Internal Revenue
bulletin

Bulletin No. 2006-9
February 27, 2006

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 2006–8, page 520.

LIFO; price indexes; department stores. The December 2005 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, December 31, 2005.

Rev. Rul. 2006–9, page 519.

Section 45 credit offset. The credit under section 45 of the Code for electricity produced from qualified energy resources at a qualified facility is not reduced under section 45(b)(3) on account of a state or local tax credit.

T.D. 9246, page 534.

Some business entities may be recognized under state or foreign law as created or organized in more than one jurisdiction at the same time ("dually chartered entities"). Final regulations under section 7701 of the Code provide clarification regarding how to determine the federal tax classification (*e.g.*, corporation, partnership, or an entity disregarded as separate from its owner) of a dually chartered entity and how to determine whether a dually chartered entity is domestic or foreign.

T.D. 9247, page 521.

Final and temporary regulations under section 861 of the Code provide an alternative method of valuing assets for purposes of apportioning expenses under the tax book value method of regulations section 1.861–9T.

T.D. 9248, page 524.

Final and temporary regulations under section 937 of the Code provide rules for determining whether an individual is a *bona fide* resident of American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, or the U.S. Virgin Islands. The regulations also provide rules for determining residency for purposes of section 881(b). Related regulations concerning the source and effectively connected income rules, together with other conforming changes, particularly under sections 931 through 935, will be finalized in a forthcoming Treasury decision.

Notice 2006–16, page 538.

This notice provides examples of transactions that are not the same or substantially similar to those in Notice 2002–35 (*i.e.*, are not "listed transactions"), such that the filing of Form 8886, *Reportable Transaction Disclosure Statement*, is not required. Further, for taxpayers who would be required to file a Form 8886 for transactions that are the same or substantially similar as those described in Notice 2002–35 solely as a result of the taxpayers' interest in a pass-through entity, this notice creates a disclosure requirement safe harbor. Notice 2002–35 clarified and modified.

EMPLOYEE PLANS

Notice 2006–19, page 539.

Weighted average interest rate update; 30–year Treasury securities. The weighted average interest rate for February 2006 and the resulting permissible range of interest rates used to calculate current liability and to determine the required contribution are set forth.

(Continued on the next page)

Finding Lists begin on page ii.
Index for January through February begins on page iv.

Department of the Treasury
Internal Revenue Service

ADMINISTRATIVE

T.D. 9246, page 534.

Some business entities may be recognized under state or foreign law as created or organized in more than one jurisdiction at the same time ("dually chartered entities"). Final regulations under section 7701 of the Code provide clarification regarding how to determine the federal tax classification (*e.g.*, corporation, partnership, or an entity disregarded as separate from its owner) of a dually chartered entity and how to determine whether a dually chartered entity is domestic or foreign.

Rev. Proc. 2006–16, page 539.

This procedure explains how a state's commercial revitalization agency may retroactively allocate commercial revitalization expenditure amounts under section 1400I of the Code for qualified revitalization buildings placed in service after December 31, 2001, in the expanded area of a renewal community. The procedure also explains how a taxpayer may make a commercial revitalization deduction election under section 1400I(a) for these buildings and may elect to deduct the increased section 179 expensing amount provided by section 1400J for qualified renewal property placed in service after December 31, 2001, in the expanded area of a renewal community. Rev. Proc. 2002–9 modified and amplified and Rev. Proc. 2003–38 modified.

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are compiled semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 45.—Electricity Produced From Certain Renewable Resources, etc.

Section 45 credit offset. The credit under section 45 of the Code for electricity produced from qualified energy resources at a qualified facility is not reduced under section 45(b)(3) on account of a state or local tax credit.

Rev. Rul. 2006–9

ISSUE

Is the credit under § 45 of the Internal Revenue Code for electricity produced from qualified energy resources at a qualified facility reduced under § 45(b)(3) on account of a state or local tax credit?

FACTS

State *X* provides tax credits for wind-powered electric generation facilities located in State *X*. Corporation *P* constructs in State *X* a wind-powered electric generation facility that is a qualified facility under § 45(d)(1). The electricity produced from the facility qualifies for the production credit under § 45. In addition, the facility qualifies for the State *X* tax credits.

LAW AND ANALYSIS

Section 45(a) provides a renewable electricity production credit for any taxable year in an amount equal to the product of 1.5 cents multiplied by the kilowatt-hours of electricity—

(A) produced by the taxpayer (i) from qualified energy resources, and (ii) at a qualified facility during the credit period beginning on the date the facility was originally placed in service; and

(B) sold by the taxpayer to an unrelated person during the taxable year.

Under § 45(b)(1), the amount of the credit determined under § 45(a) is reduced by an amount which bears the same ratio to the amount of the credit (determined without regard to § 45(b)(1)) as—

(A) the amount by which the reference price for the calendar year in which the sale occurs exceeds 8 cents, bears to

(B) 3 cents.

Under § 45(b)(2), the 1.5 cent amount in § 45(a) is adjusted by multiplying that amount by the inflation adjustment factor for the calendar year in which the sale occurs.

Under § 45(c)(1)(A), the term "qualified energy resource" includes wind.

Under section 45(d)(1), in the case of a facility using wind to produce electricity, the term "qualified facility" means any facility owned by the taxpayer that is originally placed in service after December 31, 1993, and before January 1, 2008.

Under § 45(b)(3), the amount of the credit determined under § 45(a) (determined after the application of § 45(b)(1) and (2)) with respect to any project for any taxable year (the otherwise allowable credit for the project) is reduced if specified governmental assistance has been provided with respect to the project. The amount of the reduction is equal to the otherwise allowable credit for the project multiplied by the lesser of one-half or a fraction—

(A) the numerator of which is the sum, for the taxable year and all prior taxable years, of the specified governmental assistance provided with respect to the project; and

(B) the denominator of which is the aggregate amount of additions to the capital account for the project for the taxable year and all prior taxable years.

The following governmental assistance is taken into account in determining the numerator of the fraction:

(i) grants provided by the United States, a state, or a political subdivision of a state for use in connection with the project;

(ii) proceeds of an issue of state or local government obligations used to provide financing for the project the interest on which is exempt from tax under § 103,

(iii) the aggregate amount of subsidized energy financing provided (directly or indirectly) under a federal, state, or local program provided in connection with the project, and

(iv) the amount of "any other credit allowable" with respect to any property that is part of the project.

The amounts under the preceding sentence for any taxable year are determined as of the close of the taxable year.

Neither § 45(b)(3)(A)(iv), which provides for the reduction on account of otherwise allowable credits, nor the legislative history underlying section 45 (H.R. Rep. No. 102–1018 (1992) (Conf. Rep.), at 404, 405, 1993–1 C.B. 273, 274) contains any reference to states or localities. Accordingly, the term "any other credit allowable" in § 45(b)(3)(A)(iv) will be construed to include only federal tax credits allowable under the Code with respect to property that is part of a project, and not to include state or local credits. Thus, Corporation *P*'s § 45 credit is not reduced under § 45(b)(3) on account of the State *X* tax credits. The result would be the same if, instead of a wind facility, Corporation *P* had constructed a qualified facility using another qualified energy resource subject to § 45(b)(3).

HOLDING

The credit under § 45 for electricity produced from qualified energy resources at a qualified facility is not reduced under § 45(b)(3) on account of a state or local tax credit.

