

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 301

REG-159243-03

RIN 1545-BC86

Residence and Source Rules Involving U.S. Possessions and Other Conforming Changes

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking, notice of proposed rulemaking by cross-reference to temporary regulations, and notice of public hearing.

SUMMARY: In the Rules and Regulations section of this issue of the **Federal Register**, the IRS is issuing 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 of 2004 (2004 Act).

The temporary regulations also provide updated guidance under sections 1, 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, 861, 871, 901, 1402, 6038, 6046, and 7701 of the Code. The text of the temporary regulations on this subject in this issue of the **Federal Register** also generally serves as the text of these proposed regulations set forth in this cross-referenced notice of proposed rulemaking.

This notice of proposed rulemaking also contains proposed regulations that are in addition to the text of the temporary regulations. These provisions that are issued only as proposed regulations contain additional conforming changes to the regulations under sections 1, 861, 871, and 7701.

**DATES:** Written or electronic comments must be received by July 11, 2005.

Requests to speak and outlines of topics to be discussed at the public hearing scheduled for July 21, 2005, at 10:00 a.m., must be received by June 30, 2005.

**ADDRESSES:** Send submissions to: CC:PA:LPD:PR (REG-159243-03) room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-159243-03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically, via the IRS Internet site at [www.irs.gov/regs](http://www.irs.gov/regs) or via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (IRS and REG-159243-03).

**FOR FURTHER INFORMATION CONTACT:** Concerning the proposed regulations, J. David Varley at (202) 435-5165; concerning submissions, Treena Garrett at (202) 622-3401 (not toll-free numbers).

**SUPPLEMENTARY INFORMATION:**

## **Paperwork Reduction Act**

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by July 11, 2005. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of service to provide information.

The collection of information in the proposed and temporary regulations is in §1.937-1T. Section 937(a) of the Code provides rules for determining whether an individual is a bona fide resident of Guam, Puerto Rico, American Samoa, the USVI, or the Northern Mariana Islands. Section 937(c) requires an individual who claims to become, or cease to be, a resident of a U.S. possession to file notice of such claim in such manner as the Secretary prescribes.

Accordingly, §1.937-1T(g) requires individuals claiming to become, or cease to be, a resident of a U.S. possession to file notice of such claim with the Internal Revenue Service in accordance with section 937(c) of the Code. Individuals subject to this reporting requirement must retain information to establish their residency as required by section 937(c) of the Code and 1.937-1T.

The collection of information is mandatory. The likely respondents are individuals who become (or cease to be) bona fide residents of a U.S. possession.

Estimated total annual reporting burden: 75,000 hours.

Estimated average annual burden hours per respondent: 1.5 hours.

Estimated number of respondents: 50,000

Estimated annual frequency of responses: annually

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

### **Background and Explanation of Provisions**

Temporary regulations in the Rules and Regulations section of this issue

of the **Federal Register** amend 26 CFR parts 1, 301, and 602. The temporary regulations provide rules concerning issues relating to U.S. possessions, including rules for determining whether an individual is a bona fide resident of a U.S. possession under section 937(a). 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 in a U.S. possession and rules under section 937(c) pertaining to certain reporting requirements for individuals who become (or cease to be) bona fide residents of a U.S. possession. Further, a number of sections in the Code relating to possessions were substantially revised by the 1986 Act. The temporary regulations amend regulations under affected and related sections to conform them to statutory revisions enacted by the 1986 Act and to other legislative amendments. Except as otherwise specified in this notice of proposed rulemaking, the text of the temporary regulations also serves as the text of these proposed regulations. This notice of proposed rulemaking also contains proposed regulations that are in addition to the text of the temporary regulations. These provisions that are issued only as proposed regulations contain additional conforming changes. The preamble to the temporary regulations explains the temporary regulations and these proposed regulations.

#### **Proposed Effective Date**

These regulations are generally proposed to apply for taxable years ending after October 22, 2004. For specific applicability dates, see the

temporary regulations in the Rules and Regulations section of this issue of the **Federal Register**.

### **Special Analyses**

It has been determined that this notice of proposed rulemaking 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, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### **Comments and Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing has been scheduled for July 21, 2005, at 10 a.m. in the auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition,

all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the “FOR FURTHER INFORMATION CONTACT” section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by June 30, 2005. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Comments are requested on all aspects of the proposed regulations, including those aspects for which specific requests for comments are set forth above.

