

**DEPARTMENT OF THE TREASURY****Internal Revenue Service****26 CFR Parts 1, 301, and 602**

[TD 9194]

RIN 1545-BE22

**Residence and Source Rules Involving U.S. Possessions and Other Conforming Changes****AGENCY:** Internal Revenue Service (IRS), Treasury.**ACTION:** Final and temporary regulations.

**SUMMARY:** This document contains temporary regulations that provide rules under section 937(a) of the Internal Revenue Code (Code) for determining whether an individual is a bona fide resident of the following U.S. possessions: American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, and the United States Virgin Islands. The temporary regulations also provide rules under section 937(b) for determining whether income is derived from sources within a U.S. possession and whether income is effectively connected with the conduct of a trade or business within a U.S. possession. Section 937 was added to the Code by section 908 of the American Jobs Creation Act (2004 Act).

The temporary regulations also provide updated guidance under sections 876, 881, 884, 931, 932, 933, 934, 935, 957, and 6688 of the Code to reflect amendments made by the Tax Reform Act of 1986 (1986 Act) and the 2004 Act. Conforming changes are also made to regulations under sections 170A, 243, 702, 861, 863, 871, 901, 1402, 6038, 6046, and 7701 of the Code. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the cross-referenced notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the **Federal Register**.

**DATES:** *Effective Date:* These regulations are effective April 11, 2005.

**FOR FURTHER INFORMATION CONTACT:** J. David Varley (202) 435-5165 (not a toll-free number).

**SUPPLEMENTARY INFORMATION:****Paperwork Reduction Act**

These temporary regulations are being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the collection of information contained in these regulations has been reviewed and

pending receipt and evaluation of public comments, approved by the Office of Management and Budget under control number 1545-1930. Responses to this collection of information are mandatory.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

For further information concerning this collection of information, and where to submit comments on the collection of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to the cross-referencing notice of proposed rulemaking published in the Proposed Rules section of this issue of the **Federal Register**.

Books and records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

**Background**

The income tax laws of the United States have always contained special provisions concerning the income taxation of individuals residing in U.S. possessions and corporations created or organized in U.S. possessions. See *e.g.*, sections 260 and 261 of Public Law 65-254 (40 Stat. 1057). The current rules for residents of the Commonwealth of Puerto Rico (Puerto Rico) were first enacted in 1950. See sections 220 and 221 of Public Law 81-814 (64 Stat. 906) (enacting the predecessors to sections 876 and 933 of the Code). Special rules for residents of the United States Virgin Islands (USVI) were added in 1960. See section 4 of Public Law 86-779 (74 Stat. 998) (enacting section 934 of the Code). Special rules for residents of Guam were added in 1972. See Public Law 92-606 (86 Stat. 1494) (1972 Act) (enacting sections 935 and 7654 of the Code). These special rules for residents of Guam were made applicable to residents of the Commonwealth of the Northern Mariana Islands (NMI) for tax years beginning after December 31, 1978. See section 601 of Public Law 94-241 (90 Stat. 263) and Presidential Proclamation 4534.

The 1986 Act substantially revised the provisions governing the income taxation of individuals residing in U.S. possessions. See sections 1271 through 1277 of Public Law 99-514 (amending sections 876, 931 through 935, 957(c), and 7654 of the Code). The 2004 Act

restated and supplemented certain aspects of these provisions. See section 908 of Public Law 108-357 (enacting section 937 of the Code). These regulations conform the existing regulations to the amended statutes and provide additional guidance on the proper application of the statutory provisions.

This document contains amendments to 26 CFR parts 1, 301, and 602. The cross-referenced notice of proposed rulemaking is published elsewhere in this issue of the **Federal Register**.

**Explanation of Provisions****I. Operative Provisions**

Many of the substantive and procedural provisions of the Code specifically relating to the possessions were amended by the 1986 Act. The 2004 Act further amended certain of these provisions. These regulations implement the statutory changes by modifying or replacing existing regulations as discussed below.

**A. Puerto Rico**

Individuals who are U.S. citizens generally are subject to U.S. Federal income tax on their worldwide income, regardless of source, under section 1 of the Code. As discussed in section I.F. of this explanation, alien individuals who qualify as bona fide residents of Puerto Rico (and certain other possessions) likewise are subject to U.S. Federal income tax on their worldwide income under section 1.

Under section 933, income from sources within Puerto Rico is excluded from gross income of bona fide residents of Puerto Rico (whether U.S. citizens or alien individuals) for U.S. Federal income tax purposes. Consequently, such individuals have a U.S. Federal income tax return filing obligation only if their income from sources outside Puerto Rico exceeds their deductions under section 151 relating to personal exemptions. To the extent such income constitutes income from sources outside the United States, such individuals generally may claim a foreign tax credit under section 901(b) for income taxes paid to foreign countries and U.S. possessions (including Puerto Rico) to offset their U.S. Federal income tax liability, subject to certain limitations.

Deductions (other than the deduction under section 151, relating to personal exemptions) properly allocable to or chargeable against amounts excluded from gross income under section 933 generally have been disallowed since the statute was enacted in 1950. The 1986 Act amended section 933 to provide for a similar disallowance of

credits. These regulations amend the existing regulations under section 933 to reflect this statutory change.

*B. American Samoa, Guam, and the Northern Mariana Islands*

Section 931, as enacted in the 1986 Act, operates in a similar fashion to section 933. For U.S. citizens and alien individuals who are bona fide residents of possessions to which it applies (section 931 possessions), income from sources within such possessions or effectively connected with the conduct of a trade or business in such possessions is excluded from gross income for U.S. Federal income tax purposes. Consequently, such individuals have a U.S. Federal income tax return filing obligation only if their income from sources outside section 931 possessions and not effectively connected with the conduct of a trade or business in such possessions exceeds their deductions under section 151 relating to personal exemptions. To the extent such income constitutes income from sources outside the United States, U.S. citizens who are bona fide residents of section 931 possessions generally may claim a foreign tax credit under section 901(b) for income taxes paid to foreign countries and U.S. possessions (including section 931 possessions) to offset their U.S. Federal income tax liability, subject to certain limitations. As under section 933, any deductions (other than the deduction under section 151, relating to personal exemptions) and credits properly allocable or chargeable against amounts excluded from gross income under section 931 are disallowed.

Although section 931 by its terms applies to bona fide residents of American Samoa, Guam, and the NMI (collectively, the Pacific possessions), the statute takes effect with respect to any such possession only when the possession enters into an implementing agreement with the Internal Revenue Service as required under the relevant effective date provisions of the 1986 Act. See sections 1271(b) and 1277(b) of Public Law 99-514. To date, only American Samoa has entered into such an agreement. Consequently, section 931 currently applies only to bona fide residents of American Samoa.

Although section 935 was repealed by the 1986 Act, the effective date of its repeal is contingent on the entry into force of implementing agreements, as described above, by the possessions to which section 935 historically has applied (section 935 possessions), namely, Guam and the NMI. Given that neither has agreed to the entry into force of such agreements, section 935 remains

in force with respect to bona fide residents of Guam and the NMI.

Section 935, as in effect prior to its repeal, refers only to Guam. Pursuant to section 601 of the Covenant to Establish a Commonwealth of the Northern Mariana Islands in Political Union with the United States, Public Law 94-241, however, the income tax laws of the United States entered into force in the NMI in the same manner as those laws are in force in Guam, and references in the Code to Guam generally are deemed also to refer to the NMI. Consequently, section 935 currently applies to bona fide residents of Guam and of the NMI.

These regulations amend the existing regulations under section 935 to reflect the fact that the section currently applies not only to bona fide residents of Guam but also to bona fide residents of the NMI, and may in the future apply only to bona fide residents of one or the other and will not apply to bona fide residents of either possession if both enter into the implementing agreements contemplated in the 1986 Act. Similarly, these regulations set forth the post-1986 Act statutory framework for residents of section 931 possessions in a manner that reflects the potential for bona fide residents of Guam and the NMI to be covered by its provisions upon entry into force of such implementing agreements.

*C. United States Virgin Islands*

Section 932, as enacted in the 1986 Act, provides two sets of operative rules: one for bona fide residents of the USVI, and one for U.S. citizens and resident alien individuals who are not bona fide residents of the USVI but have income from sources within the USVI or income effectively connected with the conduct of a trade or business in the USVI.

With respect to individuals who are bona fide residents of the USVI (whether U.S. citizens or alien individuals), section 932(c) generally provides that an income tax return must be filed with the USVI tax authorities. If the individual properly reports on this return his or her income from all sources and identifies the source of each item of income, and pays all of the tax properly due with respect to such income, then such income is excluded from gross income for U.S. Federal income tax purposes. Consequently, such individuals have a U.S. Federal income tax return filing obligation only if they fail to report or properly identify the source of some of their income on their USVI income tax return, or if they fail to pay all of the tax properly due with respect to their income (for example, by improperly claiming the

benefit of a tax credit or exemption provided under USVI law but subject to the limitations of section 934(b)).

With respect to U.S. citizens and resident alien individuals who are not bona fide residents of the USVI but have income from sources within the USVI or income effectively connected with the conduct of a trade or business in the USVI, section 932(a) generally provides that each such individual must file his or her income tax return with both the IRS and with the USVI Bureau of Internal Revenue. In addition, under section 932(b), such an individual must pay to the USVI the “applicable percentage” of the taxes imposed under Chapter 1 of the Code. For this purpose, the term *applicable percentage* means the percentage which the individual’s Virgin Islands adjusted gross income bears to the individual’s adjusted gross income; the term *Virgin Islands adjusted gross income* means the individual’s adjusted gross income determined by taking into account only income derived from sources within the Virgin Islands and deductions properly apportioned or allocable thereto. On the individual’s U.S. Federal income tax return, he or she may claim a credit for the tax required to be paid to the USVI, so that only the remainder is due to the United States.

In general, 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 (commonly referred to as the mirror code). However, subject to the limitations of section 934(b), as amended by the 1986 Act, the USVI has the authority to reduce or remit tax liabilities under the mirror code in certain situations.

First, under section 934(b)(1), the USVI may reduce or remit the tax otherwise imposed on the income of any person (other than a U.S. citizen or resident alien individual who is not a bona fide resident of the USVI) from sources within the USVI or effectively connected with the conduct of a trade or business in the USVI.

Second, under section 934(b)(3), the USVI may reduce or remit the tax otherwise imposed on the income (other than income from sources within the United States or effectively connected with the conduct of a trade or business in the United States) of a foreign corporation, provided that less than ten percent of its stock (by vote and value) is owned by United States persons. Given that a corporation created or organized outside of the USVI can only have a mirror code tax liability with respect to income from sources within

the USVI or effectively connected with the conduct of a trade or business within the USVI (all of which is within the scope of section 934(b)(1)), the additional waiver of the limitations of section 934(a) provided by section 934(b)(3) generally will have no practical effect for such corporations. Instead, section 934(b)(3) generally is relevant only to corporations created or organized in the USVI (which are treated as "foreign" corporations for U.S. Federal income tax purposes).

These regulations amend the existing regulations under section 934 and provide new regulations under section 932 to reflect this post-1986 Act statutory framework.

#### *D. U.S. Tax Liabilities of Certain Possessions Corporations*

Section 881(a) generally imposes a 30 percent tax on U.S.-source fixed or determinable annual or periodical income of foreign corporations. Section 884 imposes certain branch-level taxes on foreign corporations that are engaged in a trade or business in the United States. Section 881(b) provides for the reduction or elimination of the taxes otherwise imposed under sections 881(a) and 884 on corporations created or organized in U.S. possessions (possessions corporations) under certain circumstances.

Section 881(b), as enacted by the 1972 Act, provides the rules currently in effect for corporations created or organized in section 935 possessions. Under these rules, such corporations effectively are exempt from tax under section 881(a), provided that the following conditions are satisfied—

(1) At all times during the taxable year, less than 25 percent in value of the stock of such corporation is owned (directly or indirectly) by foreign persons; and

(2) At least 20 percent of the gross income of such corporation is shown to the satisfaction of the Secretary to have been derived from sources within such possession for the 3-year period ending with the close of the preceding taxable year of such corporation (or for such part of such period as the corporation has been in existence).

Section 881(b), as enacted by the 1972 Act, also provides the rules currently in effect for corporations created or organized in the United States that otherwise might incur a tax liability to a section 935 possession under a mirrored version of section 881(a). Under these rules, such corporations effectively are exempt from tax in the section 935 possession in all cases.

Section 881(b), as amended by the 1986 Act, provides the rules currently in

effect for corporations created or organized in section 931 possessions and in the USVI. Under these rules, such corporations effectively are exempt from tax under section 881(a) and section 884, provided that the following conditions (1986 conditions) are satisfied—

(1) At all times during the taxable year, less than 25 percent in value of the stock of such corporation is beneficially owned (directly or indirectly) by foreign persons;

(2) At least 65 percent of the gross income of such corporation is shown to the satisfaction of the Secretary to be effectively connected with the conduct of a trade or business in such a possession or the United States for the 3-year period ending with the close of the taxable year of such corporation (or for such part of such period as the corporation or any predecessor has been in existence); and

(3) No substantial part of the income of such corporation is used (directly or indirectly) to satisfy obligations to persons who are not bona fide residents of such a possession or the United States.

