxpayers and the respective tax administrations. For example, prior to the enactment of these deeming provisions, U.S. citizens had been treated for Virgin Islands tax purposes (disadvantageously, in most instances) as if they had been non- resident aliens, but the new provision restored their "tax citizenship."

The other most significant mirror system improvement was the provision authorizing exempt companies: The strict mirror rule that a Virgin Islands taxpayer must pay the same amount of tax as his counterpart in the United States, was eliminated for the first time since 1960 in respect to income from sources outside the Virgin Islands and not effectively connected with a trade or business in the Virgin Islands. This broad authorization of tax reductions for non-U.S. source income, was designed to provide a new "product" to stimulate the growth of the financial services sector in the U.S. Virgin Islands and to provide the Virgin Islands government with a potential source of new revenue.

The section of the Tax Reform Act of 1986 providing the authorization for Virgin Islands exempt companies could only become effective upon the effective date of an implementation agreement between the Virgin Islands and the United States. As with the implementation agreements to be adopted by the other three territories, the Virgin Islands implementation agreement is designed to facilitate the sharing of tax information and the elimination of double taxation, and to end tax evasion or improper avoidance. As the Virgin Islands was particularly eager to begin its exempt company program, it was the first of the four territories to negotiate and approve an implementation agreement. The Virgin Islands implementation agreement, along with the exempt company federal authorization provision, became effective on February 24, 1987.

II. Benefits and Requirements

Federal Benefits and Requirement

The federal authorization for the establishment of Virgin Islands exempt companies is contained in Code section 934(b). This section excepts "qualified foreign corporations" from the section 934(a) prohibition against reduction in mirror system income tax liability by the Virgin Islands government with respect to income derived from sources outside the United States and not effectively connected to a United States trade or business. A corporation is "qualified" for the purposes of section 934(b) if it is a foreign corporation and if less than 10% of the voting power and value of its stock is owned by United States persons. A foreign corporation includes a Virgin Islands corporation. United States persons include U.S. citizens and residents, as well as corporations incorporated under the laws of the United States, any of the 50 states, or the District of Columbia. For the purpose of determining ownership by United States persons, the attribution rules of section 958 are to be applied.

Any exempt company that meets the definition of a qualified foreign corporation under .934(b), and which is therefore eligible for the reduction in Virgin Islands mirror system income tax liability with respect to its non-U.S. source income, will be exempt from United States income taxes on such income under the rules generally applicable to foreign corporations under the Code. While earning U.S. source income will not necessarily prevent an exempt company from being eligible for the tax exemption with respect to its non-U.S. source income, the company will still be liable for tax on its U.S. source income.

Virgin Islands Benefits and Requirements

Shortly after the Tax Reform Act of 1986 was signed into law, the Virgin Islands Legislature approved legislation to provide for the establishment of exempt companies pursuant to the federal authorization. This legislation, known as the Virgin Islands Exempt Company Law, became effective on February 24, 1987, the date that the Virgin Islands implementation agreement became effective.

U.S. Virgin Islands exempt companies must be incorporated in the Virgin Islands and are generally subject to the Virgin Islands corporation law. Because the Virgin Islands corporation law is based on Delaware law, it is familiar to many practitioners. The requirements generally applicable to corporations formed in the U.S. Virgin Islands are as follows:

Minimum of three directors, none of whom need be resident.
Minimum of three officers: a President, a Secretary, and a Treasurer.
Registered shares only.
Minimum capital of $1,000.
Appointment of a resident agent in the Virgin Islands upon whom legal process may be served.
Filing of an annual report and payment of the annual franchise tax.

The Exempt Company Law provides that exempt companies are not subject to any of the following local taxes:

Virgin Islands income taxes on all income from sources outside the United States and the Virgin Islands.

Virgin Islands gross receipts taxes.

Virgin Islands withholding taxes on dividends, interest and all other types of passive income paid to shareholders and other persons.

An exempt company, other than an exempt international banking facility and an exempt insurer, also need not obtain a Virgin Islands business license. An exempt company may obtain a twenty-year contract from the Virgin Islands Government guaranteeing that its tax benefits will not be reduced.

In addition to providing for exemption from all local taxes except the annual franchise tax, the Exempt Company Law includes provisions designed to prevent persons engaged in local business from using an exempt company as a means of avoiding local taxes. An exempt company may not conduct business in either the United States or the Virgin Islands unless it qualifies as an exempt international banking facility or an exempt insurer. An exempt company which so qualifies may conduct business in the Virgin Islands if it obtains the appropriate license from the Commissioner of Banking and Insurance. The Exempt Company Law also prohibits Virgin Islands persons from both owning and controlling 10% or more of the stock of an exempt company; however, this restrictions does not prohibit a Virgin Islands person from having voting control of an exempt company so long as the person does not also own 10% or more of the company's stock. Thus, a Virgin Islands person may serve as a voting trustee of an exempt company. Finally, the Virgin Islands ownership limitation does not prohibit one exempt company from owning another exempt company.