### **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.

**Proposed Amendments to the Regulations**

Accordingly, 26 CFR parts 1 and 301 are proposed to be 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 1.931-1 also issued under 26 U.S.C. 7654(e).
- Section 1.932-1 also issued under 26 U.S.C. 7654(e).
- Section 1.935-1 also issued under 26 U.S.C. 7654(e). \* \* \*
- Section 1.937-1 also issued under 26 U.S.C. 937(a).
- Section 1.937-2 also issued under 26 U.S.C. 937(b).
- Section 1.937-3 also issued under 26 U.S.C. 937(b). \* \* \*
- Section 1.957-3 also issued under 26 U.S.C. 957(c). \* \* \*

Par. 2. In §1.1-1, the second sentence of paragraph (b) is revised to read as follows:

§1.1-1 Income tax on individuals.

\* \* \* \* \*

(b) \* \* \* Pursuant to section 876, a nonresident alien individual who is a bona fide resident of a section 931 possession (as defined in §1.931-1T(c)(1) of this chapter) or Puerto Rico during the entire taxable year is, except as provided in section 931 or 933 with respect to income from sources within such

possessions, subject to taxation in the same manner as a resident alien individual. \* \* \*

\* \* \* \* \*

Par. 3. 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) [The text of the proposed amendment to §1.170A-1(j)(9) is the same as the text of §1.170-1T(j)(9) published elsewhere in this issue of the **Federal Register**].

Par. 4. In §1.861-3, paragraph (a)(2) is revised to read as follows:

§1.861-3 Dividends.

\* \* \* \* \*

(a) \* \* \*

(2) [The text of the proposed amendment to §1.861-3 is the same as the text of §1.861-3T(a)(2) published elsewhere in this issue of the **Federal Register**].

Par. 5. 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) The tax base for individuals entitled to the benefits of section 931 and the section 936 tax credit of a domestic corporation which has an election in effect under section 936;

(F) The exclusion for income from Puerto Rico for bona fide residents of Puerto Rico under section 933;

\* \* \* \* \*

(H) The income derived from the U.S. Virgin Islands or from a section 935 possession (as defined in §1.935-1T(a)(3)(i)).

\* \* \* \* \*

Par. 6. Section 1.871-1 is amended as follows:

1. Revise paragraph (b)(1)(iii).
2. Revise the last two sentences of the undesignated paragraph following paragraph (b)(1)(iii).

The revisions are as follows:

§1.871-1 Classification and manner of taxing alien individuals.

\* \* \* \* \*

(b) \* \* \*

(1) \* \* \*

(iii) Nonresident alien individuals who are bona fide residents of a section 931 possession (as defined in §1.931-1T(c)(1) of this chapter) or Puerto Rico during the entire taxable year.

\* \* \* The provisions of subpart A do not apply to individuals described in paragraph (b)(1)(iii) of this section, but such individuals, except as provided in section 931 or 933, are subject to the tax imposed by section 1 or 55. See §1.876-1.

Par. 7. 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.

[The text of the proposed amendment to §1.876-1 is the same as the text of §1.876-1T published elsewhere in this issue of the **Federal Register**].

Par. 8. Section 1.881-5 is added to read as follows:

§1.881-5 Exception for certain possessions corporations.

[The text of the proposed §1.881-5 is the same as the text of §1.881-5T published elsewhere in this issue of the **Federal Register**].

Par. 9. In §1.884-0, paragraph (b) is redesignated as paragraph (c), and a new paragraph (b) is added to read as follows:

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

\* \* \* \* \*

(b) [The text of the proposed amendment to §1.884-0 is the same as the text of §1.884-0T published elsewhere in this issue of the **Federal Register**].

Par. 10. In §1.901-1, paragraph (g) is revised to read as follows:

§1.901-1 Allowance of credit for taxes.

(g) [The text of the proposed amendment to §1.901-1(g) is the same as the text of §1.901-1T(g) published elsewhere in this issue of the **Federal**

**Register].**

Par. 11. 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.

[The text of the proposed amendment to §1.931-1 is the same as the text of §1.931-1T published elsewhere in this issue of the **Federal Register**].

Par. 12. Section 1.932-1 is revised to read as follows:

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

[The text of the proposed amendment to §1.932-1 is the same as the text of §1.932-1T published elsewhere in this issue of the **Federal Register**].

Par. 13. 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) [The text of the proposed amendment to §1.933-1(a) is the same as the text of §1.933-1T(a) published elsewhere in this issue of the **Federal Register**].

\* \* \* \* \*

(c) [The text of the proposed amendment to §1.933-1(c) is the same as the text of §1.933-1T(c) published elsewhere in this issue of the **Federal Register**].

(d) [The text of the proposed amendment to §1.933-1(d) is the same as the text of §1.933-1T(d) published elsewhere in this issue of the **Federal Register**].

(e) [The text of the proposed amendment to §1.933-1(e) is the same as the text of §1.933-1T(e) published elsewhere in this issue of the **Federal Register**].

Par. 14. 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.