Corporations that are created or organized in section 935 possessions and satisfy the 1986 conditions also are exempt from the U.S. tax imposed under section 884. Similarly, corporations that are created or organized in the United States and satisfy the 1986 conditions are exempt from the tax imposed under mirrored versions of section 884 in section 935 possessions.

Section 881(b), as amended by the 2004 Act, provides a special rule for corporations created or organized in Puerto Rico. Under this rule, such corporations are subject to tax under section 881(a) at a rate of 10 percent (rather than the generally applicable rate of 30 percent) on their U.S.-source dividend income, provided that the 1986 conditions are satisfied. However, if, on or after October 22, 2004, there is an increase in the rate of Puerto Rico's withholding tax which is generally applicable to dividends paid to United States corporations not engaged in a trade or business in Puerto Rico to a rate greater than 10 percent, this special rule shall not apply to dividends received on or after the effective date of the increase.

These regulations amend the existing regulations under sections 881 and 884 to reflect this post-1986 Act and post-2004 Act statutory framework. These regulations also provide rules similar to the 1972 Act rules applicable to section 935 possessions for purposes of determining tax liability incurred to the USVI by corporations created or

organized in the United States, pursuant to section 1274(c) of the 1986 Act.

#### *E. Application of Subpart F to Bona Fide Residents of a Possession*

With respect to bona fide residents of section 935 possessions and the USVI (mirror code possessions), corporations created or organized in the possession in which they reside are treated as domestic corporations for mirror code tax purposes. Thus, provisions such as subpart F of part III of subchapter N of chapter 1 of the Code (relating to controlled foreign corporations) as mirrored do not apply with respect to their ownership of such corporations.

With respect to bona fide residents of section 931 possessions and Puerto Rico, corporations created or organized in the possession in which they reside are treated as foreign corporations for U.S. Federal income tax purposes. Thus, in cases where, after the application of section 931 or 933 as the case may be, such individuals are required to file U.S. Federal income tax returns, they generally must treat such corporations as foreign corporations for purposes of applying provisions, such as subpart F, to determine their U.S. Federal income tax liability.

Section 957(c), however, provides a significant exception for bona fide residents of section 931 possessions and Puerto Rico. In cases where it applies, the individual is not treated as a United States person for purposes of subpart F. Consequently, such individual is not treated as a United States shareholder under section 951(b), and possession corporations described in section 957(c) that are controlled by such individuals are not treated as controlled foreign corporations under section 957(a).

In the case of a bona fide resident of Puerto Rico, section 957(c)(1) applies with respect to a corporation organized under the laws of the Commonwealth of Puerto Rico if a dividend received by such individual during the taxable year from such corporation would, for purposes of section 933(1), be treated as income derived from sources within Puerto Rico. (As discussed in more detail below in section II.B. of this explanation, such would be the case if, during a three-year testing period ending with the taxable year, the corporation's gross income was derived entirely from sources within Puerto Rico or the corporation met certain gross income and trade or business requirements.)

In the case of a bona fide resident of a section 931 possession, section 957(c)(2) applies with respect to a corporation organized under the laws of

such a possession if the following conditions are satisfied—

(1) 80 percent or more of the gross income of the corporation for the 3-year period ending at the close of the taxable year (or for such part of such period as such corporation or any predecessor has been in existence) was derived from sources within such a possession or was effectively connected with the conduct of a trade or business in such a possession; and

(2) 50 percent or more of the gross income of the corporation for such period (or part) was derived from the active conduct of a trade or business within such a possession.

These regulations amend the existing regulations under section 957 to reflect this post-1986 Act statutory framework. These regulations also make corresponding changes to the regulations under sections 6038 and 6046 (relating to information reporting requirements with respect to certain foreign corporations owned by United States persons).

#### *F. Taxation of Aliens Residing in a Possession*

Under section 876, individuals who are nonresident aliens with respect to the United States and are bona fide residents of certain possessions are subject to U.S. Federal income tax on their worldwide income under section 1 (rather than solely on their income from sources within the United States or effectively connected with the conduct of a trade or business in the United States under section 871). Prior to the 1986 Act, section 876 applied only to alien individuals who were bona fide residents of Puerto Rico. As amended by the 1986 Act, section 876 applies also to alien individuals who are bona fide residents of section 931 possessions.

These regulations amend the existing regulations under section 876 to reflect this post-1986 Act statutory framework.

#### *G. Entity Status*

The IRS and Treasury are aware that some taxpayers have deliberately treated business entities in an inconsistent manner for U.S. Federal income tax purposes and for purposes of determining income tax liabilities incurred to mirror code possessions, in order to reduce their overall tax liability below what otherwise would be due in the absence of the mirror system. The IRS and Treasury believe that such inconsistent treatment is inappropriate and contrary to the purpose of the mirror system. Accordingly, these regulations contain special rules requiring consistent treatment of

business entities for U.S. and mirror code tax purposes.

Under these rules, if an entity status election (such as a subchapter S election or an election under § 301.7701-3(c)) is filed with the IRS but not with the relevant mirror code possession, then the appropriate tax authority of the mirror code possession may, at his or her discretion, deem the election also to have been made for mirror code tax purposes. Similarly, if any such election is filed in a mirror code possession but not with the IRS, the Commissioner may, at his discretion, deem the election to have been made for U.S. Federal income tax purposes. In the event that inconsistent elections are filed with the IRS and the mirror code possession, both the Commissioner and the appropriate tax authority of the mirror code possession may, at their individual discretion, deem the elections they received to be invalid and may deem the election filed with the other jurisdiction to have been made also for tax purposes in their own jurisdiction. Further, in the absence of an election, the default characterization of an eligible entity organized in a mirror code possession shall be determined under the rules applicable to domestic eligible entities under § 301.7701-3(b). These consistency rules apply to elections under section 1362(a) and § 301.7701-3(c), and to other similar elections. The IRS and Treasury request comments relating to elections that should be specifically mentioned or excluded from the regulations.

These special rules generally apply to elections made after, and entities created after, April 11, 2005. Transition rules are provided for existing entities, under which these special rules generally apply as of the beginning of the next taxable year.

#### *H. Effective Date*

To the extent they provide rules under the operative provisions of the Code relating to the possessions, as amended by 1986 Act and the 2004 Act, these regulations generally apply to taxable years ending after October 22, 2004. The underlying statutory rules, however, generally apply to taxable years beginning after December 31, 1986. Accordingly, taxpayers may rely upon the guidance provided in these regulations with respect to prior years for which the underlying statutory rules are in effect, provided that they do so consistently.

## **II. Definitional Provisions**

As indicated above in section I of this explanation, when applying the operative provisions of the Code relating

to the possessions, determinations must be made regarding whether an individual is a bona fide resident of a particular possession, or whether income is derived from sources within a particular possession or is effectively connected with the conduct of a trade or business in a particular possession. Section 937 and these regulations provide guidance on these issues, as discussed below.

#### *A. Bona Fide Residency in a Possession*

The term *bona fide resident* has been an integral part of the special provisions of the Code relating to U.S. possessions since 1950. See sections 220 and 221 of Public Law 81-814. From the beginning, this term has been used to identify the class of persons entitled to Federal tax exemptions or other special treatment under these provisions, and its meaning has remained essentially unchanged through all of the expansions and revisions of these provisions.

Historically, the determination of whether an individual is a bona fide resident of a possession has turned on the facts and circumstances and, specifically, on an individual's intentions with respect to the length and nature of his or her stay in the possession. See, e.g., §§ 1.933-1(a), 1.934-1(c)(2), and 1.935-1(a)(3) (generally applying the principles of §§ 1.871-2 through 1.871-5). But see § 301.7701(b)-1(d) (applying the rules of section 7701(b) for determining whether alien individuals qualified as residents of mirror code possessions for taxable years beginning after December 31, 1984). The qualifier "bona fide" indicates that a claim of residence in a possession is respected for Federal tax purposes when it is made in good faith.

As enacted by the 2004 Act, section 937(a) provides that an individual generally will be considered a bona fide resident of a possession only if he or she satisfies all three of the following conditions—

(1) He or she is physically present in the possession for 183 days during the taxable year (physical presence test);

(2) He or she does not have a tax home (determined under the principles of section 911(d)(3) without regard to the second sentence thereof) outside the possession during the taxable year (tax home test); and

(3) He or she does not have a closer connection (determined under the principles of section 7701(b)(3)(B)(ii) to the United States or a foreign country than to the possession (closer connection test).

Section 937(a) further provides that, for purposes of the physical presence test, the determination as to whether a

person is present for any day shall be made under the principles of section 7701(b). The legislative history explains that, under this rule, an individual is to be considered present in a possession for a particular day if he is physically present in such possession during any time during such day, and in certain circumstances (e.g., certain medical emergencies), an individual's presence outside a possession is ignored. See H.R. Rep. No. 108-755, at 780 (2004).

The tax home and closer connection tests are similar to the conditions that individuals historically have needed to meet to be considered residents of a possession.

Congress also provided regulatory authority for the IRS and Treasury to create exceptions to this general definition, for cases in which an individual's absence from the possession is motivated by reasons other than tax avoidance. In particular, the legislative history indicates that Congress anticipated that exceptions would be provided for military personnel, workers in the fisheries trade, and retirees who may travel outside of a possession for personal reasons. At the same time, the legislative history makes clear that Congress wished to ensure that individuals who live and work stateside cannot avail themselves of the tax benefits that Congress intended to provide only to individuals who actually reside in the possessions. See H.R. Rep. No. 108-755, at 780 (2004).

Consistent with this legislative history, these regulations include several exceptions to the general statutory rules of section 937(a).

First, these regulations provide several alternatives to the 183-day rule for purposes of satisfying the physical presence test. One alternative is that the individual spend no more than 90 days in the United States during the taxable year. Thus, for example, workers in the fisheries trade who spend considerable periods at sea, and individuals who travel extensively to neighboring islands to provide goods and services, may satisfy the physical presence requirement under this alternative.

Another alternative is that the individual spend more days in the possession than in the United States and have no earned income (as defined in § 1.911-3(b)) in the United States during the taxable year. Thus, for example, retirees who spend several months each year stateside for vacation, for medical treatment, or to visit relatives, and some time traveling in foreign countries, may satisfy the physical presence requirement under this alternative.

A final alternative is that the individual have no permanent connection to the United States. For this purpose, the term *permanent connection to the United States* includes a permanent residence and a spouse or dependent with a principal place of abode in the United States. In other words, the absence of a permanent connection will enable an individual to satisfy the physical presence test. Thus, for example, an individual who lives in a possession but travels extensively in the United States for business reasons or to receive medical treatment may satisfy the physical presence requirement under this alternative.

For purposes of determining whether the above-mentioned alternatives are satisfied, certain days spent in the United States are disregarded. In particular, days spent as a full-time student, as a full-time government official or employee of a possession, or as a professional athlete participating in a charitable event generally are disregarded. In addition, days spent in transit and days that an individual is prevented from leaving the United States because of a medical condition that arose while the individual was present in the United States generally will also be disregarded.

The above-mentioned alternatives apply with respect to individuals who are U.S. citizens or resident aliens (as defined in section 7701(b)). A different approach is appropriate in the case of individuals who are nonresident aliens with respect to the United States. For such individuals, in lieu of the above-mentioned alternatives, a mirrored version of the section 7701(b) substantial presence test applies.

For purposes of the tax home test, these regulations provide a special rule for seafarers. Under this special rule, an individual will not be 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 purposes of the closer connection test, these regulations provide a special rule under which another possession is not considered a foreign country. Thus, for example, an individual who has a tax home in the USVI and a closer connection to Puerto Rico, and who satisfies the presence test with respect to both possessions, generally will be considered a bona fide resident of the USVI, and not of Puerto Rico.

Special rules apply under Federal law for determining the residence of military personnel for tax purposes. See 50 App. U.S.C. 571(a). Consistent with these special rules, these regulations provide

that an individual's absence from or presence in a possession in compliance with military orders generally does not affect whether the individual qualifies as a bona fide resident of such possession.

Finally, consistent with existing law (see Notice 2000-61 (2000-2 C.B. 569)), these regulations provide that only natural persons may be considered bona fide residents of a possession for U.S. Federal income tax purposes. Thus, juridical persons such as corporations, partnerships, trusts, and estates cannot be considered bona fide residents of a possession for U.S. Federal income tax purposes.

It should be noted that the 2004 Act modified sections 932 and 935, to conform the treatment of individuals who acquire or relinquish residency in mirror code possessions with the historical treatment of individuals who acquire or relinquish residency in Puerto Rico and section 931 possessions. Thus, for example, in order to be subject to the special rules of section 932(c), an individual must qualify as a bona fide resident of the USVI during the entire year. Accordingly, an individual generally is not subject to such special rules for any year during which he or she moves to or from the USVI.

