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through revocation or by its continued failure to be a FSC.

Q–11. For what taxable year may a corporation revoke its election to be treated as a FSC or as a small FSC?

A–11. A corporation may revoke its election to be treated as a FSC or as a small FSC for any taxable year of the corporation after the first taxable year for which the election is effective.

Q–12. When must a corporation revoke a FSC or a small FSC election if revocation is to be effective for the taxable year in which revocation takes place?

A–12. If a corporation files a statement revoking its election to be treated as a FSC or as a small FSC during the first 90 days of a taxable year (other than the first taxable year for which such election is effective), such revocation will be effective for such taxable year and all taxable years thereafter. If the corporation files a statement revoking its election to be treated as a FSC or a small FSC after the firs 90 days of a taxable year, the revocation will be effective for all taxable years following such taxable year.

Q–13. Can a FSC change its status to a small FSC, or can a small FSC change its status to a FSC as of a date other than the first day of a taxable year?

A–13. No. Since a revocation of an election to be a FSC or a small FSC is effective only for entire taxable year, a corporation's change between FSC and small FSC status is effective as of the first day of a taxable year.

Q–14. How may a corporation revoke an election by a corporation to be treated as a FSC or a small FSC?

A–14. A corporation may revoke its election by filing a statement that the corporation revokes its election under section 922(a) to be treated as a FSC or under section 922(b) to be treated as a small FSC. Such statement shall indicate the corporation's name, address, employer identification number, and the first taxable year of the corporation for which the revocation is to be effective. The statement shall be signed by any person authorized to sign a corporate return under section 6062. Such revocation shall be filed with the Service Center with which the corporation filed its return.

Q–15. What if the effect is a corporation that has elected to be treated as a FSC or a small FSC fails to qualify as a FSC because it does not meet the requirements of section 922 for a taxable year?

A–15. If a corporation that has elected to be treated as a FSC or a small FSC does not qualify as a FSC or a small FSC for a taxable year, the corporation will not be treated as a FSC or a small FSC for the taxable year. However, the failure of a corporation to qualify to be treated as a FSC or a small FSC for a taxable year does not terminate the election of the corporation to be treated as FSC or a small FSC unless the corporation does not qualify under section 922 for each of 5 consecutive taxable years, as provided in Q&A 16 of this section.

Q–16. Under what circumstances is the FSC or small FSC election terminated for continued failure to be a FSC?

A–16. If a corporation that has elected to be treated as a FSC or a small FSC does not qualify under section 922 to be treated as a FSC or small FSC for each of 5 consecutive taxable years, such election terminates and will not be effective for any taxable year after such fifth taxable year. Such termination will be effective automatically without notice to such corporation or to the Internal Revenue Service.

[T.D. 8127, 52 FR 6475, Mar. 3, 1987]

POSSESSIONS OF THE UNITED STATES

§ 1.931–1 Exclusion of certain income from sources within Guam, American Samoa, or the Northern Mariana Islands.

(a) *General rule.* (1) An individual (whether a United States citizen or an alien), who is a bona fide resident of a section 931 possession during the entire taxable year, will exclude from gross income the income derived from sources within any section 931 possession and the income effectively connected with the conduct of a trade or business by such individual within any section 931 possession, except amounts received for services performed as an employee of the United States or any agency thereof. For purposes of section 931(d) and this section, an employee of

the government of a section 931 possession will not be 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. D, a United States citizen, files returns on a calendar year basis. In April 2008, D moves to American Samoa, 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, D continues to live and work in American Samoa and has a closer connection to American Samoa than to the United States or any foreign country. Assuming that D otherwise meets the requirements under section 937(a) and §1.937–1(b) and (f)(1) (year-of-move exception), D is considered a bona fide resident of American Samoa for 2008. Accordingly, under section 931 and paragraph (a)(1) of this section, D should exclude from his 2008 Federal gross income any income from sources within American Samoa and any income that is effectively connected with the conduct of a trade or business within American Samoa, as determined under section 937(b) and §§1.937–2 and 1.937–3, as applicable.

(b) *Deductions and credits.* In any case in which any amount otherwise constituting gross income is excluded from gross income under the provisions of section 931, there will not be allowed as a deduction from gross income any items of expenses or losses or other deductions (except the deduction under section 151, relating to personal exemptions), or any credit, properly allocable to, or chargeable against, the amounts so excluded from gross income. For purposes of the preceding sentence, the rules of §1.861–8 will apply (with creditable expenditures treated in the same manner as deductible expenditures).

(c) *Definitions.* For purposes of this section—

(1) The term *section 931 possession* means a possession that is a specified possession and that has entered into an implementing agreement, as described in section 1271(b) of the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2085), with the United States that is in effect for the entire taxable year;

(2) The term *specified possession* means Guam, American Samoa, or the Northern Mariana Islands;

(3) The rules of §1.937–1 will apply for determining whether an individual is a bona fide resident of a section 931 possession;

(4) The rules of §1.937–2 will apply for determining whether income is from sources within a section 931 possession; and

(5) The rules of §1.937–3 will apply for determining whether income is effectively connected with the conduct of a trade or business within a section 931 possession.

(d) *Effective/applicability date.* This section applies to taxable years ending after April 9, 2008.

[T.D. 9391, 73 FR 19360, Apr. 9, 2008]

§1.932–1 Coordination of United States and Virgin Islands income taxes.

(a) *Scope*—(1) *In general.* Section 932 and this section set forth the special rules relating to the filing of income tax returns and income tax liabilities of individuals described in paragraph (a)(2) of this section. Paragraph (h) of this section also provides special rules requiring consistent treatment of business entities in the United States and in the United States Virgin Islands (Virgin Islands).

(2) *Individuals covered.* This section will apply to any individual who—

(i) Is a bona fide resident of the Virgin Islands during the entire taxable year;

(ii)(A) Is a citizen or resident of the United States (other than a bona fide resident of the Virgin Islands) during the entire taxable year; and

(B) Has income derived from sources within the Virgin Islands, or effectively connected with the conduct of a trade or business within the Virgin Islands, for the taxable year; or

(iii) Files a joint return for the taxable year with any individual described in paragraph (a)(2)(i) or (ii) of this section.

(3) *Definitions.* For purposes of this section—

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

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

(iii) The rules of §1.937–3 will apply for determining whether income is effectively connected with the conduct of

a trade or business within the Virgin Islands.

(b) *U.S. individuals with Virgin Islands income*—(1) *Dual filing requirement.* Subject to paragraph (d) of this section, an individual described in paragraph (a)(2)(ii) of this section must make an income tax return for the taxable year to the United States and file a copy of such return with the Virgin Islands. Such individuals must also attach Form 8689, ''Allocation of Individual Income Tax to the U.S. Virgin Islands,'' to the U.S. income tax return and to the income tax return filed with the Virgin Islands.

(2) *Tax payments.* (i) Each individual to whom this paragraph (b) applies for the taxable year must pay the applicable percentage of the taxes imposed by this chapter for such taxable year (determined without regard to paragraph (b)(2)(ii) of this section) to the Virgin Islands.

(ii) A credit against the tax imposed by this chapter for the taxable year will be allowed in an amount equal to the taxes that are required to be paid to the Virgin Islands under paragraph (b)(2)(i) of this section and are so paid. Such taxes will be considered creditable in the same manner as taxes paid to the United States (for example, under section 31) and not as taxes paid to a foreign government (for example, under sections 27 and 901).

(iii) For purposes of this paragraph (b)(2)—

(A) The term *applicable percentage* means the percentage that Virgin Islands adjusted gross income bears to adjusted gross income;

(B) The term *Virgin Islands adjusted gross income* means adjusted gross income determined by taking into account only income derived from sources within the Virgin Islands and deductions properly apportioned or allocable to such income. For purposes of the preceding sentence, the rules of §1.861–8 will apply; and

(C) Pursuant to §1.937–2(a), the rules of §1.937–2(c)(1)(ii) and (c)(2) do not apply.

(c) *Bona fide residents of the Virgin Islands.* Subject to paragraph (d) of this section, an individual described in paragraph (a)(2)(i) of this section will be subject to the following income tax return filing requirements:

(1) *Virgin Islands filing requirements.* An individual to whom this paragraph (c) applies must file an income tax return for the taxable year with the Virgin Islands. On this return, the individual must report income from all sources and identify the source of each item of income shown on the return.

(2) *U.S. filing requirements.* (i) For purposes of calculating the income tax liability to the United States of an individual to whom this paragraph (c) applies, gross income will not include any amount included in gross income on the return filed with the Virgin Islands pursuant to paragraph (c)(1) of this section, and deductions and credits allocable to such income will not be taken into account, provided that—

(A) The individual fully satisfied the reporting requirements of paragraph (c)(1) of this section; and

(B) The individual fully paid the tax liability referred to in section 934(a) to the Virgin Islands with respect to such income.

(ii) For purposes of the U.S. statute of limitations under section 6501(a), an income tax return filed with the Virgin Islands by an individual who takes the position that he or she is a bona fide resident of the Virgin Islands described in paragraph (a)(2)(i) of this section (or an individual who files a joint return with such an individual under paragraph (d) of this section) will be deemed to be a U.S. income tax return, provided that the United States and the Virgin Islands have entered into an agreement for the routine exchange of income tax information satisfying the requirements of the Commissioner. The working arrangement announced in Notice 2007–31 satisfies the condition of the preceding sentence. See Notice 2007–31 (2007–16 IRB 971) (applicable to taxable years ending on or after December 31, 2006, unless and until arrangement terminates). In the absence of such an agreement, individuals to whom this paragraph (c) applies generally must file an income tax return for the taxable year with the United States to begin the period of limitations for Federal income tax purposes as provided in section 6501(a), and in such circumstances the Commissioner

may by revenue procedure, notice, or other administrative pronouncement specify U.S. filing and other information reporting requirements for such individuals. For taxable years ending before December 31, 2006, the rules provided in section 3 of Notice 2007–19 (2007–11 IRB 689) will apply. See §601.601(d)(2)(ii)(*b*).

(3) *U.S. tax payments.* In the case of an individual who is required to file an income tax return with the United States as a consequence of failing to satisfy the requirements of paragraphs (c)(2)(i)(A) or (B) of this section, there will be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to the amount of the tax liability referred to in section 934(a) to the extent paid to the Virgin Islands. Such taxes shall be considered creditable in the same manner as taxes paid to the United States (for example, under section 31) and not as taxes paid to a foreign government (for example, under sections 27 and 901).

(d) *Joint returns.* In the case of married persons, if one or both spouses is an individual described in paragraph (a)(2) of this section and they file a joint return of income tax, the spouses must file their joint return with, and pay the tax due on such return to, the jurisdiction (or jurisdictions) where the spouse who has the greater adjusted gross income for the taxable year would be required under paragraph (b) or (c) of this section to file a return if separate returns were filed and all of their income were the income of such spouse. For this purpose, adjusted gross income of each spouse is determined under section 62 and the regulations under that section but without regard to community property laws; and, if one of the spouses dies, the taxable year of the surviving spouse will be treated as ending on the date of such death.

(e) *Place for filing returns*—(1) *U.S. returns.* Except as otherwise provided for returns filed under paragraph (c)(2)(ii) of this section, a return required under the rules of paragraphs (b) and (c) of this section to be filed with the United States must be filed as directed in the applicable forms and instructions.

(2) *Virgin Islands returns.* A return required under the rules of paragraphs (b) and (c) of this section to be filed with the Virgin Islands must be filed as directed in the applicable forms and instructions.

(f) *Tax accounting standards*—(1) *In general.* A dual filing taxpayer must use the same tax accounting standards on the returns filed with the United States and the Virgin Islands. A taxpayer who has filed a return only with the United States or only with the Virgin Islands as a single filing taxpayer for a prior taxable year and is required to file a return only with the other jurisdiction as a single filing taxpayer for a later taxable year may not, for such later taxable year, use different tax accounting standards unless the second jurisdiction consents to such change. However, such change will not be effective for returns filed thereafter with the first jurisdiction unless before such later date of filing the taxpayer also obtains the consent of the first jurisdiction to make such change. Any request for consent to make a change pursuant to this paragraph (f) must be made to the office where the return is required to be filed under paragraph (e) of this section and in sufficient time to permit a copy of the consent to be attached to the return for the taxable year.

(2) *Definitions.* For purposes of this paragraph (f), the terms—

(i) *Dual filing taxpayer* means a taxpayer who is required to file returns with the United States and the Virgin Islands for the same taxable year under the rules of paragraph (b) or (c) of this section;

(ii) *Single filing taxpayer* means a taxpayer who is required to file a return only with the United States (because the individual is not described in paragraph (a)(2) of this section) or only with the Virgin Islands (because the individual is described in paragraph (a)(2)(i) of this section and satisfies the conditions of paragraphs (c)(2)(i) and (ii) of this section) for the taxable year; and

(iii) *Tax accounting standards* includes the taxpayer's accounting period, methods of accounting, and any election to which the taxpayer is bound

with respect to the reporting of taxable income.

(g) *Extension of territory*—(1) *Section 932(a) taxpayers*—(i) *General rule.* With respect to an individual to whom section 932(a) applies for a taxable year, for purposes of taxes imposed by Chapter 1 of the Internal Revenue Code (Code), the United States generally will be treated, in a geographical and governmental sense, as including the Virgin Islands. The purpose of this rule is to facilitate the coordination of the tax systems of the United States and the Virgin Islands. Accordingly, the rule will have no effect where it is manifestly inapplicable or its application would be incompatible with the intent of any provision of the Code.

(ii) *Application of general rule.* Contexts in which the general rule of paragraph (g)(1)(i) of this section apply include—

(A) The characterization of taxes paid to the Virgin Islands. An individual to whom section 932(a) applies may take income tax required to be paid to the Virgin Islands under section 932(b) into account under sections 31, 6315, and 6402(b) as payments to the United States. Taxes paid to the Virgin Islands and otherwise satisfying the requirements of section 164(a) will be allowed as a deduction under that section, but income taxes required to be paid to the Virgin Islands under section 932(b) will be disallowed as a deduction under section 275(a);

(B) The determination of the source of income for purposes of the foreign tax credit (for example, sections 901 through 904). Thus, for example, after an individual to whom section 932(a) applies determines which items of income constitute income from sources within the Virgin Islands under the rules of section 937(b), such income will be treated as income from sources within the United States for purposes of section 904;

(C) The eligibility of a corporation to make a subchapter S election (sections 1361 through 1379). Thus, for example, for purposes of determining whether a corporation created or organized in the Virgin Islands may make an election under section 1362(a) to be a subchapter S corporation, it will be treated as a domestic corporation and a shareholder to whom section 932(a) applies will not be treated as a nonresident alien individual with respect to such corporation. While such an election is in effect, the corporation will be treated as a domestic corporation for all purposes of the Internal Revenue Code. For the consistency requirement with respect to entity status elections, see paragraph (h) of this section;

(D) The treatment of items carried over from other taxable years. Thus, for example, if an individual to whom section 932(a) applies has for a taxable year a net operating loss carryback or carryover under section 172, a foreign tax credit carryback or carryover under section 904, a business credit carryback or carryover under section 39, a capital loss carryover under section 1212, or a charitable contributions carryover under section 170, the carryback or carryover will be reported on the return filed in accordance with paragraph (b)(1) of this section, even though the return of the taxpayer for the taxable year giving rise to the carryback or carryover was required to be filed with the Virgin Islands under section 932(c); and

(E) The treatment of property exchanged for property of a like kind (section 1031). Thus, for example, if an individual to whom section 932(a) applies exchanges real property located in the United States for real property located in the Virgin Islands, notwithstanding the provisions of section 1031(h), such exchange may qualify as a like-kind exchange under section 1031 (provided that all the other requirements of section 1031 are satisfied).

(iii) *Nonapplication of the general rule.* Contexts in which the general rule of paragraph (g)(1)(i) of this section does not apply include—

(A) The application of any rules or regulations that explicitly treat the United States and any (or all) of its possessions as separate jurisdictions (for example, sections 931 through 937, 7651, and 7654).

(B) The determination of any aspect of an individual's residency (for example, sections 937(a) and 7701(b)). Thus,

for example, an individual whose principal place of abode is in the Virgin Islands is not considered to have a principal place of abode in the United States for purposes of section 32(c);

(C) The characterization of a corporation for purposes other than subchapter S (for example, sections 367, 951 through 964, 1291 through 1298, 6038, and 6038B). Thus, for example, if an individual to whom section 932(a) applies transfers appreciated tangible property to a corporation created or organized in the Virgin Islands in a transaction described in section 351, he or she must recognize gain unless an exception under section 367(a) applies. Also, if a corporation created or organized in the Virgin Islands qualifies as a passive foreign investment company under sections 1297 and 1298 with respect to an individual to whom section 932(a) applies, a dividend paid to such shareholder does not constitute qualified dividend income under section 1(h)(11)(B).

(2) *Section 932(c) taxpayers*—(i) *General rule.* With respect to an individual to whom section 932(c) applies for a taxable year, for purposes of the territorial income tax of the Virgin Islands (that is, mirrored sections of the Code), the Virgin Islands generally will be treated, in a geographical and governmental sense, as including the United States. The purpose of this rule is to facilitate the coordination of the tax systems of the United States and the Virgin Islands. Accordingly, the rule will have no effect where it is manifestly inapplicable or its application would be incompatible with the intent of any provision of the Code.

(ii) *Application of general rule.* Contexts in which the general rule of paragraph (g)(2)(i) of this section apply include—

(A) The characterization of taxes paid to the United States. A taxpayer described in section 932(c)(1) may take income tax paid to the United States into account under mirrored sections 31, 6315, and 6402(b) as payments to the Virgin Islands;

(B) The determination of the source of income for purposes of the foreign tax credit (for example, mirrored sections 901 through 904). Thus, for example, any item of income that constitutes income from sources within the United States under the rules of sections 861 through 865 will be treated as income from sources within the Virgin Islands for purposes of mirrored section 904;

(C) The eligibility of a corporation to make a subchapter S election (mirrored sections 1361 through 1379). Thus, for example, for purposes of determining whether a corporation created or organized in the United States may make an election under mirrored section 1362(a) to be a subchapter S corporation, it will be treated as a domestic corporation and a shareholder to whom section 932(c) applies will not be treated as a nonresident alien individual with respect to such corporation. While such an election is in effect, the corporation will be treated as a domestic corporation for all purposes of the territorial income tax. For the consistency requirement with respect to entity status elections, see paragraph (h) of this section;

(D) The treatment of items carried over from other taxable years. Thus, for example, if an individual to whom section 932(c) applies has for a taxable year a net operating loss carryback or carryover under mirrored section 172, a foreign tax credit carryback or carryover under mirrored section 904, a business credit carryback or carryover under mirrored section 39, a capital loss carryover under mirrored section 1212, or a charitable contributions carryover under mirrored section 170, the carryback or carryover will be reported on the return filed in accordance with paragraph (c)(1) of this section, even though the return of the taxpayer for the taxable year giving rise to the carryback or carryover was required to be filed with the United States; and

(E) The treatment of property exchanged for property of a like kind (mirrored section 1031). Thus, for example, if an individual to whom section 932(c) applies exchanges real property located in the United States for real property located in the Virgin Islands, notwithstanding the provisions of mirrored section 1031(h), such exchange may qualify as a like-kind exchange under mirrored section 1031 (provided that all the other requirements of mirrored section 1031 are satisfied).

(iii) *Nonapplication of general rule.* Contexts in which the general rule of paragraph (g)(2)(i) of this section does not apply include—

(A) The determination of any aspect of an individual's residency (for example, mirrored section 7701(b)). Thus, for example, an individual whose principal place of abode is in the United States is not considered to have a principal place of abode in the Virgin Islands for purposes of mirrored section 32(c).

(B) The determination of the source of income for purposes other than the foreign tax credit (for example, sections 932(a) and (b), 934(b), and 937). Thus, for example, compensation for services performed in the United States and rentals or royalties from property located in the United States do not constitute income from sources within the Virgin Islands for purposes of section 934(b); and

(C) The definition of wages (mirrored section 3401). Thus, for example, services performed by an employee for an employer in the United States do not constitute services performed in the Virgin Islands under mirrored section 3401(a)(8).

(h) *Entity status consistency requirement*—(1) *In general.* Taxpayers should make consistent entity status elections (as defined in paragraph (h)(3) of this section), where applicable, in both the United States and the Virgin Islands. In the case of a business entity to which this paragraph (h) applies—

(i) If an entity status election is filed with the Internal Revenue Service (IRS) but not with the Virgin Islands Bureau of Internal Revenue (BIR), the Director of the BIR or his delegate, at his discretion, may deem the election also to have been made for Virgin Islands tax purposes;

(ii) If an entity status election is filed with the BIR but not with the IRS, the Commissioner, at his discretion, may deem the election also to have been made for Federal tax purposes; and

(iii) If inconsistent entity status elections are filed with the BIR and the IRS, both the Commissioner and the Director of the BIR or his delegate may, at their individual discretion, treat the elections they each received as invalid and may deem the election filed in the other jurisdiction to have been made also for tax purposes in their own jurisdiction. See Rev. Proc. 2006–23 (2006–1 CB 900) (see §601.601(d)(2)(ii)(*b*) of this chapter) for procedures for requesting the assistance of the IRS when a taxpayer is or may be subject to inconsistent tax treatment by the IRS and a U.S. possession tax agency.

(2) *Scope.* This paragraph (h) applies to the following business entities:

(i) A business entity (as defined in §301.7701–2(a) of this chapter) that is domestic (as defined in §301.7701–5 of this chapter), or otherwise treated as domestic for purposes of the Code, and that is owned in whole or in part by any person who is either a bona fide resident of the Virgin Islands or a business entity created or organized in the Virgin Islands.

(ii) A business entity that is created or organized in the Virgin Islands and that is owned in whole or in part by any U.S. person (other than a bona fide resident of the Virgin Islands).

(3) *Definition.* For purposes of this section, the term *entity status election* includes an election under §301.7701–3(c) of this chapter, an election under section 1362(a), and any other similar elections.

(4) *Default status.* Solely for the purpose of determining classification of an eligible entity under §301.7701–3(b) of this chapter and under that section as mirrored in the Virgin Islands, an eligible entity subject to this paragraph (h) will be classified for both Federal and Virgin Islands tax purposes using the rule that applies to domestic eligible entities.

(5) *Transition rules*—(i) In the case of an election filed prior to April 11, 2005, except as provided in paragraph (h)(5)(ii) of this section, the rules of paragraph (h)(1) of this section will apply as of the first day of the first taxable year of the entity beginning after April 11, 2005.

(ii) In the unlikely circumstance that inconsistent elections described in paragraph (h)(1)(iii) of this section are filed prior to April 11, 2005, and the entity cannot change its classification to achieve consistency because of the sixty-month limitation described in §301.7701–3(c)(1)(iv) of this chapter,

then the entity may nevertheless request permission from the Commissioner or the Director of the BIR or his delegate to change such election to avoid inconsistent treatment by the Commissioner and the Director of the BIR or his delegate.

(iii) Except as provided in paragraphs (h)(5)(i) and (h)(5)(ii) of this section, in the case of an election filed with respect to an entity before it became an entity described in paragraph (h)(2) of this section, the rules of paragraph (h)(1) of this section will apply as of the first day that such entity is described in paragraph (h)(2) of this section.

(iv) In the case of an entity created or organized prior to April 11, 2005, paragraph (h)(4) of this section will take effect for Federal income tax purposes (or Virgin Islands income tax purposes, as the case may be) as of the first day of the first taxable year of the entity beginning after April 11, 2005.

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

Example 1. (i) A is a U.S. citizen who resides in State R. For 2008, A files with the IRS a Form 1040, ''U.S. Individual Income Tax Return,'' reporting adjusted gross income of $90x, which includes $30x from sources in the Virgin Islands. The income tax liability reported on A's Form 1040 is $18x. A files a copy of his Form 1040 with the Virgin Islands as required by section 932(a)(2) and paragraph (b)(1) of this section. A pays to the Virgin Islands the applicable percentage of his Federal income tax liability as required by section 932(b) and paragraph (b)(2) of this section, computed as follows: $30x/$90x × $18x = $6x income tax liability to the Virgin Islands.

(ii) A claims a credit in the amount of $6x against his Federal income tax liability reported on his Form 1040. A attaches a Form 8689, ''Allocation of Individual Income Tax to the U.S. Virgin Islands,'' to the Form 1040 filed with the IRS and to the copy filed with the Virgin Islands.

Example 2. (i) B, a U.S. citizen, files returns on a calendar year basis. In November 2008, B moves to the Virgin Islands, purchases a house, and accepts a permanent position with a local employer. For the remainder of the year and throughout 2009, B continues to live and work in the Virgin Islands and has a closer connection to the Virgin Islands than to the United States or any foreign country. As a consequence of his employment in the Virgin Islands, B earns income from the performance of services in the Virgin Islands during 2008 and 2009.

(ii) For 2008, B does not qualify as a bona fide resident under section 937(a) and §1.937–1(b) and (f)(1). Therefore, B is subject to the rules of sections 932(a) and (b) and paragraph (b) of this section for 2008 because he has income derived from sources within the Virgin Islands as determined under the rules of section 937(b) and §1.937–2.

(iii) For 2009, assuming that B otherwise satisfies the requirements of section 937(a) and §1.937–1(b), B qualifies as a bona fide resident of the Virgin Islands. Therefore, section 932(c) and paragraph (c) of this section apply to B for 2009, and he must file his income tax return with the Virgin Islands under paragraph (c)(1) of this section. Provided that B fully satisfies the reporting requirements of paragraph (c)(1) of this section and fully pays the tax liability referred to in section 934(a), B will have no Federal income tax filing requirement or liability under paragraphs (c)(2) and (3) of this section.

Example 3. H and W are U.S. citizens. H resides in State T and W is a bona fide resident of the Virgin Islands. For 2008, H and W prepare a joint Form 1040, ''U.S. Individual Income Tax Return,'' reporting total adjusted gross income of $75x, of which $40x is attributable to compensation that W received for services performed in the Virgin Islands and $35x to compensation that H received for services performed in State T. Pursuant to section 932(d) and paragraph (d) of this section, because W would have the greater adjusted gross income if computed separately, H and W must file their joint Form 1040 with the Virgin Islands as required by section 932(c) and paragraph (c)(1) of this section. H and W may claim a tax credit on such return for income tax withheld during 2008 and paid to the IRS.

Example 4. (i) The facts are the same as in *Example 3*, except that H also earns $25x for services performed in the Virgin Islands, so that H and W's total adjusted gross income is $100x, and their total income tax liability is $20x.

(ii) Pursuant to section 932(d) and paragraph (d) of this section, because H would have the greater adjusted gross income if computed separately, H and W must file their joint Form 1040 with the IRS and must file a copy of that joint Form 1040 with the Virgin Islands as required by section 932(a)(2) and paragraph (b)(1) of this section. H and W must pay the applicable percentage of their Federal income tax liability to the Virgin Islands as required by section 932(b) and paragraph (b)(2) of this section, computed as follows: $65x /$100x × $20x = $13x income tax liability to the Virgin Islands.

(iii) H and W claim a credit against their Federal income tax liability reported on their joint Form 1040 in the amount of $13x,

the portion of their Federal income tax liability required to be paid to the Virgin Islands. H and W attach a Form 8689, ''Allocation of Individual Income Tax to the U.S. Virgin Islands,'' to their joint Form 1040 filed with the IRS and to the copy filed with the Virgin Islands.

Example 5. N, a U.S. citizen and calendar year taxpayer, takes the position that he is a bona fide resident of the Virgin Islands for the 2007 taxable year. On April 15, 2008, N files a Form 1040, ''U.S. Individual Income Tax Return,'' with the Virgin Islands for his 2007 taxable year. N does not file a Form 1040 with the IRS. Because there is an agreement in force between the United States and the Virgin Islands for the routine exchange of income tax information, under paragraph (c)(2)(ii) of this section, the Federal 3-year period of limitations under section 6501(a) will expire on April 15, 2011, and the IRS will make no further assessment of income tax after that date for N's 2007 taxable year except as otherwise authorized by section 6501.

Example 6. (i) J is a U.S. citizen and a bona fide resident of the Virgin Islands. In 2008, J receives compensation for services performed as an employee in the Virgin Islands in the amount of $40x. J files with the Virgin Islands a Form 1040, ''U.S. Individual Income Tax Return,'' reporting gross income of only $30x. Based on these facts, J has not satisfied the conditions of section 932(c)(4) and paragraph (c) of this section for an exclusion from gross income for Federal income tax purposes.

(ii) The facts are the same as in paragraph (i) of this *Example 6* except that on or before the last day prescribed for filing an income tax return for J's 2008 taxable year, J files with the Virgin Islands an amended Form 1040 for 2008, correctly reporting the full $40x of compensation. Provided that J otherwise fully satisfies the reporting requirements of paragraph (c)(1) of this section and fully pays the tax liability referred to in section 934(a), J will have no Federal income tax filing requirement or liability under paragraphs (c)(2) and (3) of this section.

Example 7. (i) N is a U.S. citizen and a bona fide resident of the Virgin Islands. In 2008, N receives compensation for services performed in Country M. N files with the Virgin Islands a Form 1040, ''U.S. Individual Income Tax Return,'' reporting the compensation as income effectively connected with the conduct of a trade or business in the Virgin Islands. N claims a special credit against the tax on this compensation pursuant to a Virgin Islands law enacted within the limits of its authority under section 934.

(ii) Under the principles of section 864(c)(4) as applied pursuant to section 937(b)(1) and §1.937–3(b), compensation for services performed outside the Virgin Islands may not be treated as income effectively connected with the conduct of a trade or business in the Virgin Islands for purposes of section 934(b). Consequently, N is not entitled to claim the special credit under Virgin Islands law with respect to N's income from services performed in Country M. Because N has not fully paid his tax liability referred to in section 934(a), he has not satisfied the conditions of section 932(c)(4) and paragraph (c) of this section for an exclusion from gross income for Federal income tax purposes. Therefore, income reported on the Form 1040 as filed with the Virgin Islands must be included in N's Federal gross income. Under paragraph (c)(3) of this section, the amount of tax paid to the Virgin Islands on such income will be allowed as a credit against N's Federal income tax liability.

(j) *Effective/applicability date.* Except as otherwise provided in this paragraph (j), this section applies to taxable years ending after April 9, 2008. Taxpayers may choose to apply paragraph (c)(2)(ii) of this section to open taxable years ending on or after December 31, 2006.

[T.D. 9391, 73 FR 19361, Apr. 9, 2008, as amended at T.D. 9391, 73 FR 27728, May 14, 2007; T.D. 9391, 76 FR 4244, Jan. 25, 2011]

§1.933–1 Exclusion of certain income from sources within Puerto Rico.

(a) *General rule.* (1) An individual (whether a United States citizen or an alien), who is a bona fide resident of Puerto Rico during the entire taxable year, will exclude from gross income the income derived from sources within Puerto Rico, except amounts received for services performed as an employee of the United States or any agency thereof. For purposes of section 933 and this section, an employee of the government of Puerto Rico will not be 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.

(b) *Taxable year of change of residence from Puerto Rico.* A citizen of the United States who changes his residence from Puerto Rico after having been a bona fide resident thereof for a period of at least two years immediately preceding the date of such change in residence shall exclude from his gross income the income derived from sources within Puerto Rico which is attributable to that part of such period of Puerto Rican residence which preceded the date of such change in residence, except amounts received for services performed as an employee of the United States or any agency thereof.

(c) *Deductions and credits.* In any case in which any amount otherwise constituting gross income is excluded from gross income under the provisions of section 933, there will not be allowed as a deduction from gross income any items of expenses or losses or other deductions (except the deduction under section 151, relating to personal exemptions), or any credit, properly allocable to, or chargeable against, the amounts so excluded from gross income. For purposes of the preceding sentence, the rules of §1.861–8 will apply (with creditable expenditures treated in the same manner as deductible expenditures).

(d) *Definitions.* For purposes of this section—

(1) The rules of §1.937–1 will apply for determining whether an individual is a bona fide resident of Puerto Rico; and

(2) The rules of §1.937–2 will apply for determining whether income is from sources within Puerto Rico.

(e) *Effective/applicability date.* Paragraphs (a), (c), (d), and (e) of this section apply to taxable years ending after April 9, 2008.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 9194, 70 FR 18934, Apr. 11, 2005; T.D. 9391, 73 FR 19365, Apr. 9, 2008]

§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 Virgin Islands or the United States that is effectively connected to the conduct of a trade or business in the Virgin Islands 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 this 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 provided to another person; and

(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
Compensation for services performed in Mexico—$30,000
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 934(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) × (($45,000 + $15,000) / $120,000)] − [$10,000 × ($15,000 / ($15,000 + $22,500))] = [$30,000 × ($60,000 / $120,000)] − [$10,000 × ($15,000 / $37,500)] = ($30,000 × 0.5) − ($10,000 × 0.4) = $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 934(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 × ($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. A foreign corporation constitutes a ''qualified foreign corporation'' under section 934(b)(3)(B) if less than 10 percent of the total voting power and value of the stock of the corporation is owned or treated as owned (within the meaning of section 958) by one or more United States persons. A U.S. citizen is a ''United States person'' as defined in section 7701(a)(30)(A). Given that 10 percent or more of the voting power and value of its stock is owned by U.S. citizens, A Corp does not constitute a ''qualified foreign corporation'' under section 934(b)(3)(B). Accordingly, the Virgin Islands may only 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.

Example 5. (i) The facts are the same as in *Example 4,* except that the outstanding stock of A Corp is owned by the following individuals:

U.S. citizens who are bona fide residents of the Virgin Islands—5%

U.S. citizens who are not bona fide residents of the Virgin Islands—3%

Nonresident aliens who are bona fide residents of the Virgin Islands—42%

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

(ii) Given that less than 10 percent of the voting power and value of its stock is owned by United States persons, A Corp constitutes a qualified foreign corporation under section 934(b)(3)(B). 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. In no event, however, may the Virgin Islands reduce or remit A Corp's mirror code income tax liability with respect to its $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.

(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 resident of a section 935 possession during the entire taxable year; or

(iv) Files a joint return for the taxable year with any individual described in paragraph (a)(2)(i), (ii), or (iii) of this section.

(3) *Definitions.* For purposes of this section, the following definitions apply:

(i) The term *section 935 possession* means Guam or the Northern Mariana Islands, unless such possession has entered into an implementing agreement, as described in section 1271(b) of the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2085), with the United States that is in effect for the entire taxable year.

(ii) The term *relevant possession* means—

(A) With respect to an individual described in paragraph (a)(2)(i) of this section, the section 935 possession of which such individual is a bona fide resident;

(B) With respect to an individual described in paragraph (a)(2)(ii) of this section, the section 935 possession of which such individual is a citizen; and

(C) With respect to an individual described in paragraph (a)(2)(iii) of this section, the section 935 possession from which such individual derives income.

(iii) The rules of §1.937–1 will apply for determining whether an individual is a bona fide resident of a section 935 possession.

(iv) The rules of §1.937–2 generally will apply for determining whether income is from sources within a section 935 possession. Pursuant to §1.937–2(a), however, the rules of §1.937–2(c)(1)(ii) and (c)(2) do not apply for purposes of section 935(a)(3) (as in effect before the effective date of its repeal) and paragraph (a)(2)(iii) of this section.

(v) The term *citizen of the United States* means any individual who is a citizen within the meaning of §1.1–1(c), except that the term does not include an individual who is a citizen of a section 935 possession but not otherwise a citizen of the United States. The term *citizen of a section 935 possession but not otherwise a citizen of the United States* means any individual who has become a citizen of the United States by birth or naturalization in the section 935 possession.

(vi) With respect to the United States, the term *resident* means an individual who is a citizen (as defined in §1.1–1(c)) or resident alien (as defined in section 7701(b)) and who does not have a tax home (as defined in section 911(d)(3)) in a foreign country during the entire taxable year. The term does not include an individual who is a bona fide resident of a section 935 possession.

(vii) The term *U.S. taxpayer* means an individual described in paragraph (b)(1)(i) or (iii)(B) of this section.

(b) *Filing requirement*—(1) *Tax jurisdiction.* An individual described in paragraph (a)(2) of this section must file an income tax return for the taxable year—

(i) With the United States if such individual is a resident of the United States;

(ii) With the relevant possession if such individual is described in paragraph (a)(2)(i) of this section; or

(iii) If neither paragraph (b)(1)(i) nor paragraph (b)(1)(ii) of this section applies—

(A) With the relevant possession if such individual is described in paragraph (a)(2)(ii) of this section; or

(B) With the United States if such individual is a citizen of the United States, as defined in paragraph (a)(3) of this section.

(2) *Joint returns.* In the case of married persons, if one or both spouses is an individual described in paragraph (a)(2) of this section and they file a joint return of income tax, the spouses shall file their joint return with, and pay the tax due on such return to, the jurisdiction where the spouse who has the greater adjusted gross income for the taxable year would be required under subparagraph (1) of this paragraph to file his return if separate returns were filed. For this purpose, adjusted gross income of each spouse is determined under section 62 and the regulations thereunder but without regard to community property laws; and, if one of the spouses dies, the taxable year of the surviving spouse shall be treated as ending on the date of such death.

(3) *Place for filing returns*—(i) *U.S. returns.* A return required under this paragraph (b) to be filed with the United States must be filed as directed in the applicable forms and instructions.

