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INTERNAL REVENUE SERVICE NATIONAL OFFICE
SIGNIFICANT SERVICE CENTER ADVICE

MEMORANDUM FOR [redacted], Program Analyst
Domestic and International Section, [redacted]

FROM: W. E. Williams, Senior Technical Reviewer
CC:INTL:BR1

SUBJECT: Virgin Islands Cover Over Issues

This Significant Service Center Advice responds to your memorandum [redacted].

ISSUES

1 (a) Where an individual income tax return is sent to the IRS by the U.S. Virgin Islands ("VI") Bureau of Internal Revenue ("BIR") as part of the request to the IRS for the cover over (under section 7654)[1] of taxes withheld and paid to the United States on payments made to a bonafide resident of the VI ("BRVI"), and where the IRS determines there is an overpayment, may the IRS refund the overpayment?

(b) If it is determined that it is proper to refund an overpayment under these circumstances, from what date does the interest calculation period commence under section 6611?

2) What procedure should be followed when as part of the cover over process, the IRS receives an income tax return from the BIR (which was filed by a BRVI with the VI) that contains a self-assessment of self employment tax on a U.S. Form 1040

[1] Unless otherwise indicated, all section references in this memorandum are to the Internal Revenue Code of 1986 (hereinafter "Code").

schedule SE (and does not contain a U.S. Form 1040SS), and such self-employment tax was paid into the BIR?

3 (a) Is the IRS bound by a determination of the BIR that an individual taxpayer is a BRVI, when such taxpayer originally filed a U.S. Form 1040 with the IRS not indicating such status?

(b) Is the IRS bound by a determination of the BIR that an individual taxpayer should have allocated his tax liability between the VI and the United States through the use of a U.S. Form 8689 when such taxpayer originally filed a U.S. Form 1040 with the IRS without such allocation?

CONCLUSIONS

1 (a) If the IRS receives a copy of the VI tax return from the BIR more than two years from the date the tax is considered to be paid to the IRS and the IRS determines that there is an overpayment, it may not be refunded to the taxpayer. However, where the IRS receives the tax return from the BIR within two years from the date that the tax is considered to be paid to the IRS, then the IRS may refund the overpayment.

(b) Statutory interest upon refunds accrues from the date of overpayment which for most individuals is April 15th following the close of the tax year.

2. The self-employment tax may be assessed by the IRS, and such assessed tax may be deducted from the net collections that would otherwise be covered over to the VI.

3 (a) If it is determined by the IRS that the taxpayer may be a U.S. resident, and not a BRVI, whereas the VI is claiming that the taxpayer is a BRVI, then a case of double taxation may arise. In a case of double taxation, the question of the taxpayer's residency is a matter for the competent authorities to settle.

(b) If it is determined by the IRS that the taxpayer has a requirement to allocate his U.S. income tax liability between the United States and the VI, then a case of double taxation may arise. In a case of double taxation, the question of how to source certain items of income is a matter for the competent authorities to settle.

DISCUSSION

Issue 1

Statute of Limitations Applicable to Claims for Refunds

(a) A BRVI is generally required to report worldwide income to the VI. See sections 932(c)(1)(A), (2), (3) and (4)(B). Additionally, a BRVI who reports and pays tax on his worldwide income to the VI, has no U.S. gross income and no requirement to file a return with the IRS. See sections 932(c)(4)(B) and (C) and 6012(a)(1)(A). Accordingly, a BRVI who has U.S. income tax withheld will file a VI tax return and claim a credit on his VI return for tax withheld and paid to the IRS.