Exempt companies are required to file a simplified annual report form and to pay a flat annual franchise tax of $1,000. The annual report, which may be inspected by the public, requires certification of compliance with the Exempt Company Law (including its ownership requirements) and the reporting of the company's address and the names and addresses of its officers and directors. It does not require that stockholders be identified.

Unless an exempt company earns income from United States or U.S. Virgin Islands sources, or income that is effectively connected to a trade or business in one of those jurisdictions (i.e., income which is not exempt from tax), an income tax return need not be filed with either the Virgin Islands Bureau of Internal Revenue or the United States Internal Revenue Service.

Establishment of a U.S. Virgin Islands Exempt Company

Organizing a U.S. Virgin Islands exempt company is simple and may usually be accomplished within one or two business days. A Virgin Islands company is established by the filing of articles of incorporation with the Office of Lieutenant Governor of the Virgin Islands and the payment of

the incorporation fee. In the case of an exempt company, this fee is $400. The incorporation papers must be accompanied by a consent signed by the appointed resident agent of the company.

To be eligible for exempt company benefits, a company must also elect that status. This is most easily accomplished by including in the articles of incorporation a statement to the effect that the company shall be considered an exempt company under the Exempt Company Law.

After organization, the directors and officers should be elected and the minimum capital of $1,000 should be paid in exchange for the company's stock. While the identity of the stockholders is not required to be disclosed in the annual report or otherwise on the public record, the stockholder's identity may have to be revealed to the tax authorities in the Virgin Islands or the United States should the company ever be required to prove that at least 90% of the shares of the company are owned by persons who are not United States or Virgin Islands persons. Likewise, the implementation agreement between the Virgin Islands and the United States provides that any Virgin Islands corporation owned or controlled by a person whose beneficial ownership is undisclosed (such as through bearer shares) is to be treated as owned, to that extent, by United States persons. While no regulations interpreting this provision have been promulgated to date, regulations are anticipated which will provide that a presumption of ownership by a United States person may be rebutted if a local resident agent maintains records proving that the exempt company is beneficially owned by persons who are not United States persons and such records are made available to the tax authorities on proper demand. Failure to maintain such records, or to make them available, could result in the loss of tax exempt status. Of course, another way to avoid this problem is to ensure that an exempt company is not used in a corporate structure where any of the companies in the tiers above the exempt company are bearer share companies.

III. Practical Applications

General Considerations.

In considering where and how to properly use a Virgin Islands exempt company it is essential to consider the benefits and limitations of this type of entity. The one benefit offered by an exempt company that can be obtained in no other jurisdiction is certainly the most important: the U.S. Virgin Islands exempt company is the only type of tax free entity which may be established under the United States flag. The need for an entity with United States nationality, therefore, will usually be a key factor in choosing a Virgin Islands exempt company and, as will be explained below, this status can prove beneficial in numerous ways.

For some potential owners of Virgin Islands exempt companies, the most important trade off for United States status will be the inability to completely shield the identity of the beneficial owner. As explained above, while the owner's identity may be shielded from the public eye, it may be required to be revealed to the United States or Virgin Islands tax authorities in order to maintain the company's tax exempt status. Therefore, if complete secrecy is an important factor, then a different jurisdiction should be considered.

The government fees for the establishment and maintenance of a Virgin Islands exempt company make it generally competitive with other offshore jurisdictions. For example, while it costs

somewhat more in annual fees to maintain a U.S. Virgin Islands exempt company than a British Virgin Islands International Business Corporation, the cost is substantially less than the annual fee for a Bermuda company. Establishment and management fees will, of course, vary depending on the type of services desired.

Special Types of Exempt Companies.

The law provides for two special types of exempt companies Exempt International Banking Facilities and Exempt Insurers.

Exempt International Banking Facilities

The Virgin Islands Exempt Company Law established a new type of banking entity called an Exempt International Banking Facility ("EIBF"). EIBF's must be owned by a bank or bank holding company, which may, but need not be licensed to do business in the Virgin Islands. In the case of foreign owned banks which want to establish an EIBF, it is most likely that the corporate entity to be utilized will be an exempt company.

The Virgin Islands EIBF law is patterned on the Federal Edge Act and EIBF's have the power to perform many of the same types of activities as do Edge Act Corporations. Most banking activities of EIBF's, however, may not be conducted with Virgin Islands persons. EIBF's powers include the power to borrow and lend money (but not to Virgin Islands persons); purchase, sell, discount, and negotiate notes, drafts, checks, bills of exchange, and other evidences of indebtedness; finance foreign exchange transactions; receive deposits from other than Virgin Islands persons; issue letters of credit, bonds, debentures, and promissory notes to other than Virgin Islands persons; purchase and sell securities; and "exercise such powers . . . as may be usual in connection with the transaction of the business of financial operations in the places other than the Virgin Islands in which it shall transact business . . . ."

