**Office of Chief Counsel**
**Internal Revenue Service**
# memorandum

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subject: Litigation of USVI Economic Development Program Cases, TYs 2002 to 2004

This responds to your request concerning the impact of *Vento v. Director of Virgin Islands Bureau of Internal Revenue & United States*, 715 F.3d 455 (3d Cir. 2013), *aff'g in part and rev'g in part* 107 A.F.T.R.2d 2011-951 (D.V.I. 2011), on cases involving taxpayers who appear to have participated in an arrangement described in Notice 2004-45, 2004-2 C.B. 33, *Meritless Filing Position Based on Sections 932(c) and 934(b)*. This memorandum should not be used or cited as precedent.

ISSUE

After the *Vento* decision, what factors should be applied to evaluate a claim of *bona fide* residence in the U.S. Virgin Islands ("USVI") in cases that factually are substantially similar to those described in Notice 2004-45 ("Notice 2004-45 cases") for taxable years 2002 to 2004?

CONCLUSION

The 11-factor facts-and-circumstances test set forth in *Sochurek v. Commissioner*, 300 F.2d 34 (7th Cir. 1962), continues to provide the proper standard for evaluating a claim of *bona fide* residence in the USVI for taxable years 2002 to 2004 in a case described in Notice 2004-45. The *Vento* decision did not alter this standard. The facts of the Vento parents are distinguishable from the facts in most Notice 2004-45 cases.

FACTS DESCRIBED BY NOTICE 2004-45

Notice 2004-45 describes a scheme in which a taxpayer living and working in the United States undertakes to "(i) purport to become a USVI resident by establishing certain contacts with the USVI, (ii) purport to terminate his or her existing employment relationship with his or her employer . . . and (iii) purport to become a partner of a Virgin Islands limited liability partnership . . . that is treated as a partnership for U.S. tax purposes." The taxpayer continues to provide substantially the same services to his or her former employer as before, but the former employer makes payments to the USVI partnership, which then passes the money to the taxpayer. The USVI partnership either has already secured or then secures a reduction, up to 90%, in USVI income tax liability under the USVI's Economic Development Program ("EDP"). The taxpayer claims to be a *bona fide* resident of the USVI, as required for the EDP, and claims an EDP reduction in income tax liability on his or her USVI individual income tax return. The taxpayer claims that, for purposes of computing his or her U.S. income tax liability, the income is excluded under section 932(c)(4). Notice 2004-45 states that the tax positions taken are "highly questionable, and in most cases meritless," further stating that "a claim of USVI residency for income tax purposes may be considered without merit or fraudulent when the taxpayer continues to live and work in the United States."

The notices of deficiency in these cases typically conclude that the taxpayer has entered into an abusive tax avoidance scheme as described in Notice 2004-45. This advice is provided based on the typical and shared elements in these cases.

LAW AND ANALYSIS

In *Vento*, the U.S. Court of Appeals for the Third Circuit applied the 11-factor standard set forth in *Sochurek v. Commissioner*, 300 F.2d 34 (7th Cir. 1962),[1] and held that the Vento parents were *bona fide* residents of the USVI as of December 31, 2001, but that the three Vento daughters were not.

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[1] The Third Circuit stated that "[t]he District Court . . . applied *Sochurek* to this dispute, and we will do so as well." *Vento* at 466. The 11 factors are:

"(1) intention of the taxpayer;
(2) establishment of his home temporarily in the foreign country for an indefinite period;
(3) participation in the activities of his chosen community on social and cultural levels, identification with the daily lives of the people and, in general, assimilation into the foreign environment;
(4) physical presence in the foreign country consistent with his employment;
(5) nature, extent and reasons for temporary absences from his temporary foreign home;
(6) assumption of economic burdens and payment of taxes to the foreign country;
(7) status of resident contrasted to that of transient or sojourner;
(8) treatment accorded his income tax status by his employer;
(9) marital status and residence of his family;
(10) nature and duration of his employment; whether his assignment abroad could be promptly accomplished within a definite or specified time;
(11) good faith in making his trip abroad; whether for purpose of tax evasion."

*Vento* at 466-67 (quoting *Sochurek* at 38).

When the Third Circuit's factual findings with respect to the Vento parents are compared with Notice 2004-45, it is clear that *Vento* is distinguishable from the typical Notice 2004-45 case. Of particular significance, the tax abuse in which the Ventos had engaged was not with respect to rules exclusive to the USVI but rather involved a "Son of BOSS" tax shelter.[2] The typical Notice 2004-45 case, in contrast, involves a direct abuse of a tax benefit available solely through a USVI entity and expressly conditioned on *bona fide* residence in the USVI. Furthermore, the court's specific factual findings with respect to the situation of the parents in *Vento* are distinguishable from the typical Notice 2004-45 case in many ways relevant to the *Sochurek* standard. The following discussion considers each of the relevant factors in turn.

THE 11-FACTOR TEST

As noted in both *Sochurek* and *Vento*,[3] while not all *Sochurek* factors will be present in every situation, consideration and weight should be given to each factor that is applicable. Facts distinguishing the parents in *Vento* from Notice 2004-45 cases are expected to arise in consideration of factors (1), (2), (4), (6), (9), (10), and (11).