DRAFTING INFORMATION

The principal author of this revenue ruling is David Selig of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this revenue ruling, contact David Selig at (202) 622–3040 (not a toll-free call).

Section 168.—Accelerated Cost Recovery System

May a taxpayer elect to recover the cost of a qualified revitalization building placed in service after December 31, 2001, in the expanded area of a renewal community under § 1400I of the Internal Revenue Code instead of under § 168? See Rev. Proc. 2006-16, page 539.

Section 179.—Election to Expense Certain Depreciable Business Assets

26 CFR 1.179–5: Time and manner of making election.

How is the § 179 election (or the revocation of the election) made for qualified renewal property placed in service by a taxpayer in the expanded area in 2002, 2003, 2004, or 2005? See Rev. Proc. 2006-16, page 539.

Section 446.—General Rule for Methods of Accounting

26 CFR 1.446–1: General rule for methods of accounting.

If a taxpayer changes from claiming depreciation deductions to claiming commercial revitalization deductions for a qualified revitalization building that is placed in service by the taxpayer after December 31, 2001, in the expanded area of a renewal community and for which the taxpayer received a retroactive commercial revitalization expenditure allocation, is this change a change in method of accounting? See Rev. Proc. 2006-16, page 539.

Section 472.—Last-in, First-out Inventories

26 CFR 1.472–1: Last-in, First-out inventories.

LIFO; price indexes; department stores. The December 2005 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, December 31, 2005.

Rev. Rul. 2006–8

The following Department Store Inventory Price Indexes for December 2005 were issued by the Bureau of Labor Statistics. The indexes are accepted by the Internal Revenue Service, under § 1.472–1(k) of the Income Tax Regulations and Rev. Proc. 86–46, 1986–2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, December 31, 2005.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups — soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, food, liquor, tobacco, and contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

	Groups	Dec. 2004	Dec. 2005	Percent Change from Dec. 2004 to Dec. 2005[1]
1.	Piece Goods	495.2	467.2	-5.7
2.	Domestics and Draperies	527.4	506.3	-4.0
3.	Women's and Children's Shoes	650.7	659.5	1.4
4.	Men's Shoes	841.5	862.7	2.5
5.	Infants' Wear	577.4	568.5	-1.5
6.	Women's Underwear	517.2	547.0	5.8
7.	Women's Hosiery	339.2	337.9	-0.4
8.	Women's and Girls' Accessories	565.6	558.5	-1.3
9.	Women's Outerwear and Girls' Wear	352.5	350.8	-0.5
10.	Men's Clothing	535.8	527.4	-1.6
11.	Men's Furnishings	569.9	560.6	-1.6
12.	Boys' Clothing and Furnishings	414.2	394.0	-4.9
13.	Jewelry	866.2	842.7	-2.7
14.	Notions	792.2	801.0	1.1
15.	Toilet Articles and Drugs	992.1	1000.7	0.9
16.	Furniture and Bedding	602.0	602.9	0.1
17.	Floor Coverings	592.5	614.5	3.7
18.	Housewares	708.0	697.7	-1.5
19.	Major Appliances	199.9	205.0	2.6
20.	Radio and Television	40.3	37.7	-6.5
21.	Recreation and Education[2]	78.3	77.4	-1.1
22.	Home Improvements[2]	131.7	136.7	3.8
23.	Automotive Accessories[2]	112.9	117.0	3.6

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE
INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

Groups	Dec. 2004	Dec. 2005	Percent Change from Dec. 2004 to Dec. 2005[1]
Groups 1–15: Soft Goods	552.5	548.0	-0.8
Groups 16–20: Durable Goods	378.5	375.7	-0.7
Groups 21–23: Misc. Goods[2]	92.2	93.0	0.9
Store Total[3]	490.1	487.2	-0.6

[1]Absence of a minus sign before the percentage change in this column signifies a price increase.

[2]Indexes on a January 1986 = 100 base.

[3]The store total index covers all departments, including some not listed separately, except for the following: candy, food, liquor, tobacco, and contract departments.

DRAFTING INFORMATION

The principal author of this revenue ruling is Michael Burkom of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Burkom at (202) 622–7924 (not a toll-free call).

Section 861.—Income From Sources Within the United States

26 CFR 1.861–9: Allocation and apportionment of interest expense.

T.D. 9247

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Allocation and Apportionment of Expenses Alternative Method for Determining Tax Book Value of Assets

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final regulations providing an alternative method of valuing assets for purposes of apportioning expenses under the tax book value method of §1.861–9T. The alternative tax book value method, which is elective, allows taxpayers to determine, for purposes of apportioning expenses, the tax book value of all tangible property that is subject to a depreciation deduction under section 168 by using the straight line method, conventions, and recovery periods of the alternative depreciation system under section 168(g)(2). The alternative tax book value method is intended to minimize basis disparities between foreign and domestic assets of taxpayers that may arise when taxpayers use adjusted tax basis to value assets under the tax book value method of expense apportionment. These final regulations may affect taxpayers that are required to apportion expenses under section 861.

DATES: *Effective Date:* These regulations are effective January 30, 2006.

Applicability Dates: For dates of applicability, see §1.861–9(i)(4).

FOR FURTHER INFORMATION CONTACT: David Bergkuist at (202) 622–3850 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

On September 14, 1988, the IRS published temporary regulations (T.D. 8228, 1988–2 C.B. 136 [53 FR 35467]) that address the allocation and apportionment of interest expense. On March 26, 2004, the IRS published a Treasury decision, T.D. 9120, 2004–1 C.B. 881 [69 FR 15673], which contained temporary regulations that provide for an alternative method of valuing assets for purposes of apportioning expenses under the tax book value method of §1.861–9T, and a notice of proposed rulemaking that cross-references the temporary regulations, REG–129447–01, 2004–1 C.B. 894 (69 FR 15753). A public hearing was held on July 19, 2004.

For purposes of allocating and apportioning expenses, a taxpayer may compute the value of its assets under either the tax book value method or the fair market value method. Sections 1.861–8T(c)(2) and 1.861–9T(g)(1)(ii). The temporary and proposed regulations issued in 2004 provided taxpayers with an alternative method of apportioning expenses under the tax book value method. This alternative tax book value method, which is elective, allows taxpayers to determine, for purposes of apportioning expenses, the tax book value of all tangible property that is subject to a depreciation deduction under section 168 by using the straight line method, conventions, and recovery periods of the alternative depreciation system under section 168(g)(2). The alternative method provided in the temporary and proposed regulations is intended to minimize basis disparities between foreign and domestic assets of taxpayers that may arise when taxpayers use adjusted tax basis to value assets under the tax book value method of expense apportionment.

Taxpayers using the tax book value method, including those that have elected the alternative tax book value method,

may elect to change to the fair market value method at any time. Rev. Proc. 2003–37, 2003–1 C.B. 950 (May 27, 2003). Taxpayers that elect to use the fair market value method must continue to use that method unless expressly authorized by the Commissioner to change methods. See §1.861–8T(c)(2). See also Rev. Proc. 2005–28, 2005–21 I.R.B. 1093 (May 23, 2005), regarding automatic consent procedure applicable for taxable years beginning on or after March 26, 2004, but before March 26, 2006, for which no return has previously been filed. Revocation of an election to use the alternative tax book value method, other than in conjunction with an election to use the fair market value method, for a taxable year prior to the sixth taxable year for which the election applies requires the consent of the Commissioner.

