
INTERNATIONAL

Establishing Residency in the U.S. Virgin Islands—A Look at Section 937's Reach

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The 2004 legislation brought about a fundamental change in the residency rules. While there are new final Regulations under Section 937, the combination of transition rules and open years means that practitioners must be alert to how the tests are currently applied to both citizens and nonresident aliens and how they have been interpreted in prior tax years.

Section 937 explains how an individual taxpayer can qualify as a "bona fide resident" of the U.S. Virgin Islands. It applies to U.S. citizens, resident aliens, and nonresident aliens alike.

This provision, introduced by the American Jobs Creation Act of 2004 (AJCA), was designed to close many of the loopholes that were being manipulated by individuals to take advantage of tax benefits offered to residents of the U.S. possessions.

While this article focuses on the Virgin Islands, the rules discussed herein are generally applicable to all U.S. possessions. [1]

CLASSIFICATION AS A RESIDENT ALIEN

Because Section 937 applies to nonresident aliens, a good place to start is whether an individual qualifies as a U.S. resident alien or nonresident alien. An individual is a U.S. resident alien if any one of the following conditions is met:

(1) The individual is in possession of a valid green card.
(2) The individual satisfies the "substantial presence" test.
(3) The individual elects to be classified as a resident.

Green card test. The green card test, in Section 7701(b)(6)(A), requires the individual to have been legally admitted to the U.S. for permanent residence at any time during the current tax year.

Substantial presence test. Under Section 7701(b)(3)(A), an individual must be physically present in the U.S. for 183 or more days during the current tax year. If the individual does not meet this test, the substantial presence test still can be satisfied under a three-year look-back.

Nonresident aliens who want to avoid the classification of U.S. resident status are generally familiar with the 183-day rule. The reach of the 183-day test through a three-year look-back is something that is not as well understood, however. The rule applies only to individuals who are physically present in the U.S. for a minimum of 31 days in the current year. [2] Thus, the three-year look-back will not be applied to a nonresident alien who is physically present in the U.S. for 30 days or less during the current tax year.

The rule, set forth in Section 7701(b)(3)(A), requires an individual to be physically present in the U.S. during the current tax year at least 31 days, and for a total of 183 days over a three-year period that includes the two preceding calendar years. To determine if the 183-day count is satisfied, a separate multiplier is applied to each year in the three-year period. For the current year, the multiplier is 1 and each day is counted as a full day. For the immediately preceding calendar year, the multiplier is 1/3 (e.g., 60 days in the U.S. × 1/3 = 20 days). For the next preceding calendar year, the multiplier is 1/6 (e.g., 60 days in the U.S. × 1/6 = 10 days). Thus, during either of the two preceding calendar years, even if an individual was actually present in the U.S. for 183 days or more, the individual may not be deemed a U.S. resident alien for the current tax year. In fact, if an individual is physically present in the U.S. for no more than 121 days every year, the individual will not meet the substantial presence test and will be classified as a nonresident alien. [3]

Election. If an individual does not possess a green card or the substantial presence test is not satisfied, Section 7701(b)(4) allows the individual to make an affirmative election to be classified as a resident alien. The affirmative election is most applicable to individuals who emigrate to the U.S. during a tax year. For the election to be valid, the individual must be in the U.S. for at least 31 days during the election year and satisfy the substantial presence test for the following calendar year. A discussion of the reasons as to why one would choose to be a U.S. resident alien is beyond the focus of this article, but readers should be aware that there are specific procedures to follow.

Exceptions to Resident Alien Classification

Once an individual is deemed a resident alien, the individual is subject to U.S. income tax on worldwide income. Nevertheless, even if an individual is physically present in the U.S., in many instances such presence will not count towards fulfilling the substantial presence test and the resident alien remains classified as a nonresident alien. Six specific exceptions to the substantial presence rule are discussed below, of which the first four provide that actual physical presence in the U.S. will not be counted for purposes of the substantial presence test.

In transit. If the individual is physically present in the U.S. while in transit between two points out of the U.S., the time physically present in the U.S. will not apply for purposes of the substantial presence test. In order for the "in-transit" exception in Section 7701(b)(7)(C) to apply, however, the individual must not be physically present in the U.S. for more than 24 hours.