(ii) *Guam returns.* A return required under this paragraph (b) to be filed with Guam must be filed as directed in the applicable forms and instructions.

(iii) *NMI returns.* A return required under this paragraph (b) to be filed with the Northern Mariana Islands must be filed as directed in the applicable forms and instructions.

(4) *Tax accounting standards.* A taxpayer who has filed his return with one of the jurisdictions named in subparagraph (1) of this paragraph for a prior taxable year and is required to file his return for a later taxable year with the other such jurisdiction may not, for

such later taxable year, change his accounting period, method of accounting, or any election to which he is bound with respect to his reporting of taxable income to the first jurisdiction unless he obtains the consent of the second jurisdiction to make such change. However, such change will not be effective for returns filed thereafter with the first jurisdiction unless before such later date of filing he also obtains the consent of the first jurisdiction to make such change. Any request for consent to make a change pursuant to this subparagraph must be made to the office where the return is required to be filed under subparagraph (3) of this paragraph and in sufficient time to permit a copy of the consent to be attached to the return for the taxable year.

(5) *Tax payments.* The tax shown on the return must be paid to the jurisdiction with which such return is required to be filed and must be determined by taking into account any credit under section 31 for tax withheld by the relevant possession or the United States on wages, any credit under section 6402(b) for an overpayment of income tax to the relevant possession or the United States, and any payments under section 6315 of estimated income tax paid to the relevant possession or the United States.

(6) *Liability to other jurisdiction*—(i) *Filing with the relevant possession.* In the case of an individual who is required under paragraph (b)(1) of this section to file a return with the relevant possession for a taxable year, if such individual properly files such return and fully pays his or her income tax liability to the relevant possession, such individual is relieved of liability to file an income tax return with, and to pay an income tax to, the United States for the taxable year.

(ii) *Filing with the United States.* In the case of an individual who is required under paragraph (b)(1) of this section to file a return with the United States for a taxable year, such individual is relieved of liability to file an income tax return with, and to pay an income tax to, the relevant possession for the taxable year.

(7) [Reserved]

(c) *Extension of territory*—(1) *U.S. taxpayers*—(i) *General rule.* With respect to a U.S. taxpayer, for purposes of taxes imposed by Chapter 1 of the Internal Revenue Code (Code), the United States generally will be treated, in a geographical and governmental sense, as including the relevant possession. The purpose of this rule is to facilitate the coordination of the tax systems of the United States and the relevant possession. Accordingly, the rule will have no effect where it is manifestly inapplicable or its application would be incompatible with the intent of any provision of the Code.

(ii) *Application of general rule.* Contexts in which the general rule of paragraph (c)(1)(i) of this section apply include—

(A) The characterization of taxes paid to the relevant possession. Income tax paid to the relevant possession may be taken into account under sections 31, 6315, and 6402(b) as payments to the United States. Taxes paid to the relevant possession and otherwise satisfying the requirements of section 164(a) will be allowed as a deduction under that section, but income taxes paid to the relevant possession will be disallowed as a deduction under section 275(a);

(B) The determination of the source of income for purposes of the foreign tax credit (for example, sections 901 through 904). Thus, for example, after a U.S. taxpayer determines which items of income constitute income from sources within the relevant possession under the rules of section 937(b), such income will be treated as income from sources within the United States for purposes of section 904;

(C) The eligibility of a corporation to make a subchapter S election (sections 1361 through 1379). Thus, for example, for purposes of determining whether a corporation created or organized in the relevant possession may make an election under section 1362(a) to be a subchapter S corporation, it will be treated as a domestic corporation and a U.S. taxpayer shareholder will not be treated as a nonresident alien individual with respect to such corporation. While such an election is in effect, the corporation will be treated as a domestic corporation for all purposes of the

Code. For the consistency requirement with respect to entity status elections, see paragraph (e) of this section;

(D) The treatment of items carried over from other taxable years. Thus, for example, if a U.S. taxpayer has for a taxable year a net operating loss carryback or carryover under section 172, a foreign tax credit carryback or carryover under section 904, a business credit carryback or carryover under section 39, a capital loss carryover under section 1212, or a charitable contributions carryover under section 170, the carryback or carryover will be reported on the return filed with the United States in accordance with paragraph (b)(1)(i) or (b)(1)(iii)(B) of this section, even though the return of the taxpayer for the taxable year giving rise to the carryback or carryover was required to be filed with a section 935 possession; and

(E) The treatment of property exchanged for property of a like kind (section 1031). Thus for example, if a U.S. taxpayer exchanges real property located in the United States for real property located in the relevant possession, notwithstanding the provisions of section 1031(h), such exchange may qualify as a like-kind exchange under section 1031 (provided that all the other requirements of section 1031 are satisfied).

(iii) *Nonapplication of general rule.* Contexts in which the general rule of paragraph (c)(1)(i) of this section does not apply include—

(A) The application of any rules or regulations that explicitly treat the United States and any (or all) of its possessions as separate jurisdictions (for example, sections 931 through 937, 7651, and 7654);

(B) The determination of any aspect of an individual's residency (for example, sections 937(a) and 7701(b)). Thus, for example, an individual whose principal place of abode is in the relevant possession is not considered to have a principal place of abode in the United States for purposes of section 32(c);

(C) The determination of the source of income for purposes other than the foreign tax credit (for example, sections 935, 937, and 7654). Thus, for example, income determined to be derived from sources within the relevant possession under section 937(b) will not be considered income from sources within the United States for purposes of Form 5074, ''Allocation of Individual Income Tax to Guam or the Commonwealth of the Northern Mariana Islands (CNMI)'';

(D) The definition of wages (section 3401). Thus, for example, services performed by an employee for an employer in the relevant possession do not constitute services performed in the United States under section 3401(a)(8); and

(E) The characterization of a corporation for purposes other than subchapter S (for example, sections 367, 951 through 964, 1291 through 1298, 6038, and 6038B). Thus, for example, if a U.S. taxpayer transfers appreciated tangible property to a corporation created or organized in the relevant possession in a transaction described in section 351, he or she must recognize gain unless an exception under section 367(a) applies. Also, if a corporation created or organized in the relevant possession qualifies as a passive foreign investment company under sections 1297 and 1298 with respect to a U.S. taxpayer, a dividend paid to such shareholder does not constitute qualified dividend income under section 1(h)(11)(B).

(2) *Application in relevant possession.* In applying the territorial income tax of the relevant possession, such possession generally will be treated, in a geographical and governmental sense, as including the United States. Thus, for example, income tax paid to the United States may be taken into account under sections 31, 6315, and 6402(b) as payments to the relevant possession. Moreover, a citizen of the United States (as defined in paragraph (a)(3) of this section) not a resident of the relevant possession will not be treated as a nonresident alien individual for purposes of the territorial income tax of the relevant possession. Thus, for example, a citizen of the United States (as so defined), or a resident of the United States, will not be treated as a nonresident alien individual for purposes of section 1361(b)(1)(C) of the Guam territorial income tax.

(d) *Special rules for estimated income tax*—(1) *In general.* An individual must make each payment of estimated income tax (and any amendment to the

estimated tax payment) to the jurisdiction with which the individual reasonably believes, as of the date of that payment (or amendment), that he or she will be required to file a return for the taxable year under paragraph (b)(1) of this section. In determining the amount of such estimated income tax, income tax paid to the relevant possession may be taken into account under sections 31 and 6402(b) as payments to the United States, and vice versa. For other rules relating to estimated income tax, see section 6654.

(2) *Joint estimated income tax.* In the case of married persons making a joint payment of estimated income tax, the taxpayers must make each payment of estimated income tax (and any amendment to the estimated tax payment) to the jurisdiction where the spouse who has the greater estimated adjusted gross income for the taxable year would be required under paragraph (d)(1) of this section to pay estimated income tax if separate payments were made. For this purpose, estimated adjusted gross income of each spouse for the taxable year is determined without regard to community property laws.

(3) *Erroneous payment.* If the individual or spouses erroneously pay estimated income tax to the United States instead of the relevant possession or vice versa, only subsequent payments or amendments of the payments are required to be made pursuant to paragraph (d)(1) or (d)(2) of this section with the other jurisdiction.

(4) *Place for payment.* Estimated income tax required under this paragraph (d) to be paid to Guam or the Northern Mariana Islands must be paid as directed in the applicable forms and instructions issued by the relevant possession. Estimated income tax required under paragraph (d)(1) of this section to be paid to the United States must be paid as directed in the applicable forms and instructions.

(5) *Liability to other jurisdiction*—(i) *Filing with Guam or the Northern Mariana Islands.* Subject to paragraph (d)(6) of this section, an individual required under this paragraph (d) to pay estimated income tax (and amendments thereof) to Guam or the Northern Mariana Islands is relieved of liability to pay estimated income tax (and amendments thereof) to the United States.

(ii) *Filing with the United States.* Subject to paragraph (d)(6) of this section, an individual required under this paragraph (d) to pay estimated income tax (and amendments thereof) to the United States is relieved of liability to pay estimated income tax (and amendments thereof) to the relevant possession.

(6) *Underpayments.* The liability of an individual described in paragraph (a)(2) of this section for underpayments of estimated income tax for a taxable year, as determined under section 6654, will be to the jurisdiction with which the individual is required under paragraph (b) of this section to file his or her return for the taxable year.

(e) *Entity status consistency requirement*—(1) *In general.* Taxpayers should make consistent entity status elections (as defined in paragraph (e)(3)(ii) of this section), when applicable, in both the United States and section 935 possessions. In the case of a business entity to which this paragraph (e) applies—

(i) If an entity status election is filed with the Internal Revenue Service (IRS) but not with the relevant possession, the appropriate tax authority of the relevant possession, at his discretion, may deem the election also to have been made for the relevant possession tax purposes;

(ii) If an entity status election filed with the relevant possession but not with the IRS, the Commissioner, at his discretion, may deem the election also to have been made for Federal tax purposes; and

(iii) If inconsistent entity status elections are filed with the relevant possession and the IRS, both the Commissioner and the appropriate tax authority of the relevant possession may, at their individual discretion, treat the elections they each received as invalid and may deem the election filed in the other jurisdiction to have been made also for tax purposes in their own jurisdiction. See Rev. Proc. 2006–23 (2006–1 C.B. 900) (see §601.601(d)(2)(ii)(*b*) of this chapter) for procedures for requesting

the assistance of the IRS when a taxpayer is or may be subject to inconsistent tax treatment by the IRS and a U.S. possession tax agency.)

(2) *Scope.* This paragraph (e) applies to the following business entities:

(i) A business entity (as defined in §301.7701–2(a) of this chapter) that is domestic (as defined in §301.7701–5 of this chapter), or otherwise treated as domestic for purposes of the Code, and that is owned in whole or in part by any person who is either a bona fide resident of a section 935 possession or a business entity created or organized in a section 935 possession.

(ii) A business entity that is created or organized in a section 935 possession and that is owned in whole or in part by any U.S. person (other than a bona fide resident of such possession).

(3) *Definitions.* For purposes of this section—

(i) The term *appropriate tax authority of the relevant possession* means the individual responsible for tax administration in such possession or his delegate; and

(ii) The term *entity status election* includes an election under §301.7701–3(c) of this chapter, an election under section 1362(a), and any other similar elections.

(4) *Default status.* Solely for the purpose of determining classification of an eligible entity under §301.7701–3(b) of this chapter and under that section as mirrored in the relevant possession, an eligible entity subject to this paragraph (e) will be classified for both Federal and the relevant possession tax purposes using the rule that applies to domestic eligible entities.

(5) *Transition rules*—(i) In the case of an election filed prior to April 11, 2005, except as provided in paragraph (e)(5)(ii) of this section, the rules of paragraph (e)(1) of this section will apply as of the first day of the first taxable year of the entity beginning after April 11, 2005.

(ii) In the unlikely circumstance that inconsistent elections described in paragraph (e)(1)(iii) of this section are filed prior to April 11, 2005, and the entity cannot change its classification to achieve consistency because of the sixty-month limitation described in §301.7701–3(c)(1)(iv) of this chapter, then the entity may nevertheless request permission from the Commissioner or appropriate tax authority of the relevant possession to change such election to avoid inconsistent treatment by the Commissioner and the appropriate tax authority of the relevant possession.

(iii) Except as provided in paragraphs (e)(5)(i) and (e)(5)(ii) of this section, in the case of an election filed with respect to an entity before it became an entity described in paragraph (e)(2) of this section, the rules of paragraph (e)(1) of this section will apply as of the first day that such entity is described in paragraph (e)(2) of this section.

(iv) In the case of an entity created or organized prior to April 11, 2005, paragraph (e)(4) of this section will take effect for Federal income tax purposes (or the relevant possession income tax purposes, as the case may be) as of the first day of the first taxable year of the entity beginning after April 11, 2005.

(f) *Examples.* The application of this section is illustrated by the following examples:

Example 1. (i) B, a United States citizen, files returns on a calendar year basis. In November 2008, B moves to Possession G, a section 935 possession; purchases a house; and accepts a permanent position with a local employer. For the remainder of the year and throughout 2009, B continues to live and work in Possession G and has a closer connection to Possession G than to the United States or any foreign country. As a consequence of his employment in Possession G, B earns income from the performance of services in Possession G during 2008 and 2009.

(ii) For 2008, B does not qualify as a bona fide resident of Possession G under section 937(a) and §1.937–1(b) and (f)(1). Therefore, B is subject to the rules applicable to individuals described in paragraph (a)(2)(iii) of this section for 2008 because he has income derived from sources within Possession G as determined under the rules of section 937(b) and §1.937–2.

(iii) For 2009, assuming that B otherwise satisfies the requirements of section 937(a) and §1.937–1(b), B qualifies as a bona fide resident of Possession G. Therefore, section 935(b)(1)(B) and paragraph (b)(1)(ii) of this section apply to B for 2009, and he must file his income tax return with Possession G under paragraph (b)(1) of this section. Provided that B properly files such return and pays his income tax liability to Possession G, B is relieved of liability to file an income

tax return with, and to pay an income tax to, the United States for 2009 under paragraph (b)(6) of this section.

Example 2. (i) The facts are the same as in Example 1 except that B's employment terminates in June 2011. B properly pays his April 2008 estimated tax to the United States, continues to pay estimated tax for the 2008 taxable year to the United States under paragraph (d) of this section, and properly files his 2008 return with the United States.

(ii)(A) On the date of each payment of estimated tax in 2009, B reasonably believes that he would be required to file his return for 2009 with Possession G under paragraph (b)(1) of this section.

(B) In August 2009, B determines that he has overpaid tax for the previous year in the amount of $1000. B properly pays all estimated taxes to Possession G for 2009, subtracting the $1000 overpayment from his estimated tax payments pursuant to section 6402(b), and properly files his tax return with Possession G.

(iii) In April 2010, B reasonably believes that he would be returning to the United States in the Fall of 2010, and properly pays estimated tax to the United States. By June 2010, B reasonably believes that he would not be moving from Possession G and would be a bona fide resident of Possession G for the entire taxable year. B makes his remaining estimated tax payments to Possession G. On his 2010 tax return filed with Possession G, pursuant to section 6315, B properly takes into account payments made to both the United States and Possession G as estimated taxes.

(iv) In April 2011, B reasonably believes that he would be a bona fide resident of Possession G for the entire taxable year 2011 and properly pays estimated taxes to Possession G. By the time B pays his estimated taxes for June 2011, B's employment terminates and he moves to State H. B properly makes his remaining estimated tax payments to the United States. On his return for 2011, properly filed with the United States, B determines that he has underpaid estimated taxes throughout 2011 in an amount subject to penalty under section 6654. B owes the United States an estimated tax penalty under section 6654.

(g) *Effective/applicability date.* Paragraphs (a), (b)(1), (b)(3), (b)(5) through (b)(7), and (c) through (f) of this section apply to taxable years ending after April 9, 2008.

(Secs. 7805 (68A Stat. 917; 26 U.S.C. 7805) and 7654(e) (86 Stat. 1496; 26 U.S.C. 7654 (e)) of the Internal Revenue Code of 1954)

[T.D. 7385, 40 FR 50261, Oct. 29, 1975, as amended by T.D. 9194, 70 FR 18937, Apr. 11, 2005; T.D. 9391, 73 FR 19367, Apr. 9, 2008]

§ 1.936–1 Elections.

(a) *Making an election.* A domestic corporation shall make an election under section 936(e), for any taxable year beginning after December 31, 1975, by filing Form 5712 on or before the later of—

(1) The date on which such corporation is required, pursuant to sections 6072(b) and 6081, to file its Federal income tax return for the first taxable year for which the election is made; or

(2) April 8, 1980.

Form 5712 shall be filed with the Internal Revenue Service Center, 11601 Roosevelt Boulevard, Philadelphia, Pennsylvania 19155 (Philadelphia Center).

(b) *Revoking an election.* Any corporation to which an election under section 936 (e) applies on February 8, 1980 is hereby granted the consent of the Secretary to revoke that election for the first taxable year to which the election applied. (The corporation may make a new election under § 1.936–1 (a) for any subsequent taxable year.) The corporation shall make this revocation by sending to the Philadelphia Center a written statement of revocation on or before April 8, 1980.

(Secs. 7805 and 936(e) of the Internal Revenue Code of 1954 (68A Stat. 917 and 90 Stat. 1644; 26 U.S.C. 7805 and 936(e)))

[T.D. 7673, 45 FR 8588, Feb. 8, 1980; T.D. 7673, 45 FR 16174, Mar. 13, 1980]

§ 1.936–4 Intangible property income in the absence of an election out.

The rules in this section apply for purposes of section 936(h) and also for purposes of section 934(e), where applicable.

Q. 1: If a possessions corporation and its affiliates do not make an election under either the cost sharing or 50/50 profit split option, what rules will govern the treatment of income attributable to intangible property owned or leased by the possessions corporation?

A. 1: Intangible property income will be allocated to the possessions corporation's U.S. shareholders with the proration of income based on shareholdings.

If a shareholder of the possessions corporation is a foreign person or a tax-exempt person, the possessions corporation will be taxable on that shareholder's pro rata amount of the intangible property income. If any class of the stock of a possessions corporation is regularly traded on an established securities market, then the intangible property income will be taxable to the possessions corporation rather than the corporation's U.S. shareholders. For these purposes, a United States shareholder includes any shareholder who is a United States person as described under section 7701(a)(30). The term ''intangible property income'' means the gross income of a possessions corporation attributable to any intangible property other than intangible property which has been licensed to such corporation since prior to 1948 and which was in use by such corporation on September 3, 1982.

Q. 2: What is the source of the intangible property income described in question 1?

A. 2: The intangible property income is U.S. source, whether taxed to U.S. shareholders or taxed to the possessions corporation. Such intangible property income, if treated as income of the possessions corporation, does not enter into the calculation of the 80-percent possessions source test or the 65-percent active trade or business test of section 936(a)(2)(A) and (B).

Q. 3: How will the amount of income attributable to intangible property be measured?

A. 3: Income attributable to intangible property includes the amount received by a possessions corporation from the sale, exchange, or other disposition of any product or from the rendering of a service which is in excess of the reasonable costs it incurs in manufacturing the product or rendering the service (other than costs incurred in connection with intangibles) plus a reasonable profit margin. A reasonable profit margin shall be computed with respect to direct and indirect costs other than (i) costs incurred in connection with intangibles, (ii) interest expense, and (iii) the cost of materials which are subject to processing or which are components in a product manufactured by the possessions corporation. Notwithstanding the above, certain taxpayers who have been permitted by the Internal Revenue Service in taxable years beginning before January 1, 1983, to use the cost-plus method of pricing without reflecting a return from intangibles, but including the cost of materials in the cost base, will not be precluded from doing so. (Sec. 3.02(3), Rev. Proc. 63–10, 1963–1 C.B. 490.) Thus, the Internal Revenue Service may continue in appropriate cases to permit such taxpayers to continue to report their income as they have been under existing procedures described in the previous sentence if it is appropriate under all the facts and circumstances and does not distort the income of the taxpayer.

Q. 4: If there is no intangible property related to a product produced in whole or in part by a possessions corporation, what method may the possessions corporation use to compute its income?

A. 4: The taxpayer may compute its income using the appropriate method as provided under section 482 and the regulations thereunder. The taxpayer may also elect the cost sharing or profit split method.

[T.D. 8090, 51 FR 21524, June 13, 1986]

§ 1.936–5 Intangible property income when an election out is made: Product, business presence, and contract manufacturing.

The rules in this section apply for purposes of section 936(h) and also for purposes of section 934(e), where applicable.

(a) *Definition of product.*

Q. 1: What does the term ''product'' mean?

A. 1: The term ''product'' means an item of property which is the result of a production process. The term ''product'' includes component products, integrated products, and end-product forms. A component product is a product which is subject to further processing before sale to an unrelated party. A component product may be produced from other items of property, and if it is so produced, may be treated as including or not including (at the choice of the possessions corporation) one or more of such other items of property for all purposes of section

936(h)(5). An integrated product is a product which is not subject to any further processing before sale to an unrelated party and which includes all component products from which it is produced. An end-product form is a product which—

(1) Is not subject to any further processing before sale to an unrelated party;

(2) Is produced from a component product or products; and

(3) Is treated as not including certain component products for all purposes of section 936(h)(5).

A possessions corporation may treat a component product, integrated product, or end-product form as its possession product even though the final stage or stages of production occur outside the possession. Further processing includes transformation, incorporation, assembly, or packaging.

Q. 2: If a possessions corporation produces both a component product and an integrated product (which by definition includes the end-product form), may the possessions corporation use the options under section 936(h)(5) to compute its income with respect to either the component product, the integrated product or the end-product form?

A. 2: Yes. The possessions corporation may choose to treat the component product, the integrated product, or the end-product form as the product for purposes of determining whether the possessions corporation satisfies the significant business presence test. The possessions corporation must treat the same item of property as its product (the possession product) for all purposes of section 936(h)(5) for that taxable year, including the significant business presence test under section 936(h)(5)(B)(ii), the possessions sales calculation under section 936(h)(5)(C)(i)(I), the determination of income under section 936(h)(5)(C)(i)(II), and the combined taxable income computations under section 936(h)(5)(C)(ii). Although the possessions corporation must treat the same item of property as its product for all purposes of section 936(h)(5) in a particular taxable year, its choice of the component product, integrated product or end-product form may be different from year to year. The possessions corporation must specify the possession product on a statement attached to its return (Schedule P of Form 5735). The possessions corporation may specify its choice by either listing the components that are included in the possession product or the components that are excluded from the possession product. The possessions corporation must file a separate Schedule P with respect to each possession product. The possessions corporation must attach to each Schedule P detailed computations indicating how the significant business presence test is satisfied with respect to the possession product identified in that Schedule P.

Q. 3: A possessions corporation produces a product that is sometimes sold to unrelated parties without further processing and is sometimes sold to unrelated parties after further processing. May the possessions corporation choose to treat the same item of property as the possession product even though in some cases it is an integrated product and in some cases it is a component product?

A. 3: Yes. Except as provided in questions and answers 4 and 5, the possessions corporation must designate a single possession product even though it is sometimes a component product and sometimes an integrated product.

Q. 4: A possessions corporation produces a product that is sometimes sold without further processing by any member of the affiliated group to unrelated parties or to related parties for their own consumption and is sometimes sold after further processing by any member of the affiliated group to unrelated parties or to related parties for their own consumption. May the possessions corporation designate two products as possession products?

A. 4: The possessions corporation may designate two or more possession products. The possessions corporation must use a consistent definition of the possession product for all items of property that are sold to unrelated parties or consumed by related parties at the same stage in the production process. The significant business presence test shall apply separately to each product designated by the possessions

corporation. The possessions corporation shall compute its income separately with respect to each product.

Q. 5: A possessions corporation produces a product in one taxable year and does not sell all of the units that it produced. In the next taxable year the possessions corporation produces a product which includes the product produced in the prior year. The possessions corporation could not have satisfied the significant business presence test with respect to the units produced the first taxable year if the larger possession product had been designated. May the possessions corporation designate two possession products in the second year?

A. 5: Yes. The possessions corporation may designate two possession products. However, once a product has been designated for a particular year all sales of units produced in that year must be defined in the same manner. In addition, the taxpayer must maintain a significant business presence in a possession with respect to that product. Sales shall be deemed made first out of the current year's production. If all of the current year's production is sold and some inventory is liquidated, then the taxpayer's method of inventory accounting shall be applied to determine what year's layer of inventory is liquidated.

Example 1. A possessions corporation S, manufactures a bulk pharmaceutical in a possession. S transfers the bulk pharmaceutical to its U.S. parent, P, for encapsulation and sale by P to customers. S satisifes the significant business presence test with respect to the bulk pharmaceutical (the component product) and the combination of the bulk pharmaceutical and the capsule (the integrated product). S may use the cost sharing or profit split method to compute its income with respect to either the component product or the integrated product.

Example 2. The facts are the same as in example 1 except that S does not satisfy the significant business presence test with respect to the integrated product. S may use the cost sharing or profit split method to compute its income only with respect to the component product. However, if in a later taxable year S satisfies the significant business presence test with respect to the integrated product, then S may use the cost sharing or profit split method to compute its income with respect to that integrated product for that later taxable year.

Example 3. P, a domestic corporation, produces in bulk form in the United States the active ingredient for a pharmaceutical product, P transfers the bulk form to S, a wholly owned possessions corporation. S uses the bulk form to produce in Puerto Rico the finished dosage form drug. S transfers the drug in finished dosage form to P, which sells the drug to unrelated customers in the U.S. The direct labor costs incurred in Puerto Rico by S during its taxable year in formulating, filling and finishing the dosage form are at least 65 percent of the total direct labor costs incurred by the affiliated group in producing the bulk and finished forms during that period. S manufactures (within the meaning of section 954(d)(1)(A)) the finished dosage form. S has elected out under section 936(h)(5) under the profit split option for the drug product area (SIC 283). P and S may treat the bulk and finished dosage forms as parts of an integrated product. Since S satisfies the significant business presence requirement with respect to the integrated product, it is entitled to 50 percent of the combined taxable income on the integrated product.

Example 4. A possessions corporation, S. produces the keyboard of an electric typewriter and incorporates the keyboard with components acquired from a related corporation into finished typewriters. S does not satisfy the significant business presence test with respect to the typewriters (the integrated product). Therefore, S may use the cost sharing or profit split method to compute its income only with respect to a component product or end-product form. For taxable year 1983, S specifies on a statement attached to its return (Schedule P of Form 5735) that the possession product is the end-product form. The statement indentifies the components—for example, the keyboard structure and frame—which are included in the possession product. S's definition of the possession product will apply to all units of the electric typewriters which S produces in whole or in part in the possession and which are sold in 1983. Thus, all units of a given component incorporated into such typewriters will be treated in the same way. For example, all keyboards and all frames will be included in the possession product, and all electric drive mechanisms and rollers will be excluded from the possession product.

Example 5. Possessions corporation A produces printed circuit boards in a possession. The printed circuit boards are sold to unrelated parties. A also uses the boards to produce personal computers in the possession. A may designate two possession products: printed circuit boards and personal computers. The significant business presence test applies separately with respect to each of these products. Thus, for those printed

circuit boards that are sold to unrelated parties, only the costs of the possessions corporation and the other members of the affiliated group that are incurred with respect to units of the printed circuit boards which are produced in whole or in part in the possessions and sold to third parties shall be taken into account. Conversely, with respect to personal computers, only the costs incurred with respect to the personal computers shall be taken into account. This would include the costs with respect to printed circuit boards that are incorporated into personal computers but not the costs incurred with respect to printed circuit boards that are sold without further processing to unrelated parties.

Example 6. Possessions corporation S produces integrated circuits in a possession. P, an affilate of S, produces circuit boards in the United States. P transfers the circuit boards to S. S assembles the integrated circuits and the circuit boards. S sells some of the loaded circuit boards to third parties. S retains some of the loaded circuit boards and incorporates them into central processing units. The central processing units are then sold to third parties. S may designate two possession products. S must use a consistent definition of the possession product for all units that are sold at the same stage in the production process. Thus, with respect to those units sold after assembly of the integrated circuits and the printed circuits boards, if S cannot satisfy the significant business presence test with respect to all the loaded circuit boards (the integrated product), then S must designate a lesser product, either the integrated circuit (the component product) or the loaded circuit board less the printed circuit board (the end-product form) as its possession product. With respect to the central processing units sold the same rule would apply. Thus, if S cannot satisfy the significant business presence test with respect to the entire central processing unit for all of the central processing units sold, S must designate some lesser product as its possession product.

Example 7. S is a possession corporation. In 1985, S produced 100 units of product X. Those units were finished into product Y in 1985 by affiliates of S. Product X is a component of product Y. In 1985, S satisfies the direct labor test with respect to product X but not with respect to product Y. S designates the component product X as its possession product. In 1986 S produces 100 units of product X and finishes those units into product Y. S would have satisfied the significant business presence test with respect to product X if S had designated product X as its possession product in 1986. In addition, in 1986 S satisfies the significant business presence test with respect to the integrated product Y. In 1986, S sells 150 units of Y. One hundred of those units would be deemed to be produced in 1986. With respect to those units S may designate the integrated product Y as its possession product. Under S's method of inventory accounting the remaining 50 units were determined to have been produced in 1985. With respect to those units S must define its possession product as it did for the taxable year in which those units were produced. Thus, S's possession product would be the component product X.

Q. 6: May an affiliated group establish groupings of possession products and treat the groupings as single products?

A. 6: An affiliated group may establish reasonable groupings of possession products based on similarities in the production processes of the possession products. Possession products that are grouped shall be treated as a single product. The determination of whether the production processes involved in producing the products that are to be grouped are similar is based on the production processes of the components that are included in the possession product. The affiliated group may establish new groupings each year. Any grouping which materially distorts a taxpayer's income or the application of the significant business presence test may be disallowed by the Commissioner. The mere fact that a grouping results in an increased allocation of income to the possessions corporation does not, of itself, create a material distortion of income. If the Commissioner determines that the taxpayer's grouping is improper with respect to one or more products in a group, then those products shall be excluded from the group. The effect of excluding a product or products from the group is that the taxpayer must demonstrate that the group without the excluded products (and each excluded product itself) satisfies the significant business presence test. If the group without the excluded products, or any of the excluded products themselves, fails to satisfy the significant business presence test, then the possessions corporation's income from those products shall be determined under section 936(h)(1) through (4) and the regulations thereunder.

Example 1. The following are examples of possession products the processes of production of which are sufficiently similar that

they may be grouped and treated as a single product:

(A) Beverage bases or concentrates for different soft drinks or soft drink syrups, regardless of whether some include sweeteners and some do not:

(B) Different styles of clothing;

(C) Different styles of shoes;

(D) Equipment which relies on gravity to deliver solutions to patients intravenously;

(E) Equipment which relies on machines to deliver solutions to patients intravenously;

(F) Video game cartridges, even though the concept and design of each game title is, in part, protected against infringement by separate copyrights;

(G) All integrated circuits;

(H) All printed circuit boards; and

(I) Hardware and software if the software is one of several alternative types of software offered by the manufacturer and sold only with the hardware, and a purchaser of the hardware would ordinarily purchase one or more of the manufacturer-provided alternative types of software. In all other cases, hardware and software may not be grouped and treated as a single product.

Groupings (D) and (E) do not include any solutions which are delivered through the equipment described therein.

Example 2. A possessions corporation produces in Puerto Rico non-programmable, interactive cathode ray tube computer terminals that vary in price. These terminals all interact with a computer or controller to perform their functions of data entry, graphics word processing, and program development. The terminals can be purchased with options that include a built-in printer, different language keyboards, specialized cathode ray tubes, and different power supply features. All terminals are produced in one integrated process requiring the same skills and operations. The differences in the production of the terminals include differences in the number of printed circuit boards incorporated in each terminal, the use of unique keyboards, and the installation and testing of the built-in printer. Some difference in direct labor time to manufacture the terminals occurs, primarily due to the differing number and complexity of printed circuit boards incorporated into each terminal. Different model numbers are assigned to various computer terminals. A grouping by the taxpayer of all of the terminals as one product will be respected by the Service, unless the Service establishes that substantial distortion results. This grouping is proper because the processes of producing each of the terminals are similar.

Example 3. A possessions corporation, S produces several models of serial matrix impact printers and teleprinters. These products have differing performance standards based on such factors as speed (in characters per second), numbers of columns, and cost. The production process for all types of printers involves production of three basic elements: electronic circuitry, the printing head, and the mechanical parts. The process of producing all the printers is similar. Thus, all printers could be grouped and treated as a single product. S purchases electronic circuitry and mechanical parts from a U.S. affiliate. S performs manufacturing functions relative to the printing head and assembles and tests the finished printers. S does not satisfy the significant business presence test with respect to the integrated products. S therefore specifies on a statement attached to its return (Schedule P of Form 5735) that the possession product for both the serial matrix printers and the teleprinters is the end-product form. The statement identifies the components which are included in each possession product. S may group and treat as a single product the serial matrix printers and the teleprinters if both end-product forms include and exclude similar components. Thus, if the end-product form for both the serial matrix printers and the teleprinters includes the mechanical parts and excludes the electronic circuitry, then S may group and treat as a single product the two end-product forms. If, however, the end-product forms for the two items of property contain components that are not similar and as a result of this definition of the end-product forms the production processes involved in producing the two end-product forms are not similar, then S may not group the end-product forms.

Q. 7: Is the affiliated group permitted to include in a group an item of property that is not produced in whole or in part in a possession?

A. 7: No.

Example 1. Possessions corporation S produces 70 units of product A in a possession. P, an affiliate of S, produces 30 units of product A entirely in the United States. All of the units are sold to unrelated parties. The affiliated group is not permitted to group the 30 units of product A produced in the United States with the 70 units produced in the possession because those units are not produced in whole or in part in a possession.

Example 2. The facts are the same as in example 1 except that the 30 units of product A are transferred to possessions corporation S. S incorporates the 100 units of product A into product B. This incorporation takes place in the possession. S may group and treat as a single product all of the units of product B even though some of those units contain units of product A that were produced in the possession and some that were produced in the United States.

Q. 8: What factors should be disregarded in determining whether a particular grouping of similar items of property is reasonable?

A. 8: In general, differences in the following factors will be disregarded in determining whether a particular grouping of items of property is reasonable:

(1) Differences in testing requirements (*e.g.*, some products sold for military use may require more extensive or different testing than products sold for commercial use);

(2) Differences in the product specifications that are designed to accommodate the product to its area of use or for conditions under which used (*e.g.*, electrical products designed for ultimate use in the United States differ from electrical products designed for ultimate use in Europe);

(3) Differences in packaging or labeling (*e.g.*, differences in the number of units of the items shipped in one package); and

(4) Minor differences in the operations of the items of property.

Q. 9: What rules apply for purposes of determining whether pharmaceutical products are properly grouped and treated as a single product?

A. 9: The rules contained in questions and answers 6 through 8 of this section shall apply. Thus, an affiliated group may establish reasonable groupings based on similarities in the production processes of two or more possession products. In establishing a group the affiliated group may only compare the production processes involved in producing the possession products. The fact that two pharmaceutical products contain different active or inert ingredients is not relevant to the determination of whether the pharmaceutical products may be grouped. For example, if the possession products are bulk chemicals and the production processes involved in producing the bulk chemicals are similar, those bulk chemicals may be grouped and treated as a single product even though they contain different active or inert ingredients. The affiliated group may also group and treat as a single product the finished dosage form drug as long as the production processes involved in producing the finished dosage forms are similar. For these purposes, the production processes involved in producing the following classes of items shall be considered to be sufficiently similar that possession products delivered in a form described in one of the categories may be grouped with other possession products delivered in a form described in the same category.

The categories are:

(1) Capsules, tablets, and pills;

(2) Liquids, ointments, and creams; or

(3) Injectable and intravenous preparations.

No distinctions should be based on packaging, list numbers, or size of dosage. The affiliated group may group and treat as a single product the integrated product (combination of the bulk and the delivery form) only if all the production processes involved in producing the integrated products are similar. The rules of this question and answer are illustrated by the following examples.

Example 1. Possessions corporation S produces two chemical active ingredients X and Y. Both chemical ingredients are produced through the process of fermentation. The affiliated group is permitted to group and treat as a single product the two chemical ingredients.

Example 2. The facts are the same as in example 1 and possessions corporation S finishes chemical ingredient X into tablets and chemical ingredient Y into capsules. The affiliated group is permitted to group and treat as a single product the combination of the bulk pharmaceutical and the finishing because the production processes involved in producing the integrated products are similar.

Example 3. Possessions corporation S produces in a possession a bulk chemical X by fermentation. A United States affiliate, P, produces in the United States a bulk chemical, Y, by fermentation. Both bulk chemicals are finished by S in the possession. The finished dosage form of X is in pill form. The finished dosage form of Y is in injectable form. If S's possession product is the integrated product or the end-product form then S may not group X and Y because the production processes involved in producing the finished dosage form of X and Y are not similar. If S's possession product is the component then S may not group X and Y because the bulk chemical Y is not produced in whole or in part in a possession.

Q. 10: Will the fact that a manufacturer of a drug must submit a New

Drug Application (''NDA'') or a supplemental NDA to the Food and Drug Administration have any effect on the definition or grouping of a product?