Explanation of Provisions and Summary of Comments

These final regulations adopt the rules of the temporary and proposed regulations. The alternative tax book value method, as set forth in §1.861–9(i), allows a taxpayer to elect to determine the tax book value of its tangible property that is subject to depreciation under section 168 of the Internal Revenue Code (Code) as though all such property had been depreciated using the alternative depreciation system under section 168(g) during the entire period in which the property has been in service. These final regulations prescribe the application of section 168(g)(2) solely for determining an asset's tax book value for purposes of apportioning expenses (including the calculation of the alternative minimum tax foreign tax credit pursuant to section 59(a)) under the asset method described in §1.861–9T(g). Application of section 168(g)(2) pursuant to these final regulations does not otherwise affect the results under other provisions of the Code, including the amount of any deduction claimed under sections 167, 168, 169, 263(a), 617, or any other capital cost recovery provision.

As with the temporary and proposed regulations, the final regulations generally provide that, for a taxpayer that elects the alternative tax book value method, the tax book value of tangible property that is depreciated under section 168 of the Code is determined as though such property were subject to the alternative depreciation system under section 168(g) for the entire period that such property has been in service. Thus, if a taxpayer elects the alternative tax book value method effective for the 2005 taxable year, the tax book value of tangible property placed in service in 2005 is determined each year using the rules of section 168(g) that apply to property placed in service in 2005 and the tax book value of tangible property placed in service in 2006 is determined each year using the rules of section 168(g) that apply to property placed in service in 2006. However, in the case of tangible property placed in service in a taxable year prior to the first taxable year to which the election to use the alternative tax book value method applies, the tax book value of such property is determined using the alternative depreciation system rules that apply to property placed in service in the taxable year to which the election first applies. Thus, if a taxpayer elects the alternative tax book value method effective for the 2005 taxable year, the tax book value of tangible property placed in service in 2004 and prior years is determined each year using the rules of section 168(g) that apply to property placed in service in 2005. A special rule also applies in determining tax book value in cases where a taxpayer makes an election to use the alternative tax book value method after recently (within three years) revoking a prior election to use that method.

A public hearing was held and comments were received.

One commentator viewed the rule for property placed in service prior to the election to use the alternative tax book value method as unclear and suggested alternative phrasing to that in §1.861–9T(i)(1)(ii). As the commentator noted, any lack of clarity arises only if the rule of §1.861–9T(i)(1)(ii) is read in isolation, without reference to Example 1 in §1.861–9T(i)(1)(v). Because the Treasury Department and the IRS believe that the provision is clear when read in context and properly illustrated in §1.861–9T(i)(1)(v), and because the alternative phrasing suggested by the commentator would raise greater questions of clarity, the language from the temporary regulation is retained.

Commentators also requested that disparities in addition to depreciation, such as the treatment of intangible drilling costs and certain inventory adjustments, be addressed as part of the alternative tax book value method. The Treasury Department and the IRS are actively studying these and other disparities as well as what rules might be fashioned to address them. The final regulations therefore include a subsection that reserves as to certain other adjustments, pending the outcome of this review. The Treasury Department and the IRS welcome specific suggestions as to proper treatment of such adjustments.

One commentator requested that the IRS issue guidance granting automatic consent to change from the fair market value method to the tax book value method, including an election to determine tax book value using the alternative tax book method, in the context of a merger or acquisition, allowing the parties to the transaction to conform their methods. This comment is beyond the scope of the regulations, as it is part of a broader issue as to how to address inconsistent elections when companies merge or enter into similar transactions. Accordingly, the Treasury Department and the IRS have not considered it as part of finalizing the temporary and proposed regulations.

One commentator suggested that taxpayers be able to elect the use of the alternative tax book value method for all open years. Adoption of this suggestion would raise significant fairness and administrative concerns. Accordingly, the suggestion was not adopted, and the effective date set forth in the temporary regulations is retained.

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. 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 Code, the proposed regulations preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration

for comment on their impact on small businesses.

Drafting Information

The principal author of these regulations is David Bergkuist, Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph. 1. The authority for part 1 continues to read, in part, as follows:

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

Par. 2. Section 1.861–9 is amended as follows:

1. Revise paragraphs (h)(6) and (j).

2. Add paragraph (i).

The revision and addition read as follows:

§1.861–9 Allocation and apportionment of interest expense.

* * * * *

(h)(6) [Reserved]. For further guidance, see §1.861–9T(h)(6).

(i) *Alternative tax book value method*—(1) *Alternative value for certain tangible property*. A taxpayer may elect to determine the tax book value of its tangible property that is depreciated under section 168 (section 168 property) using the rules provided in this paragraph (i)(1) (the alternative tax book value method). The alternative tax book value method applies solely for purposes of apportioning expenses (including the calculation of the alternative minimum tax foreign tax credit pursuant to section 59(a)) under the asset method described in paragraph (g) of this section.

(i) The tax book value of section 168 property placed in service during or after the first taxable year to which the election to use the alternative tax book value method applies shall be determined as though such property were subject to the alternative depreciation system set forth in section 168(g) (or a successor provision) for the entire period that such property has been in service.

(ii) In the case of section 168 property placed in service prior to the first taxable year to which the election to use the alternative tax book value method applies, the tax book value of such property shall be determined under the depreciation method, convention, and recovery period provided for under section 168(g) for the first taxable year to which the election applies.

(iii) If a taxpayer revokes an election to use the alternative tax book value method (the prior election) and later makes another election to use the alternative tax book value method (the subsequent election) that is effective for a taxable year that begins within 3 years of the end of the last taxable year to which the prior election applied, the taxpayer shall determine the tax book value of its section 168 property as though the prior election has remained in effect.

(iv) The tax book value of section 168 property shall be determined without regard to the election to expense certain depreciable assets under section 179.

(v) *Examples*. The provisions of this paragraph (i)(1) are illustrated in the following examples:

Example 1. In 2000, a taxpayer purchases and places in service section 168 property used solely in the United States. In 2005, the taxpayer elects to use the alternative tax book value method, effective for the current taxable year. For purposes of determining the tax book value of its section 168 property, the taxpayer's depreciation deduction is determined by applying the method, convention, and recovery period rules of the alternative depreciation system under section 168(g)(2) as in effect in 2005 to the taxpayer's original cost basis in such property. In 2006, the taxpayer acquires and places in service in the United States new section 168 property. The tax book value of this section 168 property is determined under the rules of section 168(g)(2) applicable to property placed in service in 2006.

Example 2. Assume the same facts as in *Example 1*, except that the taxpayer revokes the alternative tax book value method election effective for taxable year 2010. Additionally, in 2011, the taxpayer acquires new section 168 property and places it in service in the United States. If the taxpayer elects to use the alternative tax book value method effective for taxable year 2012, the taxpayer must determine the tax book value of its section 168 property as though the prior election still applied. Thus, the tax book value of property placed in service prior to 2005 would be determined by applying the method, convention, and recovery period rules of the alternative depreciation system under section 168(g)(2) applicable to property placed in service in 2005. The tax book value of section 168 property placed in service during any taxable year after 2004 would be determined by applying the method, convention, and recovery period rules of the alternative depreciation system under section 168(g)(2) applicable to property placed in service in such taxable year.