The 2004 Act provisions and these regulations as they relate to the determination of bona fide residency in a possession generally apply to taxable years ending after October 22, 2004, except that the physical presence requirement applies only to taxable years beginning after October 22, 2004. In addition, taxpayers may choose to apply the rules set forth in these regulations in their entirety (including the physical presence test) to any open taxable years by notifying the IRS upon examination of their intent to do so. Alternatively, for such years, U.S. citizens and resident alien individuals (as well as nonresident aliens in possessions other than mirror code possessions) may continue to apply the principles of §§ 1.871-2 through 1.871-5, and nonresident alien individuals in mirror code possessions may continue to apply the rules of § 301.7701(b)-1(d) (as in effect for such years).

#### *B. Income From Sources in a Possession*

In general, the rules for determining whether income is derived from sources within the United States have applied for purposes of determining whether income is derived from sources within a possession. See § 1.863-6. The 2004 Act codified this rule in section 937(b), with two exceptions.

First, section 937(b)(2) (U.S. income rule) provides that an item of income shall not be considered to be derived from sources within a possession (or effectively connected with the conduct of a trade or business within a possession) if such item of income constitutes income from sources within the United States or income effectively connected with the conduct of a trade or business in the United States under the general rules of sections 861 through 865.

Second, section 937(b) provides an express grant of authority, consistent with the authority contained in sections 931, 934, and 957 as amended by the 1986 Act, for Treasury and the IRS to provide appropriate exceptions to the general source rules.

The legislative history to the 2004 Act indicates that Congress intended for Treasury and the IRS to use this authority to continue the existing treatment of income from the sale of goods manufactured in a possession. The 2004 Act legislative history further indicates that Congress intended for this authority to be used to prevent abuse, for example, to prevent U.S. persons from avoiding U.S. tax on appreciated property by acquiring residency in a possession prior to its disposition. See H.R. Rep. No. 108-755, at 781 (2004).

The legislative history to the 1986 Act reflects similar concerns. For example, Congress did not believe that a mainland resident who moves to a possession while owning appreciated personal property such as corporate stock or precious metals and who sells that property in the possession should escape all tax, both in the United States and the possession, on that appreciation. Similarly, Congress did not believe that a resident of a possession who owns financial assets such as stocks or debt of companies organized in, but the underlying value of which is primarily attributable to activities performed outside, the possession should escape tax on the income from those assets.

Accordingly, Congress anticipated that regulations would treat such income as sourced outside the possession where the taxpayer resides. See H.R. Rep. No. 99-426, at 487 and 489 (1985); S. Rep. No. 99-313, at 481 and 484 (1986).

These regulations include several exceptions to the general statutory rules of section 937(b).

First, the regulations provide that the U.S. income rule only applies for income earned after December 31, 2004.

Second, the regulations contain a special conduit rule to prevent the avoidance of the U.S. income rule.

Under this special conduit rule, income is considered to be from sources within the United States for purposes of the U.S. income rule 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. This rule supplements, and does not supersede, other potentially applicable conduit rules. See, for example, *Aiken Indus., Inc. v. Commissioner*, 56 T.C. 925 (1971). Unlike more generally applicable conduit rules, however, the special conduit rule in these regulations applies only for purposes of section 937 (and provisions for which the rules of section 937 apply); it does not cause the income to be treated as income from sources within the United States for other purposes of the Code.

Third, the regulations preserve the existing treatment of income from the sale of goods manufactured in a possession under § 1.863-3(f). These existing rules reflect a careful consideration of the relevant policy considerations arising with respect to the transactions to which they apply, and Congress did not intend for this result to be changed through a mechanical application of the general source rules of section 937(b). For the same reason, these regulations contain rules to preserve the results with respect to the allocation of income between the United States and its possessions under sections 863(c), 863(e), 865(g)(3), and 865(h)(2)(B).

Fourth, the regulations provide special rules for gains from dispositions of certain property held by a U.S. person prior to becoming a resident of a possession. Under these rules, such gains generally are treated as income from sources outside of the possession. These rules supplement, and do not supersede, the special source rule of section 1277(e) of the 1986 Act, which applies to individuals who become residents of Pacific possessions. Under this 1986 Act special source rule, gains from dispositions of certain property held by a U.S. person prior to becoming a resident in a Pacific possession is treated as income from sources within the United States for all purposes of the Code (including section 7654 of the 1954 Code as applicable to Guam and the NMI). The regulations also contain rules that are designed to prevent the avoidance of these special gain rules.

Fifth, the regulations provide special rules for dividends from corporations

created or organized in a possession (possessions corporations). In general, such dividends constitute income from sources within a possession under the principles of section 861(a)(2)(A). A special look-through rule applies, however, when the shareholder owns, directly or indirectly, at least 10 percent of the voting stock of the corporation. Under this special rule, only a ratable portion of any dividend paid or accrued by a possessions corporation to such a shareholder is treated as income from sources within the possession. The ratable portion is determined by applying to the dividend the ratio of the corporation's income from sources within the possession over its total income over a three-year testing period ending with the year in which the dividend is paid. (See also sections 881(b) and 957(c) for which a similar three-year testing period applies.) This look-through rule does not apply, however, if the corporation meets the following conditions (the 80/50 conditions)—

(1) 80 percent or more of the gross income of the corporation for the three-year testing period was derived from sources within the possession or was effectively connected with the conduct of a trade or business in the possession; and

(2) 50 percent or more of the gross income of the corporation for such period was derived from the active conduct of a trade or business within the possession.

Sixth, the regulations provide rules for determining the extent to which income inclusions (for example, under section 951(a)) may be considered to be derived from sources within a possession. Specifically, for shareholders owning at least 10 percent of the voting stock of the corporation, the regulations generally apply the principles of section 904(h)(2), under which the source of income inclusions ordinarily is determined for foreign tax credit purposes. For all other shareholders, income inclusions are considered to be derived from sources within the jurisdiction in which the corporation is created or organized.

Seventh, the regulations provide rules for determining the extent to which interest payments may be considered to be derived from sources within a possession. In general, interest paid by possessions corporations and noncorporate residents of a possession constitutes income from sources within the possession under the principles of section 861(a)(1). A special look-through rule applies, however, when the interest is paid by a possessions corporation to a shareholder who owns, directly or

indirectly, at least 10 percent of the voting stock of the corporation. Under this special rule, which is applied in accordance with the principles of §§ 1.861–9 through 1.861–12, the interest is treated as income from sources within the possession only to the extent that such interest is allocable to assets giving rise to income from sources within the possession or income effectively connected with the conduct of a trade or business within the possession. This look-through rule does not apply, however, if the corporation meets the 80/50 conditions described above. The regulations further provide that interest paid by a partnership is treated as income from sources within a possession only to the extent that such interest is allocable (under the principles of § 1.882–5) to income effectively connected with the conduct of a trade or business in the possession.

Special rules apply under Federal law for determining, for tax purposes, the source of income from the performance of services by military personnel. See 50 App. U.S.C. 571(b). Consistent with these special rules, these regulations provide that income from military services performed stateside (or in another possession) by a bona fide resident of a possession is considered to be income from sources within such possession, and income from military services performed in a possession by an individual who is not a bona fide resident of such possession is not considered to be income from sources within such possession.

Lastly, the regulations continue the existing treatment of income from services performed within a possession and from dividends paid by corporations created or organized outside of a possession. Thus, compensation received for services performed in a possession constitutes income from sources within the possession without regard to the *de minimis* exception in section 861(a)(3), and dividends paid by corporations created or organized outside of a possession constitute income from sources outside of the possession in all cases.

The rules of section 937(b) and these regulations generally apply for purposes of all provisions of the Code for which a determination must be made regarding whether income is derived from sources within a possession. They generally do not apply, however, for purposes of applying mirrored provisions of the Code in mirror code possessions. Thus, for example, gain that is treated as income from sources outside the USVI for purposes of section 934(b) under the special gain rules described above (in

the paragraph regarding dispositions of certain property held by a U.S. person prior to becoming a resident of a possession), nonetheless may constitute income from sources within the USVI for purposes of mirrored section 904. In addition, in order to avoid unintended reduction of the tax base of mirror code possessions, certain of the special rules described above do not apply for determining whether individuals who are not bona fide residents of such possessions have income from sources within such possessions for purposes of sections 932 and 935.

The 2004 Act provisions concerning the determination of whether income is derived from sources within a possession generally apply to taxable years ending after October 22, 2004, except that the U.S. income rule applies only to income earned after October 22, 2004. The regulations generally adopt these effective dates, except that the regulations provide that the U.S. income rule only applies for income earned after December 31, 2004. Also, the special rules provided for gains from dispositions of certain personal property apply to dispositions after April 11, 2005, and the conduit rule and the look-through rules for dividends and interest from possessions corporations apply to amounts paid or accrued after April 11, 2005. For taxable years beginning after December 31, 1986, and ending before October 23, 2004, the rules of § 1.863–6 (as in effect for such years) remain applicable.

#### *C. Income Effectively Connected With the Conduct of Trade or Business in a Possession*

In 1960, in response to concerns about the reach of a local, tax-related subsidy program, section 934 was enacted to provide explicit limits on the ability of the USVI to reduce income tax liabilities. The legislative history explains that, “while recognizing the desirability of economic development” in the USVI, Congress believed that “in no case should this be attained by granting windfall gains to taxpayers with respect to income derived from investments in corporations in the continental United States, or with respect to income in any other manner derived from sources outside of the Virgin Islands.” S. Rep. No. 1767, 86th Cong., 2nd Sess. 4 (1960).

In 1986, in response to certain identified abuses and other problems related to tax administration in the possessions, section 934 was modified and current section 931 was enacted (among other changes to the rules relating to the possessions). In so doing,

Congress expressed concerns similar to those expressed in 1960:

“While the committee believes it is appropriate to provide more local autonomy to these possessions, the committee does not intend to allow them to be used as tax havens. The committee believes that it may be appropriate for these possessions to reduce tax on local income in some cases, but the committee has included antiabuse rules to prevent use of these possessions to avoid U.S. tax. The complexity and ambiguity of the present law rules have provoked taxpayers to take return positions that, while plausible under a literal reading, would result in tax avoidance beyond what taxpayers would ask from this committee or from Congress. The committee is seeking to prevent this in the future.” H.R. Rep. No. 99–426, at 485–486 (1985). See also S. Rep. No. 99–313, at 479 (1986).

This concern was also expressed in the legislative history regarding how the IRS and Treasury might exercise their authority under sections 931 and 934 as enacted and modified, respectively, by the 1986 Act, to define the scope of income that would be considered derived from sources within a possession or effectively connected with the conduct of a trade or business in a possession (possession ECI). The discussion in the legislative history was devoted exclusively to ways in which the IRS and Treasury might narrow the scope of these concepts (as compared to the scope they otherwise would have under a mirrored application of the existing principles for determining whether income is considered to be derived from sources within the United States or effectively connected with the conduct of a trade or business in the United States). H.R. Rep. No. 99–426, at 487 and 489 (1985); S. Rep. No. 99–313, at 481 and 484 (1986).

In 2004, in response to certain abusive cases that had been identified, the rules relating to the possessions were again modified. In so doing, Congress once again expressed its concern about how such rules might be used as an inappropriate means to reduce U.S. taxes: “The conferees are further concerned that the general rules for determining whether income is effectively connected with the conduct of a trade or business in a possession present numerous opportunities for erosion of the U.S. tax base.” H.R. Rep. No. 108–755, at 780 (2004). The U.S. income rule discussed above (see section II.B. of this explanation) was enacted in order to prevent such U.S. tax avoidance.



Reflecting the concern that tax benefits intended to foster economic development in the possessions should not be permitted to be used as a means to reduce U.S. taxes on income derived from U.S. economic activity, these regulations incorporate the U.S. income rule of section 937(b)(2), as well as a conduit rule (as described above in section II.B. of this explanation) that is intended to prevent the avoidance of the U.S. income rule. Accordingly, income from U.S. sources generally will not be considered possession ECI.

Section 937(b) also includes regulatory authority for the IRS and Treasury to provide exceptions to this rule. As noted above in section II.B. of this explanation, the legislative history to the 2004 Act indicates that Congress intended for Treasury and the IRS to use this authority to continue the existing treatment of income from the sale of goods manufactured in a possession. Accordingly, these regulations provide an exception from the U.S. income rule for such income. In addition, the regulations provide that the U.S. income rule only applies for income earned after December 31, 2004.

Apart from the U.S. income rule, these regulations apply the same principles for determining whether income is possession ECI as have applied since the 1986 Act. See *Francisco v. Commissioner*, 119 T.C. 317 (2002) aff'd, 370 F.3d 1228 (DC Cir. 2004) (principles of section 864(c)(4) apply for determining whether U.S. source income is possession ECI for U.S. Federal income tax purposes).

The rules of section 937(b) and these regulations generally apply for purposes of all provisions of the Code for which a determination must be made regarding whether income is possession ECI. They generally do not apply, however, for purposes of applying mirrored provisions of the Code in mirror code possessions. Thus, for example, U.S. source income that is treated as income not effectively connected with the conduct of a trade or business within the USVI for purposes of section 934(b) under the U.S. income rule described above nonetheless may constitute income effectively connected with the conduct of a trade or business within the USVI for purposes of mirrored section 871 or 882.