There does not appear to be any flexibility in the 24-hour rule in the event delays—weather related or otherwise—cause a layover at a U.S. airport to take longer than 24 hours. Additionally, the "in-transit" exception mandates that the individual not engage in any activity while in the U.S. that is not substantially related to completing his or her travel to a foreign point of destination. Reg. 301.7701(b)-3(d) specifies that even if an individual is physically present in the U.S. for less than 24 hours, and attends a business meeting at the airport, such physical presence will count for purposes of the substantial presence test. Consequently, it would appear that even though an individual only meets with friends or relatives at an airport during a less-than-24-hour layover, the same reasoning would apply to hold such visit as a day physically present in the U.S.

Possession/commonwealth/territory. Physical presence in a U.S. possession, commonwealth, or territory does not qualify as time that the individual is physically present in the U.S. for purposes of the substantial presence test.[4] Consequently, any time that an individual may have been physically present in the Virgin Islands (a possession) or Puerto Rico (a commonwealth), would be disregarded for purposes of determining whether the individual satisfied the substantial presence test and thus is classified as a U.S. resident alien.

Regular commuter. Under Section 7701(b)(7)(B), an individual who otherwise would be classified as a resident alien as a result of meeting the substantial presence test is not so classified if the presence is attributable to the individual's commuting for employment from the individual's residence in either Mexico or Canada to the U.S. "Commute" is defined in Reg. 301.7701(b)-3(e)(2)(i) to mean daily round trips from home to a job within the U.S. Similarly, the commute must be "regular," which is defined in Reg. 301.7701(b)-3(e)(1) as more than 75% of the work days during the working period.

Exempt individual. Section 7701(b)(5) provides an exemption for physical presence in the U.S. for the following individuals:

(1) An individual who is a full-time employee or official of a foreign government.
(2) A teacher or trainee.
(3) A student.
(4) A professional athlete who temporarily spends time in the U.S. to compete in a charitable sports event.

Whereas the four prior exceptions dealt with situations in which an individual's actual physical presence in the U.S. is not counted, the following two exceptions count an individual's actual physical presence in the U.S. for purposes of determining if the individual is deemed to be a U.S. resident.

Tax treaty. If the resident alien is deemed to be a resident of a country that has an income tax treaty with the U.S. and the treaty tie-breaker provisions are satisfied, the tax treaty will control and generally deem the individual to be a nonresident alien for purposes of U.S. income tax.[5]

Closer connection. The closer connection exception in Section 7701(b)(3)(B) is a further safeguard for nonresident aliens who do not want to be taxed or classified as U.S.

residents. It is only applicable to individuals termed "resident aliens" under the substantial presence test of Section 7701.

To satisfy the closer connection exception, the resident alien (1) cannot be physically present for 183 days or more in the U.S. during the current tax year, (2) must have a tax home in a foreign country, and (3) must have a closer connection to that foreign country. For purposes of the closer connection exception, the Virgin Islands, as well as the other U.S. possessions and territories, are deemed to qualify as foreign countries by Reg. 301.7701(b)-2(b). In addition, the resident alien is required to file Form 8840 notifying the IRS that he is deemed to qualify as a nonresident alien under the closer connection test. [6] Thus, if an individual satisfies the closer connection exception, he is not classified as a resident alien.

Reg. 301.7701(b)-2(d) instructs that the various "contacts" between the U.S. and the foreign country are weighed to determine whether the individual truly has a closer connection with the foreign country than with the U.S. The following is not an exclusive list:

- The location of the individual's permanent home.
- The location of the individual's family.
- The location of the individual's personal belongings, such as automobiles, furniture, clothing, and jewelry owned by the individual and his family.
- The location of social, political, cultural, or religious organizations with which the individual has a current relationship.
- The location of banks with which the individual conducts his routine banking activities.
- The location where the individual conducts his business activities other than those that give rise to a tax home.
- The jurisdiction that issued the individual's driver's license.
- The jurisdiction where the individual votes.
- The country of residence designated by the individual on forms and documents.
- The official documents filed by the individual with U.S. authorities (i.e., Form W-8BEN or Form W-9).