(2) *Timing and scope of election*. (i) Except as provided in this paragraph (i)(2), a taxpayer may elect to use the alternative tax book value method with respect to any taxable year beginning on or after March 26, 2004. However, pursuant to §1.861–8T(c)(2), a taxpayer that has elected the fair market value method must obtain the consent of the Commissioner prior to electing the alternative tax book value method. Any election made pursuant to this paragraph (i)(2) shall apply to all members of an affiliated group of corporations as defined in §§1.861–11(d) and 1.861–11T(d). Any election made pursuant to this paragraph (i)(2) shall apply to all subsequent taxable years of the taxpayer unless revoked by the taxpayer. Revocation of such an election, other than in conjunction with an election to use the fair market value method, for a taxable year prior to the sixth taxable year for which the election applies requires the consent of the Commissioner.

(ii) *Example*. The provisions of this paragraph (i)(2) are illustrated in the following example:

Example. Corporation X, a calendar year taxpayer, elects on its original, timely filed tax return for the taxable year ending December 31, 2007, to use the alternative tax book value method for its 2007 year. The alternative tax book value method applies to Corporation X's 2007 year and all subsequent taxable years. Corporation X may not, without the consent of the Commissioner, revoke its election and determine tax book value using a method other than the alternative tax book value method with respect to any taxable year beginning before January 1, 2012. However, Corporation X may automatically elect to change from the alternative tax book value method to the fair market value method for any open year.

(3) *Certain other adjustments*. [Reserved.]

(4) *Effective date*. This paragraph (i) applies to taxable years beginning on or after March 26, 2004.

(j) [Reserved]. For further guidance, see §1.861–9T(j).

Par. 3. Section 1.861–9T is amended as follows:

1. Revise the second sentence in paragraph (g)(1)(ii) introductory text.

2. Revise paragraph (i).

The revisions read as follows:

§1.861–9T Allocation and apportionment of interest expense (temporary).

* * * * *

(g) * * *

(1) * * *

(ii) * * *For rules concerning the application of an alternative method of valuing assets for purposes of the tax book value method, see §1.861–9(i). * * *

* * * * *

(i) [Reserved]. For further guidance, see §1.861–9(i).

* * * * *

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Approved January 20, 2006.

Eric Solomon,
Acting Deputy Assistant Secretary of the Treasury.

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Section 937.—Residence and Source Rules Involving Possessions

26 CFR 1.937–1: Bona fide residency in a possession.

T.D. 9248

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

Residence Rules Involving U.S. Possessions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations, temporary regulations, and removal of temporary regulations.

SUMMARY: This document contains final regulations that provide rules for determining *bona fide* residency in the following U.S. possessions: American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, and the United States Virgin Islands under sections 937(a) and 881(b) of the Internal Revenue Code (Code).

DATES: *Effective Date*: These regulations are effective January 31, 2006.

Applicability Dates: For dates of applicability, see §§1.881–5(f)(8) and 1.937–1(i).

FOR FURTHER INFORMATION CONTACT: J. David Varley, (202) 435–5262 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the **Office of Management and Budget** in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–1930.

The collections of information in these final regulations are in §1.937–1. The collection of information required by §1.937–1(h) is to ensure that individuals claiming to become, or cease to be, residents of a U.S. possession file notice of such a 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 §1.937–1. An additional collection of information in these final regulations is in §1.937–1(c)(4)(iii). This information is required to satisfy the documentation and production requirements for individuals who come within an exception to the presence test of §1.937–1(c) as a consequence of receiving (or accompanying certain family members who receive) qualifying medical treatment.

The collections of information are mandatory and will be used for audit and examination purposes. The likely respondents are individuals who become (or cease to be) *bona fide* residents of a U.S. possession and individuals who, in satisfying the presence test requirement for *bona fide* residence in a possession, exclude days in the U.S. or include days in a relevant possession because they receive (or accompany certain family members who receive) qualifying medical treatment.

Estimated total annual reporting and/or recordkeeping burden: 300,000 hours.

Estimated average annual burden hours per respondent: 4 hours.

Estimated number of respondents: 75,000.

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.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be directed to the **Office of Management and Budget**, Attn: Desk Officer for the Department of 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.

Books or records relating to a collection of information must be retained as long as their contents might 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 American Jobs Creation Act of 2004 (Public Law 108–357) was enacted on October 22, 2004. Section 809 of the Act added section 937 to the Code, relating to residence, source, and effectively connected income with respect to the U.S. possessions. On April 11, 2005, the IRS and Treasury published in the **Federal Register** temporary regulations (T.D. 9194, 2005–20 I.R.B. 1016 [70 FR 18920], as corrected at 70 FR 32589–01), which provided rules to implement section 937 and to conform existing regulations to other legislative changes with respect to U.S. possessions. A notice of proposed rulemaking (REG–159243–03, 2005–20 I.R.B. 1075 [70 FR 18949]) cross-referencing the temporary regulations was published in the **Federal Register** on the same day. Written comments were received in response to the notice of proposed rulemaking and a public hearing on the proposed regulations was held on July 21, 2005. The proposed regulations

relating to the residence rules (specifically, §§1.937–1 and 1.881–5T(f)(4)) are adopted as amended by this Treasury decision, and the corresponding temporary regulations are removed. The revisions are discussed below. The remainder of the proposed and temporary regulations, relating to source and effectively connected income with respect to U.S. possessions, will be finalized together with the other conforming changes in a forthcoming Treasury decision.

Explanation of Provisions and Summary of Comments

The proposed and temporary regulations under Code section 937(a) provide rules for determining whether an individual is a "*bona fide* resident" of a U.S. possession. Generally, §1.937–1T provides that an individual is a *bona fide* resident of a possession if the individual meets a presence test, a tax home test and a closer connection test. The IRS received comments relating to each of the three tests.

I. *Presence Test*

A. *General rule*

Under section 937(a)(1), in order to satisfy the presence test, a person must be present in the possession for at least 183 days during the taxable year (the 183-day rule). The proposed and temporary regulations provide several alternatives to the 183-day rule for purposes of satisfying the presence test. Thus, an individual who does not satisfy the 183-day rule nevertheless meets the presence test under the proposed and temporary regulations if the individual spends no more than 90 days in the United States during the taxable year; the individual spends more days in the possession than in the United States and has no earned income in the United States; or the individual has no permanent connection to the United States.

The proposed and temporary regulations also provide a special rule for nonresident aliens in lieu of the 183-day rule and its alternatives. This special rule reflects the intention of the IRS and Treasury to adopt, to the extent possible, the generally applicable rules of residence with respect to nonresident aliens. Thus, the special rule requires nonresident aliens to satisfy a mirrored version of the substantial presence test of section 7701(b) in order to meet the presence test of section 937(a)(1).

A number of commentators suggested that the IRS and Treasury should also allow U.S. citizens and residents to satisfy the 183-day rule of section 937(a)(1) by satisfying a mirrored version of the substantial presence test of section 7701(b). These comments generally argued that the 183-day rule fails to provide the flexibility necessary to reflect the realities of island life. The comments also stated that the proposed and temporary regulations subject U.S. citizens and residents to a higher presence requirement than nonresident aliens.