A. 10: No.

Q. 11: A possessions corporation which produced a product or rendered a type of service in a possession on or before September 3, 1982, is not required to meet the significant business presence test in a possession with respect to such product or type of service for its taxable years beginning before January 1, 1986 (the interim period). During such interim period, how will the term ''product'' be defined for purposes of allocating income under the cost sharing or profit split methods?

A. 11: During the interim period the product will be determined based on the activities performed by the possessions corporation within a possession on September 3, 1982. During the interim period the possessions corporation may compute its income under the cost sharing or profit split method only with respect to the product that is produced or manufactured within the meaning of section 954(d)(1)(A) within the possession. If the product is manufactured from a component or components produced by an affiliated corporation or a contract manufacturer, then the product will not be treated as including such component or components for purposes of the computation of income under the cost sharing or profit split methods. Thus, the possessions corporation is not entitled to any return on the intangibles associated with the component or components. Notwithstanding the preceding sentences, for taxable years beginning before January 1, 1986, a possessions corporation may compute its income under the cost sharing or profit split method with respect to a product which includes a component or components produced by an affiliated corporation or contract manufacturer if the possessions corporation satisfies with respect to such product the significant business presence test described in section 936(h)(5)(B)(ii) and the regulations thereunder.

Example 1. A possessions corporation, S, was manufacturing (within the meaning of section 954(d)(1)(A)) integrated circuits in a possession on September 3, 1982. S transferred those integrated circuits to related corporation P. P incorporated the integrated circuits into central processing units (CPUs in the United States) and sold the CPUs to unrelated parties. S continued to manufacture integrated circuits in the possession through Juanuary 1, 1986. For taxable years beginning before January 1, 1986, S may compute its income under the cost sharing or profit split method with respect to the integrated circuits regardless of whether S satisfies the significant business presence test. However, unless S satisfies the significant business presence test with respect to the central processing units, S may not compute its income under the cost sharing or profit split methods with respect to the CPUs, and thus, S is not entitled to any return on manufacturing intangibles associated with CPUs to the extent that they are not related to the integrated circuits produced by S, nor (except as provided in the profit split methods) to any return on marketing intangibles.

Example 2. A possessions corporation, S, was engaged on September 3, 1982, in the manufacture (within the meaning of section 954(d)(1)(A)) of a bulk pharmaceutical in Puerto Rico from raw materials. S sold the bulk pharmaceutical to its U.S. parent, P, for encapsulation and sale by P to customers as the product X. Because S was not engaged in the encapsulation of X, S is not considered to have manufactured the integrated product, X, in Puerto Rico. During the interim period, S may compute its income under the cost sharing or profit split methods with respect to the integrated product, X, only if S satisfies the significant business presence test with respect to X. S may compute its income under the cost sharing or profit split methods with respect to the component product (the bulk pharmaceutical).

Example 3. P is a domestic corporation that is not a possessions corporation. P manufactures a bulk pharmaceutical in the United States. P transfers the bulk pharmaceutical to its wholly owned subsidiary, S, a possessions corporation. On September 3, 1982, S was engaged in the encapsulation of the bulk pharmaceutical in Puerto Rico in a manner which satisfies the test of section 954(d)(1)(A). For taxable years beginning before January 1, 1986, S may compute its income under the cost sharing or profit split methods with respect to the end-product form the (the encapsulated drug) regardless of whether S meets the significant business presence test. However, unless S satisfies the significant business presence test with respect to the integrated product, S may not compute its income under the cost sharing or profit split methods with respect to the integrated product, and thus, S is not entitled to any return on the intangibles associated with the bulk pharmaceutical.

Q. 12: On September 3, 1982, a possessions corporation, S was engaged in the manufacture (within the meaning of section 954(d)(1)(A)) of X in a possession. During the interim period, after September 3, 1982, but before January 1, 1986, S produced Y, which differs from X in terms of minor design features. S did not produce Y in a possession on September 3, 1982. Will S be considered to have commenced production of a new product after September 3, 1982, for purposes of the application of the significant business presence test for the interim period?

A. 12: No. X and Y will be considered to be a single product, and therefore S will not be required to satisfy the business presence test separately with respect to Y during the interim period. In all cases in which the items of property produced on or before September 3, 1982 and the items of property produced after that date could have been grouped together under the guidelines provided in §1.936–5(a) questions and answers 6 through 10, the possessions corporation will not be considered to manufacture a new product after September 3, 1982.

Q. 13: May the term ''product'' be defined differently for export sales than for domestic sales?

A. 13: Yes. For rules concerning the application of the separate election for export sales see §1.936–7(b).

(b) *Requirement of significant business presence*—(1) *General rules.*

Q. 1: In general, a possessions corporation may compute its income under the cost sharing or profit split methods with respect to a product only if the possessions corporation has a significant business presence in a possession with respect to that product. When will a possession corporation be considered to have a significant business presence in a possession?

A. 1: For purposes of the cost sharing method, the significant business presence test is met if the possessions corporation satisfies either a value added test or a direct labor test. For purposes of the profit split method, the significant business presence test is met if the possessions corporation satisfies either a value added test or a direct labor test and also manufactures the product in the possession within the meaning of section 954(d)(1)(A).

Q. 2: How may a possessions corporation satisfy the direct labor test with respect to a product?

A. 2: The possessions corporation will satisfy the direct labor test with respect to a product if the direct labor costs incurred by the possessions corporation as compensation for services performed in a possession are greater than or equal to 65 percent of the direct labor costs of the affiliated group for units of the possession product produced during the taxable year in whole or in part by the possessions corporation.

Q. 3: How may a possessions corporation satisfy the value added test?

A. 3: In order to satisfy the value added test, the production costs of the possessions corporation incurred in the possession with respect to units of the possession product produced in whole or in part by the possessions corporation in the possession and sold or otherwise disposed of during the taxable year by the affiliated group to unrelated parties must be greater than or equal to twenty-five percent of the difference between gross receipts from such sales or other dispositions and the direct material costs of the affilated group for materials purchased for such units from unrelated parties.

Q. 4: Must the significant business presence test be met with respect to all units of the product produced during the taxable year by the affiliated group?

A. 4: No. The significant business presence test must be met with respect to only those units of the product produced during the taxable year in whole or in part by the possessions corporation in a possession.

Q. 5: For purposes of determining whether a possessions corporation satisfies the significant business presence test, how shall the possessions corporation treat the cost of components transferred to the possessions corporation by a member of the affiliated group?

A. 5: The treatment of the cost of components transferred from an affiliate depends on whether the possession product is treated as including the components for purposes of section

936(h). If it is, then for purposes of the value added test, the production costs associated with the component shall be treated as production costs of the affiliated group that are not incurred by the possessions corporation. Those production costs, other than the cost of materials, shall not be treated as a cost of materials. For purposes of the direct labor test and the alternative significant business presence test, the direct labor costs associated with such components shall be treated as direct labor costs of the affiliated group that are not incurred by the possessions corporation. If the possession product is treated as not including such component for purposes of section 936(h), then, solely for purposes of determining whether the possessions corporation satisfies the value added test, the cost of the component shall not be treated as either a cost of materials or as a production cost. For purposes of the direct labor test and the alternative significant business presence test, the direct labor costs associated with such component shall not be treated as direct labor costs of the affiliated group. If the possession product is treated as not including such component, then the possessions corporation shall not be entitled to any return on the intangibles associated with the manufacturing or marketing of the component.

Q. 6: May two or more related possessions corporations aggregate their production or direct labor costs for purposes of determining whether they satisfy the significant business presence test with respect to a single product?

A. 6: No.

Q. 7: A possessions corporation, S, purchases raw materials and components from an unrelated corporation which conducts business outside of a possession. The unrelated corporation is not a contract manufacturer. What is the treatment of such raw materials and components for purposes of the significant business presence test?

A. 7: Where Company S purchases raw materials or components from an unrelated corporation which is not a contract manufacturer, the raw materials and components are treated as materials, and the costs related thereto are treated as a cost of materials.

(2) *Direct labor costs.*

Q. 1: How is the term ''direct labor costs'' to be defined?

A. 1: The term ''direct labor costs'' has the same meaning which it has for purposes of §1.471–11(b)(2)(i). Thus, direct labor costs include the cost of labor which can be identified or associated with particular units or groups of units of a specific product. The elements of direct labor include such items as basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d)), shift differential, payroll taxes, and payments to a supplemental unemployment benefit plan paid or incurred on behalf of employees engaged in direct labor.

Q. 2: May a taxpayer treat a cost as a direct labor cost if it is not included in inventoriable costs under section 471 and the regulations thereunder?

A. 2: No. A cost may be treated as a direct labor cost only if it is included in inventoriable costs. However, a cost may be considered a direct labor cost even though the activity to which it relates would not constitute manufacturing under section 954(d)(1)(A) as long as the cost is included in inventoriable costs.

Q. 3: May the members of the affiliated group include as direct labor costs the labor element in indirect production costs?

A. 3: No. The labor element of indirect production costs may not be considered as part of direct labor costs.

Q. 4: Do direct labor costs include the costs which can be identified or associated with particular units or groups of units of a specific product if those costs could also be described as quality control and inspection?

A. 4: Yes. Direct labor costs include costs which can be identified or associated with particular units or groups of units of a specific product. Thus, if quality control and inspection is an integral part of the production process, then the labor associated with that quality control and inspection shall be considered direct labor. For example, integrated circuits are soldered to printed circuit boards by passing the boards over liquid solder. Employees inspect each of the boards and repair

any imperfectly soldered joints discovered on that inspection. The labor associated with this process is direct labor. However, if a person performs random inspections on limited numbers of products, then that labor associated with those inspections shall be considered quality control and therefore indirect labor.

Q. 5: Do direct labor costs of the possessions corporation include only the costs which were actually incurred or do they take into account, in addition, any labor savings which result because the activities were performed in a possession rather than in the United States?

A. 5: Direct labor costs include only the costs which were actually incurred.

Q. 6: For purposes of determining whether a possessions corporation satisfies the significant business presence test for a taxable year with respect to a product, how shall the possessions corporation compute its direct labor costs of units of the product?

A. 6: The direct labor test shall be applied separately to products produced in whole or in part by the possessions corporation in the possession during each taxable year. Sales shall be deemed to be made first out of the current year's production. If sales are made only out of the current year's production, then the direct labor costs of producing those units that are sold shall be the pro rata portion of the total direct labor costs of producing all the units that are produced in whole or in part in the possession by the possessions corporation during the current year. If all of the current year's production is sold and some inventory is liquidated, then the direct labor test shall be applied separately to the current year's production and the liquidated inventory. The direct labor costs of producing the liquidated inventory shall be the pro rata portion of the total direct labor costs that were incurred in producing all the units that were produced in whole or in part by the possessions corporation in the possessions in the layer of liquidated inventory determined under the member's method of inventory accounting.

Example. S is a cash basis calendar year taxpayer that has made an election under section 936(a). In 1985 S produced 100 units of product X. Fifty percent of the direct labor costs of the affiliated group were incurred by S and were compensation for services performed in the possession. Thus, S did not satisfy the significant business presence test with respect to product X in taxable year 1985. During 1986 S produced 100 units of product X. One hundred percent of the direct labor costs of the affiliated group were incurred by S and were compensation for services performed in the possession. In 1986 S sells 150 units of product X. One hundred of those units are deemed to be from the units produced in 1986. With respect to those units S satisfies the significant business presence test. Under S's method of inventory accounting the remaining 50 units were determined to be produced in 1985. With respect to those units S does not satisfy the significant business presence test because only 50% of the direct labor costs incurred in producing those units were incurred by S and were compensation for services performed in the possession.

Q. 7: What is the result if in a particular taxable year the possessions corporation satisfies the significant business presence test with respect to units of the product produced in one year and fails the significant business with respect to units produced in another year?

A. 7: For those units of the product with respect to which the possession corporation satisfies the significant business presence test, the possessions corporation may compute its income under the provisions of section 936(h)(5). For those units of the product with respect to which the possessions corporations fails the significant business presence test, the possessions corporation must compute its income under section 936(h)(1) through (4).

Q. 8: Do direct labor costs include costs incurred in a prior taxable year with respect to units of the possession product that are finished in a later taxable year?

A. 8: Yes.

(3) *Direct material costs.*

Q. 1: How is the term ''direct material costs'' to be defined?

A. 1: Direct material costs include the cost of those materials which become an integral part of the specific product and those materials which are consumed in the ordinary course of manufacturing and can be identified or associated with particular units or groups of units of that product. See

§1.471–3 for the elements of direct material costs.

Q. 2: May a taxpayer treat a cost as a direct material cost if it is not included in inventoriable costs under section 471 and the regulations thereunder?

A. 2: A taxpayer may not treat such costs as direct material costs.

(4) *Production costs.*

Q. 1: How is the term ''production costs'' defined?

A. 1: The term ''production costs'' has the same meaning which it has for purposes of §1.471–11(b) except that the term does not include direct material costs and interest. Thus, production costs include direct labor costs and fixed and variable indirect production costs (other than interest).

Q. 2: With respect to indirect production costs described in §1.471–11(c)(2)(ii) and (iii), may a possessions corporation include these costs in production costs for purposes of section 936, if they are not included in inventoriable costs under section 471 and the regulations thereunder?

A. 2: No. A possessions corporation may include these costs only if they are included for purposes of section 471 and the regulations thereunder. If a possessions corporation and the other members of the affiliated group include and exclude different indirect production costs in their inventoriable costs, then, for purposes of the significant business presence test, the possessions corporation shall compute its production costs and the production costs of the other members of the affiliated group by subtracting from the production costs of each member all indirect costs included by that member that are not included in production costs by all other members of the affiliated group.

Q. 3: Does a change in a taxpayer's method of accounting for purposes of section 471 affect the taxpayer's computation of production costs for purposes of section 936?

A. 3: Yes. If a taxpayer changes its method of accounting for purposes of section 471, then the same change shall apply for purposes of section 936.

Q. 4: For purposes of determining whether a possessions corporation satisfies the significant business presence test for a taxable year with respect to a product, how shall the possessions corporation compute its costs of producing units of the product sold or otherwise disposed to unrelated parties during the taxable year?

A. 4: All members of the affiliated group may elect to use their current year production costs regardless of whether the members use the FIFO or LIFO method of inventory accounting. If some or all of the current year's production of a product is sold, then the production costs of producing those units sold shall be the pro rata portion of the total production costs of producing all the units produced in the current year. If all of the current year's production of a product is sold and some inventory is liquidated, then the production costs of producing the liquidated inventory shall be the pro rata portion of the production costs incurred in producing the layer of liquidated inventory as determined under the member's method of inventory accounting.

Q. 5: How should the members of the affiliated group determine the portion of their production costs that is allocable to units of the product sold or otherwise disposed of during the taxable year?

A. 5: The members of the affiliated group may use either standard production costs (so long as variances are not material), average production costs, or FIFO production costs to determine the production costs that will be considered to be attributable to units of the product sold or otherwise disposed of during the taxable year. However, all members of the affiliated group must use the same method.

Q. 6: When is the quality control and inspection of a product considered to be part of the production activity for that product?

A. 6: Quality control and inspection of a manufactured product before its sale or other disposition by the manufacturer, or before its incorporation into other products, is considered to be part of the indirect production activity for that initial product. Subsequent testing of a product to ensure that the product is compatible with other products is not a part of the production activity for the initial product.

When a component is incorporated into an end-product form and the end-product form is then tested, the latter testing will be considered to be a part of the indirect production activity for the end-product form and will not be considered to be a part of the production activity for the component.

Q. 7: For purposes of the significant business presence test and the allocation of income to a possessions corporation, what is the treatment of the cost of installation of a product?

A. 7: For purposes of the significant business presence test and the allocation of income to a possessions corporation, product installation costs need not be taken into account as costs incurred in the manufacture of that product, if the taxpayer keeps such permanent books of account or records as are sufficient to establish the fair market price of the uninstalled product. In such a case, the cost of installation materials, the cost of the labor for installation, and a reasonable profit for installation will not be included in the costs and income associated with the possession product. If the taxpayer does not keep such permanent books of account or records, then the cost of installation materials and the cost of labor for installation shall be treated as costs associated with the possession product and income will be allocated to the possessions corporation and its affiliates under the rules provided in these regulations.

Q. 8: For purposes of the significant business presence test and the allocation of income to a product or service, what is the treatment of the cost of servicing and maintaining a possession product that is sold to an unrelated party?

A. 8: The cost of servicing and maintaining a possession product after it is sold is not associated with the production of that product.

Q. 9: For purposes of the significant business presence test and the allocation of income to a possessions corporation, what is the treatment of the cost of samples?

A. 9: The cost of producing samples will be treated as a marketing expense and not as inventoriable costs for these purposes. However, for taxable years beginning prior to January 1, 1986, the cost of producing samples may be treated as either a marketing expense or as inventoriable costs.

(5) *Gross receipts.*

Q. 1: How shall the affiliated group determine gross receipts from sales or other dispositions by the affiliated group to unrelated parties of the possession product?

A. 1: Gross receipts shall be determined in the same manner as possession sales under the rules contained in §1.936–6(a)(2).

(6) *Manufacturing within the meaning of section 954(d)(1)(A).*

Q. 1: What is the test for determining, within the meaning of section 954(d)(1)(A), whether a product is manufactured or produced by a possessions corporation in a possession?

A. 1: A product is considered to have been manufactured or produced by a possessions corporation in a possession within the meaning of section 954(d)(1)(A) and §1.954–3(a)(4) if—

(i) The property has been substantially transformed by the possessions corporation in the possession;

(ii) The operations conducted by the possessions corporation in the possession in connection with the property are substantial in nature and are generally considered to constitute the manufacture or production of property; or

(iii) The conversion costs sustained by the possessions corporation in the possession, including direct labor, factory burden, testing of components before incorporation into an end product and testing of the manufactured product before sales account for 20 percent or more of the total cost of goods sold of the possessions corporation.

In no event, however, will packaging, repackaging, labeling, or minor assembly operations constitute manufacture or production of property. See particularly examples 2 and 3 of §1.954–3(a)(4)(iii).

Q. 2: Does the requirement that a possession product be produced or manufactured in a possession within the meaning of section 954(d)(1)(A) apply to taxable years beginning before January 1, 1986?

A. 2: A possessions corporation must satisfy this requirement for taxable

years beginning before January 1, 1986, in the following cases:

(i) If the possessions corporation makes a separate election under section 936(h)(5)(F)(iv)(II) with respect to export sales;

(ii) If the possessions corporation is electing as its possession product a product that is subject to the interim period rules of §1.936–5(a) question and answer (10); or

(iii) If the possessions corporation is electing as its possession product a product that is not subject to the interim period rules of §1.936–5 (a) question and answer (10) and the possessions corporation computes its income under the profit split method with respect to that product.

For rules concerning products first produced in a possession after September 3, 1982, see §1.936–5(b)(7) question and answer (2).

(7) *Start-up operations.*

Q. 1: With respect to products not produced (and types of services not rendered) in the possession on or before September 3, 1982, when must a possessions corporation first satisfy the 25 percent value added test or the 65 percent direct labor test?

A. 1: A transitional period is established such that a possessions corporation engaged in start-up operations with respect to a product or service need not satisfy the 25 percent value added test or the 65 percent labor test until the third taxable year following the taxable year in which such product is first sold by the possessions corporation or such service is first rendered by the possessions corporation. During the transitional period, the applicable percentages for these tests will be as follows:

	Any year after 1982		
	1	2	3
Value added test	10	15	20
Labor test	35	45	55

Q. 2: Does the requirement that a possession product be produced or manufactured in a possessions within the meaning of section 954(d)(1)(A) apply to a product if the possessions corporation is engaged in start-up operations with respect to that product?

A. 2: The possessions corporation must produce or manufacture the possessions product within the meaning of section 954(d)(1)(A) if the possessions corporation computes its income with respect to that product under the profit split method.

Q. 3: When will a possessions corporation be considered to be engaged in start-up operations?

A. 3: A possessions corporation is engaged in start-up operations if it begins operations in a possession with respect to a product or type of service after September 3, 1982. Subject to the further provisions of this answer, a possessions corporation will be considered to begin operations with respect to a product if, under the rules of §1.936–5(a) questions and answers (6) through (10), such product could not be grouped with any other item of property manufactured in whole or in part in the possessions by any member of the affiliated group in any preceding taxable year. Any improvement or other change in a possession product which does not substantially change the production process would not be deemed to create a new product. A change in the division of manufacturing activity between the possessions corporation and its affiliates with respect to an item of property will not give rise to a new product. If a possessions corporation was producing a possession product that was either a component product or an end-product form and the possessions corporation expands its operations in the same possession so that it is now producing a product that includes the earlier possession product, the possessions corporation will not be entitled to use the start-up significant business presence test unless the production costs incurred by the possessions corporation in the possession in producing a unit of its new possession product are at least double the production costs incurred by the possessions corporation in the possession in producing a unit of the earlier possession product. If any member of an affiliated group actually groups two or more items of property then, solely for the purposes of determining whether any item of property in that group is a new product, that grouping shall be respected. However, the fact that an affiliated group does

not actually group two or more items of property shall be disregarded in determining whether any item of property is a new product. Notwithstanding the above, if a possessions corporation is producing a possession product in one possession and such corporation or a member of its affiliated group begins operations in a different possession, regardless of whether the items of property could be grouped, the affiliated group may treat the units of the item of property produced at the new site of operations in the different possession as a new product.

(8) *Alternative significant business presence test.*

Q. 1: Will the Secretary adopt a significant business presence test other than those set forth in section 936(h)(5)(B)(ii)?

A. 1: Yes. The following significant business presence test is adopted both for the transitional period and thereafter. A possessions corporation will have a significant business presence in a possession for a taxable year with respect to a product or type of service if—

(i) No less than 50 percent of the direct labor costs of the affiliated group for units of the product produced, in whole or in part, during the taxable year by the possessions corporation or for the type of service rendered by the possessions corporation during the taxable year are incurred by the possessions corporation as compensation for services performed in the possession; and

(ii) The direct labor costs of the possessions corporation for units of the product produced or the type of service rendered plus the base period construction costs are no less than 70 percent of the sum of such base period construction costs and the direct labor costs of the affiliated group for such units of the product produced or the type of service rendered.

Notwithstanding satisfaction of the above test, for purposes of determining whether a possessions corporation may compute its income under the profit split method, a possessions corporation will not be treated as having a significant business presence in a possession with respect to a product unless the possessions corporation manufactures the product in the possession within the meaning of section 954(d)(1)(A).

Q. 2: How is the term ''base period construction costs'' defined?

A. 2: The term ''base period construction costs'' means the average construction costs incurred by or on behalf of the possessions corporation for services in the possession during the taxable year and the preceding four taxable years for section 1250 property (as defined in section 1250(c) and the regulations thereunder) that is used for the production of the product or the rendering of the service in the possession, and which represents the original use of the section 1250 property. For purposes of the preceding sentence, if the possessions corporation was not in existence during one or more of the four preceding taxable years, its construction costs for that year or years shall be deemed to be zero. Construction costs include architects' and engineers' fees, labor costs, and overhead and profit (if the construction is performed by a person that is not a member of the affiliated group).

(c) *Definition and treatment of contract manufacturing.*

Q. 1: For purposes of determining whether a possessions corporation satisfies the significant business presence test with respect to a product, the costs incurred by the possessions corporation or by any of its affiliates in connection with contract manufacturing which is related to that product and is performed outside the possession shall be treated as direct labor costs of the affiliated group and shall not be treated as production costs of the possessions corporation or as material costs. How is the term ''contract manufacturing'' to be defined?

A. 1: The term ''contract manufacturing'' includes any arrangement between a possessions corporation (or another member of the affiliated group) and an unrelated person if the unrelated person:

(1) Performs work on inventory owned by a member of the affiliated group for a fee without the passage of title;

(2) Performs production activities (including manufacturing, assembling,

finishing, or packaging) under the direct supervision and control of a member of the affiliated group; or

(3) Does not undertake any significant risk in manufacturing its product (*e.g.*, it is paid by the hour).

Q. 2: Does an arrangement between a member of the affiliated group and an unrelated party constitute contract manufacturing if the unrelated party uses an intangible owned or licensed by a member of the affiliated group?

A. 2: Such an arrangement will be treated as contract manufacturing if the unrelated party makes use of a patent owned or licensed by a member of the affiliated group in producing the product which becomes part of the possession product of the possessions corporation. In addition, such use of manufacturing intangibles other than patents may be treated as contract manufacturing if it is established that the arrangement has the effect of materially distorting the application of the significant business presence test. However, the preceding sentence shall not apply if the possessions corporation establishes that the arrangement was entered into for a substantial business purpose (e.g., to obtain the benefit of special expertise of the manufacturer or economies of scale). These rules shall not apply to such contract manufacturing performed in taxable years beginning before January 1, 1986, nor shall the rules apply to binding contracts for the performance of such contract manufacturing entered into before June 13, 1986.

Q. 3: For purposes of the significant business presence test, how shall a possessions corporation treat the cost of contract manufacturing performed within a possession?

A. 3: If the possessions corporation uses the value added test, it will be permitted to treat the cost of the contract manufacturing performed in a possession, not including material costs, as a production cost of the possessions corporation. If it uses the direct labor test or the alternative significant business presence test set forth in §1.936–5(b)(8), it is permitted to treat the direct labor costs of the contract manufacturer associated with such contract manufacturing as a cost of direct labor of the possessions corporation. The allowable amount of the direct labor cost shall be determined in accordance with question and answer 4 below.

Q. 4: How are the amounts paid by a possessions corporation to a contract manufacturer for services rendered in a possession to be treated by the possessions corporation in computing the direct labor cost of the product to which such contract manufacturing relates?

A. 4: If the possessions corporation can establish the contract manufacturer's direct labor cost which was incurred in the possession, such cost will be treated as incurred by the possessions corporation as compensation for services performed in the possession. If the possessions corporation cannot establish such cost, then 50 percent of the amount paid to such contract manufacturer may be treated as incurred by the possessions corporation as compensation for services performed in the possession: provided, that not more than 50 percent of the fair market value of the product manufactured by the contract manufacturer is attributable to articles shipped into the possession, and the possessions corporation receives a statement from the contract manufacturer that this test has been satisfied. If this fair market value test is not satisfied, then the cost of contract manufacturing performed within a possession shall not be treated as a production cost or a direct labor cost of either the possessions corporation or the affiliated group.

Q. 5: For purposes of the significant business presence test, what is the treatment of costs which are incurred by a member of the affiliated group (including the possessions corporation) for contract manufacturing performed outside of the possession with respect to an item of property which is a component of the possession product?

A. 5: If the possession product is treated as including such component, the cost of the contract manufacturing shall be treated as a direct labor cost of members of the affiliated group other than the possessions corporation for purposes of the direct labor test and the alternative significant business presence test, and shall not be treated as a production cost of the possessions corporation or as a cost of materials

for purposes of the value added test. If the possession product is treated as not including such component, the cost of the contract manufacturing shall not be treated as a direct labor cost of any member of the affiliated group for purposes of the direct labor test and the alternative significant business presence test, and shall not be treated as a production cost of the possessions corporation or as a cost of materials for purposes of the value added test.

[T.D. 8090, 51 FR 21524, June 13, 1986; 51 FR 27174, July 30, 1986]

§ 1.936–6 Intangible property income when an election out is made: Cost sharing and profit split options; covered intangibles.

The rules in this section apply for purposes of section 936(h) and also for purposes of section 934(e) where applicable.

(a) *Cost sharing option*—(1) *Product area research.*

Q. 1: Cost sharing payments are based on research undertaken by the affiliated group in the ''product area'' which includes the possession product. The term ''product area'' is defined by reference to the three-digit classification under the Standard Industrial Classification (SIC) code. Which governmental agency has jurisdiction to decide the proper SIC category for any specfic product?

A. 1: Solely for the purpose of determining the tax consequences of operating in a possession, the Secretary or his delegate has exclusive jurisdiction to decide the proper SIC category under which a product is classified. For this purpose, the product area under which a product is classified will be determined according to the 1972 edition of the SIC code. From time to time and in appropriate cases, the Secretary may prescribe regulations or issue rulings determining the proper SIC category under which a particular product is to be classified, and may prescribe regulations for aggregating two or more three-digit classifications of the SIC code and for classifying product areas according to a system other than under the SIC code.

Q. 2: How is the term ''affiliated group'' defined for purposes of the cost sharing option?

A. 2: For purposes of the cost sharing option, the term ''affiliated group'' means the possessions corporation and all other organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, within the meaning of section 482.

Q. 3: Are research and development expenditures that are included in product area research limited to research and development expenditures that are deductible under section 174 or that are incurred by U.S. affiliates?

A. 3: No, product area research is not limited to product area research expenditures deductible under section 174 or to expenses incurred by U.S. affiliates. Product area research also includes deductions permitted under section 168 with respect to research property which are not deductible under section 174; qualified research expenses within the meaning of section 30(b); payments (such as royalities) for the use of, or right to use, a patent, invention, formula, process, design, pattern or know-how; and a proper allowance for amounts incurred in the acquisition of manufacturing intangible property. In the case of an acquisition of depreciable or amortizable manufacturing intangible property, the annual amount of product area research shall be be equal to the allowable depreciation or amortization on the intangible property for the taxable year. In the case of an acquisition of nondepreciable or nonamortizable manufacturing intangible property, the amount expended for the acquisition shall be deemed to be amortized over a five year period and included in product area research in the year of the deemed amortization. Any contingent payment made with respect to the acquisition of nonamortizable manufacturing intangible property shall be treated as amounts incurred in the acquisition of nonamortizable manufacturing intangible property when paid or accrued.

Q. 4: Does royalty income from a person outside the affiliated group with respect to the manufacturing intangibles within a product area reduce the product area research pool within the same product area?

A. 4: Yes.

Q. 5: Does income received from a person outside the affiliated group from the sale of a manufacturing intangible reduce the product area research pool within the same product area?

A. 5: In determining product area research, the income from the sale attributable to noncontingent payments will reduce product area research ratably over the remaining useful life of the property in the case of an amortizable intangible and ratably over a 5-year period in the case of a nonamortizable intangible. Any income attributable to contingent amounts received with respect to the sale of manufacturing intangible property shall be treated as amounts received from the sale of the manufacturing intangible property in the year in which such contingent amounts are received or accrued.

Q. 6: If a member of an affiliated group incurs research and development expenses pursuant to a contract with an unrelated person who is entitled to exclusive ownership of all the technology resulting from the expenditures, is the amount of product area research reduced by the amount of such expenditures?

A. 6: To the extent that the product area research expenditures can be allocated solely to the technology produced for the unrelated person, such expenditures will not be included in product area research expenditures provided, however, that the unrelated person has exclusive ownership of all the technology resulting from these expenditures, and further that no member of the affiliated group has a right to use any of the technology.

Q. 7: What is the treatment of product area research expenditures attributable to a component where the component and the integrated product fall within different product areas?

A. 7: For purposes of the computation of product area research expenditures in the product area by the affiliated group, the product area in which the component falls is aggregated with the product area in which the integrated product falls. However, if the component product and integrated product are in separate SIC codes and if the component product is not included in the definition of the possession product, then the product area research expenditures are not aggregated. The same rule applies where the taxpayer elects a component product which encompasses another component product and the two component products fall into separate SIC codes. In such case, the product area in which the first component falls is aggregated with the product area in which the second component falls.

(2) *Possession sales and total sales.*

Q. 1: The cost sharing payment is the same proportion of the total cost of product area research which the amount of ''possession sales'' of the affiliated group bears to the ''total sales'' of the affiliated group within the product area. How are ''possession sales'' defined for purposes of the cost sharing fraction?

A. 1: The term ''possession sales'' means the aggregate sales or other dispositions of the possession product, to persons who are not members of the affiliated group, less returns and allowances and less indirect taxes imposed on the production of the product, for the taxable year. Except as otherwise indicated in §1.936–6(a)(2), the sales price to be used is the sales price received by the affiliated group from persons who are not members of the affiliated group.

Q. 2: For purposes of the numerator of the cost sharing fraction, how are possession sales computed where the possession product is a component product or an end-product form?

A. 2: (i) The sales price of the component product or end-product form is determined as follows. With respect to a component product, an independent sales price from comparable uncontrolled transactions must be used if such price can be determined in accordance with §1.482–2(e)(2). If an independent sales price of the component product from comparable uncontrolled transactions cannot be determined, then the sales price of the component product shall be deemed to be equal to the transfer price, determined under the appropriate section 482 method, which the possessions corporation uses under the cost sharing method in computing the income it derives from the

active conduct of a trade or business in the possession with respect to the component product. The possessions corporation in lieu of using the transfer price determined under the preceding sentence may treat the sales price for the component product as equal to the same proportion of the third party sales price of the integrated product which the production costs attributable to the component product bear to the total production cost for the integrated product. Production cost will be the sum of direct and indirect production costs as defined in §1.936–5(b)(4). If the possessions corporation determines the sales price of the component product using the production cost ratio, the transfer price used by the possessions corporation in computing its income from the component product under the cost sharing method may not be greater than such sales price.

(ii) With respect to an end-product form, the sales price of the end-product form is equal to the difference between the third party sales price of the integrated product and the independent sales price of the excluded component(s) from comparable uncontrolled transactions, if such price can be determined under §1.482–2(e)(2). If an independent sales price of the excluded component(s) from uncontrolled transactions cannot be determined, then the sales price of the end-product form shall be deemed to be equal to the transfer price, determined under the appropriate section 482 method, which the possessions corporation uses under the cost sharing method in computing the income it derives from the active conduct of a trade or business in the possession with respect to such end-product form. The possessions corporation in lieu of using the transfer price determined under the preceding sentence may use the production cost ratio method described above to determine the sales price of the end-product form (*i.e.*, the same proportion of the third party sales price of the integrated product which the production costs attributable to the end-product form bear to the total production costs for the integrated product). If the possessions corporation determines the sales price of the end-product form using the production cost ratio, the transfer price used by the possessions corporation in computing its income from the end-product form under the cost sharing method may not be greater than such sales price. For similar rules applicable to the profit split option see §1.936–6(b)(1), question and answer 12.

Q. 3: For purposes of determining possessions sales in the numerator of the cost sharing fraction, will the replacement part price of the product be treated as a price from comparable uncontrolled transactions?

A. 3: Prices for replacement parts are generally higher than prices for equipment sold as part of an original system. Thus, prices for replacement parts cannot generally be used directly as prices for comparable uncontrolled transactions. However, replacement part prices may be used for estimating comparable uncontrolled prices where the price differential can be reasonably determined and taken into account under §1.482–2(e)(2).

Q. 4: For purposes of determining possession sales in the cost sharing fraction, what is the treatment of components that are purchased by one possessions corporation from an affiliated possessions corporation and which are incorporated into a possession product where the transferor possessions corporation treats the transferred component as a possession product?

A. 4: When one possessions corporation purchases components from a second possessions corporation which is an affiliated corporation, the purchase price of the components paid to the second possessions corporation shall be subtracted from the sales proceeds of the product produced in the possession by the first possessions corporation, and only the remainder is included in the numerator of the cost sharing formula for the first corporation. For example, assume that N corporation manufactures a component for sale to O corporation for $100 (a price which reflects prices in comparable uncontrolled transactions). Both N and O are affiliated possessions corporations. N has designated that component product as its possession product. O then incorporates that product into a second product which is sold to customers for

$300 N and O must make separate cost sharing payments. The cost sharing payment of N corporation is determined by including $100 as possession sales, and the payment of O is determined by subtracting that $100 purchase price from the $300 received from customers. Thus, the possessions sales amount of O is $200. This rule is intended to prevent the double counting of the sales of a component produced by one possessions corporation and incorporated into another product by an affiliated possessions corporation.

Q. 5: Are pre-TEFRA sales included in the cost sharing fraction?

A. 5: No. Pre-TEFRA sales are sales of products produced by the possessions corporation and transferred to an affiliate prior to a possessions corporation's first taxable year beginning after December 31, 1982. Pre-TEFRA sales are not included in either the numerator or denominator of the cost sharing fraction. If the U.S. affiliate uses the FIFO method of costing inventory, the pre-TEFRA inventory will be treated as the first inventory sold by the U.S. affiliate during the first year in which section 936(h) applies. If the U.S. affiliate uses the LIFO method of costing inventory (either dollar-value or specific goods LIFO), pre-TEFRA inventor will be treated as inventory sold by the U.S. affiliate in the year in which the U.S. afiliate's LIFO layer containing pre-TEFRA LIFO inventory is liquidated.

Q. 6: How are ''possession sales'' determined under the cost sharing formula if members of the affiliated group (other than the possessions corporation) include purchases of the possession product, X, in a dollar-value LIFO inventory pool (as provided under §1.472–8)?

A. 6: Possession sales may be determined by applying the revenue identification method provided under paragraph (b)(1) Question and Answer 18 of this section.

Q. 7: Do possession sales include excise taxes paid by the possessions corporation when the product is sold for ultimate use or consumption in the possession?

A. 7: No. The amount of excise taxes is excluded from both the numerator and denominator of the cost sharing fraction.

Q. 8: How are ''total sales'' defined for purposes of the cost sharing fraction?

A. 8: The term ''total sales'' means aggregate sales or other dispositions of products in the same product area as the possession product, less returns and allowances and less indirect taxes imposed on the production of the product, for the taxable year to persons who are not members of the affiliated group. The sales price to be used is the sales price received by the affiliated group from persons who are not members of the affiliated group.