EIBF's must be licensed by the Lieutenant Governor of the Virgin Islands -- Division of Banking and Insurance; however, a streamlined licensing procedure is available to a stockholder bank which is licensed in the United States or which maintains its head office in a jurisdiction which subjects banks to a form of regulation substantially similar to that of a bank chartered in the United States. The annual license fee is US $4,000 and an annual report to the Division of Banking and Insurance is required. EIBF's which are established as exempt companies and are properly licensed by the Division of Banking and Insurance have the authority to conduct business in the Virgin Islands.

Exempt Insurers

Exempt insurers are also known as "captive" insurance companies. They are permitted to establish business operations in the Virgin Islands but may not insure Virgin Islands risks. They must be licensed by the Lieutenant Governor of the Virgin Islands -- Division of Banking and Insurance. Annual license fees range from US $3,000 to US $6,000. Exempt insurers are subject to a streamlined form of regulation by the Division of Banking and Insurance. The combination of minimal regulation and no income tax makes the exempt insurer an ideal alternative for foreign

companies that would otherwise be considering self-insurance as a means of reducing insurance expense, especially if the tax law of the home jurisdiction permits the deduction of premiums paid to captives.

While an exempt company is the preferred corporate vehicle for establishing a foreign (non-U.S.) owned exempt Insurance Company in the U.S. Virgin Islands, an exempt insurer may also be established by a United States person using a standard U.S. Virgin Islands corporation. However, it should be noted that changes in federal tax law in the 1980's, and the imposition of an excise tax on insurance premiums paid by United States persons to foreign insurers, have made it much more difficult for United States companies to take advantage of the tax benefits for which captive insurance companies were traditionally created.

Offshore Investment Companies - General Applications for United States Virgin Islands Exempt Companies

Aside from the specialized areas of banking and insurance discussed above, there are many other applications for U.S. Virgin Islands exempt companies. A U.S. Virgin Islands exempt company should generally be utilized, rather than an offshore entity formed in another jurisdiction, when United States flag protection is either desirable or essential to the purposes of the company, so long as the exempt company ownership requirements can be met.

For example, foreign persons who want to register their aircraft with the United States Federal Aviation Administration in order to obtain an "N" registration number, must use an entity incorporated in the United States as the ownership vehicle and the entity must be controlled by United States persons. The only United States incorporated entity that is not subject to U.S. income tax is a Virgin Islands exempt company, making it an ideal choice for this purpose. In order to meet the domestic control requirement of the Federal Aviation Administration regulations, a voting trust is usually created to hold the stock of the aircraft- owning exempt company.

Another use for a Virgin Islands exempt company is as a holding company for assets located in a foreign country where there is a fear that the assets might be expropriated by an unfriendly government. Holding such assets through an exempt company would protect them from expropriation under United States laws and treaties.

In various situations a foreign person may wish to obtain the benefits of a treaty of friendship, commerce and navigation ("FCN treaty") entered into between the United States and a third country. Prior to the availability of U.S. Virgin Islands exempt companies, such benefits could only be obtained by establishing a domestic corporation in one of the United States and suffering the attendant U.S. tax consequences. However, United States FCN treaties apply to the United States Virgin Islands (and companies incorporated there) -- but not to any other jurisdiction where beneficial tax exemptions are available. Therefore a non-American investor may establish an exempt company in the United States Virgin Islands to take advantage of the United States FCN treaty with a third country while avoiding any United States or U.S. Virgin Islands tax consequences.

Another use for an exempt company is where there is a desire to have access to United States

courts for dispute resolution. The United States courts located in the Virgin Islands generally have jurisdiction over disputes involving a company incorporated in the U.S. Virgin Islands notwithstanding the fact that its business activities take place elsewhere.

Exempt companies are also useful as financing entities for foreign persons who are required by banks to keep accounts in U.S dollars in order to borrow money. This would be particularly appropriate if the country where the investment is to be made requires local entities to keep accounts in local currencies.

Aside from the above specialized examples, numerous other uses may be developed for exempt companies. These include many of the uses to which offshore entities established in other jurisdictions have traditionally been put, such as the offshore accumulation of income from foreign investments in order to avoid tax on repatriation to the home country. They may also include, quite simply, situations where a company incorporated in another offshore jurisdiction, which is actively engaged in commercial activities, finds that its ability to do business with United States companies is hampered by the place of its incorporation.

IV. Conclusion

The United States Virgin Islands exempt company is a unique and useful international tax planning tool for a person (other than a United States person) who requires a United States entity for primarily non-tax reasons and who is not establishing the entity to shield his identity. The availability of the U.S. Virgin Islands exempt company for this purpose is the result of a concerted effort by the Virgin Islands public and private sectors to expand the Virgin Islands' economic base through legislative means. U.S. Virgin Islands exempt companies have numerous applications for foreign owners and their role in offshore tax planning is likely to expand as practitioners develop new applications and as the entities become more widely known and accepted in the marketplace.

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[Author's Note: This article has not been revised to account for certain changes in the USVI corporate law since it was first published. Please look to other resources for details especially with regard to EIBFs abd exempt insurers. WLB, December, 2014.]