Under section 6402(a), the IRS may refund an overpayment within the "applicable period of limitations", i.e., the period during which a claim may be filed under section 6511. "If no return was filed by the taxpayer", the applicable limitations period set down by section 6511 is "within two years from the time the tax was paid". This is the applicable limitations period because, as delineated above, a compliant BRVI files a tax return with the VI, i.e, not the United States, and therefore, is not considered to have "filed" a return with the IRS.[2] Accordingly, if the IRS receives a BRVI's tax return from the VI as part of the cover over process more than two years "from the time the tax was paid" to the IRS, and it is determined that there is an overpayment, it may not be refunded to the taxpayer. However, the "net collections" associated with an individual taxpayer, i.e., tax payments to the IRS less refunds issued, if any, are covered over to the VI. See sections 7654(a) and (b)(1).

In the event, however, the IRS receives a BRVI's tax return from the BIR as part of the VI cover over process within two years "from the time the tax was paid" to the IRS, and the IRS determines that there is an overpayment, then a refund may be issued to the taxpayer. It should be noted that after the refund is paid, the "net collections" of taxes from the taxpayer, i.e., tax payments to the IRS less refunds issued, are then covered over to the VI. See sections 7654(a) and (b)(1). This result is consistent with Rev. Rul. 79-424, 1979-2 C.B. 405.

(b) Under sections 6611(a) and (b)(2), the IRS is generally required to pay interest on refunds from the date of overpayment. Section 6611(d) provides that the date of overpayment is determined under the principles set forth under section 6513. Generally, under the principles of section 6513, advance payments of tax for a calendar year individual taxpayer, are considered paid to the IRS on the April 15th immediately following the tax year. See sections 6513(a), (b), and 6072(a).

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[2] It is our view that a claim for refund filed with the BIR should not be considered to be a claim filed with the IRS despite the fact that Danbury, Inc. v. Olive, 820 F.2d 618, 627 (3d Cir. 1987) cert. denied, 484 U.S. 964 (1987) held that the filing of a corporate income tax return with the VI triggered the time bar for assessment in section 6501. Danbury is distinguishable because its holding is limited to determining the IRS' ability to assess additional taxes in "pre-1987 open years" under section 1277(c)(2) of the Tax Reform Act of 1986.

Accordingly, where the IRS determines from a copy of the BRVI's tax return sent to the IRS by the VI that there is an overpayment, and it is determined that it is proper to issue a refund, then interest on the refund should be paid. The interest on the refund accrues from the date of overpayment (See section 6611(b)(2)) or in most circumstances, for a calendar year individual taxpayer, from the April 15th immediately following the tax year.

Issue 2

Self-Employment Tax Paid to the BIR and Amount of Associated Cover Over

There have been instances where as part of the cover over process, the IRS receives an income tax return from the BIR that was filed by a BRVI with the VI. The income tax return contains a self-assessment of self-employment tax on a U.S. Form 1040 schedule SE, however, the income tax return does not have attached to it a U.S. Form 1040SS (U.S. Self-Employment Tax Return). Further, the self-employment tax reported on the U.S. Form 1040 schedule SE was paid into the BIR.

Section 7651 provides that, except as otherwise provided in section 28(a) of the Revised Organic Act of the Virgin Islands, all provisions of the laws of the United States applicable to the assessment and collection of any tax imposed by the Code, or any other liability arising under the Code, shall extend to and be applicable in any possession of the United States in the same manner and to the same extent as if such possession were a state. Under section 6020(b), if any person fails to make any return, the IRS may prepare such return from its own knowledge or otherwise and assess the tax.

Accordingly, if a taxpayer fails to file a U.S. Form 1040SS, the IRS may prepare such return and assess the tax. This determination is consistent with Internal Revenue Manual 3.21.3.48, Paragraph (4) which states that "If a taxpayer from the Virgin Islands . . .files Form 1040 with a Schedule C, CEZ, E, F, or SE to report self-employment taxes in lieu of Form 1040PR or 1040SS, [the IRS may] prepare a dummy Form 1040 PR/SS. . . ." It is also proper to deduct such assessed self-employment tax from the net collections that would otherwise be covered over to the VI.