Q. 9: In computing that cost sharing payment, how are ''total sales'' computed if the dollar-value LIFO inventory pool includes some products which are not included in the product area (determined under the 3-digit SIC code) on which the denominator of the cost sharing fraction is based?

A. 9: In such case, the amount of the total sales within the product area to persons who are not members of the affiliated group by persons who are members of the affiliated group is determined by multiplying the total sales of the products within the dollar-value LIFO inventory pool by a fraction. The numerator of the fraction includes the dollar-value of purchases by members of the affiliated group (including the possessions corporation) of products within the product area made during the year, plus any added production costs (as defined in §1.471–11(b), (c), and (d) but not including the costs of materials) incurred by the affiliates during the same period. The denominator of the fraction includes the dollar-value of purchases by members of the affiliated group (including the possessions corporation) of products within the dollar-value LIFO inventory pool made during the same period (including any production costs, as described above, incurred by the affiliate during the same period). For these purposes, purchases of a possession product are determined on the basis of the possessions corporation's cost for its inventory purposes.

Q. 10: May a possessions corporation compute its income under the cost

sharing method with respect to a possession product which the possessions corporation sells to a member of its affiliated group and which that member then leases to an unrelated person or uses in its own trade or business?

A. 10: Yes, provided that an independent sales price for the possession product from comparable uncontrolled transactions can be determined in accordance with §1.482–2(e)(2), and, provided further, that such member complies with the requirements of §1.936–6(a)(2), question and answer 14. If, however, there is a comparable uncontrolled price for an integrated product and the possession product is a component product or end-product form thereof, the possessions corporation may, if such member complies with the requirements of §1.936–6(a)(2), question and answer 14, compute its income under the cost sharing method with respect to such possession product. In that case, the cost sharing payment shall be computed under the following question and answer.

Q. 11: How are possession sales and total sales to be determined for purposes of computing the cost sharing payment with respect to a possession product which the possessions corporation sells to a member of its affiliated group where that member then leases the possession product to unrelated persons or uses it in its own trade or business?

A. 11: If the possessions corporation is entitled to compute its income from such sales of the possession product under the cost sharing method, both possession sales and total sales shall be determined as if the possession product had been sold by the affiliate to an unrelated person at the time the possession product was first leased or otherwise placed in service by the affiliate. The sales price on such deemed sale shall be equal to the independent sales price from comparable uncontrolled transactions determined in accordance with §1.482–2(e)(2), if any. If the possession product is a component product or an end-product form for which there is no such independent sales price but there is a comparable uncontrolled price for the integrated product which includes the possession product, the deemed sales price of the possession product shall be computed under the rules of §1.936–6(a)(2) question and answer 2. The full amount of income received under the lease shall be treated as income of (and taxed to) the affiliate and not the possessions corporation.

Q. 12: When may a possessions corporation take into account in computing total sales under the cost sharing method products in the same product area as the possession product (other than the possession product itself) where such products are leased by members of the affiliated group to unrelated persons or used by any such member in its own trade or business?

A. 12: For purposes of computing total sales under the cost sharing method, the possessions corporation may take into account products in the same product area as the possession product itself where such products are leased by members of the affiliated group to unrelated persons or used in the trade or business of any such member, but only if an independent sales price of such products from comparable uncontrolled transactions may be determined under §1.482–2(e)(2). In such cases, the units of such products which are leased or otherwise used internally by members of the affiliated group may be treated as sold to unrelated persons for such independent sales price for purposes of computing total sales.

Q. 13: Assuming that a possessions corporation is entitled to compute its income under the cost sharing method with respect to sales of a possession product to affiliates in cases where those affiliates lease units of the possession product to unrelated persons or use them internally, is the possessions corporation's income from the possession product any different than if the affiliates had sold the product to unrelated parties?

A. 13: No.

Q. 14: If a possessions corporation sells units of a possession product to a member of its affiliated group and that affiliate then leases those units to an unrelated person or uses the units in its own trade or business, what requirements must the affilate meet in order for the possessions corporation to be entitled to the benefits of the cost sharing method with respect to such units?

A. 14: (i) For taxable years of the possessions corporation beginning on or before June 13, 1986, the affiliate need not meet any special requirements in order for the possessions corporation to be entitled to the beneifts of the cost sharing method with respect to such units. Thus, the affiliate's basis in such units shall be equal to the transfer price used for computing the possessions corporation's gross income with respect to such units under section 936(h)(5)(C)(i)(II), and the income derived by the affiliate from such lease or internal use shall be reported by the affiliate when and to the extent actually derived. The affiliate shall not be deemed to have sold such units to an unrelated party at the time they were first leased or otherwise placed in service for any purpose other than the computation of possession sales and total sales. A similar rule applies to other products in the same product area as the possession product which are sold by any member in its own trade or business and which the possessions corporation takes into account in computing total sales under the cost sharing method.

(ii) For taxable years of the possessions corporations beginning after June 13, 1986, a possessions corporations will not be entitled to the benefits of the cost sharing method with respect to units of the possession product which the possessions corporation sells to an affiliate where the affiliate then leases such units to an unrelated person or uses them in its own trade or business, unless the affiliate agrees to be treated for all tax purposes as having sold such units to an unrelated party at the time they were first leased or otherwise placed in service by such affiliate. The affiliate must demonstrate such agreement by reporting its income from such units as if:

(A) It had sold such units to an unrelated person at such time at a price equal to the price used to compute possessions sales under §1.936–6(a)(2), question and answer 11;

(B) It had immediately repurchased such units for the same price; and

(C) Its basis in such units for all subsequent purposes was equal to its cost basis from such deemed repurchase.

For treatment of other products in the same product area as the possession product see §1.936–6(a)(2), question and answer 12.

(iii) The principles contained in questions and answers 11, 12, 13, and 14 are illustrated by the following example:

Example. Possessions corporation S and its affiliate A are calendar year taxpayers. In 1985, S manufactures 100 units of possession product X. S sells 50 units of X to unrelated persons in arm's length transactions for $10 per unit. In applying the cost sharing method to determine the portion of its gross income from such sales which qualifies for the possessions tax credit, S determines that $8 of the $10 sales price may be taken into account. S sells the remaining 50 units of X to A, and A then leases such units to unrelated persons. In 1985, A also manufacturers 100 units of product Y, the only other product in the same product area as X manufactured or sold by any member of the affiliated group. A manufactured the 100 units of Y at a cost of $15 per unit, sold 50 units of Y to unrelated persons in arm's length transactions for $20 per unit, and leased the remaining 50 units of Y to unrelated persons.

S may compute its income under the cost sharing method with respect to the 50 units of X it sold to A because S can determine an independent sales price of X from comparable uncontrolled transactions under §1.482–2(e)(2). For purposes of computing both possessions sales and total sales, the 50 units of X sold to A will be deemed to have been sold by A to an unrelated person for $10 per unit. The income of S qualifying for the possessions tax credit from the sale of those 50 units of X to A, and A's basis in those units, will both be determined using the $8 transfer price determined under section 936(h)(5)(C)(i)(II). For purposes of computing total sales in the denominator of the cost sharing fraction, S may also take into account the 50 units of Y leased by A to unrelated persons, as if A had sold those units for $20 per unit. A's basis in those units of Y will continue to be its actual cost basis of $15 per unit.

If all of the above transactions had occurred in 1987, S would be entitled to compute its income under the cost sharing method with respect to the 50 units of X it sold to A only if A agreed to be treated for all tax purposes as if it had sold such units for $10 per unit, realized income on such deemed sale of $2 per unit, repurchased such units immediately for $10 per unit, and then leased such units, which would then have a $10 per unit basis in A's hands. For purposes of computing total sales, S would be entitled to take into account the 50 units of X leased by A to unrelated persons as if A had sold such units for $20 per unit.

(3) *Credits against cost sharing payments.*

Q. 1: Is the cost of product area research paid or accrued by the possessions corporation in a taxable year creditable against the cost sharing payment?

A. 1: Yes, if the cost of the product area research is paid or accrued solely by the possessions corporation. Thus, payments by the possessions corporation under cost sharing arrangements with, or royalties paid to, unrelated persons are so creditable. Amounts (such as royalties) paid directly or indirectly to, or on behalf of, related persons and amounts paid under any cost sharing agreements with related persons are not creditable against the cost sharing payment.

Q. 2: Do royalties or other payments made by an affiliate of the possessions corporation to another member of the affiliated group reduce the cost sharing payment if such royalties or other payments are based, in part, on activity of the possessions corporation?

A. 2: No. Payments made between affiliated corporations do not reduce the cost sharing payment. Thus, for example, if a possessions corporation sells a component to a foreign affiliate for incorporation by the foreign affiliate into an integrated product sold to unrelated persons, and the foreign affiliate pays a royalty to the U.S. parent of the possessions corporation based on the total value of the integrated product, the cost sharing payment of the possessions corporation is not reduced.

(4) *Computation of cost sharing payment.*

Q. 1: S is a possessions corporation engaged in the manufacture and sale of four products (A, B, C, and D) all of which are classified under the same three-digit SIC code. S sells its production to a U.S. affiliate, P, which resells it to unrelated parties in the United States. P's third party sales of each of these products produced in whole or in part by S (computed as provided under paragraph (a)(2) of §1.936–6) are $1 million or a total of $4 million for A, B, C, and D. P's other sales of products in the same SIC code are $3,000,000; and the defined worldwide product area research of the affiliated group is $350,000. How should S compute the cost sharing amount for products A, B, C, and D?

A. 1: The cost sharing amount is computed separately for each product on Schedule P of Form 5735. S should use the following formula for each of the products A, B, C, and D:

$$\frac{\text{Sales to unrelated persons of possession product}}{\text{Total sales of products in SIC code}} \times \text{Worldwide product area research}$$

$$\frac{\$1{,}000{,}000}{\$7{,}000{,}000} \times \$350{,}000 = \$50{,}000$$

Q. 2: The facts are the same as in question 1 except that S manufactures product D under a license from an unrelated person. S pays the unrelated party an annual license fee of $20,000. Thus, the worldwide product area research expense of the affiliated group is $370,000. How should the cost sharing payment be adjusted?

A. 2: The cost sharing fee should be reduced by the $20,000 license fee made as a direct annual payment to a third party on account of product D. The cost sharing payment with respect to product D in this example will be adjusted as follows:

$$\frac{\text{Sales to unrelated persons of possession product}}{\text{Total sales of products in SIC code}} \times \text{Worldwide product area research} - \text{Amount paid by the possessions corporation to an unrelated party}$$

$$\left(\frac{1{,}000{,}000}{\$7{,}000{,}000} \times \$370{,}000\right) - \$20{,}000 = \$32{,}857$$

Q. 3: The facts are the same as in question 1 except that S also manufactures and exports product E to a foreign affiliate, which resells it to unrelated persons for $1 million. S makes a separate election for its export sales. How should S compute the cost sharing amount for product E?

A. 3: The numerator of the cost sharing fraction is the aggregate sales or other dispositions by members of the affiliated group of the units of product E produced in whole or in part in the possession to persons who are not members of the affiliated group. The cost sharing amount for product E would be computed as follows:

$$\frac{\text{Export sales of E}}{\text{Total sales of products in SIC code (In this example, U. S. Sales of A, B, C, and D + export sales of E)}} \times \text{Worldwide product area research}$$

or

$$\frac{\$1{,}000{,}000}{(\$7{,}000{,}000 + \$1{,}000{,}000)} \times \$350{,}000 = \$43{,}750$$

Q. 4: The facts are the same as in question 1, except that S also receives $10,000 in royalty income from unrelated persons for the licensing of certain manufacturing intangible property rights. What is the amount of the product area research that must be allocated in determining the cost sharing amount?

A. 4: If the affiliated group receives royalty income from unrelated persons with respect to manufacturing intangibles in the same product area, then the product area research to be considered shall be first reduced by such royalty income. In this case, the amount of product area research to be used in determining S's cost sharing payment should be reduced by the $10,000 royalty payment received to $340,000.

Q. 5: May a possessions corporation redetermine the amount of its required cost sharing payment after filing its tax return?

A. 5: If after filing its tax return, a possessions corporation files an amended return, or if an adjustment is made on audit, either of which affects the amount of the cost sharing payment required, then a redetermination of the cost sharing payment must be made. See, however, section 936(h)(5)(C)(i)(III)(*a*) with respect to the increase in the cost sharing payment due to interest imposed under section 6601(a).

(5) *Effect of election under the cost sharing method.*

Q. 1: What is the effect of the cost sharing method?

A. 1: The cost sharing payment reduces the amount of deductions (and the amount of reductions in earnings and profits) otherwise allowable to the U.S. affiliates (other than tax-exempt affiliates) within the affiliated group as determined under section 936(h)(5)(C)(i)(I)(*b*) which have incurred research expenditures (as defined in §1.936–6(a)(1), question and answer (3) in the same product area for which the cost sharing option is elected, during the taxable year in which the cost sharing payment accrues. If there are no such U.S. affiliates, the reductions with respect to deductions and earnings and profits, as the case may be, are made with respect to foreign affiliates within the same affiliated group which have incurred product area research expenditures in such product area attributable to a U.S. trade or business. If there are no affiliates which have incurred research expenditures in such product area, the reductions are then made with respect to any other U.S. affiliate and, if there is no such U.S. affiliate, then to any other foreign affiliate. The allocations of these reductions in each case shall be made in proportion to the gross income of the affiliates. In the case of foreign affiliates, the allocation shall be made in proportion to gross income attributable to the U.S. trade or business or worldwide gross income, as the case may be. With respect to each group above, the reduction of deductions shall be applied first to deductions under section 174, then to deductions under section 162, and finally to any other deductions on a pro rata basis.

Q. 2: For purposes of estimated tax payments, when is the cost sharing amount deemed to accrue?

A. 2: The cost sharing amount is deemed to accrue to the appropriate affiliate on the last day of the taxable year of each such affiliate in which or with which the taxable year of the possessions corporation ends.

Q. 3: If the cost sharing method is elected and the year of accrual of the cost sharing payment to the appropriate affiliate (described in question and answer 1 of this paragraph (a)(5)) differs from the year of actual payment by the possessions corporation, in what year are the deductions of the recipients reduced?

A. 3: In the year the cost sharing payment has accrued.

Q. 4: What is the treatment of income from intangibles under the cost sharing method?

A. 4: Under the cost sharing method, a possessions corporation is treated as the owner, for purposes of obtaining a return thereon, of manufacturing intangibles related to a possession product. The term ''manufacturing intangible'' means any patent, invention, formula, process, design, pattern, or know-how. The possessions corporation will not be treated as the owner, for purposes of obtaining a return thereon, of any manufacturing intangibles related to a component product produced by an affiliated corporation and transferred to the possessions corporation for incorporation into the possession product, except in the case that the possession product is treated as including such component product for all purposes of section 936(h)(5). Further, the possessions corporation will not be treated as the owner, for purposes of obtaining a return thereon, of any marketing intangibles except ''covered intangibles.'' (See §1.936–6(c).)

Q. 5: If the cost sharing option is elected, is it necessary for the possessions corporation to be the legal owner of the manufacturing intangibles related to the possession product in order for the possessions corporation to receive a full return with respect to such intangibles?

A. 5: No. There is no requirement that manufacturing intangibles be owned by the possessions corporation.

Q. 6: How is income attributable to marketing intangibles treated under the cost sharing method?

A. 6: Except in the case of ''covered intangibles'' (see §1.936–6(c)), the possessions corporation is not treated as the owner of any marketing intangibles, and income attributable to marketing intangible of the possessions corporation will be allocated to the possessions corporation's U.S. shareholders with the proration of income based on shareholdings. If a shareholder of the possessions corporation is a foreign, person or is otherwise tax exempt, the possessions corporation is

taxable on that shareholder's pro rata amount of the intangible property income. If the possessions corporation is a corporation any class of the stock of which is regularly traded on an established securities market, then the income attributable to marketing intangibles will be taxable to the possessions corporation rather than the corporation's U.S. shareholders.

Q. 7: What is the source of the intangible property income described in question and answer 6?

A. 7: The intangible property income is U.S. source whether taxed to the U.S. shareholder or taxed to the possessions corporation and section 863 (b) does not apply for this purpose. However, such intangible property income, if treated as income of the possessions corporation, does not enter into the calculation of the 80-percent possession source test or the 65-percent active trade or business test.

Q.7a: What is the source of the taxpayer's gross income derived from a sale in the United States of a possession product purchased by the taxpayer (or an affiliate) from a corporation that has an election in effect under section 936, if the income from such sale is taken into account to determine benefits under cost sharing for the section 936 corporation? Is the result different if the taxpayer (or an affiliate) derives gross income from a sale in the United States of an integrated product incorporating a possession product purchased by the taxpayer (or an affiliate) from the section 936 corporation, if the taxpayer (or an affiliate) processes the possession product or an excluded component in the United States?

A.7a: Under either scenario, the income is U.S. source, without regard to whether the possession product is a component, end-product, or integrated product. Section 863 does not apply in determining the source of the taxpayer's income. This Q&A 7a is applicable for taxable years beginning on or after November 13, 1998.

Q. 8: May marketing intangible income, if any, be allocated to the possessions corporation with respect to custom-made products?

A. 8: No. If the cost sharing option is elected, then income attributable to marketing intangibles (other than ''covered intangibles'' described in §1.936–6(c)) will be taxed as discussed in questions and answers 6 and 7 of paragraph (a)(5) of this section. It is immaterial whether the product is custom-made.

Q. 9: In order to sell a pharmaceutical product in the United States, a New Drug Application (''NDA'') for the product must be approved by the U.S. Food and Drug Administration. Is an NDA considered a manufacturing or marketing intangible for purposes of the allocation of income under the cost sharing method?

A. 9: A manufacturing intangible.

Q. 10: Can a copyright be, in whole or in part, a manufacturing intangible for purposes of the allocation of income under the cost sharing method?

A. 10: In general, a copyright is a marketing intangible. See section 936(h)(3)(B)(ii). However, copyrights may be treated either as manufacturing intangibles or nonmanufacturing intangibles (or as partly each) depending upon the function or the use of the copyright. If the copyright is used in manufacturing, it will be treated as a manufacturing intangible; but if it is used in marketing, even if it is also classified as know-how, it will be treated as a marketing intangible.

Q. 11: If the cost sharing option is elected and a patent is related to the product produced by the possessions corporation, does the return to the possessions corporation with respect to the manufacturing intangible include the make, use, and sell elements of the patent?

A. 11: Yes. A patent confers an exclusive right for 17 years to sell a product covered by the patent. During this period, the return to the possessions corporation includes the make, use and sell elements of the patent.

Q. 12: For purposes of the cost sharing option, may a safe haven rule be applied to determine the amount of marketing intangible income?

A. 12: No. The amount of marketing intangible income is determined on the basis of all relevant facts and circumstances. The section 482 regulations will continue to apply except to the extent modified by the election. Rev. Proc. 63–10 and Rev. Proc. 68–22 do not apply for this purpose.

Q. 13: If a product covered by the cost sharing election is sold by a possessions corporation to an affiliated corporation for resale to an unrelated party, may the resale price method under section 482 be used to determine the intercompany price of the possessions corporation?

A. 13: In general, the resale price method may be used if (a) no comparable uncontrolled price for the product exists, and (b) the affiliated corporation does not add a substantial amount of value to the product by manufacturing or by the provision of services which are reflected in the sales price of the product to the customer. The possessions corporation will not be denied use of the resale price method for purposes of such inter-company pricing merely because the reseller adds more than an insubstantial amount to the value of the product by the use of intangible property.

Q. 14: If a possessions corporation makes the cost sharing election and uses the cost-plus method under section 482 to determine the arm's-length price of a possession product, will the cost base include the cost of materials which are subject to processing or which are components in the possession product?

A. 14: A taxpayer may include the cost of materials in the cost base if it is appropriate under the regulations under §1.482–2(e)(4).

Q. 15: If the possessions corporation computes its income with respect to a product under the cost sharing method, and the price of the product is determined under the cost-plus method under section 482, does the cost base used in computing cost-plus under section 482 include the amount of the cost sharing payment?

A. 15: The amount of the cost sharing payment is included in the cost base. However, no profit with respect to the cost sharing payment will be allowed.

Q. 16: If a member of the affiliated group transfers to a possessions corporation a component which is incorporated into a possession product, how will the transfer price for the component be determined?

A. 16: The transfer price for the component will be determined under section 482, and as follows. If the possession product is treated as not including such component for purposes of section 936(h)(5), the transfer price paid for the component will include a return on all intangibles related to the component product. If the possession product is treated as including such component for purposes of section 936(h)(5), then the transfer price paid for the component by the possessions corporation will not include a return on any manufacturing intangible related to the component product, and the possessions corporation will obtain the return on the manufacturing intangibles associated with the component.

Q. 17: If the possessions corporation computes its income with respect to a product under the cost sharing method, with respect to which units of the product shall the possessions corporation be treated as owning intangible property as a result of having made the cost sharing election?

A. 17: The possessions corporation shall not be treated as owning intangible property, as a result of having made the cost sharing election, with respect to any units of a possession product which were not taken into account by the possessions corporation in applying the significant business presence test for the current taxable year or for any prior taxable year in which the possessions corporation also had a significant business presence in the possession with respect to such product.

(b) *Profit split option*—(1) *Computation of combined taxable income.*

Q. 1: In determining combined taxable income from sales of a possession product, how are the allocations and apportionments of expenses, losses, and other deductions to be determined?

A. 1: (i) Expenses, losses, and other deductions are to be allocated and apportioned on a ''fully-loaded'' basis under §1.861–8 to the combined gross income of the possessions corporation and other members of the affiliated group (other than foreign affiliates). For purposes of the profit split option, the term ''affiliated group'' is defined the same as under §1.936–6 (a)(1) question and answer 2. The amount of research, development, and experimental expenses allocated and apportioned to

combined gross income is to be determined under §1.861–8(e)(3). The amount of research, development and experimental expenses and related deductions (such as royalties paid or accrued with respect to manufacturing intangibles by the possessions corporation or other domestic members of the affiliated group to unrelated persons or to foreign affiliates) allocated and apportioned to combined gross income shall in no event be less than the amount of the cost sharing payment that would have been required under the rules set forth in section 936(h)(5)(C)(i)(II) and paragraph (a) of this section if the cost sharing option had been elected. Other expenses which are subject to §1.861–8(e) are to be allocated and apportioned in accordance with that section. For example, interest expense (including payments made with respect to bonds issued by the Puerto Rican Industrial, Medical and Environmental Control Facilities Authority (AFICA)) is to be allocated and apportioned under §1.861–8(e)(2). With the exception of marketing and distribution expenses discussed below, the other remaining expenses which are definitely related to a class of gross income shall be allocated to that class of gross income and shall be apportioned on the basis of any reasonable method, as described in §1.861–8 (b)(3) and (c)(1). Examples of such methods may include, but are not limited to, those specified in §1.861–8(c)(1)(i) through (vi).

(ii) The class of gross income to which marketing and distribution expenses relate and shall be allocated is generally to be defined by the same ''product area'' as is determined for the relevant research, development, and experimental expenses (*i.e.*, the appropriate 3-digit SIC code), but shall include only gross income generated or reasonably expected to be generated from the geographic area or areas to which the expenses relate. It shall be presumed that marketing and distribution expenses relate to all product sales within the same product area. If, however, it can be established that any of these expenses are separately identifiable expenses, such as advertising, and relate, directly or indirectly, solely to a specific product or a specific group of products, such expenses shall be allocated to the class of gross income defined by the specific product or group of products. Thus, advertising and other separately identifiable marketing expenses which relate specifically and exclusively to a particular product must be allocated entirely to the gross income from that product, even though the taxpayer or other members of an affiliated group which includes the taxpayer produce and market other products in the same 3-digit SIC code classification. The mere display of a company logo or mention of a company name solely in the context of identifying the manufacturer shall not prevent an advertisement from relating specifically and exclusively to a particular product or group of products.

(iii) If marketing and distribution expenses are allocated to a class of gross income which consists both of income from sales of possession products (the statutory grouping) and other income such as from sale by U.S. affiliates of products not produced in the possession (the residual grouping), then these marketing and distribution expenses shall be apportioned on a ''fully loaded'' basis which reflects, to a reasonably close extent, the factual relationship between these deductions and the statutory and residual groupings of gross income. Apportionment methods based upon comparisons of amounts incurred before ultimate sale of a product (including apportionment on a comparison of costs of goods sold, other expenses incurred, or other comparisons set forth in §1.861–8 (c)(1)(v), such as time spent) are not on a ''fully-loaded'' basis and do not reflect this required factual relationship. These deductions shall be apportioned on a basis of comparison of the amount of gross sales or receipts or another method if it is established that such method similarly reflects the required factual relationship. Thus, for example, a comparison of units sold may be used only where the units are of the same or similar value and are, thus, in fact comparable.

(iv) The rules for allocation and apportionment of marketing and distribution expenses may be illustrated by the following examples:

Example 1. Assume that possessions corporation A manufacturers prescription pharmaceutical product #1 for resale by P, its U.S. parent corporation, in the United States. Additionally, assume that P manufactures prescription pharmaceutical products #2 and #3 in the United States for sale there. Further, assume that all three products are within the same product area, and that marketing and distribution expenses are internally divided by P among the three products on the basis of time spent by sales persons of P on marketing of the three products, as follows:

Product #1	50X
Product #2	80X
Product #3	110X
Total	240X

These expenses of 240X are allocated to gross income generated by all three products and shall be apportioned on the basis of gross sales or receipts of product #1 as compared to products #2 and #3 or another method which similarly reflects the factual relationship between these expenses and gross income derived from product #1 and products #2 and #3. Thus, if a sales method were used and sales of product #1 accounted for one-third of sales receipts from the three products, 80X (240 ÷ 3) of marketing and distribution expenses would be apportioned to the combined gross income from product #1.

Example 2. Corporation B produces and sells Brand W whiskey, in the United States. B's subsidiary, S, which is a possessions corporation, produces soft drink extract in Puerto Rico which it sells to independent bottlers to produce Brand S soft drinks for sale in the United States. Corporation B's advertisements and other promotional materials for Brand W whiskey make no reference to Brand S soft drinks (or any other Corporation B products), and Brand S soft drink advertisements and other promotional materials make no reference to Brand W whiskey (or any other corporation B products). For purposes of section 936(h), the advertising and other promotional expenses for Brand W whiskey must be allocated entirely to the gross income from sales of Brand W whiskey and the advertising and other promotional expenses for Brand S soft drink must be allocated entirely to the gross income from the sales of soft drink extract, notwithstanding the fact that whiskey and soft drink extract are both included in SIC code 208. A similar result would apply, for example, to separately identifiable advertising and other marketing expenses which relate specifically and exclusively to one or the other of the following pairs of products: chewing gum and granulated sugar (SIC code 206); canned tuna fish and freeze-dried coffee (SIC code 209); children's underwear and ladies' brassieres (SIC code 234); aspirin tablets and prescription antibiotic tablets (SIC code 283); floor wax and perfume (SIC code 284); adhesives and inks (SIC code 289); semi-conductors and cathode-ray tubes (SIC code 367); batteries and extension cords (SIC code 369); bandages and dental supplies (SIC code 384); stainless steel flatware and jewelry parts (SIC code 391); children's toys and sporting goods (SIC code 394); hair curlers and zippers (SIC code 396); and paint brushes and linoleum tiles (SIC code 399).

Example 3. Assume the same facts as in Example 1 and that possessions corporation A also manufactures aspirin, a non-prescription product, for resale by its U.S. parent corporation, P. Further, assume that the advertising and separately identifiable marketing expenses which relate specifically and exclusively to aspirin sales total $100 and that these expenses are allocable solely to gross income derived from aspirin sales. The sales method continues to be used to apportion the marketing and distribution expenses related, directly or indirectly, to products #1, #2, and #3, and the apportionment of such expenses to product #1 for purposes of determining combined taxable income from product #1 will remain as stated in Example 1. None of the advertising and other separately identifiable marketing expenses which relate specifically and exclusively to aspirin will be taken into account in allocating and apportioning the marketing and distribution expenses relating to the gross income attributable to products #1, #2, and #3. Gross income attributable to aspirin will be considered as a separate class of gross income, and all the advertising and separately identifiable marketing expenses which relate specifically and exclusively to aspirin sales of $100 will be allocated to the class of gross income derived from aspirin sales. Similarly, none of the marketing and distribution expenses, directly or indirectly, related solely to the group of products #1, #2, and #3 will be taken into account in determining the combined taxable income from aspirin sales. the remaining marketing and distribution expenses which do not, directly or indirectly, relate solely to any specific product or group of products (*e.g.*, the salaries of a Vice-President of Marketing who has responsibility for marketing all products and his staff) shall be allocated and apportioned on the basis of the gross receipts from the sales of all of the products (or a similar method) in determining combined taxable income of any product.

Q. 2: How may the allocation and apportionment of expenses to combined gross income be verified?

A. 2: Substantiation of the allocation and apportionment of expenses will be required upon audit of the possessions corporation and affiliates. Detailed

substantiation may be necessary, particularly where the entities are engaged in multiple lines of business involving distinct product areas. Sources of substantiation may include certified financial reports. Form 10–K's, annual reports, internal production reports, product line assembly work papers, and other relevant materials. In this regard, *see* §1.861–8(f)(5).

Q. 3: Does section 936(h) override the moratorium provided by section 223 of the Economic Recovery Tax Act of 1981 and any subsequent similar moratorium?

A. 3: Yes. Thus, the allocation and apportionment of product area research described in question and answer 1 must be made without regard to the moratorium.

Q. 4: Is the cost of samples treated as a marketing expense?

A. 4: Yes. The cost of producing samples will be treated as a marketing expense and not as inventoriable costs for purposes of determining combined taxable income (and compliance with the significant business presence test). However, for taxable years beginning prior to January 1, 1986, the cost of producing samples may be treated as either a marketing expense or as inventoriable costs.

Q. 5: If a possessions corporation uses the profit split method to determine its taxable income from sales of a product, how does it determine its gross income for purposes of the 80-percent possession source test and the 65-percent active trade or business test of section 936(a)(2)?

A. 5: One-half of the deductions of the affiliated group (other than foreign affiliates) which are used in determining the combined taxable income from sales of the product are added to the portion of the combined taxable income allocated to the possessions corporation in order to determine the possessions corporation's gross income from sales of such product.

Q. 6: How will income from intangibles related to a possession product be treated under the profit split method?

A. 6: Combined taxable income of the possessions corporation and affiliates from the sale of the possession product will include income attributable to all intangibles, including both manufacturing and marketing intangibles, associated with the product.

Q. 7: Can a possessions corporation apply the profit split option to a possession product if no U.S. affiliates derive income from the sale of the possession product?

A. 7: Yes.

Q. 8: With respect to the factual situation discussed in question and answer 7 how is combined taxable income computed?

A. 8: The profit split option is applied to the taxable income of the possessions corporation from sales of the possession product to foreign affiliates and unrelated persons. Fifty percent of that income is allocated to the possessions corporation, and the remainder is allocated to the appropriate affiliates as described in question and answer 13 of this paragraph (b)(1).

Q. 9: May a possessions corporation compute its income under the profit split method with respect to units of a possession product which it sells to a U.S. affiliate if the U.S. affiliate leases such units to unrelated persons or to foreign affiliates or uses such units in its own trade or business?

A. 9: Yes, provided that an independent sales price for the possession product from comparable uncontrolled transactions can be determined in accordance with §1.482–2 (e)(2). If, however, there is a comparable uncontrolled price for an integrated product and the possession product is a component product or end-product form thereof, the possessions corporation may compute its income under the profit split method with respect to such units. In either case, the possessions corporation shall compute combined taxable income with respect to such units under the following question and answer.

Q. 10: If the possessions corporation is entitled to use the profit split method in the situation described in *Q. 9* (leasing units of the possession product or use of such units in the taxpayer's own trade or business), how should it compute combined taxable income with respect to such units?

A. 10: (i) Combined taxable income shall be computed as if the U.S. affiliate had sold the units to an unrelated person (or to a foreign affiliate) at the

time the units were first leased or otherwise placed in service by the U.S. affiliate. The sales price on such deemed sale shall be equal to the independent sales price from comparable uncontrolled transactions determined in accordance with §1.482–2(e)(2), if any.

(ii) If the possession product is a component product or an end-product form, the combined taxable income with respect to the possession product shall be determined under *Q&A. 12* of this paragraph (b)(1).

(iii) For purposes of determining the basis of a component product or an end-product form, the deemed sales price of such product must be determined. The deemed sales price of the component product shall be determined by multiplying the deemed sales price of the integrated product that includes the component product by a ratio, the numerator of which is the production costs of the component product and the denominator of which is the production costs of the integrated product that includes the component product. The deemed sales price of an end-product form shall be determined by multiplying the deemed sales price of the integrated product that includes the end-product form by a ratio, the numerator of which is the production costs of the end-product form and the denominator of which is the production costs of the integrated product that includes the end-product form. For the definition of production costs, see *Q&A. 12* of this paragraph (b)(1).

(iv)(A) If combined taxable income is determined under paragraph (v) of *A. 12* of this paragraph (b)(1), in the case of a component product, the deemed sales price shall be determined by using the actual sales price of that product when sold as an integrated product (as adjusted under the rules of the fourth sentence of §1.482–3(b)(2)(ii)(A)).

(B) If combined taxable income is determined under paragraph (v) of *A. 12* of this paragraph (b)(1), in the case of an end-product form, the deemed sales price shall be determined by subtracting from the deemed sales price of the integrated product that includes the end-product form (e.g., the leased property) the actual sales price of the excluded component when sold as an integrated product to an unrelated person (as adjusted under the rules of the fourth sentence of §1.482–3(b)(2)(ii)(A)).

(v) The full amount of income received under the lease shall be treated as income of (and be taxed to) the U.S. affiliate and not the possessions corporation.

Q. 11: In the situation described in question 9, how does the U.S. affiliate determine its basis in such units for purposes of computing depreciation and similar items?

A. 11: The U.S. affiliate shall be treated, for purposes of computing its basis in such units, as if it had repurchased such units immediately following the deemed sale and at the deemed sales price as provided in *Q&A. 10* of this paragraph (b)(1).

The principles of questions and answers 10 and 11 are illustrated by the following example:

Example: Possessions corporation S manufactures 100 units of possession product X. S sells 50 units of X to an unrelated person in an arm's length transaction for $10 per unit. S sells the remaining 50 units to its U.S. affiliate, A, which leases such units to unrelated persons. The combined taxable income for the 100 units of X is computed below on the basis of the given production, sales, and cost data:

Sales:	
1. Total sales by S to unrelated persons (50 × $10)	$500
2. Total deemed sales by A to unrelated persons (50 × $10)	500
3. Total gross receipts (line 1 plus line 2)	1,000
Total costs:	
4. Material costs	200
5. Production costs	300
6. Research expenses	0
7. Other expenses	100
8. Total (add lines 4 through 7)	600
Combined taxable income attributable to the 100 units of X:	
9. Combined taxable income (line 3 minus line 8)	400
10. Share of combined taxable income apportioned to S (50% of line 9)	200
11. Share of combined taxable income apportioned to A (line 9 minus line 10)	200
A's basis in 50 units of X leased by it to unrelated persons:	
12. 50 units times $10 deemed repurchase price	500

Subsequent leasing income is entirely taxed to A.

Q. 12: If the possession product is a component product or an end-product form, how is the combined taxable income for such product to be determined?

A. 12: (i) Except as provided in paragraph (v) of this *A. 12*, combined taxable income for a component product or an end-product form is computed under the production cost ratio (PCR) method.