The more of these contacts that the individual can establish in the foreign country, the greater the likelihood of proving such a closer connection. Nevertheless, the extent to which an individual can use the closer connection exception to prove that, in spite of being substantially present in the U.S., he had a closer connection to the Virgin Islands, ended in the 2003 tax year. As of 2004, Section 937 became the exclusive means of establishing residency in a U.S. possession or territory. The reason the closer connection exception is no longer valid is that, subsequent to the AJCA, Treasury prohibited the use of the Section 7701 substantial presence test for purposes of establishing residency in a U.S. possession. [7] Nevertheless, Section 937 (as discussed in further detail below) instructs nonresident aliens to use the substantial presence test for purposes of satisfying residence in the Virgin Islands. There are additional requirements, however, for nonresident aliens to satisfy under Section 937.

RESIDENT vs. NONRESIDENT ALIEN

An individual deemed to be a resident alien will be taxed in the U.S. on such individual's worldwide income. Under Section 871(a), a nonresident alien (including an individual who qualifies for one of the exceptions to the substantial presence test described above) will be subject to U.S. income tax only on such individual's U.S. source fixed and

determinable periodical (FDAP) income or income effectively connected to a U.S. trade or business. Nonresident aliens are generally exempt from income tax on U.S. source capital gains unless they are present in the U.S. for 183 days or more during the tax year.

APPLICATION OF SECTION 937

The final Regulations under Section 937 (TD 9248, 1/30/06) apply to individual taxpayers for tax years ending after 1/31/06. Reg. 1.937-1 applies to individual taxpayers for 2006 and subsequent tax years. To the extent a taxpayer has yet to file 2004 or 2005 tax returns, however, the final Regulations may be used for such returns. [8]

A taxpayer will qualify as a bona fide resident of the Virgin Islands if the taxpayer can satisfy *all* of the following three criteria:

(1) The presence test.
(2) The tax home test.
(3) The closer connection test.

The Presence Test

Under Reg. 1.937-1(c)(1), an individual taxpayer must be physically located in the Virgin Islands for at least 183 days during the tax year. So long as an individual is physically present in the Virgin Islands at any time during the day, for any amount of time, the day will count for purposes of the presence test. [9] A taxpayer incapable of satisfying the 183-day test may find relief in one of three safe harbors—to the extent the taxpayer can meet *any* of these three safe harbors, the taxpayer will be deemed to have satisfied the presence test:

(1) The 90-day test.
(2) The earned income test.
(3) The significant connection test.

The 90-day test. If the taxpayer is physically present in the U.S. for no more than 90 days during the current tax year, the presence test will be satisfied, under Reg. 1.937-1(c)(1)(ii). The following five exceptions permit an individual to be physically present in the U.S. without having such days count towards the 90-day test:

(1) *In transit.* The in-transit exception, discussed above in the context of the substantial presence test, is similarly applicable to Section 937. If the individual is physically present in the U.S. while in transit between two points out of the U.S., the time physically present in the U.S. will not apply for purposes of the 90-day test. In order for this exception to apply, however, the individual must not be physically present in the U.S. for more than 24 hours. [10]
(2) *U.S. and Virgin Islands.* Reg. 1.937-1(c)(3)(iii)(A) provides that when an individual is physically present in both the U.S. and the Virgin Islands during the same day, the time the individual is physically present in the U.S. will not count for purposes of the 90-day test. This rule could prove useful for an individual who cannot satisfy the in-transit exception, which requires the individual to not engage in any activity inconsistent with being in transit. Thus, under this Regulation, the individual could spend the better part of 24 hours visiting family and friends in the U.S. without such time counting for purposes of the 90-day test, so long as the individual either begins or ends the 24-hour period in the Virgin Islands.
Individuals who otherwise meet the requirements of Section 937, and who own

their own airplanes, would appear to have much greater flexibility in skirting the U.S. residency rules under this exception.
(3) *Medical issues.* An individual is permitted to spend time in the U.S. seeking medical treatment or accompanying a parent, spouse, or child seeking such medical treatment. The time such individual is actually physically present in the U.S. will not count for purposes of the 90-day test, so long as the presence is related to the receipt of "qualifying medical treatment." [11] Qualifying medical treatment generally requires at least one overnight stay in a hospital, hospice, or residential medical care facility. [12]
(4) *Evacuations.* If the individual is physically present in the U.S. because (a) the Virgin Islands has a mandatory evacuation due to a natural disaster or (b) the individual spends up to two weeks in the U.S. following the Virgin Islands' being declared a major disaster area, such days will not count as days physically present in the U.S. for purposes of the 90-day test. [13]
(5) *Exempt individual.* The Code also provides an exemption for physical presence in the U.S. for (a) an individual who is a full-time employee or official of the Virgin Islands, (b) a student, or (c) a professional athlete who temporarily spends time in the U.S. to compete in a charitable sports event. [14]

Earned income test. If the taxpayer spends more time in the Virgin Islands than in the U.S. during the tax year and has earned no more than $3,000 in income in the U.S., Reg. 1.937-1(c)(1)(iii) provides that the presence test will be satisfied.