The final regulations do not incorporate the rules of section 7701(b) as an alternative to the 183-day rule of section 937(a)(1) for U.S. citizens and residents. Congress considered but specifically rejected adopting section 7701(b) as the general rule for determining residency in a possession. See H.R. Conf. Rep. No. 108–755, at 791–795 (2004). Instead, Congress adopted the 183-day rule and gave the Service authority to adopt appropriate exceptions to the rule to provide sufficient flexibility. The proposed and temporary regulations follow that approach and provide alternatives to the 183-day rule intended to address the necessity of off-island travel. The IRS and Treasury do not believe it is appropriate to adopt a section 7701(b) rule by regulations when Congress expressly rejected this view. Accordingly, the IRS and Treasury generally retain the approach of the proposed and temporary regulations in the final regulations but also provide additional flexibility in the application of the 183-day rule and its alternatives to meet the needs of island residents and offset differences between the rules applicable to U.S. citizens and residents and the rules applicable to nonresident aliens.

Commentators also suggested that the 183-day rule should serve as a safe harbor whereby individuals who were present in the possession for at least 183 days would not need also to satisfy the tax home and closer connection tests. The IRS and Treasury believe that this type of safe-harbor rule is inconsistent with the three-part test provided by Congress under section 937(a), which requires individuals to pass an objective presence test as well as the more subjective tax home and closer connection tests. In addition, the IRS and Treasury believe that applying the presence test in combination with the tax home and closer connection tests is the most reliable method of determining whether an individual is a *bona fide* resident of a possession.

B. *Counting days of presence*

A number of commentators suggested that certain days an individual is not physically present in the possession nevertheless should be considered days during which the individual is present in the possession. Specifically, commentators suggested that days spent outside of the possession for medical treatment of the individual or a family member or because of a natural disaster in the possession, a family emergency, charitable pursuits, or business travel should be counted as days of presence in the possession for purposes of applying the 183-day rule. Similarly, commentators suggested that days spent in the United States for such purposes should not count as days spent in the United States under the alternatives to the 183-day rule.

In response to these comments, the final regulations liberalize the rules on counting days of presence. Consistent with the legislative history of section 937(a), the IRS and Treasury believe that it is desirable to allow for situations in which an individual's presence outside the possession is unlikely to be attributable to a tax avoidance purpose. See H.R. Conf. Rep. No. 108–755, at 791–795 (2004). Accordingly, the final regulations provide additional flexibility for certain situations involving medical conditions and natural disasters.

The proposed and temporary regulations provide that 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 is not treated as a day of presence in the United States for purposes of the alternatives to the 183-day rule. In response to the comments received, the final regulations provide additional flexibility for medical treatment. Under the final regulations, a temporary stay in the United States for certain documented medical treatment of the individual, or a

parent, spouse or child whom the individual accompanies to the treatment, will not count as days spent in the United States for purposes of the alternatives to the 183-day rule, irrespective of where the medical condition arose. Further, such a temporary stay outside of the possession, whether in the United States, another possession or a foreign country, also will count as days of presence in the possession. Qualifying medical treatment generally involves any period of inpatient care in a hospital or hospice in the United States, and any temporary period of time spent in the United States for medically necessary inpatient care in a residential medical care facility. The final regulations focus on the place of treatment and the formal credentials of the health care provider as an objective proxy for a determination that a medical condition is serious enough to entail periods of treatment that may not be readily covered by other alternatives to the 183-day rule.

With respect to disasters, the final regulations provide that if an individual leaves, or is unable to return to, a relevant possession during (1) a two-week period within which an officially declared major disaster in the relevant possession occurs, or (2) the period in which a mandatory evacuation order applies, then the individual will not count any day during either period as a day of presence in the United States, even though the individual has evacuated to or is otherwise present in the United States. The Federal Emergency Management Agency lists officially declared major disasters on its website at *www.fema.gov/news/disasters.fema*. Furthermore, the individual may count that day (whether the individual's temporary presence was in the United States or in some other location outside the relevant possession) as a day of presence in the relevant possession even though the major disaster or mandatory evacuation order prevented the individual from being physically present in the relevant possession.

The final regulations do not adopt commentators' suggestion that days spent outside of a possession for nonmedical family emergencies, charitable pursuits or business travel should count as days spent in the possession and outside the United States. These additional exceptions would have been administratively difficult to implement and monitor. The IRS and Treasury believe that in these situations, and in medical situations not otherwise provided for in the final regulations, the 183-day rule in combination with the alternatives to that rule, as liberalized in these final regulations, provide sufficient flexibility to accommodate absences from the possession to pursue a range of activities.

C. *Permanent connection*

Under the proposed and temporary regulations, an individual may satisfy the presence test if the individual has "no permanent connection" to the United States during the taxable year. The proposed and temporary regulations provide a nonexclusive list of three items each of which constitutes a permanent connection. The enumerated items are a "permanent home" in the United States, a spouse or dependent having a principal place of abode in the United States, and current registration to vote in any political subdivision of the United States.

The IRS and Treasury believe that the term *significant connection* is more precise and accurate than the term *permanent connection*. As a result, the final regulations use the term significant connection rather than permanent connection. In addition, the IRS and Treasury have concluded that the rules of the proposed and temporary regulations should be amended in several respects.

The IRS and Treasury believe that it is not appropriate for the listing of items constituting a significant connection to be a nonexclusive list that leaves open the possibility that undefined or unspecified factors could result in a determination that an individual has a significant connection to the United States in a particular case. The significant connection test is an alternative under the presence test, which itself is fundamentally an objective standard. Section 937(a) and the regulations already provide a more subjective, facts-and-circumstances standard in the form of the closer connection test. With respect to the significant connection test, the IRS and Treasury believe that the regulations should provide certainty and that the three items enumerated in the proposed and temporary regulations are the critical significant connections. Accordingly, the final regulations adopt these items as the exclusive list of significant connections to the United States.

The proposed and temporary regulations define *permanent home* by general reference to §301.7701(b)–2(d)(2). Commentators asserted that this definition does not provide adequate guidance as to the application of the significant connection test in the common situation of individuals who own several homes, including vacation homes. In response to these comments, the final regulations provide an exception for rental property.

With respect to a spouse or dependent whose principal place of abode is in the United States, commentators requested that an estranged spouse and a child of a noncustodial parent not be treated as a significant connection. These commentators observed that the noncustodial parent may not have any control over the place where the child resides and that a finding of significant connection in such circumstances would be inappropriate. The IRS and Treasury agree, and the final regulations exclude such children from the definition of significant connection. In addition, the final regulations provide that only minor children are the type of dependent that constitutes a significant connection. Further, the final regulations do not treat as a significant connection a minor child who resides in the United States as a student, or a spouse from whom the individual is legally separated.

D. *Earned income*

The proposed and temporary regulations provide that an individual may satisfy the presence test if the individual spends more days in the possession than in the United States and has no earned income in the United States. Commentators suggested that the regulations should permit an individual to qualify under this alternative even with some *de minimis* amount of earned income in the United States. In addition, commentators suggested that income earned on any day excluded for purposes of counting days of presence in the United States under the presence test (for example, for certain medical treatment) should be excluded from earned income.

