

The case for economic incentives

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I've lived in the US Virgin Islands for more than 16 years, and until a year or two ago these islands were regularly featured in the travel sections of various international publications – as a world-class destination for visitors of all sorts: honeymooners, divers, sailors, shoppers and sun worshippers. Recently, though, my beloved islands only seem destined for cover slots in the business section of various publications. Snippets supporting and grousing about the territory's tax incentive programme have ended up in publications ranging from the Wall Street Journal to the Sovereign Society's newsletter.

Yet as I look out my window at a cruise ship in St. Thomas Harbour, and think about the strides that the territory has taken in recent years - courtesy of the economic development programme - it is clear to me that there is a story that has not been told about the US Virgin Islands. It is a story of jobs, training, local spending, tax payments, and charitable contributions. It is also the story of how important it is to have clear and workable rules and regulations for any economic development programme – from the start.

Let's start with a little background. The US Virgin Islands has used the "regular" Internal Revenue Code as its tax Code since 1922, which was shortly after the United States bought the islands from Denmark. This was to "finance" the US Navy's administration of the territory. Beginning in the mid-1950s, the US Virgin Islands started offering tax incentives to various businesses in the territory by reducing the rate of tax on such businesses, with legislative support to do so from the US Congress. The initial recipients of these benefits, hotels and manufacturing operations, made great sense.

Many tourism-based jurisdictions give property tax abatements and other tax benefits for hotels and other tourist attractions to entice and retain high quality tourism facilities and sometimes to compete for such facilities with other jurisdictions. For many years, manufacturing was the traditional "alternative" of choice to diversify the economy of the US Virgin Islands. A business could manufacture in the US Virgin Islands (outside the US customs zone) with foreign-made components, get duty free and quota free access to the US markets and also be exempted from the Jones Act, allowing the use of foreign flag ships for delivery to the United

States. Alas, however, the US Virgin Islands is not in NAFTA, and does not offer the competitive wages of the Dominican Republic or China, for example. Manufacturing is therefore not a growth industry in the US Virgin Islands, with the exception of the manufacturing of jewellery and watches (which also receive benefits from the US Department of Commerce), items that require a high level of technical expertise, items that need to be made on US soil due to the desire for US law protection, and items that are natural to an island such as boats.

In the mid-1990s, the US Virgin Islands started seeking to attract service businesses that could use the quickly evolving satellite and cable communications systems to manage money, provide consulting services, establish call centres, and engage in e-commerce, serving clients outside the territory. Such businesses have little impact on the fragile island environment and often attract new visitors such as fund investors and other clients who use the tourist facilities – a win-win situation. The US Virgin Islands started attracting such service businesses as a means to diversify its economy – with dozens of such businesses setting up shop in the territory in the late 1990s and early 2000s.

To qualify for programme benefits, investors must invest at least USD100,000, exclusive of inventory, in an eligible business and employ at least ten US Virgin Islands residents full-time. The tax benefits are available for ten years for investments in St. Thomas and St. John. As a result of recent legislation, St. Croix has initial benefit periods ranging from ten to thirty years, depending on the location of the business. Benefit packages can be extended upon application and review.

The benefits of this economic development legislation include a 90% income tax reduction. The 90% reduction also includes eligible dividends or distributions received by a beneficiary's US Virgin Islands resident owners. In addition there are complete exemptions from US Virgin Islands property and gross receipt taxes, respectively .75% and 4%. Beneficiaries are exempt from withholding tax on interest payments and receive a reduced withholding rate of 4% on dividends.

In the last several months, the Federal Government has definitely noticed that the financial services sector has grown significantly in its unincorporated territory to the south. In May, the US Senate passed legislation directing the IRS to consider the substantial presence test in updating residency regulations for the US territories and to require all US Virgin Islands residents to provide informational copies of their income tax returns to the IRS. This legislation may be amended in Congressional conference, and I hope to see some clarifying language in the legislative history as well. On June 24 of this year the IRS issued Notice 2004-45 to provide some interim guidance on how to define source and effectively connected income. Finally, the IRS Priority Guidance Plan, issued July 26, 2004, lists "guidance on possessions issues" as one of the items on this year's agenda.

Frankly, I don't know anyone who isn't really pleased to be

getting some guidance out of the Federal government. After all, it is only 18 years after the Tax Reform Act 1986 was enacted and the promise was held out in legislative history and statutory language that guidance on residency, the application of the Code to the US Virgin Islands, source rules, and effectively connected rules would be forthcoming. At the same time, the negative connotations that have accompanied the process of developing guidance have obscured some critical factors – including the tremendous economic benefits – that are important in the US Virgin Islands. Basically, I consider the territory's economic development programme the “anti-tax shelter” – it is a powerful engine that is reshaping the economy of the US Virgin Islands.