Significant connection test. If the taxpayer has no significant connection to the U.S. during the tax year, the presence test will be satisfied, according to Reg. 1.937-1(c)(1)(iv).

The following acts, however, will automatically cause the taxpayer to have a significant connection to the U.S.:

(1) If the taxpayer's permanent home, as defined in Reg. 301.7701(b)-2(d)(2), is in the U.S. There is an exception for rental property.
(2) If the taxpayer has a spouse or minor dependent living in the U.S. There is an exception, however, for any minor children who are in school or live with a parent who is legally separated from the taxpayer.
(3) If the taxpayer has a current voter's registration card to vote in any U.S. political race.

The Tax Home Test

One of the changes brought by the Section 937 final Regulations was that the taxpayer can satisfy the tax home test even if the taxpayer moved to the Virgin Islands during the current tax year. In that event, however, the taxpayer must not have a tax home outside the Virgin Islands during the last 183 days of the tax year in which the move occurred. Additionally, the taxpayer must not have been a resident of the Virgin Islands in the three tax years immediately prior to the move and must continue to be a resident of the Virgin Islands for the subsequent three years. [15]

Closer Connection Test

The taxpayer cannot have a closer connection with the U.S. or with a foreign country than he has with the Virgin Islands. All connections with the U.S. and with foreign countries are viewed in the aggregate rather than on a country-by-country basis.

Exceptions to the Presence Test Under the Final Regs.

Section 937 contains special rules that permit an individual to have certain days counted as presence in the Virgin Islands when such person actually is absent. Thus, it is possible for a taxpayer to satisfy the 183-day test without actually being present in the Virgin Islands for that period. Additionally, Section 937 imposes a different test on nonresident alien taxpayers who seek to become residents of the Virgin Islands.

Medical care. Under Reg. 1.937-1(c)(3)(i)(B), an individual is permitted to spend time outside the Virgin Islands seeking medical treatment or accompanying a parent, spouse, or child seeking such medical treatment. The time such individual actually is absent from the Virgin Islands will count for purposes of the presence test, so long as the absence is related to the receipt of "qualifying medical treatment." Qualifying medical treatment generally requires at least one overnight stay in a hospital, hospice, or residential medical care facility. [16]

Evacuations. If the individual is physically absent from the Virgin Islands because (1) the Virgin Islands has a mandatory evacuation due to a natural disaster or (2) the individual spends up to two weeks away from the Virgin Islands following its being declared a major disaster area, such days will count as days physically present in the Virgin Islands for purposes of the presence test. [17]

Nonresident aliens. For purposes of proving bona fide residency in the Virgin Islands, Reg. 1.937-1(c)(2) requires that nonresident aliens also satisfy the three-part test imposed by Section 937, above. The only exception is that for purposes of satisfying the presence test, the individual must satisfy the requirements of the substantial presence test under Section 7701, described above. When applying the substantial presence test for this purpose, "Virgin Islands" is substituted for "U.S." Thus, instead of having to be physically present in the U.S. for 183 days or more during the current year (or over a three-year period through the application of the look-back rule), if the individual is physically present in the Virgin Islands at least 31 days during the current tax year and is physically present for 183 days or more over the three-year look-back period, the presence test is satisfied.

This is the only instance in which the Section 7701 test is to be used for purposes of residency in the Virgin Islands. The final Regulations specify that the Section 7701(b) test is not to be used for purposes of determining if a nonresident alien can be a bona fide resident of a possession, other than with respect to the presence test.

The Temporary Regulations

Until the final Regulations were issued in January 2006, Temp. Reg. 1.937-1T (issued in April 2005) was the sole guidance on the interpretation of Section 937 after the AJCA became law. Consequently, these interpretations controlled which taxpayers were able to qualify as bona fide residents of the Virgin Islands. While the Temporary Regulations were superseded for 2006 and subsequent tax years, it is possible that they still apply to individuals for the 2004 and 2005 tax years. (Reg. 1.937-1(i) gives taxpayers the option of using the final Regulations for such open tax years.)

