THE UNITED STATES VIRGIN ISLANDS
OFFICE OF THE GOVERNOR
GOVERNMENT HOUSE
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340-774-0001

October 11, 2016

The Honorable Orrin Hatch
Chairman
Congressional Task Force on
Economic Growth in Puerto Rico
104 Hart Senate Office Building
Washington DC 20510-4402

Dear Mr. Chairman:

On behalf of the Government of the U.S. Virgin Islands, I request your support for fair and equitable treatment for the U.S. Virgin Islands and the other small Territories in any report and proposed legislation being developed by the Task Force to address the challenges facing Puerto Rico. The Virgin Islands and other small Territories face many of the same challenges as Puerto Rico with many of the same underlying causes, particularly with respect to federal healthcare funding and tax law. And, more importantly, the potential solutions to the challenges faced by Puerto Rico and the small Territories are the same (with limited exceptions discussed below) and, in any event, inexorably intertwined.

As you know, the Virgin Islands economy has been battered by the economic damage caused by the Great Recession and the 2012 closure of the HOVENSA refinery, which had been the Territory's largest private employer and the mainstay of the St. Croix economy for the last half-century. The closure of the refinery threw almost 2,000 persons out of work, causing over a hundred million dollars in annual tax revenue losses, and hundreds of millions more in lost economic activity—huge losses for a small Territory. In the past four years, scores of local businesses and institutions have closed, opportunities for employment have dried up, and hundreds of families have been forced to relocate.

It is my sincere hope that the Task Force, in considering the issues facing Puerto Rico and possible solutions, will also consider the small Territories and develop legislation that will help us generate the robust and sustainable economic growth that can help the Territory improve its long-term fiscal health, generate economic growth, and avoid the situation that Puerto Rico is now in. We request that the following measures be included in any Task Force report and legislation.

First, the time is long overdue for Congress to provide state-like Medicaid funding for the Territories by increasing the federal match (FMAP). Increasing the federal match would have no federal budgetary impact. And phasing out the cap on federal Medicaid funding in later years would minimize federal costs.

Second, as with Puerto Rico, a long-term solution to our Territory's economic and fiscal crisis requires a comprehensive approach that includes sound tax policies that encourage investment and spur economic growth. One cost-effective solution would be for Congress to eliminate the cap on the rum tax cover-over program in Section 7652(f) of the Internal Revenue Code (IRC) and thus make permanent the cover-over rate which heretofore Congress has extended on a temporary (though regular) basis since 1999. Permanency would provide greater revenue and budget certainty for both Puerto Rico and the Virgin Islands, as well as increase investor and creditor confidence which is so vital to economic recovery.

Third, we request that Congress include two modest tax provisions related to our economic development commission (EDC) program to attract, promote, and enhance economic development in our Territory. First, Congress should modify the JOBS Act sourcing rule in Section 937(b)(2) of the IRC by modifying the U.S. income limitation to exclude only U.S. source (or effectively connected) income attributable to a U.S. office or fixed place of business (*i.e.*, similar to rules included in the model U.S. income tax treaty). The current rules unnecessarily inhibit economic growth in the Virgin Islands by excluding certain income from our economic development programs even when <u>all</u> of the economic activity generating such income takes place in the Virgin Islands. Second, Congress should ensure parity of treatment among the Territories with respect to the treatment of capital gains, by clarifying in IRC Section 865(j)(3) that capital gains income earned by V.I. taxpayers should be deemed to constitute V.I. source income regardless of the tax rate imposed by GVI (and thus maintain eligibility of certain V.I. capital gains income for local tax incentives). This clarification would align treatment of V.I. capital gains with treatment of capital gains in Puerto Rico. These two modest changes would provide a substantial boost to our economic development program and put our Territory on a path to sustainable long-term economic growth and fiscal stability. I understand that the Department of the Treasury is sympathetic to these proposals.

Finally, if Congress extends the Earned Income Tax Credit (EITC) and other incentives such as the Child Tax Credit (CTC) to Puerto Rico, Congress should, as a matter of fairness, take into account the differences between Puerto Rico's and the Territories' tax systems and include a provision to provide federal reimbursement for the cost of such programs incurred by the mirror code jurisdictions (*i.e.*, the Virgin Islands and Guam).

I am attaching for your consideration suggested legislative language for these proposals and other supporting materials. Thank you for your consideration. I look forward to fruitful discussions on these issues of great importance to the U.S. citizens in the U.S. Virgin Islands and the other U.S. Territories.

Very truly yours,

Kenneth Mapp
Governor

Attachments: as stated

cc: Senator Marco Rubio
Senator Robert Menendez
Senator Bill Nelson
Representative Nydia Velazquez
Resident Commissioner Pedro Pierluisi
Representative Tom McArthur
Representative Sean Duffy
Delegate Stacey Plaskett

Attachments

Healthcare

Proposed Language

SEC. ____. PAYMENTS TO TERRITORIES.