(ii) Under the PCR method, the combined taxable income for a component product will be the same proportion of the combined taxable income for the integrated product that includes the component product that the production costs attributable to the component product bear to the total production costs (including costs incurred by the U.S. affiliates) for the integrated product that includes the component product. Production costs will be the sum of the direct and indirect production costs as defined under §1.936–5(b)(4) except that the costs will not include any costs of materials. If the possession product is a component product that is transformed into an integrated product in whole or in part by a contract manufacturer outside of the possession, within the meaning of §1.936–5(c), the denominator of the PCR shall be computed by including the same amount paid to the contract manufacturer, less the costs of materials of the contract manufacturer, as is taken into account for purposes of the significant business presence test under §1.936–5(c) *Q&A. 5.*

(iii) Under the PCR method the combined taxable income for an end-product form will be the same proportion of the combined taxable income for the integrated product that includes the end-product form that the production costs attributable to the end-product form bear to the total production costs (including costs incurred by the U.S. affiliates) for the integrated product that includes the end-product form. Production costs will be the sum of the direct and indirect production costs as defined under §1.936–5(b)(4) except that the costs will not include any costs of materials. If the possession product is an end-product form and an excluded component is contract manufactured outside of the possession, within the meaning of §1.936–5(c), the denominator shall be computed by including the same amount paid to the contract manufacturer, less cost of materials of the contract manufacturer, as is also taken into account for purposes of the significant business presence test under §1.936–5(c) *Q&A. 5.*

(iv) This paragraph (iv) of *A. 12* illustrates the computation of combined taxable income for a component product or end-product form under the PCR method. S, a possessions corporation, is engaged in the manufacture of microprocessors. S obtains a component from a U.S. affiliate, O. S sells its production to another U.S. affiliate, P, which incorporates the microprocessors into central processing units (CPUs). P transfers the CPUs to a U.S. affiliate, Q, which incorporates the CPUs into computers for sale to unrelated persons. S chooses to define the possession product as the CPUs. The combined taxable income for the sale of the possession product on the basis of the given production, sales, and cost data is computed as follows:

Production costs (excluding costs of materials):	
1. O's costs for the component	100
2. S's costs for the microprocessors	500
3. P's costs for the CPUs (the possession product)	200
4. Q's costs for the computers	400
5. Total production costs for the computer (Add lines 1 through 4)	1,200
6. Combined production costs for the CPU (the possession product) (Add lines 1 through 3)	800
7. Ratio of production costs for the CPUs (the possession product) to the production costs for the computer	0.667
Determination of combined taxable income for computers:	
Sales:	
8. Total possession sales of computers to unrelated customers and foreign affiliates	7,500
Total costs of O, S, P, and Q incurred in production of a computer:	
9. Production costs (enter from line 5)	1,200
10. Material costs	100
11. Total costs (line 9 plus line 10)	1,300
12. Combined gross income from sale of computers (line 8 minus line 11)	6,200
Expenses of the affiliated group (other than foreign affiliates) allocable and apportionable to the computers or any component thereof under the rules of §§1.861–8 through 1.861–14T and 1.936–6 (b)(1), Q&A. 1:	
13. Expenses (other than research expenses)	980
Research expenses of the affiliated group allocable and apportionable to the computers:	
14. Total sales in the 3-digit SIC Code	12,500
15. Possession sales of the computers (enter from line 8)	7,500

16. Cost sharing fraction (divide line 15 by line 14)	0.6
17. Research expenses incurred by the affiliated group in 3-digit SIC Code multiplied by 120 percent	700
18. Cost sharing amount (multiply line 16 by line 17)	420
19. Research of the affiliated group (other than foreign affiliates) allocable and apportionable under §§ 1.861–17 and 1.861–14T(e)(2) to the computers	300
20. Enter the greater of line 18 or line 19	420
Computation of combined taxable income of the computer and the CPU:	
21. Combined taxable income attributable to the computer (line 12 minus line 13 and line 20)	4,800
22. Combined taxable income attributable to CPUs (multiply line 21 by line 7) (production cost ratio)	3,200
23. Share of combined taxable income apportioned to S (50 percent of line 22)	1,600
Share of combined taxable income apportioned to U.S. affiliate(s) of S:	
24. Adjustments for research expenses (line 18 minus line 19 multiplied by line 7)	80
25. Adjusted combined taxable income (line 22 plus line 24)	3,280
26. Share of combined taxable income apportioned to affiliates of S (line 25 minus line 23)	1,680

(v)(A) If a possession product is sold by a taxpayer or its affiliate to unrelated persons in covered sales both as an integrated product and as a component product and the conditions of paragraph (v)(C) of this *A. 12* are satisfied, the taxpayer may elect to determine the combined taxable income derived from covered sales of the component product under this paragraph (v). In that case, the combined taxable income derived from covered sales of the component product shall be determined by using the same per unit combined taxable income as is derived from covered sales of the product as an integrated product, but subject to the limitation of paragraph (v)(D) of this *A. 12*.

(B) In the case of a possession product that is an end-product form, if all of the excluded components are also separately sold by the taxpayer or its affiliate to unrelated persons in uncontrolled transactions and the conditions of paragraph (v)(C) of this *A. 12* are satisfied, the taxpayer may elect to determine the combined taxable income of such end-product form under this paragraph (v). In that case, the combined taxable income derived from covered sales of the end-product form shall be determined by reducing the per unit combined taxable income from the integrated product that includes the end-product form by the per unit combined taxable income for excluded components determined under the rules of this paragraph (v), but subject to the limitation of paragraph (v)(D) of this *A. 12*. For this purpose, combined taxable income of the excluded components must be determined under section 936 as if the excluded components were possession products.

(C) In the case of component products, this paragraph (v) applies only if the sales price of the possession product sold in covered sales as an integrated product (i.e., in uncontrolled transactions) would be the most direct and reliable measure of an arm's length price within the meaning of the fourth sentence of §1.482–3(b)(2)(ii)(A) for the component product. For purposes of applying the fourth sentence of §1.482–3(b)(2)(ii)(A), the sale of the integrated product that includes the component product is treated as being immediately preceded by a sale of the component (i.e. without further processing) in a controlled transaction. In the case of end-product forms, this paragraph (v) applies only if the sales price of excluded components separately sold in uncontrolled transactions would be the most direct and reliable measure of an arm's length price within the meaning of the fourth sentence of §1.482–3(b)(2)(ii)(A) for all excluded components of an integrated product that includes an end-product form. For purposes of applying the fourth sentence of §1.482–3(b)(2)(ii)(A), the sale of the integrated product that includes excluded components is treated as being immediately preceded by a sale of the excluded components (i.e. without further processing) in a controlled transaction. Under the fourth sentence of §1.482–3(b)(2)(ii)(A), the uncontrolled transactions referred to in this paragraph (v)(C) must have no differences with the controlled transactions that would affect price, or have only minor differences that have a definite and reasonably ascertainable effect on price and for which appropriate adjustments are made (resulting in appropriate adjustments to the computation of combined taxable income). If such adjustments cannot be made, or if there are more than minor differences

between the controlled and uncontrolled transactions, the method provided by this paragraph (v)(C) cannot be used. Thus, for example, these uncontrolled transactions must involve substantially identical property in the same or a substantially identical geographic market, and must be substantially identical to the controlled transaction in terms of their volumes, contractual terms, and market level. See §1.482–3(b)(2)(ii)(B).

(D) In no case can the per unit combined taxable income as determined under paragraph (v)(A) or (B) of this *A. 12* be greater than the per unit combined taxable income of the integrated product that includes the component product or end-product form.

(E) The provisions of this paragraph (v) are illustrated by the following example. Taxpayer manufactures product A in a U.S. possession. Some portion of product A is sold to unrelated persons as an integrated product and the remainder is sold to related persons for transformation into product AB. The combined taxable income of integrated product A is $400 per unit and the combined taxable income of product AB is $300 per unit. The production cost ratio with respect to product A when sold as a component of product AB, is 2/3. Unless the taxpayer elects and satisfies the conditions of this paragraph (v), the combined taxable income with respect to A will be $200 per unit (combined taxable income for AB of $300 × the production cost ratio of 2/3). If, however, the comparability standards of paragraph (v)(C) of this *A. 12* are met, the taxpayer may elect to determine combined taxable income of product A when sold as a component of product AB using the same per unit combined taxable income as product A when sold as an integrated product. However, the per unit combined taxable income from sales of product A as a component product may not exceed the per unit combined taxable income on the sale of product AB. Therefore, the combined taxable income of component product A may not exceed $300 per unit.

(vi) Taxpayers that have not elected the percentage limitation under section 936(a)(1) for the first taxable year beginning after December 31, 1993, may do so if the taxpayer has elected the profit split method and computation of combined taxable income is affected by *Q&A.12* of this paragraph (b)(1).

(vii) The rules of *Q&A. 12* of this paragraph (b)(1) apply for taxable years ending after June 9, 1996. If, however, the election under paragraph (v) of *A. 12* of §1.936–6(b)(1) is made, this election must be made for the taxpayer's first taxable year beginning after December 31, 1993, and if not made effective for that year, the election cannot be made for any later taxable year. A successor corporation that makes the same or substantially similar products as its predecessor corporation cannot make an election under paragraph (v) of A.12 of §1.936–6(b)(1) unless the election was made by its predecessor corporation for its first taxable year beginning after December 31, 1993.

Q. 13: If the profit split option is elected, how is the portion of combined taxable income not allocated to the possessions corporation to be treated?

A. 13: (i) The income shall be allocated to affiliates in the following order, but no allocations will be made to affiliates described in a later category if there are any affiliates in a prior category—

(A) First, to U.S. affiliates (other than tax exempt affiliates) within the group (as determined under section 482) that derive income with respect to the product produced in whole or in part in the possession;

(B) Second, to U.S. affiliates (other than tax exempt affiliates) that derive income from the active conduct of a trade or business in the same product area as the possession product;

(C) Third, to other U.S. affiliates (other than tax-exempt affiliates);

(D) Fourth, to foreign affiliates that derive income from the active conduct of a U.S. trade or business in the same product area as the possession product (or, if the foreign members are resident in a country with which the U.S. has an income tax convention, then to those foreign members that have a permanent establishment in the United States that derives income in the same product area as the possession product); and

(E) Fifth, to all other affiliates.

(ii) The allocations made under paragraph (i)(A) of this *A. 13* shall be made on the basis of the relative gross income derived by each such affiliate with respect to the product produced in whole or in part in the possession. For this purpose, gross income must be determined consistently for each affiliate and consistently from year to year.

(iii) The allocations made under paragraphs (i)(B) and (i)(D) of this *A. 13* shall be made on the basis of the relative gross income derived by each such affiliate from the active conduct of the trade or business in the same product area.

(iv) The allocations made under paragraphs (i)(C) and (i)(E) of this *A. 13* shall be made on the basis of the relative total gross income of each such affiliate before allocating income under this section.

(v) Income allocated to affiliates shall be treated as U.S. source and section 863(b) does not apply for this purpose.

(vi) For purposes of determining an affiliate's estimated tax liability for income thus allocated for taxable years beginning prior to January 1, 1995, the income shall be deemed to be received on the last day of the taxable year of each such affiliate in which or with which the taxable year of the possessions corporation ends. For taxable years beginning after December 31, 1994, quarterly estimated tax payments will be required as provided under section 711 of the Uruguay Round Agreements, Public Law 103–465 (1994), page 230, and any administrative guidance issued by the Internal Revenue Service thereunder.

Q. 14: What is the source of the portion of combined taxable income allocated to the possessions corporation?

A. 14: Income allocated to the possessions corporation shall be treated as possession source income and as derived from the active conduct of a trade or business within the possession.

Q. 15: How is the profit split option to be applied to properly account for costs incurred in a year with respect to products which are sold by the possessions corporation to a U.S. affiliate during such year, but are not resold by the U.S. affiliate to persons who are not members of the affiliated group or to foreign affiliates until a later year?

A. 15: The rules under §1.994–1(c)(5) are to be applied. Incomplete transactions will not be taken into consideration in computing combined taxable income. Thus, for example, if in 1983, A, a possessions corporation, sells units of a product with a cost to A of $5000 to B corporation, its U.S. affiliate, which use the dollar-value LIFO method of costing inventory, and B sells units with a cost of $4000 (representing A's cost) to C corporation, a foreign affiliate, only $4000 of such costs shall be taken into consideration in computing the combined taxable income of the possessions corporation and U.S. affiliates for 1983. If a specific goods LIFO inventory method is used by B, the determination of whether A's goods remain in B's inventory shall be based on whether B's specific goods LIFO grouping has experienced an increment or decrement for the year on the specific LIFO cost of such units, rather than on an average unit cost of such units. If the FIFO method of costing inventory is used by B, transfers may be based on the cost of the specific units transferred or on the average unit production cost of the units transferred, but in each case a FIFO flow assumption shall be used to identify the units transferred. For a determination of which goods are sold by taxpayers using the LIFO method, see question and answer 19.

Q. 16: If a possessions corporation purchases materials from an affiliate and computes combined taxable income for a possession product which includes such materials, how are those materials to be treated in the possessions corporation's inventory?

A. 16: The cost of those materials is considered to be equal to the affiliate's cost using the affiliate's method of costing inventory.

Q. 17: If the possessions corporation uses the FIFO method of costing inventory and the U.S. affiliate uses the LIFO method of costing inventory, or *vice versa*, what method of costing inventory should be used in computing combined taxable income?

A. 17: The transferor corporation's method of costing inventory determines the cost of inventory for purposes of combined taxable income while the transferee corporation's method of costing inventory determines the flow. Assume, for example, that X corporation, a possessions corporation, using the FIFO method of costing inventory purchases materials from Y corporation, U.S. affiliate, also using the FIFO method. X corporation produces a product which it transfers to Z corporation, another U.S. affiliate using the LIFO method. Assume also that the final product satisfies the significant business presence test. Under the facts, the cost of the materials purchased by X from Y is Y's FIFO cost. The costs of the inventory transferred by X to Z are determined under X's FIFO method of accounting as is the flow of the inventory from X to Z. The costs added by Z are determined under Z's LIFO method of inventory, as is the flow of the inventory from Z to unrelated persons or foreign affiliates.

Q. 18: How are the costs of a possession product and the revenues derived from the sale of a possession product determined if the U.S. affiliate includes purchases of the possessions product in a dollar-value LIFO inventory pool (as provided under §1.472–8)?

A. 18: The following method will be accepted in determining the revenues derived from the sale of a possession product and the costs of a possession product if the U.S. affiliate includes purchases of the possession product in a dollar-value LIFO inventory pool. The rules apply solely for the cost sharing and profit split options under section 936(h).

(i) *Revenue identification.* The identification of revenues derived from sales of a possession product must generally be made on a specific identification basis. The particular method employed by a taxpayer for valuing its inventory will have no impact on the determination of what units are sold or how much revenue is derived from such sales. Thus, if a U.S. affiliate sells both item A (a possession product) and item B (a non-possession product), the actual sales revenues received by the U.S. affiliate from item A sales would constitute possession product revenue for purposes of the profit split option and possession sales for purposes of the cost sharing option regardless of whether the U.S. affiliate values its inventories on the FIFO or the LIFO method. In instances where sales of item A (*i.e.*, the possession product) cannot be determined by use of specific identification (for example, in cases where items A and B are identical except that one is produced in the possession (item A) and the other (item B) is produced outside of the possession and it is not possible to segregate these items in the hands of the U.S. affiliate), it will be necessary to identify the portion of the combined sales of items A and B (which together can be identified on a specific identification basis) which is attributed to item A sales and the portion which is attributed to item B sales. The determination of the portion of aggregated sales attributable to item A and item B is independent of the LIFO method used to determine the cost of such sales and may be made under the following approach. A taxpayer may, for purposes of this section of the regulations, use the relative purchases (in units) of items A and B by the U.S. affiliate during the taxable year (or other appropriate measuring period such as the period during the taxable year used to determine current-year costs, *i.e.*, earliest acquisitions period, latest acquisitions period, etc.) in determining the ratio to apply against the combined items A and B sales revenue. If the sales exceed current purchases, the taxpayer can use a FIFO unit approach which identifies actual unit sales on a first-in, first-out basis. Revenue determination where specific identification is not possible is illustrated by the following example:

Example. At the end of year 1, there are 600 units of combined items A and B which are to be allocated between A and B on the basis of annual purchases of A and B units during year 1. During year 1, 1,000 units of item A, a possession product, and 2,000 units of item B, a non-possession product, were purchased. Thus, the 600 units in year 1 ending inventory are allocated 200 (i.e. ⅓) to item A units and 400 (i.e. ⅔) to item B units based on the relative purchases of A (1,000) and B (2,000) in year 1. These units appear as beginning inventory in year 2.

In year 2, 1,500 units of item A are purchased and 1,500 units of item B are purchased. However, 3,300 units of items A and B in the aggregate are sold for $600,000. The relative proportion of the $600,000 attributable to item A and to item B sales would be determined as follows:

Year 2 sales	Item A	Item B
Unit sales from opening inventory	200	400
Unit sale from current-year purchases	1,350	1,350
Total unit sales (3,300)	1,550	1,750
Percentage	47	53

$$\text{Revenues from Item A sales} \quad 281{,}818 \left\{\$600{,}000 \times \frac{1550}{3300}\right\}$$

$$\text{Revenues from Item B sales} \quad \$318{,}182 \left\{\$600{,}000 \times \frac{1750}{3300}\right\}$$

Year 2 Closing Inventory	Units
Item A	150
Item B	150

Thus, revenues from Item A sales for purposes of computing possession sales for the cost sharing option and revenues for the profit split option are $281,818.

(ii) *Cost identification.* The determination of the cost of possession product sales by the U.S. affiliate must be based on the LIFO inventory method of the U.S. affiliate. The LIFO cost of possession product sales will, for purposes of this section of the regulations, be determined by maintaining a separate LIFO cost for possession products in a taxpayer's opening and closing LIFO inventory and using this cost to calculate an independent cost of possession product sales. This separate LIFO cost for possession products in the LIFO pool of a taxpayer is to be determined as follows:

(A) Determine the base-year cost of possession products in ending inventory in a LIFO pool.

(B) Determine the percentage of the base-year cost of possession products in the pool as compared to the total base-year cost of all items in the pool.

(C) Multiply the percentage determined in step (B) of this subdivision (ii) by the ending LIFO inventory value of the pool to determine the deemed LIFO cost attributable to possession products in the pool.

(D) Subtract the LIFO cost of possession products in ending inventory in the pool (as calculated in step (C) of this subdivision (ii)) from the sum of:

(1) Possession product purchases for the year, plus

(2) The portion of the opening LIFO inventory value of the pool attributed to possession products (*i.e.*, the result obtained in step (C) of this subdivision (ii) for the prior year).

The number determined by this calculation is the LIFO cost of possession product sales from the taxpayer's LIFO pool.

Example: Assume that item A is a possession product and item B is a non-possession product and also assume the inventory and purchases with respect to the LIFO pool as provided below:

YEAR 1—ENDING INVENTORY

	No. of units	Base-year cost/unit	Base-year cost	Percent
Item A	100	$2.00	$200	20
Item B	200	4.00	800	80

YEAR 1—LIFO VALUE

	Base-year cost	Index	LIFO cost
Increment layer 2	$300	3.0	$900
Increment layer 1	400	2.0	800
Base layer	300	1.0	300
Pool total	$1,000		$2,000

YEAR 1—LIFO VALUE PER ITEM

	Base-year cost	LIFO value
Total pool	$1,000	$2,000
Item A	200	400
Item B	800	1,600

YEAR 2—PURCHASES

	Total purchases
Item A	$6,000
Item B	4,000

YEAR 2—ENDING INVENTORY

	No. of units	Base-year cost/unit	Base-year cost	Percent
Item A	200	$2.00	$400	50
Item B	100	4.00	400	50

YEAR 2—LIFO VALUE

	Base-year cost	Index	LIFO cost
Increment layer 2	$100	3.0	$300
Increment layer 1	400	2.0	800
Base layer	$300	1.0	300
Pool total	800		1,400

The year 2 LIFO cost of possession product A sales will be calculated as follows:

(1) Base-year cost of item in year 2 ending inventory = $400

(2) Percentage of item A base-year cost to total base-year cost ($400 ÷ $800) = 50%

(3) LIFO value of item A ($1,400 × 50%) = $700

(4) LIFO cost of item A sales is determined by adding to the beginning inventory in year 2 the purchases of item A in year 2 and subtracting from this amount the ending inventory in year 2 ($400 + $6000 − $700 = $5700). The beginning inventory in year 2 is determined by multiplying the LIFO cost of the year 1 ending inventory by a percentage of item A base year cost to the total base-year cost in year 1. The ending inventory in year 2 is determined under (3) above.

Q. 19: If a possession product is purchased from a possessions corporation by a U.S. affiliate using the dollar-value LIFO method of costing its inventory and is included in a LIFO pool of the U.S. affiliate which includes products purchased from the possessions corporation in pre-TEFRA years, how should the LIFO index computation of the U.S. affiliate be made in the first year in which section 936(h) applies and in subsequent taxable years?

A. 19: The U.S. affiliate should treat the first taxable year for which section 936(h) applies as a new base year in accordance with procedures provided by regulations under section 472. Thus, the opening inventory for the first year for which section 936(h) applies (valuing possession products purchased from the possessions corporation on the basis of the cost of such possession products), would equal the new base year cost of the inventory of such pool of the U.S. affiliate. Increments and decrements at new base year cost would be valued for LIFO purposes pursuant to the procedures provided by regulations under section 472.

Q. 20: If the possessions corporation computes its income with respect to a product under the profit split method, with respect to which units of the product shall the profit split method apply?

A. 20: The profit split method shall apply to units of the possession product produced in whole or in part by the possessions corporation in the possession and sold during the taxable year by members of the affiliated group (other than foreign affiliates) to unrelated parties or to foreign affiliates. In no event shall the profit split method apply to units of the product which were not taken into account by the possessions corporation in applying the significant business presence test for the current taxable year or for any prior taxable year in which the possessions corporation also had a significant business presence in the possession with respect to such product.

(2) *Pre-TEFRA inventory.*

Q. 1: How is pre-TEFRA inventory to be determined if the profit split option is elected and the FIFO method of costing inventory is used by the U.S. affiliate?

A. 1: Pre-TEFRA inventory is inventory which was produced by the possessions corporation and transferred to a U.S. affiliate prior to the possessions corporation's first taxable year beginning after December 31, 1982. Pre-TEFRA inventory will not be included for purposes of the profit split option. If the U.S. affiliate uses the FIFO method of costing inventory, the pre-TEFRA inventory will be treated as the first inventory sold by the U.S. affiliate during the first year in which section 936(h) applies and will not be included in the computation of combined taxable income for purposes of the profit split option. The treatment of pre-TEFRA inventory when FIFO costing is used by both the U.S. affiliate and the possessions corporation is illustrated by the following example in which FIFO unit costing is used:

Example. Assume the following:

	X		Y	
	Possessions corporation		U.S. affiliate	
	Number of units	Cost per unit	Number of units	Cost per unit
Beginning inventory	500	$150	200	$225
Units produced during 1983	1,000	200		
Ending inventory	400	200	300	

In 1983, the beginning inventory of X, a possessions corporation, is 500 units with a unit cost of $150 and the beginning inventory of Y, the U.S. affiliate, is 200 units with a unit cost of $225, which represents the section 482 price paid by Y. Y's beginning inventory in 1983 represents purchases made in 1982 of products produced by X in that year. Y sells all the units it purchases from X to Z, a foreign affiliate. In 1983, X produces 1000 units at a unit cost of $200 and sells 1100 units to Y (the difference between 1500 units, representing X's 1983 beginning inventory (500) and the units produced by X in 1983 (1000), and X's ending inventory of 400 units). Of the 1100 units sold by X to Y in 1983 only 800 units (and not 1000 units) which were sold by Y to Z are taken into consideration in computing combined taxable income for 1983. Since FIFO costing by the possessions corporation is used, the cost is $150 per unit for the first 500 units and $200 per unit for the remaining 300 units. The 200 units sold by X to Y in 1982 are pre-TEFRA inventory and are not included in the computation of combined taxable income for 1983. They are also treated as the first units sold by Y to Z in 1983. This inventory has a unit cost of $225, which reflects the section 482 transfer price from X to Y in 1982. Y's 1983 ending inventory of 300 units will not be taken into consideration in computing the combined taxable income of X and Y for 1983 because the units have not been sold to a foreign affiliate or to persons who are not members of the affiliated group. In a subsequent year when the units are sold to Z, the cost to X and selling price to Z of these units will enter into the computation of combined taxable income for that year.

(c) *Covered Intangibles.*

Q. 1: What are ''covered intangibles'' under section 936(h)(5)(C)(i)(II)?

A. 1: The term ''covered intangibles'' means (1) intangible property developed in a possession solely by the possessions corporation and owned by it, (2) manufacturing intangible property (described in section 936(h)(3)(B)(i)) which is acquired by the possessions corporation from unrelated persons, and (3) any other intangible property (described in section 936(h)(3)(B) (ii) through (v), to the extent not described in section 936(h)(3)(B)(i)) which relates to sales of products or services to unrelated persons for ultimate consumption or use in the possession in which the possessions corporation conducts its business. The possessions corporation is treated as the owner of covered intangibles for purposes of obtaining a return thereon.

Q. 2: Do covered intangibles include manufacturing intangible property which is acquired by an affiliate and subsequently transferred to the possessions corporation?

A. 2: No. In order for a manufacturing intangible to be treated as a covered intangible, the intangible property must be acquired directly by the possessions corporation from an unrelated person unless the manufacturing intangible was acquired by an affiliate from an unrelated person and was transferred to the possessions corporation by the affiliate prior to September 3, 1982.

Q. 3: If a possessions corporation licenses a manufacturing intangible from an unrelated party, will the licensed intangible be treated as a covered intangible?

A. 3: No.

Q. 4: How is ultimate consumption or use determined for purposes of the definition of covered intangibles?

A. 4: A product will be treated as having its ultimate use or consumption in a possession if it is sold by the possessions corporation to a related or unrelated person in a possession and is not resold or used or consumed outside of the possession within one year after the date of the sale.

Q. 5: Are sales of products that relate to covered intangibles excluded from the cost sharing fraction?

A. 5: If no manufacturing intangibles other than covered intangibles are associated with the possession product, then sales of such product will be excluded from the cost sharing fraction. If both covered and non-covered manufacturing intangibles are associated with the possession product, then sales of such product will be included in the cost sharing fraction.

Q. 6: If the cost sharing option is elected, is it necessary for the possessions corporation to be the legal owner

of covered intangibles described in section 936(h)(5)(C)(i)(II)(*c*) related to the product in order for the possessions corporation to receive a full return with respect to such intangibles?

A. 6: No. For purposes of section 936(h), it is immaterial whether such covered intangibles are owned by the possessions corporation or by another member of the affiliated group. Moreover, if the legal owner of such covered intangibles which are subject to section 936(h)(5) is an affiliate of the possessions corporation, such person will not be required to charge an arm's-length royalty under section 482 to the possessions corporation.

[T.D. 8090, 51 FR 21532, June 13, 1986; 51 FR 27174, July 30, 1986, as amended by T.D. 8669, 61 FR 21367, May 10, 1996; 61 FR 39072, July 26, 1996; T.D. 8786, 63 FR 55025, Oct. 14, 1998]

§ 1.936–7 Manner of making election under section 936 (h)(5); special election for export sales; revocation of election under section 936(a).

(a) The rules in this section apply for purposes of section 936(h) and also for purposes of section 934(e), where applicable.

(b) *Manner of making election.*

Q. 1: How does a possessions corporation make an election to use the cost sharing method or profit split method?

A. 1: A possessions corporation makes an election to use the cost sharing or profit split method by filing Form 5712–A (''Election and Verification of the Cost Sharing or Profit Split Method Under Section 936(h)(5)'') and attaching it to its tax return. Form 5712–A must be filed on or before the due date (including extensions) of the tax return of the possessions corporation for its first taxable year beginning after December 31, 1982. The electing corporation must set forth on the form the name and the taxpayer identification number or address of all members of the affiliated group (including foreign affiliates not required to file a U.S. tax return). All members of the affiliated group must consent to the election. For elections filed with respect to taxable years beginning before January 1, 2003, an authorized officer of the electing corporation must sign the statement of election and must declare that he has received a signed statement of consent from an authorized officer, director, or other appropriate official of each member of the affiliated group. Elections filed for taxable years beginning after December 31, 2002, must incorporate a declaration by the electing corporation that it has received a signed consent from an authorized officer, director, or other appropriate official of each member of the affiliated group and will be verified by signing the return. The election is not valid for a taxable year unless all affiliates consent. A failure to obtain an affiliate's written consent will not invalidate the election out if the possessions corporation made a good faith effort to obtain all the necessary consents or the failure to obtain the missing consent was inadvertent.

Subsequently created or acquired affiliates are bound by the election. If an election out is revoked under section 936(h)(5)(F)(iii), a new election out with respect to that product area cannot be made without the consent of the Commissioner. The possessions corporation shall file an amended Form 5712–A with its timely filed (including extensions) income tax return to reflect any changes in the names or number of the members of the affiliated group for any taxable year after the first taxable year to which the election out applies. By consenting to the election out, all affiliates agree to provide information necessary to compute the cost sharing payment under the cost sharing method or combined taxable income under the profit split method, and failure to provide such information shall be treated as a request to revoke the election out under section 936(h)(5)(F)(iii).

Q. 2: May the ''election out'' under section 936(h)(5) be made on a product-by-product basis, or must it be made on a wide basis?

A. 2: An electing corporation is required to treat products in the same product area in the same manner. Similarly, all possessions corporations in the same affiliated group that produce any products or render any services in the same product area must make the same election for all products that fall within the same product area. However, §1.936–7(b) provides that the electing corporation may make a different election for export sales than for domestic sales. The electing corporation or corporations may also make different elections for products that fall within different product areas.

Q. 3: May the possessions corporation elect to define product area more narrowly than the 3-digit SIC code?

A. 3: No. Certain alternatives, such as the 4-digit SIC code, would not be permitted under the statute. However, other methods for defining product area may be considered by the Commissioner in the future.

Q. 4: May a possessions corporation make an election out under the cost sharing method with respect to a product area if the affiliated group incurs no research, development or experimental costs in the product area?

A. 4: Yes. In that case the cost sharing payment will be zero.

Q. 5: If the significant business presence test is not satisfied for a product or type of service within the product area covered by the election out under section 936(h)(5) what rules will apply with respect to that product?

A. 5: With respect to the product which does not satisfy the significant business presence test, the provisions of section 936 (h)(1) through (h)(4) will apply to the allocation of income. However, if a cost sharing or a profit split election has been made with respect to the product area, the cost sharing payment or the research and development floor under section 936(h)(5)(C)(ii)(II) will not be reduced.

Q. 6: Is a taxpayer permitted to make a change of election with respect to the cost sharing and profit split methods?

A. 6: In general, once the election is properly made, it is binding for the first year in which it applies and all subsequent years (including upon any later created or acquired affiliates), and revocation is only permitted with the consent of the Commissioner of Internal Revenue. However, a taxpayer will be permitted to change its election once from the cost sharing method to the profit split method or *vice versa*, or from the method permitted under section 936 (h)(1) through (h)(4) to cost sharing or profit split or *vice versa*, without the consent of the Commissioner if the change is made on the taxpayer's return for its first taxable year ending after June 13, 1986. Such change will apply to such taxable year and all subsequent taxable years, and, at the taxpayer's option, may also apply to all prior taxable years for which section 936(h) was in effect. A change of election will be treated as an election subject to the procedures set forth above and to section 481 of the Internal Revenue Code.

Q. 7: If the Commissioner determines that a possessions corporation does not meet the 80-percent possession source test or the 65-percent active trade or business test (the ''qualification tests'') for any taxable year beginning after 1982, under what circumstances is the possessions corporation permitted to make a distribution of property

after the close of its taxable year to meet the qualification tests?

A. 7: A possessions corporation may make a pro rata distribution of property to its shareholders after the close of the taxable year if the Commissioner determines that the possessions corporation does not satisfy the qualification tests (a) by reason of the exclusion from gross income of intangible income under section 936(h)(1)(B) or section 936(h)(5)(C)(i)(II) or (b) by reason of the allocation to the shareholders of the possessions corporation of income under section 936(h)(5)(C)(ii)(III); provided, however, that the determination of the Commissioner does not contain a finding that the failure of such corporation to satisfy the qualification tests was due, in whole or in part, to fraud with intent to evade tax or willful neglect on the part of the possessions corporation. The possessions corporation must designate the distribution at the time the distribution is made as a distribution to meet qualification requirements, and it will be subject to the provisions of section 936(h)(4). Such distributions will not qualify for the dividends received deduction.

Q. 8: If a possessions corporation owns stock in a subsidiary possessions corporation, any intangible property income allocated to the parent possessions corporation under section 936(h) will be treated as U.S. source income and taxable to the parent possessions corporation. Is the intangible property income taken into consideration in determining whether the parent possessions corporation meets the income tests of section 936(a)(2)?

A. 8: While taxable to the parent possessions corporation, the intangible property income does not enter into the calculation of the 80-percent possession source test or the 65-percent active trade or business test of section 936(a)(2)(A) and (B). This would also be the case if the subsidiary possessions corporation made a qualifying distribution under section 936(h)(4).

(c) *Separate election for export sales.*

Q. 1: What methods of computing income can a possessions corporation use under the separate election for export sales?

A. 1: The only two methods which are available under the separate election for export sales are the cost sharing method and the profit split method.

Q. 2: What is the definition of export sales for purposes of the separate election for export sales?

A. 2: The determination of export sales is based upon the destination of the product, *i.e.*, where it is to be used or consumed. If the product is sold to a U.S. affiliate, it will be treated as an export sale only if resold or otherwise transferred abroad to a foreign person (including a foreign affiliate or foreign branch of a U.S. affiliate) within one year from the date of sale to the U.S. affiliate for ultimate use or consumption outside the United States as provided under §1.954–3(a)(3)(ii).

Q. 3: Assume that a possessions corporation sells a product to both foreign affiliates and foreign branches of U.S. affiliates. In addition, it sells the product to its U.S. parent for resale in the U.S. The possessions corporation makes a profit split election for domestic sales and a cost sharing election of export sales. Will the sales to foreign branches of U.S. affiliates be treated as exports subject to the cost sharing method or as domestic sales subject to the profit split method?

A. 3: The sales to a foreign branch of a U.S. corporation are exports if for ultimate use or consumption outside of the United States as provided under §1.954–3(a)(3)(ii).

Q. 4: Under what circumstances may a possessions corporation make the separate election under section 936(h)(5)(F)(iv)(II) for computing its income from products exported to a foreign person when the income derived by such foreign person on the resale of such products is included in foreign base company income under section 954(a)?

A. 4: If the income derived by a foreign person on the resale of products manufactured, in whole or in part, by a possessions corporation is included in foreign base company income under section 954(a), then the possessions corporation may make the separate export election under section 936(h)(5)(F)(iv)(II) for computing its income from such products only if such foreign person has been formed or is

availed of for substantial business reasons that are unrelated to an affiliated corporation's U.S. tax liability. For purposes of the proceding sentence, a foreign person will be considered to be formed or availed of for such substantial business reasons if the foreign person in the normal course of business purchases substantial quantities of products from both the possessions corporation and its affiliates for resale, and, in addition provides support services for affiliated companies such as centralized testing, marketing of products, management of local currency exposures, or other similar services. However, a foreign person that purchases and resells products only from a possessions corporation is presumed to be formed or availed of for other than such substantial business reasons, even if the foreign person provides additional services.

Q. 5: When will the ''manufacturing'' test set forth in subsection (d)(1)(A) of section 954 be applicable to the export sales of a product of a possessions corporation which makes a separate election for export sales?

A. 5: An electing corporation will be required to meet the ''manufacturing'' test set forth in subsection (d)(1)(A) of section 954 with respect to export sales of its product in each taxable year in which the separate election for export sales is in effect.

(d) *Revocation of election under section 936(a).*

Q. 1: When may an election under section 936(a) be revoked?

A. 1: An election under section 936(a) may be revoked during the first ten years of section 936 status only with the consent of the Commissioner, and without the Commissioner's consent after that time. The Commissioner hereby consents to all requests for revocation that are made with respect to the taxapayer's first taxable year beginning after December 31, 1982 provided that the section 936(a) election was in effect for the corporation's last taxable year beginning before January 1, 1983, if the taxpayer agrees not to reelect section 936(a) prior to its first taxable year beginning after December 31, 1988. A taxpayer that wishes to revoke a section 936(a) election under the terms of the blanket revocation must attach a ''Statement of Revocation—Section 936'' to the taxpayer's timely filed return (including extensions) and must state that in revoking the election the taxpayer agrees not to re-elect section 936(a) prior to its first taxable year beginning after December 31, 1988. Other requests to revoke not covered by the Commissioner's blanket consent should be addressed to the District Director having jurisdiction over the taxpayer's tax return.

[T.D. 8090, 51 FR 21545, June 13, 1986, as amended by T.D. 9100, 68 FR 70705, Dec. 19, 2003; T.D. 9300, 71 FR 71042, Dec. 8, 2006]

§ 1.936–8T Qualified possession source investment income (temporary). [Reserved]

§ 1.936–9T Source of qualified possession source investment income (temporary). [Reserved]

§ 1.936–10 Qualified investments.

(a) *In general.* [Reserved]

(b) *Qualified investments in Puerto Rico.* [Reserved]

(c) *Qualified investment in certain Caribbean Basin countries*—(1) *General rule.* An investment of qualified funds described in this section shall be treated as a qualified investment of funds for use in Puerto Rico if the funds are used for a qualified investment in a qualified Caribbean Basin country. A qualified investment in a qualified Caribbean Basin country is a loan of qualified funds by a qualified financial institution (described in paragraph (c)(3) of this section) directly to a qualified recipient (described in paragraph (c)(9) of this section) or indirectly through a single financial intermediary for investment in active busines assets (as defined in paragraph (c)(4) of this section) in a qualified Caribbean Basin country (described in paragraph (c)(10)(ii) of this section) or for investment in development projects (as defined in paragraph (c)(5) of this section) in a qualified Caribbean Basin country, provided—

(i) The investment is authorized, prior to disbursement of the funds, by the Commissioner of Financial Institutions of Puerto Rico (or his delegate) pursuant to regulations issued by such Commissioner; and

(ii) The agreement, certification, and due diligency requirements under paragraphs (c)(11), (12), and (13) of this section are met.

A loan by a qualified financial institution shall not be disqualified merely because the loan transaction is processed by the central bank of issue of the country into which the loan is made pursuant to, and solely for purposes of complying with, the exchange control laws or regulations of such country. Further, a loan by a qualified financial institution shall not be disqualified merely because the loan is acquired by another person, provided such other person is also a qualified financial institution.

