considered an employee of the United States or of an agency of the United States.

(2) The following example illustrates the application of the general rule in paragraph (a)(1) of this section:

Example. E, a United States citizen, files returns on a calendar year basis. In April 2008, E moves to Puerto Rico, where he purchases a house and accepts a permanent position with a local employer. For the remainder of the year and for the following three taxable years, E continues to live and work in Puerto Rico and has a closer connection to Puerto Rico than to the United States or any foreign country. Assuming that E otherwise meets the requirements under section 937(a) and § 1.937–1(b) and (f)(1) (year-of-move exception), E is considered a bona fide resident of Puerto Rico for 2008. Accordingly, under section 933(1) and paragraph (a)(1) of this section, E should exclude from his 2008 Federal gross income any income from sources within Puerto Rico, as determined under section 937(b) and § 1.937–2.

§ 1.934–1 Limitation on reduction in income tax liability incurred to the Virgin Islands.

(a) General rule. Section 934(a) provides that tax liability incurred to the United States Virgin Islands (Virgin Islands) must not be reduced or remitted in any way, directly or indirectly, whether by grant, subsidy, or other similar payment, by any law enacted in the Virgin Islands, except to the extent provided in section 934(b). For purposes of the preceding sentence, the term 'tax liability' means the liability incurred to the Virgin Islands pursuant to subtitle A of the Internal Revenue Code (Code), as made applicable in the Virgin Islands by the Act of July 12, 1921 (48 U.S.C. 1397), or pursuant to section 28(a) of the Revised Organic Act of the Virgin Islands (48 U.S.C. 1642), as modified by section 7651(5)(B).

(b) Exception for Virgin Islands income—(1) In general. Section 934(b)(1) provides an exception to the application of section 934(a). Under this exception, section 934(a) does not apply with respect to tax liability incurred to the Virgin Islands to the extent that such tax liability is attributable to income derived from sources within the Virgin Islands or income effectively connected with the conduct of a trade or business within the Virgin Islands.

(2) Limitation. Section 934(b)(2) limits the scope of the exception provided by section 934(b)(1). Pursuant to this limitation, the exception does not apply with respect to an individual who is a citizen or resident of the United States (other than a bona fide resident of the Virgin Islands). For the rules for determining tax liability incurred to the Virgin Islands by such an individual,
see section 932(a) and the regulations under that section.

(3) Computation rule—(i) Operative rule. For purposes of section 934(b)(1) and this paragraph (b), tax liability incurred to the Virgin Islands for the taxable year attributable to income derived from sources within the Virgin Islands or income effectively connected with the conduct of a trade or business within the Virgin Islands will be computed as follows:

(A) Add to the income tax liability incurred to the Virgin Islands any credit against the tax allowed under mirrored section 901(a).

(B) Multiply by taxable income from sources within the Virgin Islands and income effectively connected with the conduct of a trade or business within the Virgin Islands (applying the rules of § 1.861–8 to determine deductions allocable to such income).

(C) Divide by total taxable income.

(D) Subtract the portion of any credit allowed under mirrored section 901 (other than credits for taxes paid to the United States) determined by multiplying the amount of taxable income from sources outside the United States and that is not effectively connected with the conduct of a trade or business in the United States divided by the total amount of taxable income from such sources.

(ii) Limitation. Tax liability incurred to the Virgin Islands attributable to income derived from sources within the Virgin Islands or income effectively connected with the conduct of a trade or business within the Virgin Islands, as computed in paragraph (b)(3), however, will not exceed the total amount of income tax liability actually incurred.

(4) Definitions. For purposes of this section—

(i) Bona fide resident. The rules of § 1.937–1 will apply for determining whether an individual is a bona fide resident of the Virgin Islands;

(ii) Source. The rules of § 1.937–2 will apply for determining whether income is from sources within the Virgin Islands; and

(iii) Effectively connected income. The rules of § 1.937–3 will apply for determining whether income is effectively connected with the conduct of a trade or business in the Virgin Islands.

(c) Exception for qualified foreign corporations—(1) In general. Section 934(b)(3) provides an exception to the application of section 934(a). Under this exception, section 934(a) does not apply with respect to tax liability incurred to the Virgin Islands by a qualified foreign corporation to the extent that such tax liability is attributable to income that is derived from sources outside the United States and that is not effectively connected with the conduct of a trade or business within the United States.