The IRS and Treasury agree that from the standpoint of practicality, fairness and administrability, *de minimis* amounts of U.S.-earned income should not render unavailable this alternative to the 183-day

rule. In establishing a permitted amount of earned income for this purpose, the IRS and Treasury believe it appropriate to look to existing *de minimis* provisions of the Code involving compensation for services. In this regard, the final regulations cross-reference the maximum amount ($3,000 under current law) of compensation for labor or personal services performed in the United States that is not deemed to be income from sources within the United States under section 861(a)(3). The final regulations do not incorporate the suggestion that income earned on days excluded for purposes of counting days of presence should be excluded from earned income. The IRS and Treasury believe that this type of exclusion from earned income would be difficult to administer and could lead to abuse of this alternative, particularly given the additional flexibility provided in the final regulations with respect to days that can be excluded for purposes of counting days of presence.

Commentators also suggested that the no-U.S.-earned-income alternative to the 183-day rule should be applied by treating each state or other defined geographic area as a separate location so that the United States is not treated as a single location for purposes of determining if an individual was present for more days in the possession than in the United States under this alternative. The IRS and Treasury believe that this type of rule could be easily manipulated and difficult to administer. Further, with respect to residency determinations, the Code typically treats the United States as a single location. Therefore, the final regulations do not adopt this suggestion.

II. *Tax Home Test*

Sections 931, 932, 933 and 935 generally apply to an individual who is considered a *bona fide* resident of the respective possession under Code section 937(a) for the entire taxable year. The proposed and temporary regulations treat an individual as a *bona fide* resident of a possession for the entire taxable year only if the individual satisfies the presence, tax home, and closer connection tests for the taxable year.

Commentators suggested that it may be difficult for an individual moving to a possession during a taxable year to satisfy the tax home test if the individual had a regular or principal place of business in the United States or a closer connection to the United States for the portion of the year prior to the date of the move to the possession. These commentators suggested that individuals should be able to prorate their income for the taxable year of the move in accordance with the portion of the year for which they satisfy the tax home test.

The IRS and Treasury agree that special rules are appropriate for the year of a move to a possession and believe that similar rules are appropriate for the year of a move out of a possession. However, the IRS and Treasury do not believe that general statutory authority exists for the proration of a taxpayer's income for the taxable year in this context. Only in the case of Puerto Rico does the Code expressly allow for prorating income according to periods of residency, and then only when an individual moves out of Puerto Rico. See section 933(2). Sections 931, 932 and 935 contain no analogous proration provisions. As a result, except for a special rule applicable to certain individuals who move from Puerto Rico, the final regulations do not provide proration rules.

Instead, the final regulations adopt a standard whereby an individual moving to a possession during the taxable year generally will satisfy the tax home test if the individual does not have a tax home outside that possession during any part of the last 183 days of that taxable year. To prevent abuse of this special rule, the regulations further require in order to use the rule that the individual not have been a *bona fide* resident of the relevant possession during the three taxable years before the move and that the individual continue to qualify as a *bona fide* resident of the possession for the three taxable years following the year of the move. Corresponding rules will apply to the taxable year in which an individual moves from a possession. However, reflecting that section 933(2) provides for proration of a U.S. citizen's income with respect to *bona fide* residents who move from Puerto Rico, the final regulations provide a special rule that allows qualifying individuals to be treated as *bona fide* residents for the part of the year before they move from Puerto Rico.

Under the tax home test, the proposed and temporary regulations provide a special rule applicable to seafarers. The special rule prevents an individual from being considered to have a tax home outside a particular possession solely by reason of employment on a ship or other seafaring vessel that is used predominantly in local and international waters. As set forth in the proposed and temporary regulations, the special rule does not specify how to treat time that the ship spends in waters of another possession. The final regulations clarify that time spent in the waters of another possession is treated the same as time spent in the waters of the United States or a foreign country. Thus, under the final regulations, a ship is considered to be used predominantly in local or international waters if the total time it is used in local and international waters during a taxable year exceeds the total time it is used in the territorial waters of the United States, another possession, and any foreign country.

See section V of this preamble for an explanation of the transition rule concerning the effective date of the tax home test.

III. *Closer Connection Test*

Under section 937(a)(2), in order to be a *bona fide* resident of a possession, a person must 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 relevant possession. The regulations under section 7701(b)(3)(B)(ii) provide a facts-and-circumstances test to determine whether an individual has a closer connection with the United States or with a foreign country. This facts-and-circumstances test provides a nonexclusive list of factors to be taken into consideration. See §301.7701(b)–2(d). The proposed and temporary regulations under section 937 apply the principles of and factors provided in §301.7701(b)–2(d) in determining whether an individual meets the closer connection test of section 937.

Commentators suggested that the final regulations designate certain factors as primary and others as secondary, thereby indicating the relative weight of the factors listed in §301.7701(b)–2(d). Alternatively, commentators requested that the final regulations indicate that an individual who meets a majority of factors establishes a closer connection. Some commentators criticized Example 6 under §1.937–1T(f) (the closer connection example) for failing to take into account all factors listed in §301.7701(b)–2(d) and for not providing

an analysis of how the example concludes that the individual fails to satisfy the closer connection test. These commentators appeared to believe that the closer connection example suggests that the location of an individual's spouse and children is more important than other factors or even is determinative of whether the individual has a closer connection to the United States or the possession. Some commentators also seemed to confuse these factors with the permanent connection alternative to the presence test and believed that the closer connection test requires an individual's spouse and dependent children also to reside in the possession. Commentators noted that if it applied, this requirement would apparently conflict with the joint filing rule of section 932(d).

The closer connection test is a facts-and-circumstances test. The very nature of the test does not allow for weighting of factors because a factor with respect to one set of facts and circumstances may be less important than with respect to another set of facts and circumstances. Because the test must be applied to a wide variety of individual situations, the final regulations do not designate specific factors as primary, adopt a weighting of factors, or adopt a rule that counts a majority of the factors to determine closer connection. Further, because the list in §301.7701(b)–2(d) is not exclusive, other factors, including, for example, whether the individual was born and raised in the relevant possession, may be considered in the determination. The final regulations amend Example 6 to demonstrate that all factors (including any factors important in a particular case but not on the nonexclusive list) must be considered in determining an individual's closer connection.

Although the location of the individual's family is often a very important factor, it is one of many factors to be evaluated qualitatively under the facts-and-circumstances test, and in a particular case it may not be an important or overriding factor. Thus, unlike the no-significant-connection alternative (previously the no-permanent-connection alternative) to the presence test, the closer connection test can be satisfied, depending on an individual's particular facts and circumstances, even if, for example, the individual's spouse resides in the United States. In addition, Congress provided in section 937(a) that individuals must satisfy the closer connection test to establish *bona fide* residency in a possession notwithstanding the statutory joint filing rule provided in section 932(d). For these reasons, the regulations under section 937 do not conflict with section 932(d).

The proposed and temporary regulations require that an individual satisfy the closer connection test for the entire taxable year in order to be considered a *bona fide* resident of a relevant possession. Commentators noted that, as with the tax home test, it may be difficult for an individual moving into a possession during a taxable year to satisfy the closer connection test for the entire taxable year. Accordingly, the final regulations provide special year-of-move rules under the closer connection test similar to those described in section II of this preamble (relating to the tax home test).