As in the final Regulations, under the Temporary Regulations a taxpayer seeking to qualify as a bona fide resident had to satisfy (1) the presence test, (2) the tax home test, and (3) the closer connection test. While the three requirements are the same, they were interpreted differently under the Temporary Regulations.

The presence test. The presence test applied to taxpayers as of 1/1/05.[18]

90-day test. If the taxpayer was physically present in the U.S. for no more than 90 days during the current tax year, the presence test was satisfied. If the taxpayer developed a medical condition while physically present in the U.S. that prohibited the taxpayer from leaving the U.S., the days physically present in the U.S. as a result of such illness did not count towards the 90-day test. This is more stringent than the final Regulations, which permit the individual to be in the U.S. accompanying a family member seeking treatment. Under the Temporary Regulations, the illness had to have occurred while the individual was present in the U.S. and the illness had to be the reason for the individual's inability to leave the U.S.

Earned income test. If the taxpayer was physically present in the Virgin Islands more than in the U.S. during the tax year and *had no earned income* in the U.S., then the presence test was satisfied. This also was a more stringent test than in the final Regulations, which permit the individual to have earned up to $3,000 in the U.S.

Permanent connection test. If the taxpayer had no permanent connection to the U.S. during the current tax year, the presence test would be satisfied.

The final Regulations change "permanent connection" to "significant connection," and also provide an exclusive list of activities that automatically will qualify the taxpayer as having such a connection. The Temporary Regulations also had a list of activities that automatically would qualify the taxpayer as having a permanent connection, but that list was not exclusive. Thus, taxpayers were left to guess what else might qualify as a permanent connection.

The tax home test. The Temporary Regulations applied the tax home test for the 2004 tax year.[19] The final Regulations, however, permit taxpayers to delay the effective date of the tax home test until the 2005 tax year, which essentially permits taxpayers to use the prior law for determining residency. If used, the Temporary Regulations required the taxpayer to satisfy the three bona fide residency requirements in Section 937 for the *entire* tax year. Once satisfied, the tax home was generally deemed to be the location where the taxpayer had his regular place of business. Thus, a taxpayer who moved to the Virgin Islands during a tax year could not qualify as a bona fide resident during the year of the move.

Closer connection test. The closer connection test applied to taxpayers for tax year 2004.[20] However, the final regulation permits taxpayers to delay the effective date of the closer connection test until the 2005 tax year, which essentially permits taxpayers to use the prior law for determining residency.

Nonresident Aliens

For purposes of proving bona fide residency in the Virgin Islands, nonresident aliens also had to satisfy the three tests in the Temporary Regulations, discussed above. The only exception was that for purposes of satisfying the presence test, the individual had to satisfy the requirements of the substantial presence test under Section 7701, once again substituting "Virgin Islands" for "the U.S." Thus, if the individual was physically present in the Virgin Islands at least 31 days during the tax year and was physically present for 183 days or more over the three-year look-back period, the presence test was satisfied.

The Temporary Regulations specified that the Section 7701(b) test was not to be used for purposes of determining if a nonresident alien could be a bona fide resident of a possession. While it is clear that the use of Section 7701(b) for purposes of proving an alien is a resident of the Virgin Islands is currently foreclosed, this was not the case prior to 10/22/04. Consequently, for prior tax years (2003 and earlier), an argument could be made under Section 7701(b) for establishing residency in the Virgin Islands. [21]

PRE-AJCA RULES FOR 2004 AND BEFORE

There are at least two methods for qualifying as a bona fide resident of the Virgin Islands for tax year 2004. Reg. 1.937-1(b)(4) provides a transition rule that permits individuals seeking to become bona fide residents of the Virgin Islands to use the principles of Regs. 1.871-2 through 1.871-5 for 2004. Subsequent to the AJCA, the 2004 version of Publication 570 (*Tax Guide for Individuals With Income From a U.S. Possession*) advised the public that the AJCA changed the rules for individuals in a U.S. possession to become a bona fide resident. The publication noted that Regulations had not yet been issued.

Consequently, Publication 570 for 2004 advised taxpayers that for tax years that began before 10/22/04 they could qualify as a bona fide resident of the Virgin Islands if during the entire tax year they (1) did not have a tax home outside the Virgin Islands and (2) did not have a closer connection to the U.S. or a foreign country than to the Virgin Islands.