(2) Qualified foreign corporation. For purposes of paragraph (c)(1) of this section, the term qualified foreign corporation means any foreign corporation if 1 or more United States persons own or are treated as owning (within the meaning of section 958) less than 10 percent of—

(i) The total voting power of the stock of such corporation; and

(ii) The total value of the stock of such corporation.

(3) Computation rule—(i) Operative rule. For purposes of section 934(b)(3) and this paragraph (c), tax liability incurred to the Virgin Islands for the taxable year attributable to income that is derived from sources outside the United States and that is not effectively connected with the conduct of a trade or business within the United States will be computed as follows:

(A) Add to the income tax liability incurred to the Virgin Islands any credit against the tax allowed under mirrored section 901(a).

(B) Multiply by taxable income that is derived from sources outside the United States and that is not effectively connected with the conduct of a trade or business within the United States (applying the rules of § 1.861–8 to determine deductions allocable to such income).

(C) Divide by total taxable income.

(D) Subtract any credit allowed under mirrored section 901 (other than credits for taxes paid to the United States or taxes for which a credit is allowable for Federal income tax purposes under section 906 of the Code).

(ii) Limitation. Tax liability incurred to the Virgin Islands attributable to
income that is derived from sources outside the United States and that is not effectively connected with the conduct of a trade or business within the United States, as computed in this paragraph (c)(3), however, will not exceed the total amount of income tax liability actually incurred.

(4) U.S. income—(i) In general. For purposes of this section, except as provided in paragraph (c)(4)(ii) of this section, the rules of sections 861 through 865 and the regulations under those provisions will apply for determining whether income is from sources outside the United States or effectively connected with the conduct of a trade or business within the United States.

(ii) Conduit arrangements. Income will be considered to be from sources within the United States for purposes of paragraph (c)(1) of this section if, pursuant to a plan or arrangement—

(A) The income is received in exchange for consideration of a like kind to a third person in exchange for consideration provided to a plan or arrangement—

(B) Such person (or another person) provides the same consideration (or consideration of a like kind) to a third person in exchange for one or more payments constituting income from sources within the United States.

(d) Examples. The rules of this section are illustrated by the following examples:

Example 1. (i) S is a U.S. citizen and a bona fide resident of the Virgin Islands. For 2008, S files a Form 1040INFO, “Non-Virgin Islands Source Income of Virgin Islands Residents,” with the Virgin Islands on which S reports total gross income as follows:

Compensation for services performed in the Virgin Islands—$50,000
Compensation for services performed in the United States—$40,000
Income from inventory sales in Latin America attributable to Virgin Islands office—$20,000
Interest on a U.S. bank account—$6,000
Interest on a V.I. bank account—$5,000
Dividends from a U.S. corporation—$4,000

(ii) Accordingly, S has total gross income of $155,000, comprising income from sources within the Virgin Islands or effectively connected to the conduct of a trade or business in the Virgin Islands (Virgin Islands ECI) of $75,000, income from sources within the United States of $50,000, and income from other sources (not Virgin Islands ECI) of $30,000. After taking into account allowable deductions, S’s total taxable income is $120,000, of which $45,000 is taxable income from sources within the Virgin Islands, $15,000 is taxable income from other sources that is Virgin Islands ECI under the rules of section 937(b) and §§1.937–2 and 1.937–3, and $22,500 is taxable income from sources outside the Virgin Islands (and outside the United States) that is not Virgin Islands ECI. S’s tax liability incurred to the Virgin Islands pursuant to the Internal Revenue Code as applicable in the Virgin Islands (mirror code) is $30,000. S is entitled to claim a credit under section 901 of the mirror code in the amount of $10,000 for income tax paid to Mexico and other Latin American countries, for a net income tax liability of $20,000.

(iii) Pursuant to a Virgin Islands law that was duly enacted within the limits of its authority under section 934, S may claim a special deduction relating to his business activities in the Virgin Islands. However, under section 904(b), S’s ability to claim this special deduction is limited. Specifically, the maximum amount of the reduction in S’s mirror code tax liability that may result from claiming this deduction, computed in accordance with paragraph (b)(3) of this section, is as follows: $[(20,000 + $10,000) \times \left(\frac{15,000 + $15,000}{120,000}\right) - 1] = $10,000 \times \left(\frac{15,000}{120,000}\right) + 22,500 = $30,000 \times \left(\frac{15,000}{120,000}\right) - \left(\frac{10,000 \times 15,000}{37,500}\right) = \left(\frac{30,000 \times 0.5}{37,500}\right) - \left(\frac{10,000 \times 0.4}{37,500}\right) = $15,000 - $4,000 = $11,000.