(a) APPLICATION OF FMAP.—

(1) IN GENERAL.—Section 1905(b) of the Social Security Act (42 U.S.C. 1396d(b)) is amended by adding at the end the following sentence: 'Notwithstanding the first sentence of this subsection and any other provision of law, for fiscal year 2017 and subsequent fiscal years, the Federal medical assistance percentage for Puerto Rico, the Virgin Islands, Guam, the Northern Mariana Islands, and American Samoa shall be the highest Federal medical assistance percentage applicable to any of the 50 States or the District of Columbia for the fiscal year involved.'

Rum Tax Cover-Over

Suggested Language

SEC. __. REPEAL OF LIMITATION ON COVER OVER OF DISTILLED SPIRITS TAXES.

(a) IN GENERAL.—Section 7652(f) of the Internal Revenue Code of 1986 is repealed.

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to distilled spirits brought into the United States after December 31, 2015.

Economic Growth Tax Incentives

Congress should modify the Jobs Act possessions tax rules to attract, promote, and enhance economic development in the Virgin Islands

The U.S. Virgin Islands economy has been battered by the economic damage caused by the Great Recession and, more recently, the 2012 closure of the HOVENSA refinery, which had been the Territory's largest private employer and the mainstay of the St. Croix economy for the last half century. Almost 2,000 persons have lost their jobs, annual tax revenue has fallen by over a hundred million dollars, and hundreds of millions more in economic activity have been lost.

The Government of the U.S. Virgin Islands respectfully submits that the federal government has a critical role to play in helping our Territory generate robust and sustainable economic growth that can help the Territory improve its long-term fiscal health—and avoid the situation that Puerto Rico is now in. We request that Congress provide for fair and balanced tax rules by adopting two modest modifications of the possessions tax rules related to our Economic Development Commission (EDC) program to attract, promote, and enhance economic development in our Territory.

First, Congress should modify the Jobs Act sourcing rule in Section 937(b)(2) of the Internal Revenue Code (IRC) by modifying the U.S. income limitation to exclude only U.S. source (or effectively connected) income attributable to a U.S. office or fixed place of business.

Under the long-standing rules governing the tax relationship between the Virgin Islands and the United States, a bona fide resident of the Virgin Islands (*i.e.*, a tax resident) may satisfy his or her U.S. income tax obligations by filing in, and paying the applicable tax to, the Virgin Islands. Under Section 934 of the U.S. Internal Revenue Code, the Virgin Islands is authorized to reduce the otherwise applicable tax on "V.I. source income" and "income which is effectively connected with the conduct of a V.I. trade or business," regardless of source ("V.I. ECI"). This provision is a potentially powerful incentive for attracting investment to the Virgin Islands by allowing certain qualified U.S. source income (which would otherwise be subject to U.S. income tax rates under the V.I. mirror tax code) to be eligible for the concessionary tax rates under the EDC program. The Jobs Act, however, sharply limited the scope of this incentive by adding new IRC Section 937, which provides that no U.S. source income can qualify as V.I. ECI (the "U.S. income limitation") unless specifically permitted under rules promulgated by the Treasury.

To date, Treasury has permitted only inventory sales of Virgin Islands manufactured goods in the U.S. market (*i.e.*, manufacturing income) to qualify as V.I. ECI, based on the Department's narrow interpretation of an express legislative statement in the Jobs Act that Congress expected that the rules would continue the historic rule regarding inventory. Non-manufacturing income that is U.S. sourced, however, does not qualify—even if all of the economic activity that generates the income takes place in the Virgin Islands. We understand that Treasury believes a statutory change or Congressional clarification would be needed to address the issue, and that it would not oppose such a change or clarification.

This limitation has resulted in unjustified and sometimes illogical restrictions on the EDC program, and it has hindered the growth and development of high tech and knowledge-based industries in the Territory. For example, royalty income earned through licensing of a software

created by a Virgin Islands company to clients in foreign countries may qualify as V.I. ECI under the Jobs Act rules and thus eligible for EDC tax incentives, while licensing of the same software to U.S. customers would not, thus incentivizing Virgin Islands high tech companies to look to foreign markets rather than the U.S. market. Similarly, a Virgin Islands captive insurer which insures foreign risks would qualify for EDC tax incentives, while the insurance of U.S. risks would not, ironically putting V.I. companies at a competitive disadvantage compared to companies in Bermuda and other Caribbean countries.

We therefore request that Congress modify the sourcing rules in the Jobs Act by adopting the model income tax treaty rules for determining effectively connected income and modifying the U.S. income limitation to exclude only U.S. source (or effectively connected) income attributable to a U.S. office or fixed place of business.

Second, Congress should ensure parity of treatment among the Territories with respect to the treatment of capital gains, by clarifying in IRC Section 865(j)(3) that capital gains income earned by V.I. taxpayers should be deemed to constitute V.I. source income regardless of the tax rate imposed by the V.I. government (to maintain eligibility of certain capital gains income for EDC tax incentives). This change would correct an apparent drafting oversight by conforming the sourcing of capital gains of V.I. EDC beneficiaries with the rules already applicable to Puerto Rico. Providing such parity would make our EDC economic growth program more effective in attracting and retaining V.I. resident beneficiaries with capital gains. We understand that Treasury also is not opposed to this modification.