(1) *Intention of the taxpayer*. The *Vento* court found that the Vento parents "certainly decided to move to the Virgin Islands." *Vento* at 473. In contrast, the promotional materials described in Notice 2004-45 falsely advised that participants could "continue to live and work in the United States and, nevertheless, be a bona fide resident of the USVI."

(2) *Establishment of his home*. The Third Circuit found that the house in the USVI the Ventos purchased and were renovating was "not unlivable." *Vento* at 476 n. 21. "Establishment of a home" should take into consideration the type of property, amount expended, and type of accommodation; by contrast to the Ventos, many Notice 2004-45 taxpayers had only shared or short-term accommodations in the USVI.

(4) *Physical presence*. Mr. Vento was present in the USVI for the entire month of December 2001, a fact on which the court focused because his *bona fide* residence was only at issue for that year. *Vento* at 474-75. Most Notice 2004-45 cases involve more than one tax year, and in many cases *bona fide* residence is at issue for an entire taxable year.[4] Even where a single month is critical, the taxpayer may not be present for the entire month.

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[2] *See VI Derivatives, LLC v. United States*, No. 06-cv-0012-JRS-RM (D.V.I. December 13, 2011) and *VIFX, LLC v. United States*, No. 06-cv-0013-JRS-RM (D.V.I. December 13, 2011) (granting Government motions for partial summary judgment).

[3] *Sochurek*, 300 F.2d at 38; *Vento*, 715 F.3d at 467.

[4] Pursuant to § 908(c)(2) of the American Jobs Creation Act of 2004, P.L. 108-357, the wording in Code section 932(c)(4)(A) was changed from "at the close of the taxable year" to "during the entire taxable year," effective for tax years ending after October 22, 2004.

(6) *Assumption of economic burdens*. The court found that the Vento parents had "observed all the legal formalities of residency," *Vento* at 477; in many Notice 2004-45 cases, the taxpayers maintain their driver's licenses, voting, and other registrations in the United States and not in the USVI.

(9) *Marital status and residence of his family*. The Third Circuit found that Mr. and Mrs. Vento lived with one another in the USVI. *Vento* at 477. Their daughters, who lived elsewhere, were adults and not dependents of their parents. *Id*. By contrast, many taxpayers in Notice 2004-45 cases have spouses or minor children living outside the USVI.

(10) *Nature and duration of his employment*. Mr. Vento had sold the company he co-founded and "began developing professional relationships in the Virgin Islands." *Vento* at 476-77. By contrast, typical Notice 2004-45 participants return to the United States as part of providing services to their former employers, which do not benefit from the participants' time in the USVI.

(11) *Good faith*. In its application of *Sochurek*'s "good faith" factor, the Third Circuit found that two of the three USVI entities formed by the Vento parents were "bona fide companies with non-tax, business purposes" and that "Richard Vento's establishment of business interests in the Virgin Islands supports his claim of bona fide residency." *Vento* at 471. In *Sochurek*, this factor turned on the absence of a "scheme or arrangement" relating to taxes. *Sochurek* at 39. A typical Notice 2004-45 case involves the use of a USVI partnership, and sometimes additional entities, in an attempt to convert U.S.-source income into income that is treated as effectively connected with the conduct of a trade or business in the USVI. Claims of *bona fide* residence when using such arrangements, found "highly questionable" by Notice 2004-45, are the clearest cases when individuals would fail to meet the "good faith" factor.

In sum, when challenging a *bona fide* USVI residence position in a Notice 2004-45 case, the IRS should carefully distinguish the facts from those involving the Vento parents with respect to each applicable *Sochurek* factor, in particular the 11th ("good faith") factor, where the direct USVI nexus presented by the abusive tax arrangement in which the taxpayers participated (*e.g.*, inappropriately claiming the EDP benefit with respect to activities unconnected to the USVI) is an important difference from *Vento*.

LIMITATIONS PERIOD ON ASSESSMENT

Finally, we note that it is not appropriate for the IRS to concede automatically the statute-of-limitations issue often present in Notice 2004-45 cases. Such a concession is appropriate only after a determination has been made under the *Sochurek* standard that a taxpayer is a *bona fide* USVI resident. It is important to recognize that the holding in *Appleton v. Commissioner*, 140 T.C. 273 (2013), is limited to situations in which the

taxpayer is a *bona fide* resident of the USVI for the tax year in issue.[5] In such cases, the period of limitations on assessment under section 6501(a) begins to run upon the filing of the taxpayer's filing of his return with the USVI Bureau of Internal Revenue (BIR).[6] If a taxpayer is not a *bona fide* resident of the USVI, then the filing of the taxpayer's return with the USVI BIR does not start the running of the period of limitations under section 6501(a), pursuant to sections 932(a) and 6501(c)(3).

Please call Jacob Russin at (202) 317-6941 if you have any further questions.

[5] The parties stipulated that Mr. Appleton was a *bona fide* resident of the USVI for the relevant tax years.

[6] If another exception to the running of the statute of limitations under section 6501 applies, then the IRS should pursue that avenue.