Prior to the AJCA, there was no definitive law on how to determine whether a taxpayer was a resident of the Virgin Islands. Former Reg. 1.934-1(c)(2), now superseded by Section 937, provided that "[i]n determining whether a United States citizen is a bona fide resident of the Virgin Islands, the principles of §§1.871-2, 1.871-3, 1.871-4, and 1.871-5, relating to the determination of residence and nonresidence in the United States, shall apply." Finally, the three-part test under Section 7701(b) for determining an individual's residency for purposes of U.S. income tax also was used. Nevertheless, as of its 10/22/04 effective date, Reg. 301.7701(b)-1(d)(2) provided that this test, while valid for determining whether a taxpayer was subject to U.S. income tax, alone was insufficient to determine residency in the Virgin Islands.

In 1992, draft Regulations were proposed for Section 932 but ultimately were cancelled. The draft Regulations, which were intended to be used to determine when someone was a bona fide resident of a U.S. possession, provide insights into prior IRS thinking. Draft section 1.932-1T(c)(2)(i)(A) provided a list of factors that were relevant in determining residency, including:

> (1) The intention of the individual to be a resident of the possession as shown by the totality of the circumstances.
> (2) The establishment of a permanent home in the possession for an indefinite period.
> (3) The nature and duration of employment in the possession and elsewhere.
> (4) The nature, extent, and reasons for absences from the possession.

There were also secondary factors that were relevant in determining residency if the primary factors were not met. These secondary factors, in draft section 1.932-1T(c)(2)(i)(B), included (1) the existence of other homes or abodes outside the possession, (2) the residence of the individual's family, (3) the place of residence during prior and later years, and (4) the assimilation of the individual into the cultural, social, and economic environment of the possession.

When courts have applied a facts and circumstances test, it has been used to determine whether an individual is a resident of a foreign country. The following factors have been considered in such analysis:

(1) The taxpayer's intention.
(2) Establishment of the taxpayer's home *temporarily* in the foreign country for an *indefinite* period of time.
(3) Participation in the activities of the 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 the taxpayer's employment.
(5) The nature, extent, and reasons for temporary absences from the 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 of the taxpayer's income tax status by the employer.
(9) Marital status and residence of taxpayer's family.
(10) The nature and duration of the taxpayer's employment, such as whether the assignment abroad could be promptly completed within a definite or specified time.
(11) The taxpayer's good faith in making the trip abroad (i.e., not for the purpose of tax evasion). [22]

COMPLIANCE ISSUES

Once a taxpayer satisfies Section 937 and is deemed to be "a bona fide resident" of the Virgin Islands, compliance issues must be addressed. A thorough analysis and discussion of such compliance issues is beyond the scope of this article, but two requirements are of utmost importance—filing Form 8898 ("Statement for Individuals Who Begin or End Bona Fide Residence in a U.S. Possession"), and filing income tax returns.

Form 8898

Any individual taking the position that he is a bona fide resident of the Virgin Islands, in a year following that in which the individual was required to file a U.S. income tax return as either a citizen or resident, is required by Reg. 1.937-1(h) to provide notice to the IRS. [23] Form 8898 is the designated form for such notice.

Although the AJCA became effective as of 10/22/04, the draft of Form 8898 was not released until 7/6/05. On 8/18/05, the Treasury published a notice in the *Federal Register* that written comments on Form 8898 should be provided to the Service by 10/17/05. Instructions to Form 8898 were available in late March 2006 and the actual form was released in April 2006.

The instructions reiterate that Form 8898 must be filed by any taxpayer who previously filed a U.S. income tax return, but who now qualifies as a bona fide resident of the Virgin Islands and who has worldwide income in excess of $75,000. The instructions similarly indicate that the form is required beginning with tax year 2001, apparently without regard to any applicable statute of limitations or closing agreements. Thus, individuals who qualified as bona fide residents of the Virgin Islands prior to the AJCA, or even those who successfully satisfied Section 937 subsequent to the AJCA but prior to the release date of Form 8898, must now file such documentation. Form 8898 would appear to be an

independent filing requirement. Accordingly, a taxpayer could be a bona fide resident of the Virgin Islands by satisfying the three tests imposed by Section 937 in spite of failing to file the form. Form 8898 is filed alone, rather than with the Form 1040.