(iv) Accordingly, S’s net tax liability incurred to the Virgin Islands must be at least $19,000 ($30,000 - $11,000), prior to taking into account any foreign tax credit.

Example 2. The facts are the same as Example 1, except that S is a U.S. citizen who resides in the United States. As required by section 932(a) and (b), S files with the Virgin Islands a copy of his Federal income tax return and pays to the Virgin Islands the portion of his Federal income tax liability that his Virgin Islands adjusted gross income bears to his adjusted gross income. Under section 904(b)(2), S may not claim the special deduction offered under Virgin Islands law relating to business activities like his in the Virgin Islands to reduce any of his tax liability payable to the Virgin Islands under section 932(b).

Example 3. (i) Z is a nonresident alien who resides in Country FC. In 2008, Z receives dividends from a corporation organized under the law of the Virgin Islands in the amount of $90x. Z’s tax liability incurred to the Virgin Islands pursuant to section 871(a) of the Code as applicable in the Virgin Islands (mirror code) is $27x.
(ii) Pursuant to a Virgin Islands law that was duly enacted within the limits of its authority under section 934, Z may claim a special exemption for income relating to his investment in the Virgin Islands. The maximum amount of the reduction in Z’s mirror code tax liability that may result from claiming this exemption, computed in accordance with paragraph (b)(3) of this section, is as follows: $27x \times (\frac{90x}{90x}) = 27x.

(iii) Accordingly, depending on the terms of the exemption as provided under Virgin Islands law, Z’s net tax liability incurred to the Virgin Islands may be reduced or eliminated entirely.

Example 4. (i) A Corp is organized under the laws of the Virgin Islands and is engaged in a trade or business in the United States through an office in State N. All of A Corp’s outstanding stock is owned by U.S. citizens who are bona fide residents of the Virgin Islands. During 2008, A Corp had $50x in gross income from sources within the Virgin Islands (as determined under section 937(b) and §1.937–2) that is not effectively connected with the conduct of a trade or business in the United States; $20x in gross income from sources in Country H that is effectively connected with the conduct of A Corp’s trade or business in the United States; and $10x in gross income from sources in Country R that is not effectively connected with the conduct of A Corp’s trade or business in the United States.

(ii) Section 934(b)(3) permits the Virgin Islands to reduce or remit the income tax liability of a qualified foreign corporation arising under the Code as applicable in the Virgin Islands (mirror code) with respect to income that is derived from sources outside the United States and that is not effectively connected with the conduct of a trade or business in the United States. Accordingly, the Virgin Islands may reduce or remit A Corp’s mirror code income tax liability with respect to its $50x in gross income from sources within the Virgin Islands and its $10x in gross income from sources in Country R that is not effectively connected with the conduct of A Corp’s trade or business in the United States.

(e) Effective/applicability date. This section applies for taxable years ending after April 9, 2008.

[T.D. 9391, 73 FR 19365, Apr. 9, 2008]

§ 1.935–1 Coordination of individual income taxes with Guam and the Northern Mariana Islands.

(a) Application of section—(1) Scope. Section 935 and this section set forth the special rules relating to the filing of income tax returns, income tax liabilities, and estimated income tax of individuals described in paragraph (a)(2) of this section. Paragraph (e) of this section also provides special rules requiring consistent treatment of business entities in the United States and in section 935 possessions.

(2) Individuals covered. This section applies to any individual who—

(i) Is a bona fide resident of a section 935 possession during the entire taxable year, whether or not such individual is a citizen of the United States or a resident alien (as defined in section 7701(b)(1)(A));

(ii) Is a citizen of a section 935 possession but not otherwise a citizen of the United States;

(iii) Has income from sources within a section 935 possession for the taxable year, is a citizen of the United States or a resident alien (as defined in section 7701(b)(1)(A)) and is not a bona fide U.S. citizens who are not bona fide residents of the Virgin Islands—5%.

Nonresident aliens who are not bona fide residents of the Virgin Islands—42%.

Nonresident aliens who are not bona fide residents of the Virgin Islands—50%.

Nonresident aliens who are bona fide residents of the Virgin Islands—3%.

U.S. citizens who are not bona fide residents of the Virgin Islands—5%.