(2) *Termination of qualification*—(i) *In general.* An investment that, at any time after having met the requirements for a qualified investment in a qualified Caribbean Basin country under the terms of this paragraph (c), fails to meet any of the conditions enumerated in this paragraph (c) shall no longer be considered a qualified investment in a qualified Caribbean Basin country from the time of such failure, unless the investment satisfies the requirements for a timely cure described in paragraph (c)(2)(ii) of this section. Such a failure includes, but is not limited to, the occurrence of any of the following events:

(A) Active business assets cease to qualify as such;

(B) Proceeds from the investment are diverted for the financing of assets, projects, or operations that are not active business assets or development projects or are not the assets or the project of the qualified recipient;

(C) The holder of the qualified recipient's obligation is not a qualified financial institution;

(D) The qualified recipient's qualified business activity ceases to qualify as such; or

(E) The qualified Caribbean Basin country ceases to be a country described in paragraph (c)(10)(ii) of this section.

(ii) *Timely cure*—(A) *In general.* A timely cure shall be considered to have been made if the event or events that cause disqualification of the investment are corrected within a reasonable period of time. For purposes of this section, a reasonable period of time shall not exceed 60 days after such event or events come to the attention of the qualified recipient or the qualified financial institution or should have some to their attention by the exercise of reasonable diligence.

(B) *Due diligence requirements.* A time cure of a failure to comply with the due diligence requirements of paragraphs (c)(11), (12), and (13) of this section shall be considered to be made if the failure to comply is due to reasonable cause and, upon request of the Commissioner of Financial Institutions of Puerto Rico (or his delegate) or of the Assistant Commissioner (International) (or his authorized representative), the qualified financial institution (and its trustee or agent), if any), the financial intermediary, or the qualified recipient establishes to the satisfaction of the Commissioner of Financial Institutions of Puerto Rico (or his delegate) or of the Assistant Commissioner (International) (or his authorized representative) that it has exercised due diligence in ensuring that the funds were property disbursed to a qualified recipient and applied by or on behalf of such qualified recipient to uses that qualify the investment as an investment in qualified business assets or a development project under the provisions of this paragraph (c).

(iii) *Assumption of qualified recipient's obligation.* An investment shall not cease to qualify merely because the qualified recipient's obligation to the qualified financial institution (or to a financial intermediary, if any) is assumed by another person, provided such other person assumes the qualified recipient's agreement and certification requirements under paragraph (c)(11)(i) of this section and is either—

(A) A qualified recipient on the date of assumption, in which case such person shall be treated for purposes of this section as the original qualified recipient and shall be subject to all the requirements of this section for continued qualification of the loan as a qualified investment in a qualified Caribbean Basin country; or

(B) An international organization, the principal purpose of which is to foster economic development in developing countries and which is described

in section 1 of the International Organizations Immunities Act (22 U.S.C. 288), if the assumption of the obligation is pursuant to a bona fide guarantee agreement.

(3) *Qualified financial institution*—(i) *General rule.* For purposes of section 936(d)(4)(A) and this section, a qualified financial institution includes only—

(A) A banking, financing, or similar business defined in §1.864–4(c)(5)(i) that is an eligible institution described in paragraph (c)(3)(ii) of this section, but not including branches of such institution outside of Puerto Rico;

(B) A single-purpose entity described in paragraph (c)(3)(iii) of this section;

(C) The Government Development Bank for Puerto Rico;

(D) The Puerto Rico Economic Development Bank; and

(E) Such other entity as may be determined by the Commissioner by Revenue Procedure or other guidance published in the Internal Revenue Bulletin.

(ii) *Eligible institution.* An eligible institution means an institution—

(A) That is an entity organized under the laws of the Commonwealth of Puerto Rico or is the Puerto Rican branch of an entity organized under the laws of another jurisdiction, if such entity is engaged in a banking, financing, or similar business defined in §1.864–4(c)(5)(i), and

(B) That is licensed as an eligible institution under Regulation No. 3582 (or any successor regulation) issued by the Commissioner of Financial Institutions of Puerto Rico (hereinafter ''Puerto Rican Regulation No. 3582'').

(iii) *Single-purpose entity.* A single-purpose entity is an entity that meets all of the following conditions:

(A) The entity is organized under the laws of the Commonwealth of Puerto Rico and is a corporation, a partnership or a trust, which conducts substantially all of its activities in Puerto Rico.

(B) The sole purpose of the entity is to use qualified funds from possessions corporations to make one or more qualified investments in a qualified Caribbean Basin country and the entity actually uses such funds only for such purpose.

(C) In the case of an entity that is a trust, one of the trustees is a qualified financial institution described in paragraph (c)(3)(i) of this section.

(D) The entity is licensed as an eligible institution under Puerto Rican Regulation No. 3582 (or any successor regulation).

(E) Any temporary investment by the entity for its own account of funds received from a possessions corporation, and the income from the investment thereof, and any temporary investment by the entity for its own account of principal and interest paid by a borrower to the entity, and the income from the investment thereof, are limited to investments in eligible activities, as described in section 6.2.4 of Puerto Rican Regulation No. 3582, as in effect on September 22, 1989.

(4) *Investments in active business assets*—(i) *In general.* For purposes of section 936(d)(4)(A)(i)(I) and this section and subject to the provisions of paragraph (c)(8) of this section, a loan qualifies as an investment in active business assets if—

(A) The amounts disbursed to a qualified recipient under the loan or bond issue are promptly applied (as defined in paragraphs (c)(6) and (7) of this section) by (or on behalf of) the qualified recipient solely for capital expenditures for the construction, rehabilitation (including demolition associated therewith), improvement, or upgrading of qualified assets described in paragraphs (c)(4)(ii)(A), (B), (E), and (F) of this section, for the acquisition of qualified assets described in paragraphs (c)(4)(ii)(B), (C), (E), and (F) of this section, for the expenditures described in paragraphs (c)(4)(ii)(D), (E), and (F) of this section, and, if applicable, for the financing of incidental expenditures described in paragraph (c)(4)(iii) of this section;

(B) The qualified recipient owns the assets for United States income tax purposes and uses them in a qualified business activity (as defined in paragraph (c)(4)(iv)); and

(C) The requirements of paragraph (c)(6) of this section (regarding temporary investments and time periods within which the funds must be invested) and of paragraph (c)(7) of this section (regarding the refinancing of

existing funding and the time periods within which funding for investments must be secured) are satisfied.

(ii) *Definition of qualified assets.* For purposes of this paragraph (c), qualified assets mean—

(A) Real property;

(B) Tangible personal property (such as furniture, machinery, or equipment) that is not property described in section 1221(1) and that is either new property or property which at no time during the period specified in paragraph (c)(4)(v) of this section was used in a business activity in the qualified Caribbean Basin country in which the property is to be used;

(C) Rights to intangible property that is a patent, invention, formula, process, design, pattern, know-how, or similar item, or rights under a franchise agreement, provided that such rights—

(*1*) Were not at any time during the period specified in paragraph (c)(4)(v) of this section used in a business activity in the qualified Caribbean Basin country in which the rights are to be used,

(*2*) Are not rights the use of which gives rise, or would give rise if used, to United States source income, and

(*3*) Are not rights acquired by the qualified recipient from a person related (within the meaning of section 267(b), using ''10 percent'' instead of ''50 percent'' in the places where it appears) to the qualified recipient;

(D) Exploration and development expenditures incurred by a qualified recipient for the purpose of ascertaining the existence, location, extent or quality of any deposit of ore, oil, gas, or other mineral in a qualified Caribbean Basin country, as well as for purposes of developing such deposit (within the meaning of section 616 of the Code and the regulations thereunder);

(E) Living plants and animals (other than crops, plants, and animals that are acquired primarily to hold as inventory by the qualified recipient for resale in the ordinary course of trade or business) acquired in connection with a farming business (as defined in §1.263–1T(c)(4)(i)), expenditures of a preparatory nature to prepare the land or area for farming (such as planting trees, drilling wells, clearing brush, leveling land, laying pipes, building roads, constructing tanks and reservoirs), expenditures for soil and water conservation of a type described in section 175(c)(1), and expenditures of a development nature incurred in connection with, and during, the preproductive period of property produced in a farming business (as defined in §1.263–1T(c)(4)(ii));

(F) Other assets or expenditures that are not described in paragraphs (c)(4)(ii)(A) through (E) of this section and that the Commissioner may, by Revenue Procedure or other guidance published in the Internal Revenue Bulletin or by ruling issued to a qualified financial institution or qualified recipient upon its request, determine to be qualified assets.

(iii) *Incidental expenditures.* An amount in addition to the loan proceeds borrowed to make an investment in active business assets shall be considered an investment in active business assets if such amount is applied to finance expenditures that are incidental to making the investment in active business assets, provided such amount is disbursed at or about the same time the proceeds for making the investment in active business assets are disbursed. For purposes of this section, expenditures incidental to an investment in active business assets include only the following items:

(A) A reasonable amount of costs (other than the cost of credit enhancement or bond insurance premiums) associated with arranging the financing of an investment in active business assets, not to exceed 3.5 percent of the proceeds of the loan or bond issue.

(B) A reasonable amount of installation costs and other reasonable costs associated with placing an active business asset in service in the qualified business activity.

(C) An amount not in excess of 10 percent of the total amount of investment in qualified assets to finance the acquisition of inventory, and other working capital requirements, but if an investment is in connection with a manufacturing or farming business, the percentage limitation shall be 50 percent rather than 10 percent provided the excess over the 10 percent limitation is used to finance inventory property. For

purposes of this paragraph (c), whether a business is a manufacturing business shall be determined under principles similar to those described in section 954(d)(1)(A) and the regulations thereunder; whether a business is a farming business shall be determined under §1.263–1T(c)(4)(i).

(D) An amount not in excess of 5 percent of the sum of the investment in active business assets and the costs described in paragraphs (c)(4)(iii)(A), (B), and (C) of this section for the refinancing of an existing debt of the qualified recipient if such refinancing is incidental to an investment in active business assets. For this purpose, the replacement of an existing loan arrangement shall not be considered the refinancing of an existing indebtedness to the extent that the funds under such loan arrangement have not yet been disbursed to the qualified recipient.

(iv) *Qualified business activity.* A qualified business activity is a lawful industrial or commercial activity that is conducted as an active trade or business (under principles similar to those described in §1.367(a)–2T(b) (2) and (3)) in a qualified Caribbean Basin country. A trade or business for purposes of this paragraph (c)(4)(iv) is any business activity meeting the principles of section 367 of the Code and described in Divisions A through I (excluding group 43 in Division E (relating to the United States Postal Service) and groups 84 (relating to museums, art galleries, and botanical and zoological gardens), 86 (relating to membership organizations), and 88 (relating to private households in Division I) of the 1987 Standard Industrial Classification Manual issued by the Executive Office of the President, Office of Management and Budget, or in the comparable provisions of any successor Standard Industrial Classification Manual that is adopted by the Commissioner of Internal Revenue in a notice, regulation, or other document published in the Internal Revenue Cumulative Bulletin.

(v) *Period of use.* The period referred to in paragraphs (c)(4)(ii)(B) and (C) of this section shall be a five year period preceding the date of acquisition with the loan proceeds, if the date of acquisition is on or before May 13, 1991. If the date of acquisition is after May 13, 1991, then the period specified in this paragraph (c)(4)(v) shall be three years preceding the date of acquisition with the loan proceeds.

(5) *Investments in development projects*—(i) *In general.* Subject to the provisions of paragraph (c)(8) of this section, this paragraph (c)(5)(i) describes the requirements in order for a loan by a qualified financial institution to qualify as an investment in a development project for purposes of section 936(d)(4)(A)(i)(II) and for this section.

(A) The amounts disbursed under the loan or bond issue must be promptly applied (as defined in paragraphs (c)(6) and (7) of this section) by (or on behalf of) the qualified recipient solely for one or more investments described in paragraph (c)(4)(i)(A) of this section and in any land, buildings, or other property functionally related and subordinate to a facility described in paragraph (c)(5)(ii) of this section (determined under principles similar to those described in §1.103–8(a)(3)), for use (under principles similar to those described in §1.367(a)–2T(b)(5)) in connection with one or more activities described in paragraph (c)(5)(i)(B) of this section.

(B) The activities referred to in paragraph (c)(5)(i)(A) of this section are—

(*1*) A development project described in paragraph (c)(5)(ii) of this section in a qualified Caribbean Basin country; or

(*2*) The performance in a qualified Caribbean Basin country of a non-commercial governmental function described in paragraph (c)(5)(iv) of this section;

(C) The qualified recipient must own the assets for United States income tax purposes;

(D) The requirements of paragraph (c)(6) of this section (regarding temporary investments and time periods within which the funds must be invested) and of paragraph (c)(7) of this section (regarding the refinancing of existing funding and time periods within which funding for investments must be secured) must be satisfied.

(ii) *Development project.* For purposes of this paragraph (c), a development project is one or more facilities in a qualified Caribbean Basin country that support economic development in that

country and that satisfy the public use requirement of paragraph (c)(5)(iii) of this section. Examples of facilities that may meet the public use requirement include, but are not limited to—

(A) Transportation systems and equipment, including sea, surface, and air, such as roads, railways, air terminals, runways, harbor facilities, and ships and aircraft;

(B) Communications facilities;

(C) Training and education facilities related to qualified business activities;

(D) Industrial parks, including necessary support facilities such as roads; transmission lines for water, gas, electricity, and sewage; docks; plant sites preparations; power generation; sewage disposal; and water treatment;

(E) Sports facilities;

(F) Convention or trade show facilities;

(G) Sewage, solid waste, water, and electric facilities;

(H) Housing projects pursuant to a government program designed to provide affordable housing to low or moderate income families, based upon local standards; and

(I) Hydroelectric generating facilities.

(iii) *Public use requirement.* To satisfy the public use requirement in paragraph (c)(5)(ii) of this section, a facility must serve or be available on a regular basis for general public use, as contrasted with similar types of facilities which are constructed for the exclusive use of a limited number of persons as determined under principles similar to those described in §1.103–8(a)(2).

(iv) *Non-commercial governmental functions.* For purposes of paragraph (c)(5)(i)(B) of this section, the term ''non-commercial governmental functions'' refers to activities that, under U.S. standards, are not customarily attributable to or carried on by private enterprises for profit and are performed for the general public with respect to the common welfare or which relate to the administration of some phase of government. For example, the operation of libraries, toll bridges, or local transportation services, and activities substantially equivalent to those carried out by the Federal Aviation Authority, Interstate Commerce Commission, or United States Postal Service, are considered non-commercial governmental functions. For purposes of this section, non-commercial government functions shall not include military activities.

(v) [Reserved]

(6) *Prompt application of borrowed proceeds.* This paragraph (c)(6) provides rules for determining whether amounts disbursed to a qualified recipient by a qualified financial institution (or a financial intermediary) shall be considered to have been promptly applied for the purpose of paragraphs (c)(4)(i)(A) and (c)(5)(i)(A) of this section.

(i) *In general.* Except as otherwise provided in paragraphs (c)(6)(ii) and (c)(7)(iii)(B) of this section, amounts disbursed to a qualified recipient by a qualified financial institution (or a financial intermediary) shall be considered to have been promptly applied for the purpose of paragraphs (c)(4)(i)(A) and (c)(5)(i)(A) of this section if the amounts are fully expended for any of the purposes described in paragraphs (c)(4)(i)(A) or (c)(5)(i)(A) of this section no later than six months from the date of such disbursement and any temporary investment of such funds by the qualified recipient during such period complies with the rules of paragraph (c)(6)(iii)(A) of this section. Where the amounts disbursed are bond proceeds described in paragraph (c)(6)(iv)(A) of this section, the six-month period shall begin on the date of issuance of the bonds. In the event the qualified financial institution (or financial intermediary) invests any part of the bond proceeds before disbursement of those proceeds to the qualified recipient, all earnings from any such investment shall be paid to the qualified recipient or applied for its benefit.

(ii) *Special rules for long term projects financed out of bond proceeds.* In the case of a long term project described in paragraph (c)(6)(iv)(B) of this section that is financed out of bond proceeds, the six-month period described in paragraph (c)(6)(i) of this section shall be extended with respect to the amount of bond proceeds used to fund the project for such reasonable period of time as shall be necessary until completion of the project or until beginning of production (in the case of a farming business), but, in any event, not to exceed

three years from the date of issuance of the bonds, and only if—

(A) The project that is financed out of bond proceeds was identified as of the date of issue;

(B) A construction and expenditure plan certified by an independent expert (such as an engineer, an architect, or a farming expert) is filed with, and approved by, the Commissioner of Financial Institutions of Puerto Rico (or his delegate) prior to the date of issue, which makes a reasonable estimate, as of the date of filing of the plan, of the amounts and uses of the bond proceeds and the time of completion or production, and includes a schedule of progress payments until such time;

(C) The terms of the construction and expenditure plan are disclosed in the public offering memorandum, private placement memorandum, or similar document prepared for information or disclosure purposes in relation to the issuance of bonds; and

(D) Any temporary investment of the bond proceeds complies with the rules of paragraph (c)(6)(iii)(A) and (B) of this section.

(iii) *Temporary investments*—(A) *During six-month period.* During the six-month period described in paragraph (c)(6)(i) of this section, during the first six months of the period described in paragraph (c)(6)(ii) of this section, and during the 30-day period described in paragraph (c)(7)(iii)(A) of this section, loan proceeds disbursed to a qualified recipient, bond proceeds, and income from the investment thereof, may be held in unrestricted yield investments, provided such yield reflects normal market yield for such type of investments and provided the income from such investments, if any, is or would be sourced either in Puerto Rico or in a country in which the investment in active business assets or development project is to be made.

(B) *During other periods.* During any other period, any temporary investment of bond proceeds, and of income from such investments, shall be limited to investments in eligible activities. For purposes of this paragraph (c)(6)(iii)(B), the term ''eligible activities'' shall mean those investments described in section 6.2.4 of Puerto Rican Regulation No. 3582, as in effect on September 22, 1989.

(iv) *Definitions*—(A) *Bond proceeds.* For purposes of this paragraph (c), bond proceeds shall mean the proceeds from the issuance of obligations by way of a public offering or a private placement by a qualified financial institution for investment in active business assets or a development project that has been identified at the time of issue and is described in a public offering memorandum, private placement memorandum, or similar document prepared for information or disclosure purposes in relation to the issuance of the bonds.

(B) *Long term project.* For purposes of this section, the term long term project means—

(*1*) A project, whether or not under a contract, for the construction, rehabilitation, improvement, upgrading, or production of qualified assets, or for expenditures, described in paragraph (c)(4)(ii) of this section (other than paragraph (c)(4)(ii)(C) of this section), which is reasonably expected to require more than 12 months to complete; or

(*2*) The production of property in a farming business referred to in paragraph (c)(4)(ii)(E) of this section, which is reasonably expected to require a preproductive period in excess of 12 months.

(7) *Financing of previously incurred costs.* Loan or bond proceeds which are disbursed after a qualified recipient has paid or incurred part or all of the costs of acquiring active business assets or investing in a development project shall be considered to have been applied for such purposes only as provided in this paragraph (c)(7).

(i) *Replacement of temporary non-section 936 financing of a qualified investment.* This paragraph (c)(7)(i) prescribes the maximum time limits within which temporary non-section 936 financing of qualified investments may be replaced with section 936 funds without being considered a prohibited refinancing transaction. This paragraph (c)(7)(i) applies to the refinancing of costs incurred with respect to investments that, at the time the costs were first incurred, were either qualified investments in a qualified Caribbean Basin country or were investments by a

qualified recipient in active business assets or a development project in a qualified Caribbean Basin country. This paragraph (c)(7)(i) applies also to the refinancing of costs incurred with respect to any other investment. However, in the latter case, the amount of costs that may be refinanced with section 936 funds is limited to the amount of costs that are incurred with respect to the investment after the investment becomes a qualified investment in a qualified Caribbean Basin country. For purposes of this paragraph (c)(7)(i), the time when costs are incurred shall be determined under principles similar to those applicable under section 461(h) dealing with the economic performance test for the accrual of deductible liabilities. This paragraph (c)(7)(i) applies only to the situations described in this paragraph (c)(7)(i).

(A) In the case of an investment in active business assets or a development project, a loan shall be a qualified investment for purposes of this paragraph (c) if the loan proceeds are disbursed, or the obligations are issued, no later than six months after the date on which the qualified recipient takes possession of the asset or the facility or, if earlier, places the asset or the facility in service. However, in the case of a small project described in paragraph (c)(8)(v) of this section, the six-month period shall be one year.

(B) In the case of an investment in active business assets or a development project that is part of a long term project described in paragraph (c)(6)(iv)(B) of this section, a loan shall also be a qualified investment for purposes of this paragraph (c) if the loan proceeds are disbursed, or the obligations are issued, no later than six months after completion of the project or, in the case of a farming business, after the beginning of production, and in any event, no later than three years after the date on which the first payment is made toward the eligible costs of the project. The amount of the qualified investment may not exceed the sum of—

(*1*) The eligible costs relating to investments described in paragraph (c)(4)(i)(A) in the case of an investment in active business assets, or the eligible costs relating to investments described in paragraph (c)(5)(i) of this section in the case of a development project, but only to the extent of the costs that are incurred after the date described in paragraph (c)(7)(i)(D) of this section, and

(*2*) The portion of unpaid interest that would be required to be capitalized under U.S. tax rules and that accrued on prior temporary non-section 936 financing from the date described in paragraph (c)(7)(i)(D) of this section through the date the section 936 loan proceeds are disbursed or the section 936 obligations are issued.

(C) In order to qualify for the special rules of this paragraph (c)(7)(i), a plan must be filed with the Commissioner of Financial Institutions of Puerto Rico (or his delegate) stating the qualified recipient's intention to refinance the costs of the long term project with section funds.

(D) The date referred to in paragraph (c)(7)(i)(B) (*1*) and (*2*) of this section is a date that is the later of—

(*1*) The date the plan described in paragraph (c)(7)(i)(C) is filed, or

(*2*) The date the investment becomes a qualified investment by a qualified recipient in active business assets or a development project in a qualified Caribbean Basin country.

(ii) *Refinancing of section 936 financing.* A section 936 loan or bond issue used to finance a qualified investment described in paragraph (c)(1) of this section may be refinanced with section 936 funds through a new loan or bond issue to the extent of the remaining principal balance on such existing qualified financing, increased by the amount of unpaid interest accrued through the date the new loan proceeds are disbursed or the new obligations are issued and that would be required to be capitalized under U.S. tax rules.

(iii) *Prompt application of borrowed proceeds*—(A) *In general.* In the case of a loan or bond issue described in paragraph (c)(7)(i) or (ii) of this section, the rules of paragraph (c)(6) of this section shall apply but the six-month period described in paragraph (c)(6)(i) of this section shall be limited to 30 days from the date of disbursement of loan proceeds to the qualified recipient or from the date of issuance in the case of a bond issue.

(B) *Special rules for long term projects financed out of bond proceeds.* In the case of a long term project described in paragraph (c)(6)(iv)(B) of this section that is financed out of bond proceeds, the 30-day period described in paragraph (c)(7)(iii)(A) of this section shall be extended with respect to the amount of bond proceeds used for the permanent financing of the long term project for such reasonable period of time as shall be necessary until completion of the project or beginning of production (in the case of a farming business), but, in any event, not to exceed three years from the date of issuance of the bonds. For purposes of this paragraph (c)(7)(iii)(B), the period of time shall be considered reasonable only if—

(*1*) A construction and expenditure plan certified by an independent expert (such as an engineer, an architect, or a farming expert) is filed with, and approved by, the Commissioner of Financial Institutions of Puerto Rico (or his delegate) prior to the date of issue, which makes a reasonable estimate, as of the date of issue, of the amounts and uses of the bond proceeds and the time of completion or production, and includes a schedule of progress payments until such time; and

(*2*) The terms of the construction and expenditure plan are disclosed in the public offering memorandum, private placement memorandum, or similar document prepared for information or disclosure purposes in relation to the bond issue.

(8) *Miscellaneous operating rules*—(i) *Sale and leaseback.* An asset that is acquired and leased back to the person from whom acquired does not constitute an investment in an active business asset or an investment in a development project.

(ii) *Use of asset in qualified business activity.* For purposes of paragraph (c)(4)(i)(B), an asset shall be considered used or held for use in a qualified business activity if it is used or held for use in such activity under principles similar to those described in §1.367(a)-2T(b)(5), or a successor provision.

(iii) *Definition of capital expenditures.* For purposes of this paragraph (c), capital expenditures mean those expenditures described in section 263(a) of the Code (without regard to paragraphs (A) through (G) of section 263(a)(1)), and those costs required to be capitalized under section 263A with respect to property described in section 263A(b)(1), relating to self-constructed assets.

(iv) *Loans through certain financial intermediaries.* A loan by a qualified financial institution shall not be disqualified from being an investment in active business assets or in a development project merely because the proceeds are first lent to a financial intermediary (as defined in paragraph (c)(8)(iv)(H) of this section) which, in turn, on-lends the proceeds directly to a qualified recipient, provided the requirements of this paragraph (c)(8)(iv) are satisfied.

(A) The loan to the qualified recipient must satisfy the requirements of paragraph (c)(4)(i) of this section in the case of an investment in active business assets, or of paragraph (c)(5)(i) of this section in the case of an investment in a development project.

(B) The qualified recipient and the active business assets or development project in which the proceeds are to be invested must be identified prior to disbursement of any part of the proceeds by the qualified financial institution to the financial intermediary.

(C) The effective interest rate charged by the qualified financial institution to the financial intermediary must not exceed the average interest rate paid by the qualified financial institution with respect to its eligible funds, increased by such number of basis points as is required to provide reasonable compensation to the qualified financial institution for services performed and risks assumed with respect to the loan to the financial intermediary that are not ordinarily required to be performed or assumed with respect to a deposit, loan, repurchase agreement or other transfer of eligible funds with another qualified financial institution. The average interest rate shall be the average rate, determined on a daily basis, paid by the qualified financial institution on its eligible funds over the most recent quarter preceding the date on which the rate on the loan to the financial intermediary is committed.

(D) The effective interest rate charged by the financial intermediary to the qualified recipient must not exceed the effective interest rate charged to the financial intermediary by the qualified financial institution, increased by such number of basis points as is required to provide reasonable compensation to the financial intermediary for services performed and risks assumed with respect to the loan to the qualified recipient.

(E) The financial intermediary must borrow from the qualified financial institution under substantially the same terms as it lends to the qualified recipient. In particular, both loans must have disbursement terms, repayment schedules and maturity dates for interest and principal amounts such that the financial intermediary does not retain for more than 48 hours any of the funds disbursed by the qualified financial institution nor any of the funds paid by the qualified recipient in repayment of principal or interest on the loan.

(F) The financial institution and the financial intermediary must agree to comply with the due diligence requirements described in paragraphs (c)(11), (12), and (13) of this section;

(G) The time periods and temporary investments rules in paragraphs (c)(6) and (7) of this section must be complied with; and

(H) For purposes of this paragraph (c), the financial intermediary must be—

(*1*) An active trade or business which a person maintains in a qualified Caribbean Basin country and which consists of a banking, financing or similar business as defined in §1.864–4(c)(5)(i) (other than a central bank of issue); or

(*2*) A public international organization, the principal purpose of which is to foster economic development in developing countries and which is described in section 1 of the International Organizations Immunities Act (22 U.S.C. 288).

For purposes of paragraphs (c)(8)(iv)(C) and (D) of this section, the determination of whether compensation is reasonable shall be made in relation to normal commercial practices for comparable transactions carrying a similar degree of commercial, currency and political risk. Reasonable credit enhancement fees and other reasonable fees and amounts charged to the financial intermediary or the qualified recipient with respect to the loan transaction in addition to interest shall be added to the interest cost in determining the effective interest rate.

(v) *Small project.* For purposes of this paragraph (c), a small project shall be a project (including the acquisition of an asset) for which the total amount of section 936 funds used for its financing does not exceed $1,000,000 in the aggregate, or such other amount as the Commissioner may publish, from time to time, in the Internal Revenue Bulletin.

(9) *Qualified recipient.* For purposes of this section, a qualified recipient is any person described in paragraph (c)(9)(i) or (ii) of this section. The term ''person'' means a person described in section 7701(a)(1) or a government (within the meaning of §1.892–2T(a)(1)) of a qualified Caribbean Basin country.

(i) In the case of an investment described in paragraph (c)(4) of this section (relating to investments in active business assets), a qualified recipient is a person that carries on a qualified business activity in a qualified Caribbean Basin country, and complies with the agreement and certification requirements described in paragraph (c)(11)(i) of this section at all times during the period in which the investment remains outstanding.

(ii) In the case of an investment described in pargraph (c)(5) of this section (relating to investments in development projects), a qualified recipient is the borrower (including a person empowered by the borrower to authorize expenditures for the investment in the development project) that has authority to comply, and complies, with the agreement and certification requirements described in paragraph (c)(11)(i) of this section at all times during the period in which the investment remains outstanding.

(10) *Investments in a qualified Caribbean Basin country*—(i) *Rules for determining the place of an investment.* The rules of this paragraph (c)(10)(i) shall apply to determine the extent to which an investment in an active business asset or a development project will be

considered made in qualified Caribbean Basin Country.

(A) An investment in real property is considered made in the qualified Caribbean Basin country in which the real property is located.

(B) Except as otherwise provided in this paragraph (c)(10)(i)(B), an investment in tangible personal property is considered made in a qualified Caribbean Basin Country so long as the tangible personal property is predominantly used in that country. Whether property is used predominantly in a qualified Caribbean Basin country shall be determined under principles similar to those described in §1.48–1(g)(1), (g)(2)(ii), (g)(2)(iv), (g)(2)(vi), (g)(2)(viii), and (g)(2)(x) (relating to investment tax credits for property used outside the United States) as in effect on December 31, 1985. A vessel, container, or aircraft shall be considered for use predominantly in a qualified Caribbean Basin country in any year if it is used for transport to and from such country with some degree of frequency during that year and at least 30 percent of the income from the use of such vessel, container or aircraft for that year is sourced in such country under principles similar to those described in section 863(c)(1) and (2) (relating to source rules for certain transportation income). Cables and pipelines which are premanently installed as part of a communication or transportation system between a qualified Caribbean Basin country and another country or among several countries which include a qualified Caribbean Basin country shall be considered used in a qualified Caribbean Basin country to the extent of 50 percent of the portion of the facility that directly links the qualified country to another country or to a hub, unless it is established by notice or other guidance published in the Internal Revenue Bulletin or by ruling issued to a qualified institution or qualified recipient upon request that it is appropriate to attribute a greater portion of the cost of the facility to the qualified Caribbean Basin country.

(C) An investment in rights to intangible property is considered made in a qualified Caribbean Basin country to the extent such rights are used in that country. Where rights to intangible property are used shall be determined under principles similar to those described in §1.954–2T(b)(3)(vii) or a successor provision.

(ii) *Qualified Caribbean Basin country.* For purposes of this section, the term ''qualified Caribbean Basin country'' means any beneficiary country (within the meaning of section 212(a)(1)(A) of the Caribbean Basin Economic Recovery Act, Public Law 98–67 (Aug. 5, 1983), 97 Stat. 384, 19 U.S.C. 2702(a)(1)(A)), which meets the requirements of section 274(h)(6)(A)(i) and (ii) and the U.S. Virgin Islands, and includes the territorial waters and continental shelf thereof.

(11) *Agreements and certifications by qualified recipients and financial intermediaries*—(i) *In general.* In order for an investment to be considered a qualified investment under section 936(d)(4) and paragraph (c)(1) of this section, a qualified recipient must certify to the qualified financial institution (or to the financial intermediary, if the loan is made through a financial intermediary) on the date of closing of the loan agreement and on each anniversary date thereof, that it is a qualified recipient described in paragraph (c)(9) of this section. In addition, the qualified recipient must agree in the loan agreement with the qualified financial institution (or with the financial intermediary, if the loan is made through a financial intermediary)—

(A) To use the funds at all times during the period the loan is outstanding solely for the purposes and in the manner described in paragraph (c)(4) of this section (regarding investment in active business assets) or in paragraph (c)(5) of this section (regarding investment in development projects);

(B) To comply with the requirements of paragraph (c)(6) of this section (regarding temporary investments and time periods within which the funds must be invested) and paragraph (c)(7) of this section (regarding the refinancing of existing funding and the time periods within which funding for investments must be secured);

(C) To notify the Assistant Commissioner (International), the qualified financial institution (or the financial intermediary, if the loan is made through a financial intermediary), and

the Commissioner of Financial Institutions of Puerto Rico (or his delegate) pursuant to paragraph (c)(14) of this section if it no longer is a qualified recipient or if, for any other reason, the investment has ceased to qualify as a qualified investment described in paragraph (c)(1) of this section, promptly upon the occurrence of such disqualifying event; and

(D) To permit examination by the office of the Assistant Commissioner (International) (or by the office of any District Director authorized by the Assistant Commissioner (International)) and the Commissioner of Financial Institutions of Puerto Rico (or his delegate) of all necessary books and records that are sufficient to verify that the funds were used for investments in active business assets or development projects in conformity with the terms of the loan agreement.

(ii) *Certification by a financial intermediary.* In the case of a loan by a qualified financial institution to a financial intermediary, the financial intermediary must certify to the qualified financial institution (using the procedures described in paragraph (c)(11)(i) of this section) that it is a financial intermediary described in paragraph (c)(8)(iv)(H) of this section, and must furnish to the qualified financial institution a copy of the qualified recipient's certification described in paragraph (c)(11)(i) of this section and of its loan agreement with the qualified recipient. In addition, the financial intermediary must agree in the loan agreement with the qualified financial institution:

(A) To comply with the requirements of paragraph (c)(8)(iv) of this section; and

(B) To permit examination by the office of the Assistant Commissioner (International) (or by the office of any District Director authorized by the Assistant Commissioner (International)) and the Commissioner of Financial Institutions of Puerto Rico (or his delegate) of all its necessary books and records that are sufficient to verify that the funds were used in conformity with the terms of the loan agreements.

(12) *Certification requirements.* In order for an investment to be considered a qualified investment under section 936(d)(4), section 936(d)(4)(C)(i) requires that both the person in whose trade or business such investment is made and the financial institution certify to the Secretary of the Treasury and the Commissioner of Financial Institutions of Puerto Rico that the proceeds of the loan will be promptly used to acquire active business assets or to make other authorized expenditures. This certification requirement is satisfied as to the qualified financial institution, the financial intermediary (if any), and the qualified recipient if the qualified financial institution submits a certificate to both the Assistant Commissioner (International) and to the Commissioner of Financial Institutions of Puerto Rico (or his delegate) pursuant to paragraph (c)(14) of this section upon authorization of the investment by the Commissioner of Financial Institutions and, in any event, prior to the first disbursement of the loan proceeds to the qualified recipient or to the financial intermediary (if any), in which the qualified financial institution—

(i) Represents that, as of the date of the certification, the qualified recipient and the financial intermediary (if any) have complied with the requirements described in paragraph (c)(11) of this section;

(ii) Describes the important terms of the loan to the financial intermediary (if any) and to the qualified recipient, including the amount of the loan, the nature of the investment, the basis for its qualification as an investment in active business assets or a development project under this section, the identity of the financial intermediary (if any) and of the qualified recipient, the qualified Caribbean Basin country involved, and the nature of the collateral or other security used, including any guarantee;

(iii) Agrees to permit examination by the Assistant Commissioner (International) (or by the office of any District Director authorized by the Assistant Commissioner (International)) and the Commissioner of Financial Institutions of Puerto Rico (or his delegate) of all its necessary books and records that are sufficient to verify that the funds were used for investments in active business assets or development

projects in conformity with the terms of the loan agreement or agreements with the financial intermediary (if any) and with the qualified recipient; and

(iv) In the case of a single-purpose entity that is a qualified financial institution, discloses the name and address of the entity's trustee or agent, if any, that assists the qualified financial institution in the performance of its due diligence requirement under paragraph (c) of this section, and represents that the trustee or agent has agreed with the qualified financial institution to permit examination by the Assistant Commissioner (International) (or by the office of any District Director authorized by the Assistant Commissioner (International)) and the Commissioner of Financial Institutions of Puerto Rico (or his delegate) of all necessary books and records of such trustee or agent that are sufficient to verify that the funds were used for investments in active business assets or development projects in conformity with the terms of the loan agreement or agreements with the financial intermediary (if any) and with the qualified recipient.

(13) *Continuing due diligence requirements.* In order to maintain the qualification for an investment under paragraph (c)(1) of this section, the continuing due diligence requirements described in this paragraph (c)(13) must be satisfied.

(i) *Requirements of qualified recipient.* A qualified recipient must—

(A) Submit annually to the qualified financial institution or to the financial intermediary from which its qualified funds were obtained a copy of its most recent annual financial statement accompanied by an opinion of an independent accountant familiar with the financials of the qualified recipient disclosing the amount of the loan, the current outstanding balance of the loan, describing the assets financed with such loan and the qualified business activity in which such assets are used or the development project for which the loan is used, and stating that there are no reasons to doubt that the loan proceeds have been properly used and continue to be properly used, and

(B) Act in a manner consistent with its representations and agreements described in paragraph (c)(11) of this section.