The 2004 Act provisions concerning the determination of whether income is possession ECI generally apply to taxable years ending after October 22, 2004, except that the U.S. income rule applies only to income earned after October 22, 2004. The regulations generally adopt these effective dates, except that the regulations provide that

the U.S. income rule only applies for income earned after December 31, 2004. In addition, the conduit rule applies only to amounts paid or accrued after April 11, 2005. For taxable years beginning after December 31, 1986, and ending before October 23, 2004, the principles of section 864(c) (including section 864(c)(4)) remain applicable.

### III. Information Reporting by Residents of a Possession

Section 7654(e), as enacted by the 1972 Act and still applicable with respect to section 935 possessions, provides an express grant of authority for the IRS and Treasury to issue regulations prescribing information reporting requirements for individuals to whom section 935 applies, as necessary to carry out the provisions of sections 935 and 7654. Section 7654(e), as amended by the 1986 Act, provides a similar express grant of authority for the IRS and Treasury to issue regulations prescribing information reporting requirements for individuals to whom sections 931 and 932 apply, as necessary to carry out the provisions of those sections and section 7654. The penalty provided under section 6688, as amended by the 2004 Act, for failure to satisfy such reporting requirements is \$1,000.

The 2004 Act supplemented this general grant of authority with a specific requirement under section 937(c) for information reporting by individuals who take the position for U.S. income tax reporting purposes that they became, or ceased to be, bona fide residents of Guam, American Samoa, the NMI, Puerto Rico, or the USVI. For taxable years ending after October 22, 2004, as well as for any of an individual's preceding three taxable years, section 937(c) requires that such individuals provide notice of their change in residency. Thus, for calendar year taxpayers, such information reporting generally is required if they changed their residency to or from a possession during 2001, 2002, 2003, or 2004 (or if they do so in any future year).

Section 937(c) authorizes the IRS and Treasury to prescribe the time and manner by which taxpayers are to provide such notice. In early 2005, the IRS will provide a form on which the notice required by section 937(c) is to be made, as well as instructions specifying the time and manner for filing the form. The IRS and Treasury anticipate issuing guidance that will provide appropriate exceptions to the general statutory rules in order to minimize the reporting burden on taxpayers. Reporting will not be required until the form and instructions are made available. The

same \$1,000 penalty under section 6688 will apply in cases of failure to file this form when required.

### IV. Removal of Obsolete Regulations

This document also removes certain regulations, and cross-references to such regulations, which became obsolete with the enactment of the 1986 Act. The 1986 Act amendments that rendered them obsolete were effective for tax years beginning after December 31, 1986. For example, the regulations promulgated by TD 6500, 25 FR 11910; TD 7283, 38 FR 20825; and TD 7385, 40 FR 50260, relating to former section 931, were rendered obsolete with the enactment of the 1986 Act. Thus, such regulations have no legal effect for taxable years beginning after December 31, 1986. See, e.g., *Specking v. Commissioner*, 117 T.C. 95 (2001), aff'd sub nom. *Umbach v. Commissioner*, 357 F.3d 1108 (10th Cir. 2004).

#### Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6) refer to the Special Analyses section of the preamble to the cross-referencing notice of proposed rulemaking published in the Proposed Rules section in this issue of the **Federal Register**. Pursuant to section 7805(f) of the Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

#### Drafting Information

The principal authors of these regulations are W. Edward Williams and J. David Varley, Office of the Associate Chief Counsel (International), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

#### List of Subjects

##### 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

##### 26 CFR Part 301

Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Penalties, Reporting and recordkeeping requirements.



## 26 CFR Part 602

Reporting and recordkeeping requirements.

**Amendments to the Regulations**

■ Accordingly, 26 CFR parts 1, 301, and 602 are amended as follows:

**PART 1—INCOME TAXES**

■ **Paragraph 1.** The authority citation for part 1 is amended by adding entries in numerical order to read, in part, as follows:

**Authority:** 26 U.S.C. 7805 \* \* \*  
 Section 1.931-1T also issued under 26 U.S.C. 7654(e).  
 Section 1.932-1T also issued under 26 U.S.C. 7654(e).  
 Section 1.935-1T also issued under 26 U.S.C. 7654(e). \* \* \*  
 Section 1.937-1T also issued under 26 U.S.C. 937(a).  
 Section 1.937-2T also issued under 26 U.S.C. 937(b).  
 Section 1.937-3T also issued under 26 U.S.C. 937(b). \* \* \*  
 Section 1.957-3T also issued under 26 U.S.C. 957(c). \* \* \*

■ **Par. 2.** In § 1.170A-1, paragraph (j)(9) is revised to read as follows:

**§ 1.170A-1 Charitable, etc., contributions and gifts; allowance of deduction.**

(j)(9) [Reserved]. For further guidance see § 1.170A-1T(j)(9).  
 \* \* \* \* \*

■ **Par. 3.** Section 1.170A-1T is added to read as follows:

**§ 1.170A-1T Charitable, etc., contributions and gifts; allowance of deduction (temporary).**

(a) through (j)(8) [Reserved]. For further guidance, see § 1.170A-1(a) through (j)(8).  
 (j)(9) Charitable contributions paid by bona fide residents of a section 931 possession as defined in § 1.931-1T(c)(1) or Puerto Rico are deductible only to the extent allocable to income that is not excluded under section 931 or 933. For the rules for allocating deductions for charitable contributions, see the regulations under section 861.  
 (j)(10) and (11) [Reserved]. For further guidance, see § 1.170-1(j)(10) and (11).  
 (k) *Effective date.* This section shall apply for taxable years ending after October 22, 2004.

■ **Par. 4.** In § 1.243-3, paragraph (a)(2)(iii) is revised to read as follows:

**§ 1.243-3 Certain dividends from foreign corporations.**

(a)(2) \* \* \*  
 (iii) by a domestic corporation during any period to which section 931

(relating to income from sources within possessions of the United States), as in effect for taxable years beginning before January 1, 1976, applied.

■ **Par. 5.** In § 1.702-1, paragraph (c)(1)(iii) is revised to read as follows:

**§ 1.702-1 Income and credits of partner.**

(c)(1) \* \* \*  
 (iii) In computing the amount of gross income received from sources within possessions of the United States (section 937).

■ **Par. 6.** In § 1.861-3, paragraph (a)(2) is revised to read as follows:

**§ 1.861-3 Dividends.**

(a)(2) [Reserved]. For further guidance, see § 1.861-3T(a)(2).  
 ■ **Par. 7.** Section 1.861-3T is added to read as follows:

**§ 1.861-3T Dividends (temporary).**

(a)(1) [Reserved]. For further guidance, see § 1.861-3(a)(1).  
 (2) *Dividend from a domestic corporation.* A dividend described in this paragraph (a)(2) is a dividend from a domestic corporation other than a corporation which has an election in effect under section 936. See paragraph (a)(5) of this section for the treatment of certain dividends from a DISC or former DISC.

(a)(3) through (c) [Reserved]. For further guidance, see § 1.861-3(a)(3) through (c).

(d) *Effective date.* This section shall apply for taxable years ending after October 22, 2004.

■ **Par. 8.** In § 1.861-8, paragraphs (f)(1)(vi)(E), (F), and (H) are revised to read as follows:

**§ 1.861-8 Computation of taxable income from sources within the United States and from other sources and activities.**

(f) \* \* \*  
 (1) \* \* \*  
 (vi) \* \* \*  
 (E) [Reserved].  
 (F) [Reserved].  
 (H) [Reserved].

■ **Par. 9.** Section 1.863-6 is revised to read as follows:

**§ 1.863-6 Income from sources within a foreign country.**

The principles applied in sections 861 through 863 and section 865 and the regulations thereunder for determining the gross and the taxable income from

sources within and without the United States shall generally be applied in determining the gross and the taxable income from sources within and without a particular foreign country when such a determination must be made under any provision of Subtitle A of the Internal Revenue Code, including section 952(a)(5). This section shall not apply, however, to the extent it is determined by applying § 1.863-3 that a portion of the taxable income is from sources within the United States and the balance of the taxable income is from sources within a foreign country. In the application of this section, the name of the particular foreign country shall be used instead of the term *United States*, and the term *domestic* shall be construed to mean created or organized in such foreign country. In applying section 861 and the regulations thereunder for purposes of this section, references to sections 243 and 245 shall be excluded, and the exception in section 861(a)(3) shall not apply. In the case of any item of income, the income from sources within a foreign country shall not exceed the amount which, by applying any provision of sections 861 through 863 and section 865 and the regulations thereunder without reference to this section, is treated as income from sources without the United States. See § 1.937-2T for rules for determining income from sources within a possession of the United States.

■ **Par. 10.** Section 1.871-1 is amended by:

- 1. Removing paragraph (b)(6).
- 2. Redesignating paragraph (b)(7) as (b)(6).

■ **Par. 11.** Section 1.876-1 is revised to read as follows:

**§ 1.876-1 Alien residents of Puerto Rico, Guam, American Samoa, or the Northern Mariana Islands.**

[Reserved]. For further guidance, see § 1.876-1T.

■ **Par. 12.** Section 1.876-1T is added to read as follows:

**§ 1.876-1T Alien residents of Puerto Rico, Guam, American Samoa, or the Northern Mariana Islands (temporary).**

(a) *Scope.* Section 876 and this section apply to any nonresident alien individual who is a bona fide resident of Puerto Rico or of a section 931 possession during the entire taxable year.

(b) *In general.* An individual to whom this section applies is, in accordance with the provisions of section 876, subject to tax under sections 1 and 55 in generally the same manner as an alien resident of the United States. See §§ 1.1-1(b) and 1.871-1. The tax

generally is imposed upon the taxable income of such individual, determined in accordance with section 63(a) and the regulations thereunder, from sources both within and without the United States, except for amounts excluded from gross income under the provisions of section 931 or 933. For determining the form of return to be used by such an individual, see section 6012 and the regulations thereunder.

(c) *Exceptions.* Though subject to the tax imposed by section 1, an individual to whom this section applies shall nevertheless be treated as a nonresident alien individual for the purpose of many provisions of the Internal Revenue Code relating to nonresident alien individuals. Thus, for example, such an individual is not allowed the standard deduction (section 63(c)(6)); is subject to withholding of tax at source under chapter 3 of the Internal Revenue Code (e.g., section 1441(e)); is generally excepted from the collection of income tax at source on wages for services performed in the possession (section 3401(a)(6)); is not allowed to make a joint return (section 6013(a)(1)); and, if described in section 6072(c), must pay his first installment of estimated income tax on or before the 15th day of the 6th month of the taxable year (section 6654(j) and (k)) and must pay his income tax on or before the 15th day of the 6th month following the close of the taxable year (sections 6072(c) and 6151(a)). In addition, under section 152(b)(3), an individual is not allowed a deduction for a dependent who is a resident of the relevant possession unless the dependent is a citizen or national of the United States.

(d) *Credits against tax.*—(1) Certain credits under the Internal Revenue Code are available to any taxpayer subject to the tax imposed by section 1, including individuals to whom this section applies. For example, except as otherwise provided under section 931 or 933, the credits provided by the following sections are allowable to the extent provided under such sections against the tax determined in accordance with this section—

- (i) Section 23 (relating to the credit for adoption expenses);
- (ii) Section 31 (relating to the credit for tax withheld on wages);
- (iii) Section 33 (relating to the credit for tax withheld at source on nonresident aliens); and
- (iv) Section 34 (relating to the credit for certain uses of gasoline and special fuels).

(2) Certain credits under the Internal Revenue Code are not available to nonresident aliens or are subject to limitations based on such factors as

principal place of abode in the United States. For example, the credits provided by the following sections are not allowable against the tax determined in accordance with this section except to the extent otherwise provided under such sections—

- (i) Section 22 (relating to the credit for the elderly and disabled);
- (ii) Section 25A (relating to the Hope Scholarship and Lifetime Learning Credits); and
- (iii) Section 32 (relating to the earned income credit).

(e) *Definitions.* For purposes of this section:

(1) *Bona fide resident* is defined in § 1.937-1T.

(2) *Section 931 possession* is defined in § 1.931-1T(c)(1).

(f) *Effective date.* This section shall apply for taxable years ending after October 22, 2004.

■ **Par. 13.** In § 1.881-1(c), revise the third and fourth sentences to read as follows:

**§ 1.881-1 Manner of taxing foreign corporations.**

\* \* \* \* \*

(c) \* \* \* The term *foreign corporation* has the meaning assigned to it by section 7701(a)(3) and (5) and the regulations thereunder. However, for special rules relating to possessions of the United States, see § 1.881-5T.

\* \* \* \* \*

■ **Par. 14.** Section 1.881-5T is added to read as follows:

**§ 1.881-5T Exception for certain possessions corporations (temporary).**

(a) *Scope.* Section 881(b) and this section provide special rules for the application of sections 881 and 884 to certain corporations created or organized in possessions of the United States. Paragraph (g) of this section provides special rules for the application of sections 881 and 884 to corporations created or organized in the United States for purposes of determining tax liability incurred to certain possessions that administer 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. See § 1.884-0T(b) for special rules relating to the application of section 884 with respect to possessions of the United States.