Issue 3

Disposition of Question of Taxpayer's Residence – Competent Authority

(a) Generally, the IRS may "inquire after and concerning all persons . . . who may be liable to pay any internal revenue tax". See section 7601. Accordingly, for any tax return that is filed, the IRS may examine the return and inquire about any issues

relevant to the assessment or collection of any internal revenue tax. Further, an examination may be initiated by the IRS on the basis of information "of sufficient compliant value". See IRM 4200, Subsection 4219. Moreover, section 7651 provides that, except as otherwise provided in section 28(a) of the Revised Organic Act of the Virgin Islands, the provisions of the Code applicable to the assessment and collection of any tax imposed by the Code, shall extend to and be applicable in any possession of the United States in the same manner and to the same extent as if such possession were a state. Thus, if a taxpayer files an income tax return with the IRS claiming to be a resident of the United States, and subsequently, as part of the cover over process, the BIR informs the IRS that the taxpayer, in the BIR's opinion, is a BRVI, then it is proper for the IRS to inquire as to the true residence of the taxpayer.

If it is determined by the IRS that the taxpayer is a U.S. resident, then, the IRS may take the position that the United States is the primary taxing jurisdiction. Therefore, a case of double taxation may arise because both the United States and the VI could claim to be the primary taxing jurisdiction. In a case of double taxation, the Implementation Agreement Between the United States and the Virgin Islands (signed February 24, 1987) (or "Agreement") directs the competent authorities to "agree upon the facts and circumstances necessary to achieve consistent application of the tax laws of the respective Governments." See Paragraph 6 of the Agreement.

In its list of non-exhaustive examples as to what the competent authorities may "consult together to endeavor to agree", the Agreement includes " . . . [a] determination of residency of a particular taxpayer". Accordingly, where it is believed that the taxpayer is a U.S. resident and not a BRVI, then determination of a taxpayer's residency is a matter for the competent authorities of the respective tax administrations to settle. Additionally, Rev. Proc. 89-8, 1989-1 C.B. 778, allows a taxpayer to request competent authority assistance in cases of double taxation.

(b) As discussed above, the IRS may inquire into any issue on a tax return that is relevant to the assessment or collection of any internal revenue tax. That is to say, for a U.S. taxpayer who is a resident in the VI, the United States has a residual right to collect U.S. income taxes for income sourced in the VI. See sections 932(c)(3) and (c)(4). Further, examinations may be initiated by the IRS on the basis of information received from other sources that are "of sufficient compliant value". See IRM 4200, Subsection 4219. Additionally, section 7651 provides that, except as otherwise provided in section 28(a) of the Revised Organic Act, Code provisions associated with the assessment and collection of any internal revenue tax, shall be applicable to any possession of the United States as if such possession were a state. Thus, if a taxpayer files a U.S. Form 1040 with the IRS and does not allocate his U.S. income tax liability between the United States and the VI on a Form 8689, and subsequently, the BIR informs the IRS that, in the

BIR's opinion, the taxpayer should have allocated his U.S. tax liability between the United States and the VI, then it is proper for the IRS to inquire as to the true source of the taxpayer's income in order to verify whether the taxpayer's income is U.S. sourced or VI sourced.

If it is determined by the IRS that the taxpayer has items of income that are sourced in the United States and the VI, then, a case of double taxation may arise. That is to say, two separate jurisdictions could claim taxing authority on the same items of income. In a case of double taxation, the Agreement permits the competent authorities to agree to " . . . [a] determination of the source of particular items of income." Accordingly, where it is believed that the taxpayer has items of income sourced in the United States and the VI, and therefore, may have to allocate U.S. tax liability on a Form 8689, it is a matter for the competent authorities of the respective tax administrations to settle. It should be noted that if a taxpayer is required to file a Form 8689 and willfully neglects to do so, the taxpayer may be subject to a $100 penalty for each such occurrence. See section 6688. Further, Rev. Proc. 89-8, 1989-1, C.B. 778, allows a taxpayer to request competent authority assistance in cases of double taxation.

If you have any further questions, please call [redacted] at [redacted]