The final regulations make clarifying amendments to the closer connection test. Section 1.937–1T(e)(2) of the proposed and temporary regulations specifies that another possession is not considered a foreign country for purposes of the closer connection test. The final regulations do not specify this because a special rule distinguishing possessions from foreign countries is unnecessary and potentially confusing. In the absence of an explicit provision, possessions are not treated as foreign countries under the Code or Treasury Regulations. The final regulations also clarify that an individual's connections to the United States and foreign countries are considered in the aggregate, rather than on a country-by-country basis, when comparing those connections with the individual's connections to the relevant possession.

See section V of this preamble for an explanation of the transition rule concerning the effective date of the closer connection test.

IV. *Withholding Tax Exceptions for Certain Possessions Corporations*

Section 881(b) provides exemptions from, or reductions of, withholding tax and branch profits tax on certain U.S.-source income received by corporations organized in U.S. possessions. As one of the conditions for such treatment in certain cases, section 881(b)(1)(C) sets forth a "base-erosion" test requiring that no substantial part of the possessions corporation's income be used to satisfy obligations to "persons" who are not *bona fide* residents of such a possession or of the United States. Section 937(a) provides in relevant part that for purposes of section 881(b), except as provided in regulations, a "person" is a *bona fide* resident if the person satisfies the requirements of section 937(a). For purposes of the base-erosion test, §1.881–5T(f)(4)(i) defines a *bona fide* resident of a possession by reference to §1.937–1T, which provides that only a natural person, rather than a juridical person, may qualify as a *bona fide* resident of a possession. Similarly, §1.881–5T(f)(4)(ii) defines *bona fide* residents of the United States for purposes of the base-erosion test as including only certain individuals who are citizens or residents of the United States.

Commentators observed that the interaction of these rules in the proposed and temporary regulations could result in disqualifying income from the withholding tax exceptions in any situation where the possessions corporation makes payments to satisfy obligations to persons other than individuals. These commentators further noted that many common business arrangements would run afoul of the base-erosion test if corporations cannot constitute *bona fide* residents.

The IRS and Treasury agree that such results would be undesirable and unintended. In the context of section 881(b), the IRS and Treasury believe that the statutory terms *persons* and *bona fide residents* should not be interpreted as limited to individuals. Accordingly, the final regulations additionally provide that a corporation, or a business association that is treated as a corporation for tax purposes, may qualify as a *bona fide* resident of a relevant possession or the United States for purposes of the base-erosion test if it is created or organized in that jurisdiction. The final regulations reflect that section 937(a) and the regulations under that section are intended to apply only to individuals in determining whether a person is a *bona fide* resident of a possession within the meaning of section 881(b)(1)(C).

Note that the IRS and Treasury believe that the words "direct or indirect" in section 881(b)(1)(C) (and §1.881–5(c)(3)) would authorize an anti-abuse rule that

prohibits payments to possessions corporations that are a part of back-to-back loan arrangements or other base erosion schemes. Accordingly, the IRS and Treasury are strongly considering including such an anti-abuse rule when finalizing the remaining proposed and temporary regulations under section 881(b). It is expected that any such anti-abuse rule would be retroactive to January 31, 2006.

Commentators also proposed that the final regulations adopt a special rule whereby publicly traded corporations may qualify for favorable tax treatment without regard to the conditions under section 881(b)(1), including the base-erosion test. A similar rule is provided under section 884(e)(4)(B) and §1.884–5(d) under the branch profits tax. However, the final regulations do not adopt such a special rule in this context. The IRS and Treasury note that section 881(b) does not grant authority to depart from the statutory conditions of section 881(b)(1), including the base-erosion test.

V. *Effective Date*

The proposed and temporary regulations are generally effective for tax years ending after October 22, 2004. Consistent with the effective date of section 937(a), the proposed and temporary regulations provide a transition rule that delays the effective date of the presence test until tax years beginning after October 22, 2004 (tax year 2005 for calendar year taxpayers). A number of commentators suggested that the final regulations should provide a similar transition rule with respect to the effective date of the tax home and closer connection tests so that the prior-law, facts-and-circumstances test continues to apply through tax years beginning on or before October 22, 2004.

The IRS and Treasury believe that it is appropriate to provide a transition rule with respect to the tax home and closer connection tests consistent with the effective date of the presence test. The effective date of the final regulations reflects the fact that most taxpayers already will have filed their income tax returns for taxable year 2004. As a result, this transition rule is elective so that taxpayers may apply at their option the prior-law test for determining residency.

Under section 937(a), an individual's tax home outside the relevant possession conclusively forecloses *bona fide* residency in the possession, rather than being one of a number of facts and circumstances that are considered under the prior-law test. However, in most instances the outcome of the residency determination under prior law should be the same as with the application of the section 937(a) tax home and closer connection tests because individuals are required to demonstrate similar factors to support claims that they are *bona fide* residents of a particular possession. See, *e.g.*, *Sochurek v. Commissioner*, 300 F.2d 34, 38 (7th Cir. 1962) (enumerating representative factors), and *Bergersen v. Commissioner*, 109 F.3d 56, 61–62 (1st Cir. 1997), aff'g T.C. Memo 1995–424 (applying prior-law facts-and-circumstances test in same way closer connection test is applied by "taking account of all of the [taxpayers'] ties to both places" to determine residency under principles of §§1.871–2 through 1.871–5). The optional effective date for the tax home and closer connection tests is intended to create symmetry with the effective date of the presence test. No inference is intended or may be drawn from this transition rule as to the result under prior law.

VI. *Miscellaneous Changes*

Consistent with section 937(a), the final regulations specify that the residency rules apply for purposes of the income tax and certain other enumerated provisions of the Code. With respect to the estate and gift taxes, see §§20.2209–1 and 25.2501–1(d).

The final regulations also reflect various nonsubstantive stylistic edits to the proposed and temporary regulations to enhance clarity and readability.

VII. *Mutual Agreement Procedures*

In the application of the operative provisions of the Code relating to possessions, for example sections 931 through 935, section 937(a) and the final regulations govern whether an individual is a *bona fide* resident of a particular possession. A commentator observed that there is a possibility that the IRS and the taxing authority of a particular possession might reach different conclusions with respect to certain determinations, including residency, when administering their respective income tax laws. In such cases, taxpayers are advised that mutual agreement procedures are available. For procedures to request the assistance of the IRS when a taxpayer is or may be subject to inconsistent tax treatment by the IRS and a possession tax agency, see Revenue Procedure 89–8, 1989–1 C.B. 778.

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. 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 Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

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

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 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 1.937–1 also issued under 26 U.S.C. 937(a). * * *

Par. 2. Section 1.881–5 is added to read as follows:

§1.881–5 Exception for certain possessions corporations.

(a) through (f)(3) [Reserved]. For more information, see §1.881–5T(a) through (f)(3).

(f)(4) *Bona fide resident*—

(i) With respect to a particular possession, means—

(A) An individual who is a *bona fide* resident of the possession as defined in §1.937–1; or

(B) A business entity organized under the laws of the possession and taxable as a corporation in the possession; and

(ii) With respect to the United States, means—

(A) An individual who is a citizen or resident of the United States (as defined under section 7701(b)(1)(A)); or

(B) A business entity organized under the laws of the United States or any State that is classified as a corporation for federal tax purposes under §301.7701–2(b) of this chapter.