(b) *Operative rules.* (1) Corporations described in paragraphs (c) and (d) of this section are not treated as foreign corporations for purposes of section 881. Accordingly, they are exempt from the tax imposed by section 881(a).

(2) For corporations described in paragraph (e) of this section, the rate of

tax imposed by section 881(a) on U.S. source dividends received is 10 percent (rather than the generally applicable 30 percent).

(c) *U.S.V.I. and section 931 possessions.* A corporation created or organized in, or under the law of, the United States Virgin Islands or a section 931 possession is described in this paragraph (c) for a taxable year when the following conditions are satisfied—

(1) At all times during such taxable year, less than 25 percent in value of the stock of such corporation is beneficially owned (directly or indirectly) by foreign persons;

(2) At least 65 percent of the gross income of such corporation is shown to the satisfaction of the Commissioner upon examination to be effectively connected with the conduct of a trade or business in such a possession or the United States for the 3-year period ending with the close of the taxable year of such corporation (or for such part of such period as the corporation or any predecessor has been in existence); and

(3) No substantial part of the income of such corporation for the taxable year is used (directly or indirectly) to satisfy obligations to persons who are not bona fide residents of such a possession or the United States.

(d) *Section 935 possessions.* A corporation created or organized in, or under the law of, a section 935 possession is described in this paragraph (d) for a taxable year when the following conditions are satisfied—

(1) At all times during such taxable year, less than 25 percent in value of the stock of such corporation is owned (directly or indirectly) by foreign persons; and

(2) At least 20 percent of the gross income of such corporation is shown to the satisfaction of the Commissioner upon examination to have been derived from sources within such possession for the 3-year period ending with the close of the preceding taxable year of such corporation (or for such part of such period as the corporation has been in existence).

(e) *Puerto Rico.* A corporation created or organized in, or under the law of, Puerto Rico is described in this paragraph (e) for a taxable year when the conditions of paragraphs (c)(1) through (3) are satisfied (using the language “Puerto Rico” instead of “such a possession”).

(f) *Definitions and other rules.* For purposes of this section:

(1) *Section 931 possession* is defined in § 1.931-1T(c)(1).

(2) *Section 935 possession* is defined in § 1.935-1T(a)(3)(i).

(3) *Foreign person* means any person other than—

(i) A United States person (as defined in section 7701(a)(30) and the regulations thereunder); or

(ii) A person who would be a United States person if references to the United States in section 7701 included references to a possession of the United States.

(4) *Bona fide resident*—

(i) With respect to a possession, is defined in § 1.937-1T; and

(ii) With respect to the United States, means an individual who is a citizen or resident of the United States and who does not have a tax home (as defined in section 911(d)(3)) in a foreign country.

(5) *Source*. The rules of § 1.937-2T shall apply for determining whether income is from sources within a possession.

(6) *Effectively connected income*. The rules of § 1.937-3T (other than paragraph (c) of that section) shall apply for determining whether income is effectively connected with the conduct of a trade or business in a possession.

(7) *Indirect ownership*. The rules of section 318(a)(2) shall apply except that the language “5 percent” shall be used instead of “50 percent” in section 318(a)(2)(C).

(g) *Mirror code jurisdictions*. For purposes of applying mirrored section 881 to determine tax liability incurred to a section 935 possession or the United States Virgin Islands—

(1) The rules of paragraphs (b) through (d) of this section shall not apply; and

(2) A corporation created or organized in, or under the law of, such possession or the United States shall not be considered a foreign corporation.

(h) *Example*. The principles of this section are illustrated by the following example:

*Example 1.* X is a corporation organized under the law of the United States Virgin Islands (USVI) with a branch located in State F. At least 65 percent of the gross income of X is effectively connected with the conduct of a trade or business in the USVI and no substantial part of the income of X for the taxable year is used to satisfy obligations to persons who are not bona fide residents of the United States or the USVI. Seventy-four percent of the stock of X is owned by unrelated individuals who are residents of the United States or the USVI. Y, a corporation organized under the law of State D, and Z, a partnership organized under the law of State F, each own 13 percent of the stock of X. A, an unrelated foreign individual, owns 100 percent of the stock of corporation Y. B and C, unrelated foreign individuals, each own a 50 percent interest in partnership Z. Thus, the condition of paragraph (c)(1) of this section is not

satisfied, because 26 percent of X is owned indirectly by foreign persons (A, B, and C). Accordingly, X is treated as a foreign corporation for purposes of section 881.

(i) *Effective dates*. Except as provided in this paragraph (i), this section applies to payments made after April 11, 2005. The rules of paragraphs (b)(2) and (e) apply to dividends paid after October 22, 2004. However, if, on or after October 22, 2004, an increase in the rate of the Commonwealth of Puerto Rico's withholding tax which is generally applicable to dividends paid to United States corporations not engaged in a trade or business in the Commonwealth to a rate greater than 10 percent takes effect, the rules of paragraphs (b)(2) and (e) shall not apply to dividends received on or after the effective date of the increase.

■ **Par. 15.** In § 1.884-0, paragraph (b) is redesignated as paragraph (c), and a new paragraph (b) is added.

The addition reads as follows:

**§ 1.884-0 Overview of regulation provisions for section 884.**

\* \* \* \* \*

(b) *Special rules for U.S. possessions*. [Reserved]. For further guidance, see § 1.884-0T(b).

\* \* \* \* \*

■ **Par. 16.** Section 1.884-0T is added as follows.

**§ 1.884-0T Overview of regulation provisions for section 884 (temporary).**

(a) [Reserved]. For further guidance, see § 1.884-0(a).

(b) *Special rules for U.S. possessions*. (1) Section 884 does not apply to a corporation created or organized in, or under the law of, American Samoa, Guam, the Northern Mariana Islands, or the United States Virgin Islands, provided that the conditions of § 1.881-5T(c)(1) through (3) are satisfied with respect to such corporation. The preceding sentence applies for taxable years ending after April 11, 2005.

(2) Section 884 does not apply for purposes of determining tax liability incurred to a section 935 possession or the United States Virgin Islands by a corporation created or organized in, or under the law of, such possession or the United States. The preceding sentence applies for taxable years ending after April 11, 2005.

(c) [Reserved]. For further guidance, see § 1.884-0(c).

■ **Par. 17.** In § 1.901-1, paragraph (g) is revised to read as follows:

**§ 1.901-1 Allowance of credit for taxes.**

\* \* \* \* \*

(g) [Reserved]. For further guidance, see § 1.901-1T(g).

\* \* \* \* \*

■ **Par. 18.** Section 1.901-1T is added to read as follows:

**§ 1.901-1T Allowance of credit for taxes (temporary).**

(a) through (f) [Reserved]. For further guidance, see § 1.901-1(a) through (f).

(g) *Taxpayers to whom credit not allowed*. Among those to whom the credit for taxes is not allowed are the following—

(1) Except as provided in section 906, a foreign corporation;

(2) Except as provided in section 906, a nonresident alien individual who is not described in section 876 (see sections 874(c) and 901(b)(4));

(3) A nonresident alien individual described in section 876 other than a bona fide resident (as defined in section 937(a) and the regulations thereunder) of Puerto Rico during the entire taxable year (see sections 901(b)(3) and (4)); and

(4) A U.S. citizen or resident alien individual who is a bona fide resident of a section 931 possession (as defined in § 1.931-1T(c)(1)), the U.S. Virgin Islands, or Puerto Rico, and who excludes certain income from U.S. gross income to the extent of taxes allocable to the income so excluded (see sections 931(b)(2), 933(1), and 932(c)(4)).

(h) [Reserved]. For further guidance, see § 1.901-1(h).

(i) [Reserved]. For further guidance, see § 1.901-1(i).

(j) *Effective date*. This section shall apply for taxable years ending after October 22, 2004.

■ **Par. 19.** Section 1.931-1 is revised to read as follows:

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

[Reserved]. For further guidance, see § 1.931-1T.

■ **Par. 20.** Section 1.931-1T is added to read as follows:

**§ 1.931-1T Exclusion of certain income from sources within Guam, American Samoa, or the Northern Mariana Islands (temporary).**

(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, shall 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.

(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 2005, D moves to American Samoa, purchases a house, and accepts a permanent position with a local employer. For the remainder of the year and throughout 2006, D continues to live and work in American Samoa, and establishes a closer connection to American Samoa than to the United States or any foreign country. In September 2007, as a result of the termination of his employment in American Samoa, D sells his house and moves to State H. D is entitled to the exclusion provided in section 931 for 2006, but not for 2005 or 2007 (assuming that during the first quarter of 2005 and the last quarter of 2007, D has a tax home outside of American Samoa or a closer connection to the United States or a foreign country).

(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 shall 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 shall 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 § 1.937-1T shall apply for determining whether an individual is a bona fide resident of a section 931 possession.

(4) The rules of § 1.937-2T shall apply for determining whether income is from sources within a section 931 possession.

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

(d) *Effective date.* This section shall apply for taxable years ending after October 22, 2004.

■ **Par. 21.** Section 1.932-1 is revised to read as follows:

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

[Reserved]. For further guidance, see § 1.932-1T.

■ **Par. 22.** Section 1.932-1T is added to read as follows:

**§ 1.932-1T Coordination of United States and Virgin Islands income taxes (temporary).**

(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 shall 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 § 1.937-1T shall apply for determining whether an individual is a bona fide resident of the Virgin Islands.

(ii) The rules of § 1.937-2T shall apply for determining whether income is from sources within the Virgin Islands.

(iii) The rules of § 1.937-3T shall 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 V.I. income*—(1) *Dual filing requirement.*

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

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

(A) The term *applicable percentage* means the percentage which 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 thereto. For purposes of the preceding sentence, the rules of § 1.861-8 shall apply.

(C) Pursuant to § 1.937-2T(a), the rules of § 1.937-2T(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 shall be subject to the following income tax return filing requirements:

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

(2) *U.S. filing requirements.* For purposes of calculating the income tax liability to the United States of an individual to whom this paragraph (c) applies, gross income shall 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 shall not be taken into account, provided that—

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

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

(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 shall 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 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.

(e) *Place for filing returns*—(1) *U.S. returns.* A return required under the rules of paragraphs (b) and (c) of this section to be filed with the United States shall be filed as directed in the applicable forms and instructions.

(2) *V.I. returns.* A return required under the rules of paragraphs (b) and (c) of this section to be filed with the Virgin Islands shall 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):

(i) The term *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) The term *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.

(iii) The term *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, the United States generally shall 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 Internal Revenue 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 (e.g., 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 shall 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 shall be treated as a domestic corporation and a shareholder to whom section 932(a) applies shall not be treated as a nonresident alien individual with respect to such corporation. While such an election is in effect, the corporation shall 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 tax 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).

(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 (e.g., sections 931 through 937, 7651, and 7654).

(B) The determination of any aspect of an individual's residency (e.g., 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 (e.g., 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 (*i.e.*, mirrored sections of the Internal Revenue Code), the Virgin Islands generally shall 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 Internal Revenue 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 (*e.g.*, 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 shall 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 shall be treated as a domestic corporation and a shareholder to whom section 932(c) applies shall not be treated as a nonresident alien

individual with respect to such corporation. While such an election is in effect, the corporation shall 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 tax 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.

(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 (*e.g.*, 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 (*e.g.*, 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).

(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 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 Internal Revenue Service, the Commissioner, at his discretion, may deem the election also to have been made for U.S. Federal tax purposes.

(iii) If inconsistent entity status elections are filed with the BIR and the Internal Revenue Service, 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. 89-8 (1989-1 C.B. 778) for procedures for requesting the assistance of the Internal Revenue Service when a taxpayer is or may be subject to inconsistent tax treatment by the Internal Revenue Service 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 Internal Revenue 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), and § 301.7701-3(b) as mirrored in the Virgin Islands, an eligible entity subject

to this paragraph (h) shall be classified for both U.S. 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 shall 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) 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 shall 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 shall take effect for U.S. 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. The Federal Individual Income Tax Return, Form 1040, that A prepares for 2004 reports adjusted gross income of \$90x, including \$30x from sources in the U.S. Virgin Islands (USVI). The income tax liability reported on A's Form 1040 is \$18x. A files a copy of his Federal Form 1040 with the USVI Bureau of Internal Revenue as required by section 932(a)(2) and paragraph (b)(1) of this section, and pays the applicable percentage of his Federal income tax liability to the USVI as required by section 932(b) and paragraph (b)(2) of this section, computed as follows:

$30/90 \times 18x = \$6x$  income tax liability to the USVI

(ii) A claims a credit against his Federal income tax liability reported on his Form 1040 in the amount of \$6x. A attaches a Form 8689, "Allocation of Individual Income Tax to the Virgin Islands," to the Form 1040 filed with the Internal Revenue Service and to the copy of the Form 1040 filed with the USVI.