Proposed language follows:

SEC. __. MODIFICATION TO SOURCE RULES INVOLVING POSSESSIONS.

(a) SOURCE RULES.—Section 937(b)(2) of the Internal Revenue Code of 1986 is amended by striking the period at the end and inserting the following: ‘‘to the extent such income is attributable to an office or fixed place of business within the United States (determined under the rules of section 864(c)(5)).’’.

(b) SOURCE RULES FOR PERSONAL PROPERTY SALES.—Section 865(j)(3) of such Code is amended by adding ‘‘932,’’ after ‘‘931,’’ and before ‘‘933.’’.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2016.

Work Incentives

If Congress provides Puerto Rico access to federal tax credits, Congress should provide analogous growth incentives for the Territories

The earned income tax credit (EITC) and child tax credit (CTC) are intended to encourage work among low-income individuals. If Congress extends the EITC or other incentives such as the CTC to Puerto Rico, Congress should provide analogous economic growth incentives for the Territories—with adjustments to take into account the differences between Puerto Rico's and the Territories' tax systems and economic bases. Specifically, the Virgin Islands and Guam, unlike Puerto Rico, already administer the EITC and CTC under their respective mirror income tax codes. Unlike the programs in the States, however, the cost of the EITC and CTC programs in the mirror code jurisdictions is borne solely by the fiscally-pressed Territorial governments, not the federal government. If Congress extends the EITC or CTC to Puerto Rico, Congress should, as a matter of fairness, provide (similar to ARRA) for federal reimbursement for the cost of such programs incurred by the mirror code jurisdictions. Proposed language follows:

SEC. _. PAYMENTS TO UNITED STATES TERRITORIES AND POSSESSIONS.

(a) EARNED INCOME CREDIT.—Section 32 of the Internal Revenue Code of 1986 is amended by adding at the end the following:

''(n) TREATMENT OF POSSESSIONS.—

''(1) PAYMENTS TO POSSESSIONS.—

''(A) MIRROR CODE POSSESSION.—The Secretary of the Treasury shall periodically (but not less frequently than annually) pay to each possession of the United States with a mirror code tax system amounts equal to the loss to that possession by reason of the application of this section (determined without regard to paragraph (2)) with respect to taxable years beginning after December 31, 2015. Such amounts shall be determined by the Secretary of the Treasury based on information provided by the government of the respective possession.

''(B) OTHER POSSESSIONS.—The Secretary of the Treasury shall periodically (but no less frequently than annually) pay to each possession of the United States which does not have a mirror code tax system amounts estimated by the Secretary of the Treasury as being equal to the aggregate benefits that would have been provided to residents of such possession by reason of the application of this section for taxable years beginning after December 31, 2015, if a mirror code tax system had been in effect in such possession. The preceding sentence shall not apply with respect to any possession of the United States unless such possession has a plan, which has been approved by the Secretary of the Treasury, under which such possession will promptly distribute such payments to the residents of such possession.

''(2) COORDINATION WITH CREDIT ALLOWED AGAINST UNITED STATES INCOME TAXES.—No credit shall be allowed under this section for any taxable year to any person—

''(A) to whom a credit is allowed against taxes imposed by the possession by reason of this section (determined without regard to this paragraph) for such taxable year, or

''(B) who is eligible for a payment under a plan described in paragraph (1)(B) with respect to such taxable year.

''(3) DEFINITIONS AND SPECIAL RULES.—

''(A) POSSESSION OF THE UNITED STATES.—For purposes of this subsection, the term 'possession of the United States' includes the Commonwealth of Puerto Rico and the Commonwealth of the Northern Mariana Islands.

''(B) MIRROR CODE TAX SYSTEM.—For purposes of this subsection, the term 'mirror code tax system' means, with respect to any possession of the United States, the income tax system of such possession if the income tax liability of the residents of such possession under such system is determined by reference to the income tax laws of the United States as if such possession were the United States, and such system includes a tax credit substantially identical to the credit allowed under this section.

''(C) TREATMENT OF PAYMENTS.—For purposes of section 1324(b)(2) of title 31, United States Code, or any similar rule of law, any payment made under this subsection shall be treated in the same manner as a refund due from the credit allowed under this section.''.

(b) CHILD TAX CREDIT.—Section 24 of such Code is amended by adding at the end the following:

''(h) PAYMENTS TO VIRGIN ISLANDS AND GUAM FOR LOST REVENUE.—The Secretary shall make annual payments to the Virgin Islands and to Guam in amounts equal to the aggregate loss to the Virgin Islands or Guam, as the case may be, by reason of the application of this section with respect to taxable years beginning after 2015. Such amounts shall be determined by the Secretary based on information provided by the Virgin Islands and Guam. For purposes of section 1324(b)(2) of title 31, United States Code, the payments under this subsection shall be treated in the same manner as a refund due from the credit allowed under this section.''.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to taxable years beginning after December 31, 2015.