[The text of the proposed amendment to §1.934-1 is the same as the text of §1.934-1T published elsewhere in this issue of the **Federal Register**].

Par. 15. Section 1.935-1 is amended is amended as follows:

1. Revise 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) [The text of the proposed amendment to §1.935-1(a)(1) through (3) is the same as the text of §1.935-1T(a)(1) through (a)(3) published elsewhere in this issue of the **Federal Register**].

(b)(1) [The text of the proposed amendment to §1.935-1(b)(1) is the same as the text of §1.935-1T(b)(1) published elsewhere in this issue of the **Federal Register**].

\* \* \* \* \*

(b)(3) [The text of the proposed amendment to §1.935-1(b)(3) is the same as the text of §1.935-1T(b)(3) published elsewhere in this issue of the **Federal Register**].

\* \* \* \* \*

(b)(5) through (b)(7) [The text of the proposed §1.935-1(b)(5) through (b)(7) is the same as the text of §1.935-1T(b)(5) through (b)(7) published elsewhere in this issue of the **Federal Register**].

(c) [The text of the proposed amendment to §1.935-1(c) is the same as the text of §1.935-1T(c) published elsewhere in this issue of the **Federal Register**].

(d) [The text of the proposed amendment to §1.935-1(d) is the same as the text of §1.935-1T(d) published elsewhere in this issue of the **Federal Register**].

(e) [The text of the proposed amendment to §1.935-1(e) is the same as the text of §1.935-1T(e) published elsewhere in this issue of the **Federal Register**].

(f) [The text of the proposed amendment to §1.935-1(f) is the same as the text of §1.935-1T(f) published elsewhere in this issue of the **Federal Register**].

(g) [The text of the proposed §1.935-1(g) is the same as the text of §1.935-1T(g) published elsewhere in this issue of the **Federal Register**].

Par. 16. Section 1.937-1 is added to read as follows:

§1.937-1 Bona fide residency in a possession.

[The text of the proposed §1.937-1 is the same as the text of §1.937-1T published elsewhere in this issue of the **Federal Register**].

Par. 17. Section 1.937-2 is added as follows:

§1.937-2 Income from sources within a possession.

[The text of the proposed §1.937-2 is the same as the text of §1.937-2T published elsewhere in this issue of the **Federal Register**].

Par. 18. Section 1.937-3 is added to read as follows:

§1.937-3 Income effectively connected with the conduct of a trade or business in a possession.

[The text of the proposed §1.937-3 is the same as the text of §1.937-3T published elsewhere in this issue of the **Federal Register**].

Par. 19. Section 1.957-3 is revised to read as follows:

§1.957-3 United States person defined.

[The text of the proposed amendment to §1.957-3 is the same as the text of §1.957-3T published elsewhere in this issue of the **Federal Register**].

Par. 20. Section 1.1402(a)-12 is revised to read as follows:

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

[The text of the proposed amendment to §1.1402(a)-12 is the same as the text of §1.1402(a)-12T published elsewhere in this issue of the **Federal Register**].

Par. 21. 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) [The text of the proposed amendment to §1.6038-2(d) is the same as the text of §1.6038-2T(d) published elsewhere in this issue of the **Federal Register**].

Par. 22. In §1.6046-1, paragraph (f)(3) is revised to read as follows:  
§1.6046-1 Returns as to organization or reorganization of foreign corporations and as to acquisitions of their stock.

\* \* \* \* \*

(f) \* \* \*

(3) [The text of the proposed amendment to §1.6046-1(f)(3) is the same as the text of §1.6046-1T(f)(3) published elsewhere in this issue of the **Federal Register**].

## **PART 301 -- PROCEDURE AND ADMINISTRATION**

Par. 23. The authority citation for part 301 continues to read, in part, as follows:

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

Par. 24. 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.

[The text of the proposed amendment to §301.6688-1 is the same as the text of §301.6688-1T published elsewhere in this issue of the **Federal Register**].

Par. 25. In §301.7701-3, paragraph (c)(1)(i) is amended by adding a final sentence to read as follows:

§301.7701-3 Classification of certain business entities.

\* \* \* \* \*

(c) \* \* \*

(1) \* \* \*

(i) \* \* \* For entity status consistency rules with respect to certain possessions of the United States, see §§1.932-1T(h) and 1.935-1T(e).

\* \* \* \* \*

Par. 26. In §301.7701(b)-1, paragraph (d) is revised to read as follows:

§301.7701(b)-1 Resident alien.

\* \* \* \* \*

(d) [The text of the proposed amendment to §301.7701(b)-1(d) is the

same as the text of §301.7701(b)-1T(d) published elsewhere in this issue of the **Federal Register**].

/s/ Linda M. Kroening  
Deputy Commissioner for Services and Enforcement.