(ii) *Requirements of qualified financial institutions.* Except as otherwise provided in paragraph (c)(13)(iii) of this section, a qualified financial institution described in paragraph (c)(3) of this section must maintain in its records and have available for inspection the documentation described in paragraph (c)(13)(ii)(A) or (B) of this section. In addition, the qualified financial institution is required to notify the Assistant Commissioner (International) and the Commissioner of Financial Institutions of Puerto Rico (or his delegate) pursuant to paragraph (c)(14) of this section upon becoming aware that a loan has ceased to be an investment in active business assets or a development project under this section. For purposes of this paragraph (c)(13)(ii), multiple loans for investment in a single qualified business activity or development project will be aggregated in determining what due diligence requirements apply.

(A) In the case of a small project described in paragraph (c)(8)(v) of this section, the following documents must be maintained and available for inspection:

(*1*) The loan application or other similar document;

(*2*) The financial statements of the qualified recipient filed as part of the loan application;

(*3*) The statement required by section 6.4.3(a)(iii) of Puerto Rican Regulation No. 3582 or any successor thereof, signed by the qualified recipient (or its duly authorized representative), acknowledging the receipt of the loan proceeds, describing the assets financed with such loan and the business activity in which such assets are to be used or the development project for which the funds will be utilized, the collateral to be provided for the transaction including any guarantee, and the basis for its qualification as a qualified recipient;

(*4*) The loan documents; and

(*5*) In the case of a qualified financial institution that is a single-purpose entity, a copy of the agreement with the

entity's trustee or agent, if any, described in paragraph (c)(12)(iv) of this section.

(B) In the case of a disbursement concerning a project that is not a small project described in paragraph (c)(8)(v) of this section, the following documents must be maintained and available for inspection, in addition to the documents required by paragraph (c)(13)(ii)(A) of this section:

(*1*) A memorandum of credit prepared by an officer of the qualified financial institution (or, in the case of a single purpose entity, an agent of the entity or a trustee for the entity, if any) and signed by the officer of the qualified financial institution, containing the details of the investigation and review that the qualified financial institution, or its trustee or agent, if any, conducted in order to evaluate whether the investment is qualified under paragraph (c)(1) of this section and the opinion of the officer of the qualified financial institution, or the opinion of an officer of the agent of, or of the trustee for, the qualified financial institution, if any, that there is no reasonable ground for belief that the qualified funds will be diverted to a use that is not permitted under the provisions of this section; in making this investigation and review, factors that must be utilized are ones similar to those listed in Puerto Rico Regulation No. 3582, section 6.4.2;

(*2*) The annual financial statement of the qualified recipient; and

(*3*) The written report of an officer of the qualified financial institution, or of an officer of an agent of, or of the trustee for, the qualified financial institution, if any, documenting discussions, both before and after the disbursement of the loan proceeds, with each recipient's accounting, financial and executive personnel with respect to the proposed and actual use of the loan proceeds and his analysis of the annual financial statements of the qualified recipient including an analysis of the statement of sources and uses of funds. After the loan disbursement, such discussions and review shall occur annually during the term of the loan. Such report shall include the conclusion that in such officer's opinion there is no reasonable ground for belief that the qualified recipient is improperly utilizing the funds.

(iii) *Requirements in the case of a financial intermediary*. Where a qualified financial institution lends funds to a financial intermediary which are on-lent to a qualified recipient—

(A) The obligation to maintain the documentation described in paragraph (c)(13)(ii)(A) or (B) of this section shall apply only to the financial intermediary and not to the qualified financial institution and the provisions of paragraph (c)(13)(ii)(A) or (B) of this section shall be read so as to impose on the financial intermediary any obligation imposed on the qualified financial institution.

(B) The financial intermediary shall forward annually to the qualified financial institution a copy of the documentation it is required to maintain in its records pursuant to the provisions of this paragraph (c)(13)(iii) and shall notify the Assistant Commissioner (International), the Commissioner of Financial Institutions of Puerto Rico (or his delegate) and the qualified financial institution pursuant to paragraph (c)(14) of this section upon becoming aware that a loan has ceased to be an investment in active business assets or a development project under this section. The qualified financial institution must maintain in its records and have available for inspection the documentation furnished by the financial intermediary pursuant to this paragraph (c)(13)(iii)(B).

(C) The qualified financial institution shall cause one of its officers (or one of the officers of its agent or trustee, if any) to prepare a written report documenting his analysis of the documentation furnished by the financial intermediary pursuant to paragraph (c)(13)(iii)(B) of this section, his discussions, both before and after the disbursement of the loan proceeds, with the financial intermediary's accounting, financial and executive personnel with respect to the proposed and actual use of the loan proceeds, and his analysis of the annual financial statements of the qualified recipient including an analysis of the statement of sources and uses of funds. After the loan disbursement, such discussions and review shall occur annually during the term of

the loan. Such report shall include the conclusion that in such officer's opinion there is no reasonable ground for belief that the qualified recipient is improperly utilizing the funds.

(14) *Procedures for notices and certifications.* Notices and certifications to the Assistant Commissioner (International) required under paragraphs (c)(11), (12) and (13) of this section shall be addressed to the attention of the Assistant Commissioner (International), Office of Taxpayer Service and Compliance, IN:C, 950 L'Enfant Plaza South, SW., Washington, DC 20024. Notices and certifications to the Commissioner of Financial Institutions of Puerto Rico required under paragraphs (c)(11), (12), and (13) of this section shall be addressed as follows: Commissioner of Financial Institutions, GPO Box 70324, San Juan, Puerto Rico 00936.

(15) *Effective date.* This paragraph (c) is effective May 13, 1991. It is applicable to investments by a possessions corporation in a financial institution that are used by a financial institution for investments in accordance with a specific authorization granted by the Commissioner of Financial Institutions of Puerto Rico (or his delegate) after September 22, 1989. However, the taxpayer may choose to apply §1.936–10T(c) for periods before June 12, 1991.

[T.D. 8350, 56 FR 21927, May 13, 1991]

§ 1.936–11 New lines of business prohibited.

(a) *In general.* A possessions corporation that is an existing credit claimant, as defined in section 936(j)(9)(A) and this section, that adds a substantial new line of business during a taxable year, or that has a new line of business that becomes substantial during the taxable year, loses its status as an existing credit claimant for that year and all years subsequent.

(b) *New line of business*—(1) *In general.* A new line of business is any business activity of the possessions corporation that is not closely related to a pre-existing business of the possessions corporation. The term *closely related* is defined in paragraph (b)(2) of this section. The term *pre-existing business* is defined in paragraph (b)(3) of this section.

(2) *Closely related.* To determine whether a new activity is closely related to a pre-existing business of the possessions corporation all the facts and circumstances must be considered, including those set forth in paragraphs (b)(2)(i)(A) through (G) of this section.

(i) *Factors.* The following factors will help to establish that a new activity is closely related to a pre-existing business activity of the possessions corporation—

(A) The new activity provides products or services very similar to the products or services provided by the pre-existing business;

(B) The new activity markets products and services to the same class of customers;

(C) The new activity is of a type that is normally conducted in the same business location;

(D) The new activity requires the use of similar operating assets;

(E) The new activity's economic success depends on the success of the pre-existing business;

(F) The new activity is of a type that would normally be treated as a unit with the pre-existing business' in the business accounting records; and

(G) The new activity and the pre-existing business are regulated or licensed by the same or similar governmental authority.

(ii) *Safe harbors.* An activity is not a new line of business if—

(A) If the activity is within the same six-digit North American Industry Classification System (NAICS) code (or four-digit Standard Industrial Classification (SIC) code). The similarity of the NAICS or SIC codes may not be relied upon to determine whether the activity is closely related to a pre-existing business where the code indicates a miscellaneous category;

(B) If the new activity is within the same five-digit NAICS code (or three-digit SIC code) and the facts relating to the new activity also satisfy at least three of the factors listed in paragraphs (b)(2)(i)(A) through (G) of this section; or

(C) If the pre-existing business is making a component product or end-product form, as defined in §1.936–5(a)(1),Q&A1, and the new business activity is making an integrated product, or an end-product form with fewer excluded components, that is not within

the same six-digit NAICS code (or four-digit SIC code) as the pre-existing business solely because the component product and the integrated product (or two end-product forms) have different end-uses.

(3) *Pre-existing business*—(i) *In general.* Except as provided in paragraph (b)(3)(ii) of this section, a business activity is a pre-existing business of the existing credit claimant if—

(A) The existing credit claimant was actively engaged in the activity within the possession on or before October 13, 1995; and

(B) The existing credit claimant had elected the benefits of the Puerto Rico and possession tax credit pursuant to an election which was in effect for the taxable year that included October 13, 1995.

(ii) *Acquisition of an existing credit claimant.* (A) If all the assets of one or more trades or businesses of a corporation of an existing credit claimant are acquired by an affiliated or non-affiliated existing credit claimant which carries on the business activity of the predecessor existing credit claimant, the acquired business activity will be treated as a pre-existing business of the acquiring corporation. A non-affiliated acquiring corporation will not be bound by any section 936(h) election made by the predecessor existing credit claimant with respect to that business activity.

(B) Where all of the assets of one or more trades or businesses of a corporation of an existing credit claimant are acquired by a corporation that is not an existing credit claimant, the acquiring corporation may make a section 936(e) election for the taxable year in which the assets are acquired with the following effects—

(*1*) The acquiring corporation will be treated as an existing

(*2*) The activity will be considered a pre-existing business of the acquiring corporation;

(*3*) The acquiring corporation will be deemed to satisfy the rules of section 936(a)(2) for the year of acquisition; and

(*4*) After making an election under section 936(e), a non-affiliated acquiring corporation will not be bound by elections under sections 936(a)(4) and (h) made by the predecessor existing credit claimant.

(C) For purposes of this section the assets of a trade or business are determined at the time of acquisition provided that the transferee actively conducts the trade or business acquired.

(D) A mere change in the stock ownership of a possessions corporation will not affect its status as an existing credit claimant for purposes of this section.

(4) *Leasing of Assets.* (i) The leasing of assets (and employees to operate leased assets) will not, for purposes of this section, be considered a new line of business of the existing credit claimant if—

(A) The existing credit claimant used the leased assets in an active trade or business for at least five years;

(B) The existing credit claimant does not through its own officers or staff of employees perform management or operational functions (but not including operational functions performed through leased employees) with respect to the leased assets; and

(C) The existing credit claimant does not perform marketing functions with respect to the leasing of the assets.

(ii) Any income from the leasing of assets not considered a new line of business pursuant to paragraph (b)(4)(i) of this section will not be income from the active conduct of a trade or business (and, therefore, the existing credit claimant may not receive a possession tax credit with respect to such income).

(5) *Timing rule.* The tests for a new line of business in this paragraph (whether the new activity is closely related to a pre-existing business) are applied only at the end of the taxable year during which the new activity is added.

(c) *Substantial*—(1) *In general.* A new line of business is considered to be substantial as of the earlier of—

(i) The taxable year in which the possessions corporation derives more than 15 percent of its gross income from that new line of business (gross income test); or

(ii) The taxable year in which the possessions corporation directly uses in that new line of business more than 15 percent of its assets (assets test).

(2) *Gross income test.* The denominator in the gross income test is the amount that is the gross income of the possessions corporation for the current taxable year, while the numerator is the amount that is the gross income of the new line of business for the current taxable year. The gross income test is applied at the end of each taxable year. For purposes of this test, if a new line of business is added late in the taxable year, the income is not to be annualized in that year. In the case of a new line of business acquired through the purchase of assets, the gross income of such new line of business for the taxable year of the acquiring corporation that includes the date of acquisition is determined from the date of acquisition through the end of the taxable year. In the case of a consolidated group election made pursuant to section 936(i)(5), the test applies on a company by company basis and not on a consolidated basis.

(3) *Assets test*—(i) *Computation.* The denominator is the adjusted tax basis of the total assets of the possessions corporation for the current taxable year. The numerator is the adjusted tax basis of the total assets utilized in the new line of business for the current taxable year. The assets test is computed annually using all assets including cash and receivables.

(ii) *Exception.* A new line of business of a possessions corporation will not be treated as substantial as a result of meeting the assets test if an event that is not reasonably anticipated causes assets used in the new line of business of the possessions corporation to exceed 15 percent of the adjusted tax basis of the possessions corporation's total assets. For example, an event that is not reasonably anticipated would include the destruction of plant and equipment of the pre-existing business due to a hurricane or other natural disaster, or other similar circumstances beyond the control of the possessions corporation. The expiration of a patent is not such an event and will not permit use of this exception.

(d) *Examples.* The following examples illustrate the rules described in paragraphs (a), (b), and (c) of this section. In the following examples, X Corp. is an existing credit claimant unless otherwise indicated:

Example 1. X Corp. is a pharmaceutical corporation which manufactured bulk chemicals (a component product). In March 1997, X Corp. began to also manufacture pills (e.g., finished dosages or an integrated product). The new activity provides products very similar to the products provided by the pre-existing business. The new activity is of a type that is normally conducted in the same business location as the pre-existing business. The activity's economic success depends on the success of the pre-existing business. The manufacture of bulk chemicals is in NAICS code 325411, Medicinal and Botanical Manufacturing, while the manufacture of the pills is in NAICS code 325412, Pharmaceutical Preparation Manufacturing. Although the products have a different end-use, may be marketed to a different class of customers, and may not use similar operating assets, they are within the same five-digit NAICS code and the activity also satisfies paragraphs (b)(2)(i)(A), (C), and (E) of this section. The manufacture of the pills by X Corp. will be considered closely related to the manufacture of the bulk chemicals. Therefore, X Corp. will not be considered to have added a new line of business for purposes of paragraph (b) of this section because it falls within the safe harbor rule of (b)(2)(ii)(B).

Example 2. X Corp. currently manufactures printed circuit boards in a possession. As a result of a technological breakthrough, X Corp. could produce the printed circuit boards more efficiently if it modified its existing production methods. Because demand for its products was high, X Corp. expanded when it modified its production methods. After these modifications to the facilities and production methods, the products produced through the new technology were in the same six-digit NAICS code as products produced previously by X Corp. See paragraph (b)(2)(ii)(A) of this section. Therefore, X Corp. will not be considered to have added a new line of business for purposes of paragraph (b) of this section because it falls within the safe harbor rule of (b)(2)(ii)(A).

Example 3. X Corp. has manufactured Device A in Puerto Rico for a number of years and began to manufacture Device B in Puerto Rico in 1997. Device A and Device B are both used to conduct electrical current to the heart and are both sold to cardiologists. There is no significant change in the type of activity conducted in Puerto Rico after the transfer of the manufacturing of Device B to Puerto Rico. Similar manufacturing equipment, manufacturing processes and skills are used in the manufacture of both devices. Both are regulated and licensed by the Food

and Drug Administration. The economic success of Device B is dependent upon the success of Device A only to the extent that the liability and manufacturing prowess with respect to one reflects favorably on the other. Depending upon the heart abnormality, the cardiologist may choose to use Device A, Device B or both on a patient. The manufacture of Device B is treated as a unit with the manufacture of Device A in X Corp.'s accounting records. The manufacture of Device A is in the six-digit NAICS code 339112, Surgical and Medical Instrument Manufacturing. The manufacture of Device B is in the six-digit NAICS code 334510, Electromedical and Electrotherapeutic Apparatus Manufacturing. (The manufacture of Device A is in the four-digit SIC code 3845, Electromedical and Electrotherapeutic Apparatus. The manufacture of Device B is in the four-digit SIC code 3841, Surgical and Medical Instruments and Apparatus.) The safe harbor of paragraph (b)(2)(ii)(B) of this section applies because the two activities are within the same three-digit SIC code and Corp. X satisfies paragraphs (b)(2)(i)(A), (B), (C), (D), (F), and (G) of this section.

Example 4. X Corp. has been manufacturing house slippers in Puerto Rico since 1990. Y Corp. is a U.S. corporation that is not affiliated with X Corp. and is not an existing credit claimant. Y Corp. has been manufacturing snack food in the United States. In 1997, X Corp. purchased the assets of Y Corp. and began to manufacture snack food in Puerto Rico. House slipper manufacturing is in the six-digit NAICS code 316212 (Four-digit SIC code 3142, House Slippers). The manufacture of snack foods falls under the six-digit NAICS code 311919, Other Snack Food Manufacturing (four-digit SIC code 2052, Cookies and Crackers (pretzels)). Because these activities are not within the same five or six digit NAICS code (or the same three or four-digit SIC code), and because snack food is not an integrated product that contains house slippers, the safe harbor of paragraph (b)(2)(ii) of this section cannot apply. Considering all the facts and circumstances, including the seven factors of paragraph (b)(2)(i) of this section, the snack food manufacturing activity is not closely related to the manufacture of house slippers, and is a new line of business, within the meaning of paragraph (b) of this section.

Example 5. X Corp., a calendar year taxpayer, is an existing credit claimant that has elected the profit-split method for computing taxable income. P Corp. was not an existing credit claimant and manufactured a product in a different five-digit NAICS code than the product manufactured by X Corp. In 1997, X Corp. acquired the stock of P Corp. and liquidated P Corp. in a tax-free liquidation under section 332, but continued the business activity of P Corp. as a new business segment. Assume that this new business segment is a new line of business within the meaning of paragraph (c) of this section. In 1997, X Corp. has gross income from the active conduct of a trade or business in a possession computed under section 936(a)(2) of $500 million and the adjusted tax basis of its assets is $200 million. The new business segment had gross income of $60 million, or 12 percent of the X Corp. gross income, and the adjusted basis of the new segment's assets was $20 million, or 10 percent of the X Corp. total assets. In 1997, X Corp. does not derive more than 15 percent of its gross income, or directly use more that 15 percent of its total assets, from the new business segment. Thus, the new line of business acquired from P Corp. is not a *substantial* new line of business within the meaning of paragraph (c) of this section, and the new activity will not cause X Corp. to lose its status as an existing credit claimant during 1997. In 1998, however, the gross income of X Corp. grew to $750 million while the gross income of the new line of business grew to $150 million, or 20% of the X Corp. 1998 gross income. Thus, in 1998, the new line of business is substantial within the meaning of paragraph (c) of this section, and X Corp. loses its status as an existing credit claimant for 1998 and all years subsequent.

(e) *Loss of status as existing credit claimant.* An existing credit claimant that adds a substantial new line of business in a taxable year, or that has a new line of business that becomes substantial in a taxable year, loses its status as an existing credit claimant for that year and all years subsequent.

(f) *Effective date*—(1) *General rule.* This section applies to taxable years of a possessions corporation beginning on or after January 25, 2000.

(2) *Election for retroactive application.* Taxpayers may elect to apply retroactively all the provisions of this section for any open taxable year beginning after December 31, 1995. Such election will be effective for the year of the election and all subsequent taxable years. This section will not apply to activities of pre-existing businesses for taxable years beginning before January 1, 1996.

[T.D. 8868, 65 FR 3815, Jan. 25, 2000]

§ 1.937–1 Bona fide residency in a possession.

(a) *Scope*—(1) *In general.* Section 937(a) and this section set forth the rules for determining whether an individual qualifies as a bona fide resident of a particular possession (the relevant possession) for purposes of subpart D,

part III, Subchapter N, Chapter 1 of the Internal Revenue Code as well as section 865(g)(3), section 876, section 881(b), paragraphs (2) and (3) of section 901(b), section 957(c), section 3401(a)(8)(C), and section 7654(a).

(2) *Definitions.* For purposes of this section and §§ 1.937–2 and 1.937–3—

(i) *Possession* means one of the following United States possessions: American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, or the Virgin Islands. When used in a geographical sense, the term comprises only the territory of each such possession (without application of sections 932(c)(3) and 935(c)(2) (as in effect before the effective date of its repeal)).

(ii) *United States*, when used in a geographical sense, is defined in section 7701(a)(9), and without application of sections 932(a)(3) and 935(c)(1) (as in effect before the effective date of its repeal).

(b) *Bona fide resident*—(1) *General rule.* An individual qualifies as a bona fide resident of the relevant possession if such individual satisfies the requirements of paragraphs (c) through (e) of this section with respect to such possession.

(2) *Special rule for members of the Armed Forces.* A member of the Armed Forces of the United States who qualified as a bona fide resident of the relevant possession in a prior taxable year is deemed to have satisfied the requirements of paragraphs (c) through (e) of this section for a subsequent taxable year if such individual otherwise is unable to satisfy such requirements by reason of being absent from such possession or present in the United States during such year solely in compliance with military orders. Conversely, a member of the Armed Forces of the United States who did not qualify as a bona fide resident of the relevant possession in a prior taxable year is not considered to have satisfied the requirements of paragraphs (c) through (e) of this section for a subsequent taxable year by reason of being present in such possession solely in compliance with military orders. *Armed Forces of the United States* is defined (and members of the Armed Forces are described) in section 7701(a)(15).

(3) *Juridical persons.* Except as provided in § 1.881–5(f):

(i) Only natural persons may qualify as bona fide residents of a possession; and

(ii) The rules governing the tax treatment of bona fide residents of a possession do not apply to juridical persons (including corporations, partnerships, trusts, and estates).

(4) *Transition rule.* For taxable years beginning before October 23, 2004, and ending after October 22, 2004, an individual is considered to qualify as a bona fide resident of the relevant possession if that individual would be a bona fide resident of the relevant possession by applying the principles of §§ 1.871–2 through 1.871–5.

(5) *Special rule for cessation of bona fide residence in Puerto Rico.* See paragraph (f)(2)(ii) of this section for a special rule applicable to a citizen of the United States who ceases to be a bona fide resident of Puerto Rico during a taxable year.

(c) *Presence test*—(1) *In general.* A United States citizen or resident alien individual (as defined in section 7701(b)(1)(A)) satisfies the requirements of this paragraph (c) for a taxable year if that individual—

(i) Was present in the relevant possession for at least 183 days during the taxable year;

(ii) Was present in the relevant possession for at least 549 days during the three-year period consisting of the taxable year and the two immediately preceding taxable years, provided that the individual was also present in the relevant possession for at least 60 days during each taxable year of the period;

(iii) Was present in the United States for no more than 90 days during the taxable year;

(iv) During the taxable year had earned income (as defined in § 1.911–3(b)) in the United States, if any, not exceeding in the aggregate the amount specified in section 861(a)(3)(B) and was present for more days in the relevant possession than in the United States; or

(v) Had no significant connection to the United States during the taxable year. See paragraph (c)(5) of this section.

(2) *Special rule for alien individuals.* A nonresident alien individual (as defined in section 7701(b)(1)(B)) satisfies the requirements of this paragraph (c) for a taxable year if during that taxable year that individual satisfies the substantial presence test of §301.7701(b)–1(c) of this chapter (except for the substitution of the name of the relevant possession for the term *United States* where appropriate).

(3) *Days of presence.* For purposes of paragraph (c)(1) of this section—

(i) An individual is considered to be present in the relevant possession on:

(A) Any day that the individual is physically present in that possession at any time during the day;

(B) Any day that an individual is outside of the relevant possession to receive, or to accompany on a full-time basis a parent, spouse, or child (as defined in section 152(f)(1)) who is receiving, qualifying medical treatment as defined in paragraph (c)(4) of this section; and

(C) Any day that an individual is outside the relevant possession because the individual leaves or is unable to return to the relevant possession during any—

(*1*) 14-day period within which a major disaster occurs in the relevant possession for which a Federal Emergency Management Agency Notice of a Presidential declaration of a major disaster is issued in the FEDERAL REGISTER; or

(*2*) Period for which a mandatory evacuation order is in effect for the geographic area in the relevant possession in which the individual's place of abode is located.

(ii) An individual is considered to be present in the United States on any day that the individual is physically present in the United States at any time during the day. Notwithstanding the preceding sentence, the following days will not count as days of presence in the United States:

(A) Any day that an individual is temporarily present in the United States under circumstances described in paragraph (c)(3)(i)(B) or (C) of this section;

(B) Any day that an individual is in transit between two points outside the United States (as described in §301.7701(b)–3(d) of this chapter), and is physically present in the United States for fewer than 24 hours;

(C) Any day that an individual is temporarily present in the United States as a professional athlete to compete in a charitable sports event (as described in §301.7701(b)–3(b)(5) of this chapter);

(D) Any day that an individual is temporarily present in the United States as a student (as defined in section 152(f)(2)); and

(E) In the case of an individual who is an elected representative of the relevant possession, or who serves full time as an elected or appointed official or employee of the government of the relevant possession (or any political subdivision thereof), any day spent serving the relevant possession in that role.

(iii) If, during a single day, an individual is physically present—

(A) In the United States and in the relevant possession, that day is considered a day of presence in the relevant possession;

(B) In two possessions, that day is considered a day of presence in the possession where the individual's tax home is located (applying the rules of paragraph (d) of this section).

(4) *Qualifying medical treatment*—(i) *In general.* The term *qualifying medical treatment* means medical treatment provided by (or under the supervision of) a physician (as defined in section 213(d)(4)) for an illness, injury, impairment, or physical or mental condition that satisfies the documentation and production requirements of paragraph (c)(4)(iii) of this section and that involves—

(A) Any period of inpatient care in a hospital or hospice and any period immediately before or after that inpatient care to the extent it is medically necessary; or

(B) Any temporary period of inpatient care in a residential medical care facility for medically necessary rehabilitation services;

(ii) *Inpatient care.* The term *inpatient care* means care requiring an overnight stay in a hospital, hospice, or residential medical care facility, as the case may be.

(iii) *Documentation and production requirements.* In order to satisfy the documentation and production requirements of this paragraph, an individual must, with respect to each qualifying medical treatment, prepare (or obtain), maintain, and, upon a request by the Commissioner (or the person responsible for tax administration in the relevant possession), make available within 30 days of such request:

(A) Records that provide—

(*1*) The patient's name and relationship to the individual (if the medical treatment is provided to a person other than the individual);

(*2*) The name and address of the hospital, hospice, or residential medical care facility where the medical treatment was provided;

(*3*) The name, address, and telephone number of the physician who provided the medical treatment;

(*4*) The date(s) on which the medical treatment was provided; and

(*5*) Receipt(s) of payment for the medical treatment;

(B) Signed certification by the providing or supervising physician that the medical treatment was qualified medical treatment within the meaning of paragraph (c)(4)(i) of this section, and setting forth—

(*1*) The patient's name;

(*2*) A reasonably detailed description of the medical treatment provided by (or under the supervision of) the physician;

(*3*) The dates on which the medical treatment was provided; and

(*4*) The medical facts that support the physician's certification and determination that the treatment was medically necessary; and

(C) Such other information as the Commissioner may prescribe by notice, form, instructions, or other publication (see §601.601(d)(2) of this chapter).

(5) *Significant connection.* For purposes of paragraph (c)(1)(v) of this section—

(i) The term *significant connection to the United States* means—

(A) A permanent home in the United States;

(B) Current registration to vote in any political subdivision of the United States; or

(C) A spouse or child (as defined in section 152(f)(1)) who has not attained the age of 18 whose principal place of abode is in the United States other than—

(*1*) A child who is in the United States because the child is living with a custodial parent under a custodial decree or multiple support agreement; or

(*2*) A child who is in the United States as a student (as defined in section 152(f)(2)).

(ii) *Permanent home*—(A) *General rule.* For purposes of paragraph (c)(5)(i)(A) of this section, except as provided in paragraph (c)(5)(ii)(B) of this section, the term *permanent home* has the same meaning as in §301.7701(b)–2(d)(2) of this chapter.

(B) *Exception for rental property.* If an individual or the individual's spouse owns property and rents it to another person at any time during the taxable year, then notwithstanding that the rental property may constitute a permanent home under §301.7701(b)–2(d)(2) of this chapter, it is not a permanent home under this paragraph (c)(5)(ii) unless the taxpayer uses any portion of it as a residence during the taxable year under the principles of section 280A(d). In applying the principles of section 280A(d) for this purpose, an individual is treated as using the rental property for personal purposes on any day determined under the principles of section 280A(d)(2) or on any day that the rental property (or any portion of it) is not rented to another person at fair rental for the entire day. The rental property is not used for personal purposes on any day on which the principal purpose of the use of the rental property is to perform repair or maintenance work on the property. Whether the principal purpose of the use of the rental property is to perform repair or maintenance work is determined in light of all the facts and circumstances including, but not limited to, the following: The amount of time devoted to repair and maintenance work, the frequency of the use for repair and maintenance purposes during a taxable year, and the presence and activities of companions.

(iii) For purposes of this paragraph (c)(5), the term *spouse* does not include a spouse from whom the individual is

legally separated under a decree of divorce or separate maintenance.

(d) *Tax home test*—(1) *General rule.* Except as provided in paragraph (d)(2) of this section, an individual satisfies the requirements of this paragraph (d) for a taxable year if that individual did not have a tax home outside the relevant possession during any part of the taxable year. For purposes of section 937 and this section, an individual's tax home is determined under the principles of section 911(d)(3) without regard to the second sentence thereof. Thus, under section 937, an individual's tax home is considered to be located at the individual's regular or principal (if more than one regular) place of business. If the individual has no regular or principal place of business because of the nature of the business, or because the individual is not engaged in carrying on any trade or business within the meaning of section 162(a), then the individual's tax home is the individual's regular place of abode in a real and substantial sense.

(2) *Exceptions*—(i) *Year of move.* See paragraph (f) of this section for a special rule applicable to an individual who becomes or ceases to be a bona fide resident of the relevant possession during a taxable year.

(ii) *Special rule for seafarers.* For purposes of section 937 and this section, an individual is not considered to have a tax home outside the relevant possession solely by reason of employment on a ship or other seafaring vessel that is predominantly used in local and international waters. For this purpose, a vessel is considered to be predominantly used in local and international waters if, during the taxable year, the aggregate amount of time it is used in international waters and in the waters within three miles of the relevant possession exceeds the aggregate amount of time it is used in the territorial waters of the United States, another possession, and a foreign country.

(iii) *Special rule for students and government officials.* Any days described in paragraphs (c)(3)(ii)(D) and (E) of this section are disregarded for purposes of determining whether an individual has a tax home outside the relevant possession under paragraph (d)(1) of this section during any part of the taxable year.

(e) *Closer connection test*—(1) *General rule.* Except as provided in paragraph (e)(2) of this section, an individual satisfies the requirements of this paragraph (e) for a taxable year if that individual did not have a closer connection to the United States or a foreign country than to the relevant possession during any part of the taxable year. For purposes of this paragraph (e)—

(i) The principles of section 7701(b)(3)(B)(ii) and §301.7701(b)–2(d) of this chapter apply (without regard to the final sentence of §301.7701(b)–2(b) of this chapter); and

(ii) An individual's connections to the relevant possession are compared to the aggregate of the individual's connections with the United States and foreign countries.

(2) *Exception for year of move.* See paragraph (f) of this section for a special rule applicable to an individual who becomes or ceases to be a bona fide resident of the relevant possession during a taxable year.

(f) *Year of move*—(1) *Move to a possession.* For the taxable year in which an individual's residence changes to the relevant possession, the individual satisfies the requirements of paragraphs (d)(1) and (e)(1) of this section if—

(i) For each of the 3 taxable years immediately preceding the taxable year of the change of residence, the individual is not a bona fide resident of the relevant possession;

(ii) For each of the last 183 days of the taxable year of the change of residence, the individual does not have a tax home outside the relevant possession or a closer connection to the United States or a foreign country than to the relevant possession; and

(iii) For each of the 3 taxable years immediately following the taxable year of the change of residence, the individual is a bona fide resident of the relevant possession.

(2) *Move from a possession*—(i) *General rule.* Except for a bona fide resident of Puerto Rico to whom §1.933–1(b) and paragraph (f)(2)(ii) of this section apply, for the taxable year in which an individual ceases to be a bona fide resident of the relevant possession, the individual satisfies the requirements of

paragraphs (d)(1) and (e)(1) of this section if—

(A) For each of the 3 taxable years immediately preceding the taxable year of the change of residence, the individual is a bona fide resident of the relevant possession;

(B) For each of the first 183 days of the taxable year of the change of residence, the individual does not have a tax home outside the relevant possession or a closer connection to the United States or a foreign country than to the relevant possession; and

(C) For each of the 3 taxable years immediately following the taxable year of the change of residence, the individual is not a bona fide resident of the relevant possession.

(ii) *Year of move from Puerto Rico.* Notwithstanding an individual's failure to satisfy the presence, tax home, or closer connection test prescribed under paragraph (b)(1) of this section for the taxable year, the individual is a bona fide resident of Puerto Rico for that part of the taxable year described in paragraph (f)(2)(ii)(E) of this section if the individual—

(A) Is a citizen of the United States;

(B) Is a bona fide resident of Puerto Rico for a period of at least 2 taxable years immediately preceding the taxable year;

(C) Ceases to be a bona fide resident of Puerto Rico during the taxable year;

(D) Ceases to have a tax home in Puerto Rico during the taxable year; and

(E) Has a closer connection to Puerto Rico than to the United States or a foreign country throughout the part of the taxable year preceding the date on which the individual ceases to have a tax home in Puerto Rico.

(g) *Examples.* The principles of this section are illustrated by the following examples:

Example 1. Presence test. H, a U.S. citizen, is engaged in a profession that requires frequent travel. H spends 195 days of each of the years 2005 and 2006 in Possession N. In 2007, H spends 160 days in Possession N. Under paragraph (c)(1)(ii), H satisfies the presence test of paragraph (c) of this section with respect to Possession N for taxable year 2007. Assuming that in 2007 H does not have a tax home outside of Possession N and does not have a closer connection to the United States or a foreign country under paragraphs (d) and (e) of this section respectively, then regardless of whether H was a bona fide resident of Possession N in 2005 and 2006, H is a bona fide resident of Possession N for taxable year 2007.

Example 2. Presence test. W, a U.S. citizen, lives for part of the taxable year in a condominium, which she owns, located in Possession P. W also owns a house in State N where she lives for 120 days every year to be near her grown children and grandchildren. W is retired and her income consists solely of pension payments, dividends, interest, and Social Security benefits. For 2006, W is only present in Possession P for a total of 175 days because of a 70-day vacation to Europe and Asia. Thus, for taxable year 2006, W is not present in Possession P for at least 183 days, is present in the United States for more than 90 days, and has a significant connection to the United States by reason of her permanent home. However, under paragraph (c)(1)(iv) of this section, W still satisfies the presence test of paragraph (c) of this section with respect to Possession P because she has no earned income in the United States and is present for more days in Possession P than in the United States.

Example 3. Presence test. T, a U.S. citizen, was born and raised in State A, where his mother still lives in the house in which T grew up. T is a sales representative for a company based in Possession V. T lives with his wife and minor children in their house in Possession V. T is registered to vote in Possession V and not in the United States. In 2006, T spends 120 days in State A and another 120 days in foreign countries. When traveling on business to State A, T often stays at his mother's house in the bedroom he used when he was a child. T's stays are always of short duration, and T asks for his mother's permission before visiting to make sure that no other guests are using the room and that she agrees to have him as a guest in her house at that time. Therefore, under paragraph (c)(5)(ii) of this section, T's mother's house is not a permanent home of T. Assuming that no other accommodations in the United States constitute a permanent home with respect to T, then under paragraphs (c)(1)(v) and (c)(5) of this section, T has no significant connection to the United States. Accordingly, T satisfies the presence test of paragraph (c) of this section for taxable year 2006.

Example 4. Alien resident of possession—presence test. F is a citizen of Country G. F's tax home is in Possession C and F has no closer connection to the United States or a foreign country than to Possession C. F is present in Possession C for 123 days and in the United States for 110 days every year. Accordingly, F is a nonresident alien with respect to the United States under section 7701(b), and a bona fide resident of Possession C under

paragraphs (b), (c)(2), (d), and (e) of this section.

Example 5. Seafarers—tax home. S, a U.S. citizen, is employed by a fishery and spends 250 days at sea on a fishing vessel in 2006. When not at sea, S resides with his wife at a house they own in Possession G. The fishing vessel upon which S works departs and arrives at various ports in Possession G, other possessions, and foreign countries, but is in international and local waters (within the meaning of paragraph (d)(2) of this section) for 225 days in 2006. Under paragraph (d)(2) of this section, for taxable year 2006, S will not be considered to have a tax home outside Possession G for purposes of section 937 and this section solely by reason of S's employment on board the fishing vessel.

Example 6. Seasonal workers—tax home and closer connection. P, a U.S. citizen, is a permanent employee of a hotel in Possession I, but works only during the tourist season. For the remainder of each year, P lives with her husband and children in Possession Q, where she has no outside employment. Most of P's personal belongings, including her automobile, are located in Possession Q. P is registered to vote in, and has a driver's license issued by, Possession Q. P does her personal banking in Possession Q and P routinely lists her address in Possession Q as her permanent address on forms and documents. P satisfies the presence test of paragraph (c) of this section with respect to both Possession Q and Possession I, because, among other reasons, under paragraph (c)(1)(iii) of this section she does not spend more than 90 days in the United States during the taxable year. P satisfies the tax home test of paragraph (d) of this section only with respect to Possession I, because her regular place of business is in Possession I. P satisfies the closer connection test of paragraph (e) of this section with respect to both Possession Q and Possession I, because she does not have a closer connection to the United States or to any foreign country (and possessions generally are not treated as foreign countries). Therefore, P is a bona fide resident of Possession I for purposes of the Internal Revenue Code.