*Example 2.* B, a U.S. citizen, files returns on a calendar year basis. In April 2005, B moves to the U.S. Virgin Islands (USVI), purchases a house, and accepts a permanent position with a local employer. For the remainder of the year and throughout 2006, B continues to live and work in the USVI, and establishes a closer connection to the USVI than to the United States or any foreign country. In September 2007, as a result of the termination of his employment in the USVI, B sells his house and moves to State G. As a consequence of his employment in the USVI, B earns income from the performance of services in the USVI from April 2005 through September 2007. Section 932(c) and paragraph (c) of this section apply to B for 2006, but not for 2005 or 2007 (assuming that during the first quarter of 2005 and the last quarter of 2007, B has a tax home outside of the USVI or a closer connection to the United States or a foreign country). For 2005 and 2007, B is subject to the rules of sections 932(a) and (b) and paragraph (b) of this section because he has income derived from sources within the USVI as determined under the rules of section 937(b) and § 1.937–2T.

*Example 3.* H and W are U.S. citizens. H resides in State T and W is a bona fide resident of the U.S. Virgin Islands (USVI). For 2004, H and W prepare a joint Individual Income Tax Return, Form 1040, which reports total adjusted gross income of \$75x of which \$40x is attributable to compensation that W received for services performed in the USVI and \$35x to compensation that H received for services performed in State T. Pursuant to section 932(d) and paragraph (d) of this section, the joint income tax return of H and W is filed with the USVI as required by section 932(c) and paragraph (c) of this section. H and W may claim a tax credit on such return for income tax withheld during 2004 and paid to the Internal Revenue Service.

*Example 4.* (i) The facts are the same as in example 3, except that H also earns \$25x for services performed in the USVI, 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, H and W must file a copy of their joint Federal Form 1040 with the Bureau of Internal Revenue of the USVI as required by section 932(a)(2) and paragraph (b)(1) of this section, and pay the applicable percentage of their Federal income tax liability to the USVI as required by section 932(b) and paragraph (b)(2) of this section, computed as follows:

$65/100 \times 20x = \$13x$  income tax liability to the USVI

(iii) H and W claim a credit against their Federal income tax liability reported on the Form 1040 in the amount of \$13x, the portion of their Federal income tax liability required to be paid to the USVI. H and W attach a Form 8689, "Allocation of Individual Income Tax to the Virgin Islands," to the Form 1040 filed with the Internal Revenue Service and to the copy of the Form 1040 filed with the USVI.

*Example 5.* J is a U.S. citizen and a bona fide resident of the U.S. Virgin Islands (USVI). In 2005, J receives compensation for

services performed in the USVI in the amount of \$40x. J prepares and files an Individual Income Tax Return, Form 1040, with the USVI and reports gross income of only \$30x. J has not satisfied the conditions of section 932(c)(4) and paragraph (c) of this section for an exclusion from gross income for U.S. Federal income tax purposes and, therefore, must file a Federal income tax return in accordance with the Internal Revenue Code and the regulations.

*Example 6.* (i) N is a U.S. citizen and a bona fide resident of the U.S. Virgin Islands. In 2004, N receives compensation for services performed in Country M. N prepares and files an Individual Income Tax Return, Form 1040, with the USVI and reports the compensation as income effectively connected with the conduct of a trade or business in the USVI. N claims a special credit against the tax on this compensation purportedly pursuant to a USVI 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 § 1.937–3T(b), compensation for services performed outside the USVI may not be treated as income effectively connected with the conduct of a trade or business in the USVI for purposes of section 934(b). Consequently, N is not entitled to claim the special credit under USVI law with respect to N's income from services performed in Country M. Given that 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 U.S. Federal income tax purposes. Accordingly, N must file a Federal income tax return in accordance with the Internal Revenue Code and the regulations.

(j) *Effective date.* This section shall apply for taxable years ending after October 22, 2004.

■ **Par. 23.** Section 1.933–1 is amended by revising paragraphs (a) and (c) and adding paragraphs (d) and (e) to read as follows:

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

(a) [Reserved]. For further guidance, see § 1.933–1T(a).

\* \* \* \* \*

(c) [Reserved]. For further guidance, see § 1.933–1T(c).

(d) [Reserved]. For further guidance, see § 1.933–1T(d).

(e) [Reserved]. For further guidance, see § 1.933–1T(e).

■ **Par. 24.** Section 1.933–1T is added to read as follows:

**§ 1.933–1T Exclusion of certain income from sources within Puerto Rico (temporary).**

(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, shall 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.

(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 2005, E moves to Puerto Rico, purchases a house, and accepts a permanent position with a local employer. For the remainder of the year and throughout 2006, E continues to live and work in Puerto Rico, and establishes a closer connection to Puerto Rico than to the United States or any foreign country. In September 2007, as a result of the termination of his employment in Puerto Rico, E sells his house and moves to State J. E is entitled to the exclusion provided in section 933 for 2006, but not for 2005 or 2007 (assuming that during the first quarter of 2005 and the last quarter of 2007, E has a tax home outside of Puerto Rico or a closer connection to the United States or a foreign country).

(b) [Reserved]. For further guidance, see § 1.933-1(b).

(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 shall 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 shall apply (with creditable expenditures treated in the same manner as deductible expenditures).

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

(1) The rules of § 1.937-1T shall apply for determining whether an individual is a bona fide resident of Puerto Rico.

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

(e) *Effective date.* This section shall apply for taxable years ending after October 22, 2004.

■ **Par. 25.** Section 1.934-1 is revised to read as follows:

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

[Reserved]. For further guidance, see § 1.934-1T.

■ **Par. 26.** Section 1.934-1T is added to read as follows:

**§ 1.934-1T Limitation on reduction in income tax liability incurred to the Virgin Islands (temporary).**

(a) *General rule.* Section 934(a) provides that tax liability incurred to the United States Virgin Islands (Virgin Islands) shall 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, 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 V.I. 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 thereunder.

(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 shall 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; and

(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, shall 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 § 1.937-1T shall apply for determining whether an individual is a bona fide resident of the Virgin Islands.

(ii) *Source.* The rules of § 1.937-2T shall apply for determining whether income is from sources within the Virgin Islands.

(iii) *Effectively connected income.* The rules of § 1.937-3T shall 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 which is derived from sources outside the United States and which 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 which is derived from sources outside

the United States and which is not effectively connected with the conduct of a trade or business within the United States shall 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 which is derived from sources outside the United States and which 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; and

(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 U.S. Federal income tax purposes under section 906 of the Internal Revenue Code).

(ii) *Limitation* Tax liability incurred to the Virgin Islands attributable to income which is derived from sources outside the United States and which is not effectively connected with the conduct of a trade or business within the United States, as computed in this paragraph (c)(3), however, shall 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 thereunder shall 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 shall 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 U.S. Virgin Islands (USVI). For 2005, S files a Form 1040INFO, “Non-Virgin Islands Source Income of Virgin Islands Residents,” with the USVI on which S reports total gross income as follows:

Compensation for services performed in the USVI .....	\$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 USVI 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 USVI or effectively connected to the conduct of a trade or business in the USVI (USVI ECI) of \$75,000, income from sources within the United States of \$50,000, and income from other sources (not USVI 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 USVI, \$15,000 is taxable income from other sources that is USVI ECI under the rules of section 937(b) and §§ 1.937–2T and 1.937–3T, and \$22,500 is taxable income from sources outside the USVI (and outside the United States) that is not USVI ECI. S's tax liability incurred to the USVI pursuant to the Internal Revenue Code as applicable in the USVI (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 USVI 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 USVI. 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:  $(20,000 + 10,000) \times ((45,000 + 15,000) / 120,000) / (10,000 \times (15,000 / (15,000 + 22,500))) = 30,000 \times (.5) - 10,000 \times (.4) = 15,000 - 4,000 = \$11,000$

(iv) Accordingly, S's net tax liability incurred to the USVI 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 U.S. Virgin Islands (USVI) a copy of his Federal income tax return and pays to the USVI 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 USVI law relating to business activities like his in the USVI to reduce any of his tax liability payable to the USVI under section 932(b).

*Example 3.* (i) Z is a nonresident alien who resides in Country FC. In 2005, Z receives dividends from a corporation organized under the law of the U.S. Virgin Islands

(USVI) in the amount of \$90x. Z's tax liability incurred to the USVI pursuant to section 871(a) of the Internal Revenue Code as applicable in the USVI (mirror code) is \$27x.

(ii) Pursuant to a USVI 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 USVI. 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 USVI law, Z's net tax liability incurred to the USVI may be reduced or eliminated entirely.

*Example 4.* (i) A Corp is organized under the laws of the U.S. Virgin Islands (USVI) 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 USVI. During 2005, A Corp had \$50x in gross income from sources within the USVI (as determined under section 937(b) and § 1.937–2T) 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 USVI to reduce or remit the income tax liability of a *qualified foreign corporation* arising under the Internal Revenue Code as applicable in the USVI (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 USVI 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 USVI.

*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 USVI .....	5%
U.S. citizens who are not bona fide residents of the USVI .....	3%
Nonresident aliens who are bona fide residents of the USVI .....	42%
Nonresident aliens who are not bona fide residents of the USVI ..	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 USVI may reduce or remit A Corp's mirror code income tax liability with respect to its \$50x in gross income from sources within the USVI 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 USVI 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 date.* Except as otherwise provided in this paragraph (e), this section applies for taxable years ending after October 22, 2004. Paragraph (c)(4)(ii) of this section applies to amounts paid or accrued after April 11, 2005.

■ **Par. 27.** Section 1.935-1 is amended as follows:

- 1. Revise the heading and paragraphs (a)(1) through (a)(3).
- 2. Revise paragraphs (b)(1) and (b)(3), and add paragraphs (b)(5) through (b)(7).
- 3. Revise paragraphs (c) through (f).
- 4. Add paragraph (g).

The revisions and additions are as follows:

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

(a)(1) through (a)(3) [Reserved]. For further guidance, see § 1.935-1T(a)(1) through (a)(3).

(b)(1) [Reserved]. For further guidance, see § 1.935-1T(b)(1).

\* \* \* \* \*

(b)(3) [Reserved]. For further guidance, see § 1.935-1T(b)(3).

\* \* \* \* \*

(b)(5) through (b)(7) [Reserved]. For further guidance, see § 1.935-1T(b)(5) through (b)(7).

(c) through (f) [Reserved]. For further guidance, see § 1.935-1T(c) through (f).

(g) [Reserved]. For further guidance, see § 1.935-1T(g).

■ **Par. 28.** Section 1.935-1T is added to read as follows:

**§ 1.935-1T Coordination of individual income taxes with Guam and the Northern Mariana Islands (temporary).**

(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 shall apply 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:

(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 (Pub. L. 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.

(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 § 1.937-1T shall apply for determining whether an individual is a bona fide resident of a section 935 possession.

(iv) The rules of § 1.937-2T generally shall apply for determining whether income is from sources within a section 935 possession. Pursuant to § 1.937-2T(a), however, the rules of § 1.937-2T(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 shall 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) [Reserved]. For further guidance, see § 1.935-1(b)(2).

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

(4) [Reserved]. For further guidance, see § 1.935-1(b)(4).

(5) *Tax payments.* The tax shown on the return shall be paid to the jurisdiction with which such return is required to be filed and shall 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) *Information reporting*. [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, the United States generally shall 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 Internal Revenue 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 (e.g., 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 shall 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 shall be treated as a domestic corporation and a U.S. taxpayer shareholder shall not be treated as a nonresident alien individual with respect to such corporation. While such an election is in effect, the corporation shall 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 (e) of this section.

(D) The treatment of items carried over from other tax 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.

(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 (e.g., sections 931 through 937, 7651, and 7654).

(B) The determination of any aspect of an individual's residency (e.g., 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 (e.g., sections 935, 937, and 7654). Thus, for example, income determined to be derived from sources within the relevant possession under section 937(b) shall 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".

(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).

(E) The characterization of a corporation for purposes other than subchapter S (e.g., 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 shall 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 Guamanian 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 shall 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 shall 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, shall 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 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 Internal Revenue Service, the Commissioner, at his discretion, may deem the election also to have been made for U.S. Federal tax purposes.

(iii) If inconsistent entity status elections are filed with the relevant possession and the Internal Revenue Service, 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. 89-8 (1989-1 C.B. 778) for procedures for requesting the assistance of the Internal Revenue Service when a taxpayer is or may be subject to inconsistent tax treatment by the Internal Revenue Service 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 Internal Revenue 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.

(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), and § 301.7701-3(b) as mirrored in the relevant possession, an eligible entity subject to this paragraph (e) shall be classified for both U.S. 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 shall 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) 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 shall 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 shall take effect for U.S. 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.* B, a United States citizen, files returns on a calendar year basis. In April 2005, B moves to Possession G, which is a section 935 possession, purchases a house, and accepts a permanent position with a

local employer. For the remainder of the year and throughout 2006, B continues to live and work in Possession G, and establishes a closer connection to Possession G than to the United States or any foreign country. In September 2007, as a result of the termination of his employment in Possession G, B sells his house and moves to State H. As a consequence of his employment in Possession G, B earns income from the performance of services in Possession G from April 2005 through September 2007. Section 935(b)(1)(B) and paragraph (b)(1)(ii) of this section apply to B for 2006, but not for 2005 or 2007 (assuming that during the first quarter of 2005 and the last quarter of 2007, B has a tax home outside of Possession G or a closer connection to the United States or a foreign country). For 2005 and 2007, B is subject to the rules applicable to individuals described in paragraph (a)(2)(iii) of this section because he has income derived from sources within Possession G as determined under the rules of section 937(b) and § 1.937-2T.