First, there are the jobs. Each beneficiary of the economic development programme must hire at least 10 persons, who must work full-time. At least 80% of all employees must be residents of the US Virgin Islands – and that does not mean moving to the US Virgin Islands to take the job with the beneficiary. The Economic Development Commission, in holding public hearings for each applicant for benefits, is now asking for a commitment that the beneficiary's workforce reflect the incredible diversity of the US Virgin Islands and be made up of persons who resided in the US Virgin Islands before a particular application was filed for benefits.

There are more than 50 businesses in the economic development programme that are in the “designated service business” category – which means providing services to clients outside the US Virgin Islands. (You avoid competing with fully tax-paying local businesses that way.) If you assume an average of 12 employees a business, that means a minimum of 600 full-time jobs. And many of the businesses employ a lot more than 10 persons – even the service businesses – and create many more jobs indirectly through enhanced economic activity.

While this number may not sound particularly high for a territory with a population of more than 123,000, the jobs that the designated service businesses provide – investment managers, business consultants, e-commerce businesses – are well-paying jobs and are the types of jobs that will attract persons who would otherwise be forced to seek employment outside of the territory or with the large public sector. They include accounting jobs, marketing jobs, trading jobs, IT jobs, legal jobs, administrative jobs – you name it. In fact, it seems that many of the local CPA firms are chronically short-handed because their best and brightest are being hired “in-house.”

And many of these jobs are going to people who grew up in the US Virgin Islands but left due to the lack of opportunity who are now moving back – the brain drain reversal – or to people who would leave without good jobs at home.

I first went to Ireland in 1986, and it was a sleepy country with sheep, unoccupied stone buildings, and a down-at-the-heels main city in Dublin (but with great theatre). Now Dublin is the “in” place of Europe and the Irish youth stay or hurry home to work there instead of seeking jobs in London or New York. The US Virgin Islands has the strong potential to

be the “Ireland of the Caribbean” with a little less rain – trading the European Union for the Stars and Stripes.

And these are just the direct jobs. Employees of successful businesses need homes, groceries, aeroplane tickets, computers, furniture, and so forth. In speaking with building contractors, I've learned they can't employ enough people. Tickets at Seaborne Airlines and Cape Air often sell out days in advance, and St. Thomas just got its first Home Depot – and hundreds of jobs along with it.

Second, there are the charitable contributions. Most beneficiaries commit to at least USD50,000 in annual charitable contributions these days – and that does not include the personal donations from the owners and employees. Beneficiaries often direct their charitable focus during the application process in such areas as public education, youth sports, family issues, and broad based charities.

Third, there are the local purchases. If an item that a beneficiary needs is available locally, the beneficiary must purchase it locally from eligible US Virgin Islands suppliers – that means telephone systems, office equipment, building contractors – the exceptions are few.

Beneficiaries, too, are required to keep funds in local banks and their employees and owners often keep substantial amounts, if not all, of their deposits in US Virgin Islands financial institutions.

Finally, there are the taxes. People who live in the US Virgin Islands pay tax on all their income to the US Virgin Islands, and anecdotally I know that many of the people who own businesses with economic development benefits have a lot of income that does not come from the business. Such income is subject to tax at regular rates – and paid to the US Virgin Islands. Owners and employees of economic development beneficiaries buy houses – more stamp tax and property tax and income tax there – and have friends come and stay in the hotels. Many people who come to the US Virgin Islands for the economic development programme see other opportunities – real estate development, retail business opportunities – and the next thing you know they are branching out. And the markets that this economic development programme is creating result in more (a lot more) taxes being paid by the suppliers of goods and services.

So the cruise ships pull out – with their loads of day visitors – and the residents are left. Not too long ago, when I first moved here, that would have meant that the windows of Charlotte Amalie would be dark and merchants would be looking to the next day's tourists. But now the computers are humming 24/7 (for better or for worse), the Bloomburghs are spitting out data, the Blackberrys are ringing, and people are waking up to careers that a decade ago could only be found in New York or Miami. With its diverse population, beautiful terrain, economic diversification and use of carefully crafted incentives to bring non-polluting jobs to the territory, the US Virgin Islands has the potential to be the model 21st Century community.

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