Example 7. Closer connection to United States than to possession. Z, a U.S. citizen, relocates to Possession V in a prior taxable year to start an investment consulting and venture capital business. Z's wife and two teenage children remain in State C to allow the children to complete high school. Z travels back to the United States regularly to see his wife and children, to engage in business activities, and to take vacations. He has an apartment available for his full-time use in Possession V, but he remains a joint owner of the residence in State C where his wife and children reside. Z and his family have automobiles and personal belongings such as furniture, clothing, and jewelry located at both residences. Although Z is a member of the Possession V Chamber of Commerce, Z also belongs to and has current relationships with social, political, cultural, and religious organizations in State C. Z receives mail in State C, including brokerage statements, credit card bills, and bank advices. Z conducts his personal banking activities in State C. Z holds a State C driver's license and is registered to vote in State C. Based on the totality of the particular facts and circumstances pertaining to Z, Z is not a bona fide resident of Possession V because he has a closer connection to the United States than to Possession V and therefore fails to satisfy the requirements of paragraphs (b)(1) and (e) of this section.

Example 8. Year of move to possession. D, a U.S. citizen, files returns on a calendar year basis. From January 2003 through May 2006, D resides in State R. In June 2006, D moves to Possession N, purchases a house, and accepts a permanent position with a local employer. D's principal place of business from July 1 through December 31, 2006 is in Possession N, and during that period (which totals at least 183 days) D does not have a closer connection to the United States or a foreign country than to Possession N. For the remainder of 2006, and throughout years 2007 through 2009, D continues to live and work in Possession N and maintains a closer connection to Possession N than to the United States or any foreign country. D satisfies the tax home and closer connection tests for 2006 under paragraphs (d)(2), (e)(2), and (f)(1) of this section. Accordingly, assuming that D also satisfies the presence test in paragraph (c) of this section, D is a bona fide resident of Possession N for all of taxable year 2006.

Example 9. Year of move from possession (other than Puerto Rico). J, a U.S. citizen, files returns on a calendar year basis. From January 2007 through December 2009, J is a bona fide resident of Possession C because she satisfies the requirements of paragraph (b)(1) of this section for each year. J continues to reside in Possession C until September 6, 2010, when she accepts new employment and moves to State H. J's principal place of business from January 1 through September 5, 2010 is in Possession C, and during that period (which totals at least 183 days) J does not have a closer connection to the United States or a foreign country than to Possession C. For the remainder of 2010 and throughout years 2011 through 2013, D continues to live and work in State H and is not a bona fide resident of Possession C. J satisfies the tax home and closer connection tests for 2010 with respect to Possession C under paragraphs (d)(2)(i), (e)(2), and (f)(2)(i) of this section. Accordingly, assuming that J also satisfies the presence test of paragraph (c) of this section, J is a bona fide resident of Possession C for all of taxable year 2010.

Example 10. Year of move from Puerto Rico. R, a U.S. citizen who files returns on a calendar year basis satisfies the requirements of paragraphs (b) through (e) of this section for years 2006 and 2007. From January through April 2008, R continues to reside and maintain his principal place of business in and closer connection to Puerto Rico. On May 5, 2008, R moves and changes his principal place of business (tax home) to State N and later that year establishes a closer connection to the United States than to Puerto Rico. R does not satisfy the presence test of paragraph (c) for 2008 with respect to Puerto Rico. Moreover, because R had a tax home outside of Puerto Rico and establishes a closer connection to the United States in 2008, R does not satisfy the requirements of paragraph (d)(1) or (e)(1) of this section for 2008. However, because R was a bona fide resident of Puerto Rico for at least two taxable years before his change of residence to State N in 2008, he is a bona fide resident of Puerto Rico from January 1 through May 4, 2008 under paragraphs (b)(5) and (f)(2)(ii) of this section. See section 933(2) and §1.933–1(b) for rules on attribution of income.

(h) *Information reporting requirement.* The following individuals are required to file notice of their new tax status in such time and manner as the Commissioner may prescribe by notice, form, instructions, or other publication (see §601.601(d)(2) of this chapter):

(1) Individuals who take the position for U.S. tax reporting purposes that they qualify as bona fide residents of a possession for a tax year subsequent to a tax year for which they were required to file Federal income tax returns as citizens or residents of the United States who did not so qualify.

(2) Citizens and residents of the United States who take the position for U.S. tax reporting purposes that they do not qualify as bona fide residents of a possession for a tax year subsequent to a tax year for which they were required to file income tax returns (with the Internal Revenue Service, the tax authorities of a possession, or both) as individuals who did so qualify.

(3) Bona fide residents of Puerto Rico or a section 931 possession (as defined in §1.931–1(c)(1)) who take a position for U.S. tax reporting purposes that they qualify as bona fide residents of that possession for a tax year subsequent to a tax year for which they were required to file income tax returns as bona fide residents of the U.S. Virgin Islands or a section 935 possession (as defined in §1.935–1(a)(3)(i)).

(i) *Effective/applicability date.* Except as provided in this paragraph (i), this section applies to taxable years ending after January 31, 2006. Paragraph (h) of this section also applies to a taxpayer's 3 taxable years immediately preceding the taxpayer's first taxable year ending after October 22, 2004. Taxpayers also may choose to apply this section in its entirety to all taxable years ending after October 22, 2004 for which the statute of limitations under section 6511 is open.

[T.D. 9248, 71 FR 5001, Jan. 31, 2006, as amended by T.D. 9297, 71 FR 66234, Nov. 14, 2006; T.D. 9391, 73 FR 19370, Apr. 9, 2008]

§1.937–2 Income from sources within a possession.

(a) *Scope.* Section 937(b) and this section set forth the rules for determining whether income is considered to be from sources within a particular possession (the relevant possession) for purposes of the Internal Revenue Code, including section 957(c) and Subpart D, Part III, Subchapter N, Chapter 1 of the Internal Revenue Code, as well as section 7654(a) of the 1954 Internal Revenue Code (until the effective date of its repeal). Paragraphs (c)(1)(ii) and (c)(2) of this section do not apply, however, for purposes of sections 932(a) and (b) and 935(a)(3) (as in effect before the effective date of its repeal). In the case of a possession or territory that administers income tax laws that are identical (except for the substitution of the name of the possession or territory for the term ''United States'' where appropriate) to those in force in the United States, these rules do not apply for purposes of the application of such laws. These rules also do not affect the determination of whether income is considered to be from sources without the United States for purposes of the Internal Revenue Code.

(b) *In general.* Except as provided in paragraphs (c) through (i) of this section, the principles of sections 861 through 865 and the regulations under those provisions (relating to the determination of the gross and the taxable income from sources within and without the United States) generally will be applied in determining the gross and

the taxable income from sources within and without the relevant possession. In the application of such principles, it generally will be sufficient to substitute, where appropriate, the name of the relevant possession for the term ''United States,'' and to substitute, where appropriate, the term ''bona fide resident of'' followed by the name of the relevant possession for the term ''United States resident.'' Furthermore, the term *domestic* will be construed to mean created or organized in the relevant possession. In applying these principles, additional substitutions may be necessary to accomplish the intent of section 937(b) and this section. For example, in applying the principles of sections 863(d) and (e) to individuals under this paragraph (b), the term ''bona fide resident of a possession'' will be used instead of the term ''United States person.'' In no case, however, will a bona fide resident or other person have, as a result of the application of these principles, more income from sources within the relevant possession than the amount of income from sources within the United States that a similarly situated U.S. person who is not a bona fide resident would have under sections 861 through 865.

(c) *U.S. income*—(1) *In general.* Except as provided in paragraph (d) of this section, income from sources within the relevant possession will not include any item of income determined under the rules of sections 861 through 865 and the regulations under those provisions to be—

(i) From sources within the United States; or

(ii) Effectively connected with the conduct of a trade or business within the United States.

(2) *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—

(i) The income is received in exchange for consideration provided to another person; and

(ii) 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) *Income from certain sales of inventory property.* For special rules that apply to determine the source of income from certain sales of inventory property, see §1.863–3(f).

(e) *Service in the Armed Forces.* In the case of a member of the Armed Forces of the United States, the following rules will apply for determining the source of compensation for services performed in compliance with military orders:

(1) If the individual is a bona fide resident of a possession and such services are performed in the United States or in another possession, the compensation constitutes income from sources within the possession of which the individual is a bona fide resident (and not from sources within the United States or such other possession).

(2) If the individual is not a bona fide resident of a possession and such services are performed in a possession, the compensation constitutes income from sources within the United States (and not from sources within such possession).

(f) *Gains from certain dispositions of property*—(1) *Property of former U.S. residents.* (i) Except to the extent an election is made under paragraph (f)(1)(vi) of this section, income from sources within the relevant possession will not include gains from the disposition of property described in paragraph (f)(1)(ii) of this section by an individual described in paragraph (f)(1)(iii) of this section. See also section 1277(e) of the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2085) (providing that gains from the disposition of certain property by individuals who acquired residency in certain possessions will be considered to be from sources within the United States).

(ii) Property is described in this paragraph (f)(1)(ii) when the following conditions are satisfied—

(A) The property is of a kind described in section 731(c)(3)(C)(i) or 954(c)(1)(B); and

(B) The property was owned by the individual before such individual became a bona fide resident of the relevant possession.

(iii) An individual is described in this paragraph (f)(1)(iii) when the following conditions are satisfied—

(A) For the taxable year for which the source of the gain must be determined, the individual is a bona fide resident of the relevant possession; and

(B) For any of the 10 years preceding such year, the individual was a citizen or resident of the United States (other than a bona fide resident of the relevant possession).

(iv) If an individual described in paragraph (f)(1)(iii) of this section exchanges property described in paragraph (f)(1)(ii) of this section for other property in a transaction in which gain or loss is not required to be recognized (in whole or in part) under U.S. income tax principles, such other property will also be considered property described in paragraph (f)(1)(ii) of this section.

(v) If an individual described in paragraph (f)(1)(iii) of this section owns, directly or indirectly, at least 10 percent (by value) of any entity to which property described in paragraph (f)(1)(ii) of this section is transferred in a transaction in which gain or loss is not required to be recognized (in whole or in part) under U.S. income tax principles, any gain recognized upon a disposition of the property by such entity will be treated as income from sources outside the relevant possession if any gain recognized upon a direct or indirect disposition of the individual's interest in such entity would have been so treated under paragraph (f)(1)(iv) of this section.

(vi) Notwithstanding the general rule of paragraph (f)(1)(i) of this section and section 1277(e) of the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2085), an individual described in paragraph (f)(1)(iii) of this section may elect to treat as gain from sources within the relevant possession the portion of the gain attributable to the individual's possession holding period. The election under this paragraph (f)(1)(vi) will be considered made if the individual's income tax return for the year of disposition of the property reports the portion of gain attributable to the taxpayer's possession holding period as determined in accordance with paragraph (f)(1)(vi)(A) or paragraph (f)(1)(vi)(B) of this section, as the case may be.

(A) In the case of marketable securities, the portion of gain attributable to the possession holding period will be determined by reference to the fair market value of the marketable security at the close of the market on the first day of the individual's possession holding period. In the event that the individual is a bona fide resident of the relevant possession for more than a single continuous period, the portion of gain described in this paragraph (f)(1)(vi)(A) will be the aggregate of the portions of gain (or offsetting loss) attributable to each possession holding period.

(B) In the case of property other than marketable securities, the portion of gain attributable to the possession holding period in the relevant possession will be determined by multiplying the total gain on disposition of the property by a fraction, the numerator of which is the number of days in the possession holding period and the denominator of which is the total number of days in the individual's holding period for the property. For purposes of the preceding sentence, in the event that the individual is a bona fide resident of the relevant possession for more than a single continuous period, the number of days in the numerator will be the aggregate of the number of days in each possession holding period. For purposes of this paragraph (f)(1)(vi)(B), the denominator will include days that are required to be included in an individual's holding period under section 735(b), section 1223, and any other applicable holding period rule in the Internal Revenue Code.

(vii) For purposes of paragraph (f)(1)(vi) of this section—

(A) The term *marketable securities* means property described in paragraph (f)(1)(ii) of this section that is, throughout the individual's holding period, actively traded within the meaning of §1.1092(d)–1(a); and

(B) The term *possession holding period* means the part of the individual's holding period for the property during which the individual is a bona fide resident of the relevant possession. However, for this purpose, the possession holding period will be considered to

commence in all cases on the first day during such period that the individual does not have a tax home outside the relevant possession. In the event that the individual is a bona fide resident of the relevant possession for more than a single continuous period, each possession holding period prior to the one ending on the date of sale or other disposition will be considered to end on the first day that the individual has a tax home outside the relevant possession. With respect to the determination of tax home, see §1.937–1(d).

(2) *Special rules under section 865 for possessions*—(i) Except as provided in paragraph (f)(1) of this section—

(A) Gain that is considered to be derived from sources outside of the United States under section 865(g)(3) will be considered income from sources within Puerto Rico; and

(B) Gain that is considered to be derived from sources outside of the United States under section 865(h)(2)(B) will be considered income from sources within the possession in which the liquidating corporation is created or organized.

(ii) In applying the principles of section 865 and the regulations under that section pursuant to paragraph (b) of this section, the rules of section 865(g) will not apply, but the special rule of section 865(h)(2)(B) will apply with respect to gain recognized upon the liquidation of corporations created or organized in the United States.

(g) *Dividends*—(1) *Dividends from certain possessions corporations*—(i) *In general.* Except as provided in paragraph (g)(1)(ii) of this section, with respect to any possessions shareholder, only the possessions source ratio of any dividend paid or accrued by a corporation created or organized in a possession (possessions corporation) will be treated as income from sources within such possession. For purposes of this paragraph (g)—

(A) The *possessions source ratio* will be a fraction, the numerator of which is the gross income of the possessions corporation from sources within the possession in which it is created or organized (applying the rules of this section) for the testing period and the denominator of which is the total gross income of the corporation for the testing period; and

(B) The term *possessions shareholder* means any individual who is a bona fide resident of the possession in which the corporation is created or organized and who owns, directly or indirectly, at least 10 percent of the total voting stock of the corporation.

(ii) *Dividends from corporations engaged in the active conduct of a trade or business in the relevant possession.* The entire amount of any dividend paid or accrued by a possessions corporation will be treated as income from sources within the possession in which it is created or organized when the following conditions are met—

(A) 80 percent or more of the gross income of the corporation for the testing period was derived from sources within such possession (applying the rules of this section) or was effectively connected with the conduct of a trade or business in such possession (applying the rules of §1.937–3); and

(B) 50 percent or more of the gross income of the corporation for the testing period was derived from the active conduct of a trade or business within such possession.

(iii) *Testing period.* For purposes of this paragraph (g)(1), the term *testing period* means the 3-year period ending with the close of the taxable year of the payment of the dividend (or for such part of such period as the corporation has been in existence).

(iv) *Subsidiary look-through rule.* For purposes of this paragraph (g)(1), if a possessions corporation owns (directly or indirectly) at least 25 percent (by value) of the stock of another corporation, such possessions corporation will be treated as if it—

(A) Directly received its proportionate share of the income of such other corporation; and

(B) Actively conducted any trade or business actively conducted by such other corporation.

(2) *Dividends from other corporations.* In applying the principles of section 861 and the regulations under that section pursuant to paragraph (b) of this section, the special rules relating to dividends for which deductions are allowable under section 243 or 245 will not apply.

(h) *Income inclusions.* For purposes of determining whether an amount described in section 904(h)(1)(A) constitutes income from sources within the relevant possession—

(1) If the individual owns (directly or indirectly) at least 10 percent of the total voting stock of the corporation from which such amount is derived, the principles of section 904(h)(2) will apply. In the case of an individual who is not a possessions shareholder (as defined in paragraph (g)(1)(i)(B) of this section), the preceding sentence will apply only if the corporation qualifies as a ''United States-owned foreign corporation'' for purposes of section 904(h); and

(2) In all other cases, the amount will be considered income from sources in the jurisdiction in which the corporation is created or organized.

(i) *Interest*—(1) *Interest from certain possessions corporations*—(i) *In general.* Except as provided in paragraph (i)(1)(ii) of this section, with respect to any possessions shareholder (as defined in paragraph (g)(1)(i)(B) of this section), interest paid or accrued by a possessions corporation will be treated as income from sources within the possession in which it is created or organized to the extent that such interest is allocable to assets that generate, have generated, or could reasonably have been expected to generate income from sources within such possession (under the rules of this section) or income effectively connected with the conduct of a trade or business within such possession (under the rules of §1.937–3). For purposes of the preceding sentence, the principles of §§1.861–9 through 1.861–12 will apply.

(ii) *Interest from corporations engaged in the active conduct of a trade or business in the relevant possession.* The entire amount of any interest paid or accrued by a possessions corporation will be treated as income from sources within the possession in which it is created or organized when the conditions of paragraphs (g)(1)(ii)(A) and (B) of this section are met (applying the rules of paragraphs (g)(1)(iii) and (iv) of this section).

(2) *Interest from partnerships.* Interest paid or accrued by a partnership will be treated as income from sources within a possession only to the extent that such interest is allocable to income effectively connected with the conduct of a trade or business in such possession. For purposes of the preceding sentence, the principles of §1.882–5 will apply (as if the partnership were a foreign corporation and as if the trade or business in the possession were a trade or business in the United States).

(j) *Indirect ownership.* For purposes of this section, the rules of section 318(a)(2) will apply except that the language ''5 percent'' will be used instead of ''50 percent'' in section 318(a)(2)(C).

(k) *Examples.* The provisions of this section may be illustrated by the following examples:

Example 1. (i) X, a U.S. citizen, resides in State N and acquires stock of Corporation C, a domestic corporation, in 2008 for $10x. X moves to the Northern Mariana Islands (NMI) on March 1, 2009 and changes his principal place of business to NMI on that same date. Assume for purposes of this example that, under §1.937–1(b) and (f)(1) (year-of-move exception), X is considered a bona fide resident of NMI for 2009 through 2012. On March 1, 2009, the closing value of X's stock in Corporation C, a marketable security (within the meaning of paragraph (f)(1)(vii)(A) of this section), is $20x. On January 3, 2012, X sells all his Corporation C stock for $70x.

(ii) Pursuant to section 1277(e) of the Tax Reform Act of 1986, and absent an election under paragraph (f)(1)(vi) of this section, all of X's gain ($60x) will be treated as income from sources within the United States for all purposes of the Internal Revenue Code (including section 7654, as in effect with respect to the NMI), and (under paragraph (f)(1)(i) of this section) not as income from sources in the NMI. However, pursuant to paragraph (f)(1)(vi) of this section, X may elect on his 2012 income tax return filed with NMI to treat the portion of this gain attributable to X's possession holding period with respect to NMI as gain from sources within NMI. X's possession holding period with respect to NMI begins on March 1, 2009, the date his tax home changes to the NMI. Under paragraph (f)(1)(vi)(A) of this section, the portion of X's gain attributable to this possession holding period is $50x, the excess of the sale price of the stock ($70x) over its closing value ($20x) on the first day of the possession holding period. By reporting $50x of gain on his 2012 NMI return, X will elect under paragraph (f)(1)(vi) of this section to treat that amount as NMI source income.

Example 2. (i) R, a U.S. citizen, resides in State F and acquires a 5 percent interest in Partnership P on January 1, 2009. R moves to

Puerto Rico on June 1, 2010 and changes her principal place of business to Puerto Rico on that same date. Assume for purposes of this example that under §1.937–1(b) and (f)(1) (year-of-move exception), R is considered a bona fide resident of Puerto Rico for 2010 through 2012. On June 1, 2010, R's interest in Partnership P is not a marketable security within the meaning of paragraph (f)(1)(vii)(A) of this section. On December 31, 2012, having owned the interest in Partnership P for a period of 4 years (1461 days), R sells it, recognizing gain of $100x.

(ii) Pursuant to paragraph (f)(1) of this section, and absent an election under paragraph (f)(1)(vi) of this section, the gain will not be treated as income from sources within Puerto Rico for purposes of the Internal Revenue Code (including section 933(1)). However, pursuant to paragraph (f)(1)(vi) of this section, R may elect on her 2012 return filed with the IRS to treat the portion of this gain attributable to R's possession holding period with respect to Puerto Rico as gain from sources within Puerto Rico. R's possession holding period with respect to Puerto Rico is the 945-day period from June 1, 2010, the date her tax home changes to Puerto Rico, through December 31, 2012, the date of sale. Under paragraph (f)(1)(vi)(B) of this section, the portion of R's gain attributable to this possession holding period is $64.68x, computed as follows:

$$\$100x \text{ gain} \times \frac{945 \text{ days in possession holding period}}{1461 \text{ days in total holding period}}$$

(iii) By reporting $64.68x of gain on her 2012 Federal return, R will elect under paragraph (f)(1)(vi) of this section to treat that amount as Puerto Rico source income.

Example 3. X, a bona fide resident of Possession S, a section 931 possession (as defined in §1.931–1(c)(1)), is engaged in a trade or business in the United States through an office in State H. In 2008, this office materially participates in the sale of inventory property in Possession S, such that the income from these inventory sales is considered effectively connected to this trade or business in the United States under section 864(c)(4)(B)(iii). This income will not be treated as income from sources within Possession S for purposes of section 931(a)(1) pursuant to paragraph (c)(1)(ii) of this section, but nonetheless will continue to be treated as income from sources without the United States under section 862 (for example, for purposes of section 904).

Example 4. (i) X, a bona fide resident of Possession I, owns 25 percent of the outstanding shares of A Corp, a corporation organized under the laws of Possession I. In 2010, X receives a dividend of $70x from A Corp. During 2008 through 2010, A Corp has gross income from the following sources:

	Possession I sources	*Sources outside possession I*
2008	$10x	$20x
2009	20x	10x
2010	25x	15x

(ii) A Corp owns 50 percent of the outstanding shares of B Corp, a corporation organized under the laws of Country FC. During 2008 through 2010, B Corp has gross income from the following sources:

	Possession I sources	*Sources outside possession I*
2008	$10x	$6x
2009	14x	8x
2010	10x	4x

(iii) A Corp is treated as having received 50 percent of the gross income of B Corp. Therefore, for 2008 through 2010, the gross income of A Corp is from the following sources:

	Possession I sources	*Sources outside possession I*
2008	$15x	$23x
2009	27x	14x
2010	30x	17x
Totals	$72x	$54x

(iv) Pursuant to paragraph (g) of this section, the portion of the dividend of $70x that X receives from Corp A in 2010 that is treated as income from sources within Possession I is 72/126 of $70x, or $40x.

Example 5. X is a U.S. citizen and a bona fide resident of the Northern Mariana Islands (NMI). In 2008, X receives compensation for services performed as a member of the crew of a fishing boat. Ten percent of the services for which X receives compensation are performed in the NMI, and 90 percent of X's services are performed in international waters. Under the principles of section 861(a)(3) as applied pursuant to paragraph (b) of this section, the compensation that X receives for services performed in the NMI is treated as income from sources within the NMI.

Under the principles of section 863(d)(1)(A) as applied pursuant to paragraph (b) of this section, the compensation that X receives for services performed in international waters is treated as income from sources within the NMI for purposes of the Internal Revenue Code (including section 7654, as in effect with respect to the NMI). Thus, all of X's compensation for services during 2008 is treated as income from sources within the NMI.

Example 6. X, a U.S. citizen, resides in State L and receives $2,500 of compensation for services performed in Possession J during 2008 for Y, X's employer. X is temporarily present in Possession J in 2008 for a period (or periods) not exceeding a total of 90 days. Y, a U.S. citizen, is not a bona fide resident of Possession J and is not engaged in a trade or business within Possession J. Under the principles of section 861(a)(3) as applied pursuant to paragraph (b) of this section, the compensation that X receives for services performed in Possession J during 2008 is not treated as income from sources within Possession J.

Example 7. (i) Company Y, a corporation organized in State C, produces, markets, and distributes music products. Y enters into a recording contract with Z, a recording artist who is a bona fide resident of the U.S. Virgin Islands (USVI). Pursuant to the contract between Y and Z, Z agrees to perform services as writer, musician, and vocalist on the recording of a new musical composition and related music video. Under the contract, all songs, recordings and related artwork, packaging copy, and liner notes, together with copyrights and other intellectual property in those works, are the sole property of Y, and Z obtains no proprietary rights in that property. As compensation for Z's services, all of which are performed at a recording studio or other locations in the USVI, Y agrees to pay amounts designated as the ''writer's share'' to Z based on a percentage of the music products sold. Y also agrees to make an upfront payment to Z as an advance against future portions of Z's writer's share.

(ii) To the extent that Z performs personal services within the USVI, the compensation that Z receives for his services is sourced to the USVI under the principles of section 861(a)(3) and §1.861–4 as applied pursuant to §1.937–2(b). If all of Z's services are performed in the USVI, none of the writer's share is derived from sources within the United States under section 861(a)(3) and §1.861–4, nor is it effectively connected with the conduct of a trade or business in the United States under section 864(c)(3). Accordingly, the U.S. income rule of section 937(b)(2) and paragraph (c)(1) of this section would not operate to prevent Z's services income from being USVI source or USVI effectively connected income within the meaning of section 937(b)(1). If Z also performs services in the United States, however, then the U.S. income rule would apply to the part of Z's compensation that is sourced to the United States under section 861(a)(3) and §1.861–4. In the event that Y and Z are controlled taxpayers within the meaning of §1.482–1(i)(5), section 482 and the regulations under that section, including §1.482–9T(i), would apply to evaluate the arm's length amount charged for Z's controlled services.

(l) *Effective/applicability dates.* Except as otherwise provided in this paragraph (l), this section applies to income earned in taxable years ending after April 9, 2008. Taxpayers may choose to apply paragraph (b) of this section to income earned in open taxable years ending after October 22, 2004. Taxpayers may choose to apply paragraph (f)(1) of this section to dispositions made after April 11, 2005.

[T.D. 9391, 73 FR 19370, Apr. 9, 2008, as amended at T.D. 9391, 73 FR 27728, May 14, 2008; T.D. 9391, 73 FR 36594, June 27, 2008]

§1.937–3 Income effectively connected with the conduct of a trade or business in a possession.

(a) *Scope.* Section 937(b) and this section set forth the rules for determining whether income is effectively connected with the conduct of a trade or business within a particular possession (the relevant possession) for purposes of the Internal Revenue Code, including sections 881(b) and 957(c) and Subpart D, Part III, Subchapter N, Chapter 1 of the Internal Revenue Code. Paragraph (c) of this section does not apply, however, for purposes of section 881(b). In the case of a possession or territory that administers income tax laws that are identical (except for the substitution of the name of the possession or territory for the term ''United States'' where appropriate) to those in force in the United States, these rules do not apply for purposes of the application of such laws.

(b) *In general.* Except as provided in paragraphs (c) and (d) of this section, the principles of section 864(c) and the regulations under that section (relating to the determination of income, gain or loss that is effectively connected with the conduct of a trade or business within the United States) generally will be applied in determining whether income is effectively connected with the conduct of a trade or

business within the relevant possession, without regard to whether the taxpayer qualifies as a nonresident alien individual or a foreign corporation with respect to such possession. Subject to the rules of this section, the principles of section 864(c)(4) will apply for purposes of determining whether income from sources without the relevant possession is effectively connected with the conduct of a trade or business in the relevant possession. For purposes of the preceding sentence, all income other than income from sources within the relevant possession (as determined under the rules of §1.937–2) will be considered income from sources without the relevant possession in the application of the principles of section 864(c) under this paragraph (b), it generally will be sufficient to substitute the name of the relevant possession for the term ''United States'' where appropriate, but additional substitutions may be necessary to accomplish the intent of section 937(b) and this section. In no case, however, will a bona fide resident or other person have, as a result of the application of these principles, more income effectively connected with the conduct of a trade or business in the relevant possession than the amount of U.S. effectively connected income that a similarly situated U.S. person who is not a bona fide resident would have under section 864(c).

(c) *U.S. income*—(1) *In general.* Except as provided in paragraph (d) of this section, income considered to be effectively connected with the conduct of a trade or business within the relevant possession will not include any item of income determined under the rules of sections 861 through 865 and the regulations under those provisions to be—

(i) From sources within the United States; or

(ii) Effectively connected with the conduct of a trade or business within the United States.

(2) *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—

(i) The income is received in exchange for consideration provided to another person; and

(ii) 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) *Income from certain sales of inventory property.* Paragraph (c) of this section will not apply to income from sales of inventory property described in §1.863–3(f).

(e) *Examples.* The provisions of this section may be illustrated by the following examples:

Example 1. X is a bona fide resident of Possession I, a section 931 possession (as defined in §1.931–1(c)(1)). X has an office in Possession I from which X conducts a business consisting of the development and sale of specialized computer software. A purchaser of software will frequently pay X an additional amount to install the software on the purchaser's operating system and to ensure that the software is functioning properly. X performs the installation services at the purchaser's place of business, which may be in Possession I, in the United States, or in another country. The provision of such services is not de minimis and constitutes a separate transaction under the rules of §1.861–18. Under the principles of section 864(c)(4) as applied pursuant to paragraph (b) of this section, the compensation that X receives for personal services performed outside of Possession I is not considered to be effectively connected with the conduct of a trade or business in Possession I for purposes of section 931(a)(2).

Example 2. (i) F Bank is organized under the laws of Country FC and operates an active banking business from offices in the U.S. Virgin Islands (USVI). In connection with this banking business, F Bank makes loans to and receives interest payments from borrowers who reside in the USVI, in the United States, and in Country FC.

(ii) Under the principles of section 861(a)(1) as applied pursuant to §1.937–2(b), interest payments received by F Bank from borrowers who reside in the United States or in Country FC constitute income from sources outside of the USVI. Under the principles of section 864(c)(4) as applied pursuant to paragraph (b) of this section, interest income from sources outside of the USVI generally may constitute income that is effectively connected with the conduct of a trade or business within the USVI for purposes of the Internal Revenue Code. However, interest payments received by F Bank from borrowers who reside in the United States constitute income from sources within the

United States under section 861(a)(1). Accordingly, under paragraph (c)(1) of this section, such interest income will not be treated as effectively connected with the conduct of a trade or business in the USVI for purposes of the Internal Revenue Code (for example, for purposes of section 934(b)). Interest payments received by F Bank from borrowers who reside in Country FC, however, may be treated as effectively connected with the conduct of a trade or business in the USVI for purposes of the Internal Revenue Code (including section 934(b)).

(iii) To the extent that, as described in section 934(a), the USVI administers income tax laws that are identical (except for the substitution of the name of the USVI for the term ''United States'' where appropriate) to those in force in the United States, interest payments received by F Bank from borrowers who reside in the United States or in Country FC may be treated as income that is effectively connected with the conduct of a trade or business in the USVI for purposes of F Bank's income tax liability to the USVI under mirrored section 882.

Example 3. (i) G is a partnership that is organized under the laws of, and that operates an active financing business from offices in, Possession I. Interests in G are owned by D, a bona fide resident of Possession I, and N, an alien individual who resides in Country FC. Pursuant to a pre-arrangement, G loans $x to T, a business entity organized under the laws of Country FC, and T in turn loans $y to E, a U.S. resident. In accordance with the arrangement, E pays interest to T, which in turn pays interest to G.

(ii) The arrangement constitutes a conduit arrangement under paragraph (c)(2) of this section, and the interest payments received by G are treated as income from sources within the United States for purposes of paragraph (c)(1) of this section. Accordingly, the interest received by G will not be treated as effectively connected with the conduct of a trade or business in Possession I for purposes of the Internal Revenue Code (including sections 931(a)(2) and 934(b), if applicable with respect to D). Whether such interest constitutes income from sources within the United States for other purposes of the Internal Revenue Code under generally applicable conduit principles will depend on the facts and circumstances. See, for example, *Aiken Indus., Inc.* v. *Commissioner*, 56 T.C. 925 (1971).

(iii) If Possession I administers income tax laws that are identical (except for the substitution of the name of the possession for the term ''United States'' where appropriate) to those in force in the United States, the interest received by G may be treated as income effectively connected with the conduct of a trade or business in Possession I under mirrored section 864(c)(4) for purposes of determining the Possession I territorial income tax liability of N under mirrored section 871.

Example 4. (i) Corporation A, a corporation organized in Possession X, is engaged in a business consisting of the development of computer software and the sale of that software. Corporation A has its sole place of business in Possession X and is not engaged in the conduct of a trade or business in the United States. Corporation A receives orders for its software from customers in the United States and around the world. After orders are accepted, Corporation A's software is either loaded onto compact discs at Corporation A's Possession X facility and shipped via common carrier, or downloaded from Corporation A's server in Possession X. The sales contract provides that the rights, title, and interest in the product will pass from Corporation A to the customer either at Corporation A's place of business in Possession X (if shipped in compact disc form) or at Corporation A's server in Possession X (if electronically downloaded). Assume for purposes of this example that each transaction is classified as a sale of a copyrighted article under §1.861–18(c)(1)(ii) and (f)(2).

(ii) Under the principles of section 863(a), as applied pursuant to §1.937–2(b), because Corporation A passes the rights, title, and interest to the copyrighted articles in Possession X, Corporation A's sales income is sourced to Possession X. Corporation A's sales income is also effectively connected with the conduct of a trade or business in Possession X, under the principles of section 864(c)(3) as applied pursuant to §1.937–3(b). Corporation A's income is not from sources within the United States, nor is it effectively connected with the conduct of a trade or business in the United States. Accordingly, the U.S. income rule of section 937(b)(2), §1.937–2(c)(1), and paragraph (c)(1) of this section does not operate to prevent Corporation A's sales income from being Possession X source and Possession X effectively connected income under section 937(b)(1).

Example 5. (i) Corporation B, a corporation organized in Possession X, has its sole place of business in Possession X and is not engaged in the conduct of a trade or business in the United States. Corporation B employs a software business model generally referred to as an application service provider. Employees of Corporation B in Possession X develop software and maintain it on Corporation B's server in Possession X. Corporation B's customers in the United States and around the world transmit detailed data about their own customers to Corporation B's server and electronic storage facility in Possession X. The customers pay a monthly fee to Corporation B under a Subscription Agreement, and they can use the software to generate reports analyzing the data at any time but do not receive a copy of the software. Corporation B's software allows its

customers to generate the reports from their location and to keep track of their relationships with their own customers. Assume for purposes of this example that Corporation B's income from these transactions is derived from the provision of services.

(ii) Under the principles of section 861(a)(3) and §1.861–4(a), as applied pursuant to §1.937–2(b), because Corporation B performs personal services wholly within Possession X, the compensation Corporation B receives for services is sourced to Possession X. Corporation B's services income is also effectively connected with the conduct of a trade or business in Possession X, under the principles of section 864(c)(3) as applied pursuant to §1.937–3(b). Corporation B's income is not from sources within the United States, nor is it effectively connected with the conduct of a trade or business in the United States. Accordingly, the U.S. income rule of section 937(b)(2), §1.937–2(c)(1), and paragraph (c)(1) of this section does not operate to prevent Corporation B's services income from being Possession X source or Possession X effectively connected income within the meaning of section 937(b)(1).

(f) *Effective/applicability date.* Except as otherwise provided in this paragraph (f), this section applies to income earned in taxable years ending after April 9, 2008. Taxpayers may choose to apply paragraph (b) of this section to income earned in open taxable years ending after October 22, 2004.

[T.D. 9391, 73 FR 19374, Apr. 9, 2008, as amended at T.D. 9391, 73 FR 27728, May 14, 2008]

CHINA TRADE ACT CORPORATIONS

§ 1.941–1 Special deduction for China Trade Act corporations.

In addition to the deductions from taxable income otherwise allowed such a corporation, a China Trade Act corporation is, under certain conditions, allowed an additional deduction in computing taxable income. This special deduction is an amount equal to the proportion of the taxable income derived from sources within Formosa and Hong Kong (determined without regard to this section and determined in a manner similar to that provided in part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder) which the par value of the shares of stock of the corporation, owned on the last day of the taxable year by (a) persons resident in Formosa, Hong Kong, the United States, or possessions of the United States, and (b) individual citizens of the United States wherever resident, bears to the par value of the whole number of shares of stock of the corporation outstanding on that date. The decrease, by reason of such deduction, in the tax imposed by section 11 must not, however, exceed the amount of the special dividend referred to in section 941 (b), and is not allowable unless the special dividend has been certified to the Commissioner by the Secretary of Commerce.

§ 1.941–2 Meaning of terms used in connection with China Trade Act corporations.

(a) A China Trade Act corporation is one organized under the provisions of the China Trade Act, 1922 (15 U.S.C. chapter 4).

(b) The term ''special dividend'' means the amount which is distributed as a dividend to or for the benefit of such persons as on the last day of the taxable year were resident in Formosa, Hong Kong, the United States, or possessions of the United States, or were individual citizens of the United States, and owned shares of stock of the corporation. Such dividend must be distributed prior to or at the time fixed by law for filing the return of the corporation, including the period of any extension of time granted under rules and regulations prescribed by the Commissioner with the approval of the Secretary or his delegate. Such special dividend does not include any other amounts payable or to be payable to such persons or for their benefit by reason of their interest in the corporation and must be made in proportion to the par value of the shares of stock of the corporation owned by each.

(c) For the purposes of section 941, the shares of stock of a China Trade Act corporation are considered to be owned by the person in whom the equitable right to the income from such shares is in good faith vested.

(d) ''Taxable income derived from sources within Formosa and Hong Kong'' is the sum of the taxable income from sources wholly within Formosa and Hong Kong and that portion of the taxable income from sources partly within and partly without Formosa and Hong Kong which may be allocated