**Example 2.** The facts are the same as in *Example 1* except that B's employment terminated in September 2008 rather than 2007. B properly pays his April 2005 estimated tax to the United States, continues to pay estimated tax for the 2005 tax year to the United States under paragraph (d) of this section, and properly files his 2005 return with the United States.

(i)(A) On the date of each payment of estimated tax in 2006, B reasonably believes that he would be required to file his return for 2006 with Possession G under paragraph (b)(1) of this section.

(B) In August 2006, 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 2006, subtracting the \$1000 overpayment from his estimated tax payments pursuant to section 6402(b), and properly files his tax return with Possession G.

(ii) In April 2007, B reasonably believes that he would be returning to the United States in the Fall of 2007, and properly pays estimated tax to the United States. By June 2007, 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 2007 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.

(iii) In April and June 2008, B reasonably believes that he would be a bona fide resident of Possession G for the entire taxable year 2008 and properly pays estimated taxes to Possession G. By the time B pays his estimated taxes for September 2008, 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 2008, properly filed with the United States, B determines that he has underpaid estimated taxes throughout 2008 in an amount subject to penalty under section 6654. B owes the United States an estimated tax penalty under section 6654.

(g) *Effective date.* This section shall apply for taxable years ending after October 22, 2004.

■ **Par. 29.** Section 1.937-1T is added to read as follows:

**§ 1.937-1T Bona fide residency in a possession (temporary).**

(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 the Internal Revenue Code, including 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 shall be 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 shall not be 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.* Only natural persons may qualify as bona fide residents of a possession. The rules governing the tax treatment of bona fide residents of a possession do not apply to juridical persons (e.g., corporations, partnerships, trusts, and estates).

(4) *Transition rule.* For taxable years beginning before October 23, 2004, and ending after October 22, 2004, an individual will be considered to qualify as a bona fide resident of the relevant possession if such individual satisfies the requirements of paragraphs (d) and (e) of this section with respect to such possession for such year.

(c) *Presence test*—(1) *In general.* A United States citizen or resident alien (as defined in section 7701(b)(1)(A)) individual satisfies the requirements of this paragraph (c) for a taxable year if during that taxable year such individual—

(i) Was present in the relevant possession for at least 183 days;

(ii) Was present in the United States for no more than 90 days;

(iii) Had no earned income (as defined in § 1.911-3(b)) in the United States and was present for more days in the relevant possession than in the United States; or

(iv) Had no permanent connection (see paragraph (c)(4) of this section) to the United States.

(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 such 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 any day that he or she is physically present in such possession at any time during the day.

(ii) An individual is considered to be present in the United States on any day that he or she is physically present in the United States at any time during the day. However, the following days shall be excluded and will not count as days of presence in the United States:

(A) Any day that an individual is prevented from leaving the United States because of a medical condition



that arose while the individual was present in the United States (as described in § 301.7701(b)–3(c) of this chapter);

(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 during which the individual is temporarily 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 such role.

(iii) If, during a single day, an individual is physically present—

(A) In the United States and in the relevant possession, such day shall be considered a day of presence in the relevant possession;

(B) In two possessions, such day shall be 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) *Permanent connection.* For purposes of paragraph (c)(1) of this section—

(i) A permanent connection to the United States includes—

(A) A permanent home (as described in § 301.7701(b)–2(d)(2) of this chapter) in the United States;

(B) A spouse or dependent (as defined in section 152 and the regulations thereunder) whose principal place of abode is in the United States; or

(C) Current registration to vote in any political subdivision of the United States.

(ii) However, a permanent connection to the United States does not include—

(A) A valid professional license conferred by any political subdivision of the United States; or

(B) Relatives (other than those specified in paragraph (c)(4)(B) of this section) whose principal place of abode is in the United States.

(d) *Tax home test*—(1) *General rule.* An individual satisfies the requirements of this paragraph (d) for a taxable year if such 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) *Special rule for seafarers.* For purposes of section 937 and this section, an individual will not be 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 will be 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 water and in the water within three miles of the relevant possession exceeds the aggregate amount of time it is used in the territorial water of the United States or any foreign country.

(3) *Special rule for students and government officials.* Any days described in paragraphs (c)(3)(ii)(D) and (E) of this section shall be 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.* An individual satisfies the requirements of this paragraph (e) for a taxable year if such individual did not have a closer connection to the United States or a foreign country than to the relevant possession. For purposes of the preceding sentence—

(1) The principles of section 7701(b)(3)(B)(ii) and § 301.7701(b)–2(d) of this chapter shall apply; and

(2) Another possession shall not be considered a foreign country.

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

*Example 1. Presence test.* H and W are U.S. citizens who live for part of the taxable year in a condominium, which they own, located in Possession P. H and W also own a house in State N where they live for 120 days a year to be near their grown children and grandchildren. H and W are retired and their income consists solely of pension payments, dividends, interest, and Social Security

benefits. In 2005, H and W are only present in Possession P for a total of 175 days because of a 70 day vacation to Europe and Asia. Thus, in 2005, H and W are not present in Possession P for at least 183 days, are present in the United States for more than 90 days, and have a permanent connection to the United States by reason of their permanent home. However, under paragraph (c)(1)(iii) of this section, H and W each still satisfy the presence test in paragraph (c) of this section with respect to Possession P because they have no earned income in the United States and are physically present for more days in Possession P than in the United States.

*Example 2. Presence test.* T, a U.S. citizen, 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, where he is also registered to vote. T's business travel requires T to spend 120 days in the United States and another 120 days in foreign countries. When traveling on business, T generally stays at hotels but sometimes stays with his brother, who lives in State A. Under paragraphs (c)(1)(iv) and (c)(4) of this section, T satisfies the presence test in paragraph (c) of this section because he has no permanent connection to the United States.

*Example 3. 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 physically 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 4. Seafarers—tax home.* S, a U.S. citizen, is employed by a fishery and spends 250 days at sea on a fishing vessel. 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 or local waters (within the meaning of paragraph (d)(2) of this section) for 225 days. Under paragraph (d)(2) of this section, 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 5. 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 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)(ii) 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 for this purpose, under paragraph (e)(2) of this section, Possession Q is not treated as a foreign country with respect to Possession I). Therefore, P is a bona fide resident of Possession I for purposes of the Internal Revenue Code.

*Example 6. Closer connection to United States than to possession.* Z, a U.S. citizen, relocates to Possession V in 2003 to start an investment consulting and venture capital business. Z's wife and two teen-aged 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 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.

(g) *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 § 1.931-1T(c)(1)) who take a position

for U.S. tax reporting purposes that they qualify as bona fide residents of such 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 United States Virgin Islands or a section 935 possession (as defined in § 1.935-1T(a)(3)(i)).

(h) *Effective date.* Except as provided in this paragraph (h), this section shall apply to taxable years ending after October 22, 2004. Paragraph (g) of this section also applies to the 3 taxable years preceding the first taxable year ending after October 22, 2004.

■ **Par. 30.** Section 1.937-2T is added to read as follows:

**§ 1.937-2T Income from sources within a possession (temporary).**

(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 thereunder (relating to the determination of the gross and the taxable income from sources within and without the United States) generally shall be applied in determining the gross and the taxable income from sources within and without the relevant possession. In the application of such principles, the name of the relevant possession shall be used instead of the term *United States*, the term *bona fide resident* of followed by the name of the relevant possession shall be used instead of the term *United States resident*, and the term *domestic* shall be construed to mean created or organized in such possession.

(c) *U.S. income—(1) In general.* Except as provided in paragraph (d) of this section, income from sources within the relevant possession shall not include any item of income determined under the rules of sections 861 through 865 and the regulations thereunder 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 shall 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) *Income from services—(1) No de minimis rule.* In applying the principles of section 861 and the regulations thereunder pursuant to paragraph (b) of this section, the exception in section 861(a)(3) shall not apply.

(2) *Service in the Armed Forces.* In the case of a member of the Armed Forces of the United States, the following rules shall apply for determining the source of compensation for services performed in compliance with military orders:

(i) 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).

(ii) 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) Income from sources within the relevant possession shall 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

Public Law 99-514 (100 Stat. 2985) (providing that gains from the disposition of certain property by individuals who acquired residency in certain possessions shall 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 shall 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 shall 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.

(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) shall 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)

shall 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 thereunder pursuant to paragraph (b) of this section, the rules of section 865(g) shall not apply, but the special rule of section 865(h)(2)(B) shall 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) shall be treated as income from sources within such possession. For purposes of this paragraph (g)—

(A) The possessions source ratio shall be a fraction, the numerator of which equals 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 equals 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 shall 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 § 1.937-3T); 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 shall 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 thereunder pursuant to paragraph (b) of this section, the special rules relating to dividends for which deductions are allowable under section 243 or 245 shall 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) shall 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 shall 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 shall 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 shall 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 § 1.937-3T). For purposes of the preceding sentence, the principles of §§ 1.861-9 through 1.861-12 shall 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 shall 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 shall 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 shall 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) shall apply except that the language “5 percent” shall 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.* X, a U.S. citizen, resides in State N and acquires the stock of Corporation C, a domestic corporation, in 2000. X moves to the Northern Mariana Islands (NMI) in 2003. In 2004, while a bona fide resident of the NMI, X recognizes gain on the sale of the Corporation C stock. Pursuant to section 1277(e) of the Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2085) (October 22, 1986), this gain is 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 not as income from sources in the NMI.

*Example 2.* X, a U.S. citizen, resides in State F and acquires a 5 percent interest in Partnership P in 2003. X moves to the U.S. Virgin Islands (USVI) in 2004. In 2006, while a bona fide resident of the USVI, X recognizes gain on the sale of the interest in Partnership P. Pursuant to paragraph (f)(1) of this section, the gain shall not be treated as income from sources within the USVI for purposes of the Internal Revenue Code (for example, for purposes of section 934(b)).

*Example 3.* X, a bona fide resident of Possession I, a section 931 possession (as defined in § 1.931-1T(c)(1)), is engaged in a trade or business in the United States through an office in State H. In 2005, this office materially participates in the sale of inventory property in Possession I, 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 shall not be treated as income from sources within Possession I for purposes of section 931(a)(1)

pursuant to paragraph (c)(1)(ii) of this section, but nonetheless shall 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 2006, X receives a dividend of \$70x from A Corp. During 2004 through 2006, A Corp has gross income from the following sources:

Year	Possession I sources	Sources outside possession I
2004 .....	\$10x	\$20x
2005 .....	20x	10x
2006 .....	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 2004 through 2006, B Corp has gross income from the following sources:

Year	Possession I sources	Sources outside possession I
2004 .....	\$10x	\$6x
2005 .....	14x	8x
2006 .....	10x	4x

(iii) A Corp is treated as having received 50 percent of the gross income of B Corp. Therefore, for 2004 through 2006, the gross income of A Corp is from the following sources:

Year	Possession I sources	Sources outside possession I
2004 .....	\$15x	\$23x
2005 .....	27x	14x
2006 .....	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 2006 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 2005, 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. X is a “United States person” as defined in section 7701(a)(30)(A). Accordingly, pursuant to section 863(d)(1)(A), the compensation that X receives for services performed in international waters is treated as income from sources within the United States for purposes of the Internal Revenue Code (including section 7654, as in effect with respect to the NMI). 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.

(l) *Effective date.* Except as otherwise provided in this paragraph (l), this section applies to income earned in tax years ending after October 22, 2004. Paragraph (c)(1) of this section applies to income earned after December 31, 2004. Paragraph (f) of this section applies to dispositions after April 11, 2005. Paragraphs (c)(2), (g)(1), (h), and (i) of this section apply to amounts paid or accrued after April 11, 2005.

■ **Par. 31.** Section 1.937-3T is added to read as follows:

**§ 1.937-3T Income effectively connected with the conduct of a trade or business in a possession (temporary).**

(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 thereunder (relating to the determination of income, gain or loss which is effectively connected with the conduct of a trade or business within the United States) shall generally be applied in determining whether income is effectively connected with the conduct of a trade or business within the relevant possession (except for the substitution of the name of the relevant possession for the term *United States* where appropriate), without regard to whether the taxpayer qualifies as a nonresident alien individual or a foreign corporation with respect to such possession. For purposes of the preceding sentence, all income other than income from sources within the relevant possession (as determined under the rules of 1.937-2T) shall be considered income from sources

without the relevant possession, and subject to the rules of this section, the principles of section 864(c)(4) shall apply for purposes of determining whether such income constitutes income effectively connected with the conduct of a trade or business in the relevant possession.

(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 shall not include any item of income determined under the rules of sections 861 through 865 and the regulations thereunder 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 shall 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 shall 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 § 1.931–1T(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 § 1.937–2T(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 shall 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 shall 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.

(f) *Effective date*. Except as otherwise provided in this paragraph (f), this section applies to income earned in taxable years ending after October 22, 2004. Paragraph (c)(1) of this section applies to income earned after December 31, 2004. Paragraph (c)(2) of this section applies to amounts paid or accrued after April 11, 2005.