Depending on the tax year in which the individual is seeking to qualify as a bona fide resident of the Virgin Islands, there are different instructions on how Form 8898 should be completed. Failure to file Form 8898, or filing an incomplete or erroneous Form 8898, may expose the taxpayer to a $1,000 penalty in addition to criminal penalties, unless it is shown that there was reasonable cause for the failure to file. The form must be filed by 10/16/06 for tax years 2001-2005. [24] Individuals who have extensions for their 2005 tax returns have until the extended due date to file the Form 8898 for 2005.

Income Tax Returns

Section 932 coordinates the income tax systems of the U.S. and the Virgin Islands. It explains where a tax return must be filed, what must be included on the return, and where tax is to be paid. While the AJCA became effective on 10/22/04, the changes affecting Section 932 did not become applicable to taxpayers prior to the 2005 tax year.

After the AJCA, if an individual taxpayer is a bona fide resident of the Virgin Islands (i.e., satisfies Section 937), such individual should file an income tax return in the Virgin Islands reporting all income earned from all sources regardless of location, and pay tax to the Virgin Islands. Additionally, if the taxpayer generally filed a joint return, Section 932(c) indicates the taxpayer should file a joint Virgin Islands income tax return even if the spouse was not a bona fide resident of the Virgin Islands.

All U.S. taxpayers who do not qualify as bona fide residents (because they fail to satisfy Section 937) and who have earned income in the Virgin Islands, or income related to a business in the Virgin Islands, must file income tax returns in both the U.S. and the Virgin Islands. [25] Additionally, if the taxpayer generally filed a joint return, Section 932(a) indicates the returns filed in both jurisdictions should be joint.

Prior to the AJCA, if an individual was a bona fide resident of the Virgin Islands as of the last day of the year, that taxpayer could file an income tax return in the Virgin Islands reporting all income earned from all sources and pay tax to the Virgin Islands. Additionally, if the taxpayer generally filed a joint return, the taxpayer should file a joint Virgin Islands income tax return, even if the spouse was not a bona fide resident of the Virgin Islands.

All U.S. taxpayers who did not qualify as bona fide residents of the Virgin Islands, and who had earned income in the Virgin Islands or related to a business in the Virgin Islands, were required to file income tax returns in both the U.S. and the Virgin Islands. Additionally, if the individual taxpayer generally filed a joint return, the returns filed in both jurisdictions should be joint.

CONCLUSION

A plethora of publicity has surrounded the Service's intent to enforce the residency rules. Included in that effort is the imposition of tax penalties for willful noncompliance or affirmative acts of tax evasion. These penalties can range from the civil to the criminal. Nevertheless, IRS has had precious little to offer on how a taxpayer should be appropriately penalized under a body of ever-changing, inconsistent, overlaying, and sometimes retroactive rules and Regulations. Unfortunately for taxpayers, the lack of

clarity will result in their continuing to be stuck in a minefield, especially during the next few years when prior years' returns remain open for review. For practitioners, the Service's silence on an appropriate penalty should lead to an ever-increasing workload.

Practice Notes

To establish residency in the Virgin Islands:

- *As of 2006.* To prove that an individual is a bona fide resident of the Virgin Islands for 2006, the taxpayer must satisfy the three-part test provided in Section 937: (1) the presence test, (2) the tax home test, and (3) the closer connection test. If the individual is a nonresident alien, however, the presence test is satisfied by meeting the substantial presence test under Section 7701(b).
- *2005 tax year.* To prove that an individual was a bona fide resident of the Virgin Islands under the Temporary Regulations, which may remain applicable for the 2005 tax year, the taxpayer must satisfy the three-part test provided in Section 937: (1) the presence test, (2) the tax home test, and (3) the closer connection test. If the individual is a nonresident alien, however, the presence test is satisfied by meeting the substantial presence test under Section 7701(b). In order to satisfy the tax home test, the taxpayer had to satisfy the three bona fide residency requirements in Section 937 for the entire tax year. The Temporary Regulations are superseded by the final Regulations for 2006 and subsequent tax years.
- *2005/year of move.* Under the final Regulations for tax year 2005 and subsequent tax years, an individual can establish bona fide residency in the Virgin Islands during the year such individual moves to the possession so long as (1) during the last 183 days of the tax year, the individual does not have a closer connection or tax home anywhere else, (2) the individual was not a bona fide resident of the Virgin Islands in any of the three tax years immediately preceding the move, and (3) the individual remains a bona fide resident of the Virgin Islands for each of three tax years immediately subsequent to the move.
- *2004 tax year.* During the 2004 tax year, individuals had two alternatives to qualify as bona fide residents of the Virgin Islands. The first approach was to satisfy both (1) the tax home test and (2) the closer connection test established under Section 937. In order to satisfy the tax home test, the taxpayer had to satisfy the bona fide residency requirements in Section 937 for the entire tax year. The second approach to establishing residency in the Virgin Islands for 2004 was to use the principles of Regs. 1.871-2 through 1.871-5. These rules are now superseded with the exception of returns for 2004 that have not yet been filed.
- *Tax years prior to 2004.* The irony under the Code is that even though Section 937 is entitled "Residence and source rules involving possessions," prior to the adoption of the final Regulations in 2006 "bona fide resident" was not defined. Thus, a taxpayer seeking to demonstrate that he was a bona fide resident of the Virgin Islands was venturing into an uncharted area. Case law demonstrated that courts used up to 11 factors when applying a facts and circumstances analysis. Additionally, there was no statutory prohibition on using the Section 7701(b) test for proving residency in the Virgin Islands during such years. These rules are now superseded.

[1]

Section 937 applies to individuals seeking to become "bona fide residents" of American Samoa, Guam, the Commonwealth of the Northern Mariana Islands, Puerto Rico, or the U.S. Virgin Islands. While the rules are generally the same for all possessions, differences

do exist, and this article should not be considered a thorough analysis of the application of Section 937 to any other U.S. possession.

[2] Reg. 301.7701(b)-1(c)(4).

[3] 121 days in each of the years 2004, 2005 and 2006 = 181.5 days in the U.S. The formula would yield 121 days in 2006; 40.3 days in 2005 (121 days/3); and 20.2 days in 2004 (121 days/6).

[4] Section 7701(a)(9); Reg. 301.7701(b)-1(c)(2)(ii).

[5] Reg. 301.7701(b)-7.

[6] Section 7701(b)(8); Reg. 301.7701(b)-2(g).

[7] Temp. Reg. 301.7701(b)-1T(d).

[8] Reg. 1.937-1(i).

[9] Reg. 1.937-1(c)(3)(i)(A).

[10] Reg. 1.937-1(c)(3)(ii)(B).

[11] Reg. 1.937-1(c)(3)(ii)(A).

[12] Reg. 1.937-1(c)(4).

[13] Reg. 1.937-1(c)(3)(ii)(A).

[14] Regs. 1.937-1(c)(3)(ii)(C), (D), and (E).

[15] Regs. 1.937-1(d)(2)(i) and -1(f)(1).

[16] Reg. 1.937-1(c)(4).

[17] Reg. 1.937-1(c)(3)(i)(C).

[18] AJCA section 908(d)(2); Temp. Reg. 1.937-1T(b)(4).

[19] AJCA section 908(d)(1).

[20] *Id.,* section 908(d)(2).

[21] But see Bergersen, 79 AFTR 2d 97-1530, 109 F3d 56 (CA-1, 1997), *aff'g* TC Memo 1995-424, RIA TC Memo ¶95424 , and Preece, 95 TC 594 (1990), in which U.S. citizens were unable to use Section 7701(b) to prove residency in a U.S. possession. The courts in both cases determined that Section 871 and the Regulations thereunder were the appropriate manner for establishing residency in a possession. These two cases, however, dealt with U.S. citizens attempting to qualify as residents of a U.S. possession, rather than a nonresident alien.

[22] Sochurek, 9 AFTR 2d 883, 300 F2d 34 (CA-7, 1962), *rev'g* 36 TC 131 (1961). It is not clear how in number 2 one can be somewhere *temporarily* for an *indefinite* period.

[23] Form 8898 also is required when a U.S. citizen or resident ceases to be a bona fide resident of the Virgin Islands in a year after which the individual filed an income tax

return with the IRS, Virgin Islands Bureau of Internal Revenue, or both.
[24]

The 7/17/06 due date for Form 8898, in the form's instructions, was changed to 10/16/06 by Notice 2006-57, 2006-27 IRB xxx.
[25]

CCA 200624002 stresses that the filing of a Virgin Islands return does not start running the statute of limitations for U.S. purposes.