■ **Par. 32.** Section 1.957–3 is revised to read as follows:

**§ 1.957–3 United States person defined.**

[Reserved]. For further guidance, see § 1.957–3T.

■ **Par. 33.** Section 1.957–3T is added to read as follows:

**§ 1.957–3T United States person defined (temporary).**

(a) *Basic rule*—(1) *In general*. The term *United States person* has the same meaning for purposes of sections 951 through 965 which it has under section 7701(a)(30) and the regulations thereunder, except as provided in paragraphs (b) and (c) of this section which provide, with respect to corporations organized in possessions of the United States, that certain residents of such possessions are not United States persons. The effect of determining that an individual is not a United States person for such purposes is to exclude such individual in determining whether a foreign corporation created or organized in, or under the laws of, a possession of the United States is a controlled foreign corporation. See § 1.957–1 for the definition of the term *controlled foreign corporation*.

(2) *Special provisions applicable to possessions of the United States*. For purposes of this section—

(i) The term *possession of the United States* means the Commonwealth of Puerto Rico (Puerto Rico) or any section 931 possession.

(ii) The term *section 931 possession* has the same meaning which it has under § 1.931–1T(c)(1).

(iii) The rules of § 1.937–1T shall apply for determining whether an

individual is a bona fide resident of a possession of the United States.

(iv) The rules of § 1.937-2T shall apply for determining whether income is from sources within a possession of the United States.

(v) The rules of § 1.937-3T shall apply for determining whether income is effectively connected with the conduct of a trade or business in a possession of the United States.

(b) *Puerto Rico corporation and resident.* An individual (who, without regard to this paragraph (b), is a United States person) shall not be considered a United States person with respect to a foreign corporation created or organized in, or under the laws of, Puerto Rico for the taxable year of such corporation which ends with or within the taxable year of such individual if—

(1) Such individual is a bona fide resident of Puerto Rico during his entire taxable year in which or with which the taxable year of such foreign corporation ends; and

(2) A dividend received by such individual from such corporation during the taxable year of such corporation would, for purposes of section 933(1), be treated as income derived from sources within Puerto Rico.

(c) *Section 931 possession corporation and resident.* An individual (who, without regard to this paragraph (c), is a United States person) shall not be considered a United States person with respect to a foreign corporation created or organized in, or under the laws of, a section 931 possession for the taxable year of such corporation which ends with or within the taxable year of such individual if—

(1) Such individual is a bona fide resident of such section 931 possession during his entire taxable year in which or with which the taxable year of such foreign corporation ends; and

(2) Such corporation satisfies the following conditions—

(i) 80 percent or more of its gross income for the 3-year period ending at the close of the taxable year (or for such part of such period as such corporation or any predecessor has been in existence) was derived from sources within section 931 possessions or was effectively connected with the conduct of a trade or business in section 931 possessions; and

(ii) 50 percent or more of its gross income for such period (or part) was derived from the active conduct of a trade or business within section 931 possessions.

(d) *Effective date.* This section shall apply for taxable years ending after October 22, 2004.

#### § 1.957-4 [Removed]

■ **Par. 34.** Section 1.957-4 is removed.

■ **Par. 35.** In § 1.1402(a)-11, paragraph (b) is revised to read as follows:

#### § 1.1402(a)-11 Ministers and members of religious orders.

\* \* \* \* \*

(b) *In employ of American employer.* If a minister or member of a religious order engaged in a trade or business described in section 1402(c) and § 1.1402(c)-5 is a citizen of the United States and performs service, in his capacity as a minister or member of a religious order, as an employee of an American employer, as defined in section 3121(h) and the regulations thereunder in part 31 of this chapter (Employment Tax Regulations), his net earnings from self-employment derived from such service shall be computed as provided in paragraph (a) of this section but without regard to the exclusions from gross income provided in section 911, relating to earned income from sources without the United States, and section 931, relating to income from sources within certain possessions of the United States. Thus, even though all the income of the minister or member for service of the character to which this paragraph is applicable was derived from sources without the United States, or from sources within certain possessions of the United States, and therefore may be excluded from gross income, such income is included in computing net earnings from self-employment.

\* \* \* \* \*

■ **Par. 36.** Section 1.1402(a)-12 is revised to read as follows:

#### § 1.1402(a)-12 Continental shelf and certain possessions of the United States.

[Reserved]. For further guidance, see § 1.1402(a)-12T.

■ **Par. 37.** Section 1.1402(a)-12T is added to read as follows:

#### § 1.1402(a)-12T Continental shelf and certain possessions of the United States (temporary).

(a) *Certain possessions.* For purposes of the tax on self-employment income, the exclusion from gross income provided by section 931 (relating to bona fide residents of certain possessions of the United States) shall not apply. Net earnings from self-employment are subject to the tax on self-employment income even if such amounts are excluded from gross income under section 931.

(b) *Continental shelf.* For the definition of the term *United States* and for other geographical definitions

relating to the continental shelf, see section 638 and § 1.638-1.

(c) *Effective date.* This section shall apply for taxable years ending after October 22, 2004.

■ **Par. 38.** In § 1.6038-2, paragraph (d) is revised to read as follows:

#### § 1.6038-2 Information returns required of United States persons with respect to annual accounting periods of certain foreign corporations.

\* \* \* \* \*

(d) [Reserved]. For further guidance, see § 1.6038-2T(d).

■ **Par. 39.** Section 1.6038-2T is added to read as follows:

#### § 1.6038-2T. Information returns required of United States persons with respect to annual accounting periods of certain foreign corporations (temporary).

(a) through (c) [Reserved]. For further guidance, see § 1.6038-2(a) through (c).

(d) *U.S. person—(1) In general.* For purposes of section 6038 and this section, the term *United States person* has the meaning assigned to it by section 7701(a)(30), except as provided in paragraphs (d)(2) and (3) of this section.

(2) *Special rule for individuals residing in certain possessions.* With respect to individuals who are bona fide residents of Puerto Rico or any section 931 possession, as defined in § 1.931-1T(c)(1), the term *United States person* has the meaning assigned to it by § 1.957-3T.

(3) *Special rule for certain nonresident aliens.* An individual for whom an election under section 6013(g) or (h) is in effect shall, subject to the exceptions contained in paragraph (d)(2) of this section, be considered a United States person for purposes of section 6038 and this section.

(e) through (l)(2) [Reserved]. For further guidance, see § 1.6038-2(e) through (l)(2).

(m) *Effective date.* This section shall apply for taxable years ending after October 22, 2004.

■ **Par. 40.** Section 1.6046-1 is amended as follows:

■ 1. Revise the heading.

■ 2. Revise paragraph (f)(3).

■ 3. Remove the undesignated paragraph that follows paragraph (f)(3)(iii).

The revisions are as follows:

#### § 1.6046-1 Returns as to organization or reorganization of foreign corporations and as to acquisitions of their stock.

\* \* \* \* \*

(f)(3) [Reserved]. For further guidance, see § 1.6046-1T(f)(3).

\* \* \* \* \*

■ **Par. 41.** Section 1.6046-1T is added to read as follows:

**§ 1.6046-1T Returns as to organization or reorganization of foreign corporations and as to acquisitions of their stock (temporary).**

(a) through (f)(2) [Reserved]. For further guidance, see § 1.6046-1(a) through (f)(2).

(f)(3) *U.S. person*—(i) *In general*. For purposes of section 6046 and this section, the term *United States person* has the meaning assigned to it by section 7701(a)(30), except as provided in paragraphs (f)(3)(ii) and (iii) of this section.

(ii) *Special rule for individuals residing in certain possessions*. With respect to individuals who are bona fide residents of Puerto Rico or any section 931 possession, as defined in § 1.931-1T(c)(1), the term *United States person* has the meaning assigned to it by § 1.957-3T.

(iii) *Special rule for certain nonresident aliens*. An individual for whom an election under section 6013(g) or (h) is in effect shall, subject to the exceptions contained in paragraph (f)(3)(ii) of this section, be considered a *United States person* for purposes of section 6046 and this section.

(f)(4) through (k) [Reserved]. For further guidance, see § 1.6046-1(f)(4) through (k).

(l) *Effective date*. This section shall apply for taxable years ending after October 22, 2004.

**PART 301—PROCEDURE AND ADMINISTRATION**

■ **Par. 42.** The authority citation for part 301 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 \* \* \*

■ **Par. 43.** Section 301.6688-1 is revised to read as follows:

**§ 301.6688-1 Assessable penalties with respect to information required to be furnished with respect to possessions.**

[Reserved]. For further guidance, see § 301.6688-1T.

■ **Par. 44.** Section 301.6688-1T is added to read as follows:

**§ 301.6688-1T Assessable penalties with respect to information required to be furnished with respect to possessions (temporary).**

(a) *In general*. Each individual who is subject to an information reporting requirement promulgated under the authority of section 937(c) or 7654 and who fails to fully satisfy such requirement within the time prescribed for reporting such information shall, in addition to any criminal penalty provided by law, pay a penalty of \$1000 for each such failure. Information reporting requirements promulgated

under the authority of sections 937(c) and 7654(e) include the following:

(1) The requirement to file Form 8689, “Allocation of Individual Income Tax to the Virgin Islands,” under § 1.932-1T(b)(1) of this chapter, for certain individuals with income from sources within the United States Virgin Islands.

(2) [Reserved].

(3) [Reserved].

(4) The requirement for individuals to report that they became or ceased to be a bona fide resident of a possession under § 1.937-1T(g) of this chapter.

(b) *Manner of payment*. The penalty set forth in paragraph (a) of this section shall be paid in the same manner as tax upon the issuance of a notice and demand therefor.

(c) *Reasonable cause*—(1) *In general*. The penalty set forth in paragraph (a) of this section shall not apply if it is established to the satisfaction of the appropriate tax authority (as defined in paragraph (c)(2) of this section) that the failure to file the information return or furnish the information within the prescribed time was due to reasonable cause and not to willful neglect. An individual who wishes to avoid the penalty must make an affirmative showing of all facts alleged as a reasonable cause for failure to file the information return on time, or furnish the information on time, in the form of a written statement containing a declaration that it is made under penalties of perjury. Such statement must be filed with the appropriate tax authority. In determining whether there was reasonable cause for failure to furnish the required information, account will be taken of the fact that the individual was unable to furnish the required information in spite of the exercise of ordinary business care and prudence in his effort to furnish the information. An individual will be considered to have exercised ordinary business care and prudence in his effort to furnish the required information if he made reasonable efforts to furnish the information but was unable to do so because of a lack of sufficient facts on which to make a proper determination.

(2) *Appropriate tax authority*. For purposes of this section, the appropriate tax authority is the person responsible for tax administration in the jurisdiction to which the information is required to be provided. Thus, in the case of information required under section 937(c) or under section 7654 to be provided to the Internal Revenue Service, the appropriate tax authority is the Commissioner. In the case of information required under section 7654 (as in effect with respect to section 935 possessions (as defined in § 1.935-

1T(a)(3)(i) of this chapter) to be provided to the tax authorities of a section 935 possession, the appropriate tax authority is the person responsible for tax administration in such possession or his delegate. See § 1.935-1(b) of this chapter for the rules that specify where returns of income tax must be filed for the taxable year by individuals to whom section 935 applies.

(d) *Effective date*. This section shall apply for taxable years ending after October 22, 2004.

■ **Par. 45.** In § 301.7701(b)-1, paragraph (d) is revised to read as follows:

**§ 301.7701(b)-1 Resident alien.**

\* \* \* \* \*

(d) [Reserved]. For further guidance, see § 301.7701(b)-1T(d).

\* \* \* \* \*

■ **Par. 46.** Section 301.7701(b)-1T is added to read as follows:

**§ 301.7701(b)-1T Resident alien.**

(a) through (c) [Reserved]. For further guidance, see § 301.7701(b)-1(a) through (c).

(d) *Application of section 7701(b) to the possessions and territories*—(1) *Application to aliens for purposes of mirror systems*. Section 7701(b) provides the basis for determining whether an alien individual is a resident of a United States 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, for purposes of applying such laws with respect to income tax liability incurred to such possession or territory.

(2) *Non-application for bona fide resident determination*. Section 7701(b) does not provide the basis for determining whether an individual (including an alien individual) is a bona fide resident of a United States possession or territory for U.S. Federal income tax purposes. For the applicable rules for making this determination, see section 937(a) and the regulations thereunder.

(e) [Reserved]. For further guidance, see § 301.7701(b)-1(e).

(f) *Effective date*. This section shall apply for taxable years ending after October 22, 2004.

**PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT**

■ **Par. 47.** The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

■ **Par. 48.** In § 602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

\* \* \* \* \*  
(b) \* \* \*

CFR part or section where identified and described	Current OMB control No.
* * * * *	* * * * *
1.937-1T .....	1545-1930
* * * * *	* * * * *

**Linda M. Kroening,**  
*Acting Deputy Commissioner for Services and Enforcement.*

Approved: March 25, 2005.

**Eric Solomon,**  
*Acting Deputy Assistant Secretary of the Treasury.*

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