(5) through (7) [Reserved]. For more information, see §1.881–5T(f)(5) through (7).

(8) *Effective date*. This section applies to payments made after January 31, 2006. However, taxpayers may choose to apply this section to all payments made after October 22, 2004 for which the statute of limitations under section 6511 is open.

(g) through (i) [Reserved]. For more information, see §1.881–5T(g) through (i).

Par. 3. In §1.881–5T, paragraph (f)(4) is revised to read as follows:

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

* * * * *

(f)(4) [Reserved]. For more information, see §1.881–5(f)(4).

* * * * *

§1.931–1T [Amended]

Par. 4. In §1.931–1T, paragraph (a)(2) is amended by removing and reserving the *Example*.

§1.932–1T [Amended]

Par. 5. In §1.932–1T, paragraph (i) is amended by removing and reserving *Example 2*.

§1.933–1T [Amended]

Par. 6. In §1.933–1T, paragraph (a)(2) is amended by removing and reserving the *Example*.

§1.935–1T [Amended]

Par. 7. In §1.935–1T, paragraph (f) is amended by removing and reserving *Examples 1* and *2*.

Par. 8. Section 1.937–1 is added to read as follows:

§1.937–1 Bona fide residency in a possession.

(a) *Scope*— (1) *In general*. Section 937(a) and this section set forth the rules for determining whether an individual qualifies as a *bona fide* resident of a particular possession (the relevant possession) for purposes of Subpart D, Part III, Subchapter N, Chapter 1 of the Internal Revenue Code as well as section 865(g)(3), section 876, section 881(b), paragraphs (2) and (3) of section 901(b), section 957(c), section 3401(a)(8)(C), and section 7654(a).

(2) *Definitions*. For purposes of this section and §§1.937–2 and 1.937–3—

(i) *Possession* means one of the following United States possessions: American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, or the Virgin Islands. When used in a geographical sense, the term comprises only the territory of each such possession (without application of sections 932(c)(3) and 935(c)(2) (as in effect before the effective date of its repeal)).

(ii) *United States*, when used in a geographical sense, is defined in section 7701(a)(9), and without application of sections 932(a)(3) and 935(c)(1) (as in effect before the effective date of its repeal).

(b) *Bona fide resident*— (1) *General rule*. An individual qualifies as a *bona fide* resident of the relevant possession if such individual satisfies the requirements of paragraphs (c) through (e) of this section with respect to such possession.

(2) *Special rule for members of the Armed Forces*. A member of the Armed Forces of the United States who qualified as a *bona fide* resident of the relevant possession in a prior taxable year is deemed to have satisfied the requirements of paragraphs (c) through (e) of this section for a subsequent taxable year if such individual otherwise is unable to satisfy such requirements by reason of being absent from such possession or present in the United States during such year solely in compliance with military orders. Conversely, a member of the Armed Forces of the United States who did not qualify as a *bona fide* resident of the relevant possession in a prior taxable year is not considered to have satisfied the requirements of paragraphs (c) through (e) of this section for a subsequent taxable year by reason of being present in such possession solely in compliance with military orders. *Armed Forces of the United States* is defined (and members of the Armed Forces are described) in section 7701(a)(15).

(3) *Juridical persons*. Except as provided in §1.881–5(f):

(i) Only natural persons may qualify as *bona fide* residents of a possession; and

(ii) The rules governing the tax treatment of *bona fide* residents of a possession do not apply to juridical persons (including corporations, partnerships, trusts, and estates).

(4) *Transition rule*. For taxable years beginning before October 23, 2004, and ending after October 22, 2004, an individual is considered to qualify as a *bona fide* resident of the relevant possession if that individual would be a *bona fide* resident of the relevant possession by applying the principles of §§1.871–2 through 1.871–5.

(5) *Special rule for cessation of bona fide residence in Puerto Rico*. See paragraph (f)(2)(ii) of this section for a special rule applicable to a citizen of the United States who ceases to be a *bona fide* resident of Puerto Rico during a taxable year.

(c) *Presence test*— (1) *In general*. A United States citizen or resident alien individual (as defined in section 7701(b)(1)(A)) satisfies the requirements of this paragraph (c) for a taxable year if during that taxable year that 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 earned income (as defined in §1.911–3(b)) in the United States, if any, not exceeding in the aggregate the amount specified in section 861(a)(3)(B) and was present for more days in the relevant possession than in the United States; or

(iv) Had no significant connection to the United States. See paragraph (c)(5) of this section.

(2) *Special rule for alien individuals*. A nonresident alien individual (as defined in section 7701(b)(1)(B)) satisfies the requirements of this paragraph (c) for a taxable year if during that taxable year that individual satisfies the substantial presence test of §301.7701(b)–1(c) of this chapter (except for the substitution of the name of the relevant possession for the term *United States* where appropriate).

(3) *Days of presence*. For purposes of paragraph (c)(1) of this section—

(i) An individual is considered to be present in the relevant possession on:

(A) Any day that the individual is physically present in that possession at any time during the day;

(B) Any day that an individual is outside of the relevant possession to receive, or to accompany on a full-time basis a parent, spouse, or child (as defined in section 152(f)(1)) who is receiving, qualifying medical treatment as defined in paragraph (c)(4) of this section; and

(C) Any day that an individual is outside the relevant possession because the individual leaves or is unable to return to the relevant possession during any—

(*1*) 14-day period within which a major disaster occurs in the relevant possession for which a Federal Emergency Management Agency Notice of a Presidential declaration of a major disaster is issued in the Federal Register; or

(*2*) Period for which a mandatory evacuation order is in effect for the geographic area in the relevant possession in which the individual's place of abode is located.

(ii) An individual is considered to be present in the United States on any day that the individual is physically present in the United States at any time during the day. Notwithstanding the preceding sentence, the following days will not count as days of presence in the United States:

(A) Any day that an individual is temporarily present in the United States under circumstances described in paragraph (c)(3)(i)(B) or (C) of this section;

(B) Any day that an individual is in transit between two points outside the United States (as described in §301.7701(b)–3(d) of this chapter), and is physically present in the United States for fewer than 24 hours;

(C) Any day that an individual is temporarily present in the United States as a professional athlete to compete in a charitable sports event (as described in §301.7701(b)–3(b)(5) of this chapter);

(D) Any day that an individual is temporarily present in the United States as a student (as defined in section 152(f)(2)); and

(E) In the case of an individual who is an elected representative of the relevant possession, or who serves full time as an elected or appointed official or employee of the government of the relevant possession (or any political subdivision thereof), any day spent serving the relevant possession in that role.

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

(A) In the United States and in the relevant possession, that day is considered a day of presence in the relevant possession;

(B) In two possessions, that day is considered a day of presence in the possession where the individual's tax home is located (applying the rules of paragraph (d) of this section).

(4) *Qualifying medical treatment*—(i) *In general*. The term *qualifying medical treatment* means medical treatment provided by (or under the supervision of) a physician (as defined in section 213(d)(4)) for an illness, injury, impairment, or physical or mental condition that satisfies the documentation and production requirements of paragraph (c)(4)(iii) of this section and that involves—

(A) Any period of inpatient care in a hospital or hospice and any period immediately before or after that inpatient care to the extent it is medically necessary; or

(B) Any temporary period of inpatient care in a residential medical care facility for medically necessary rehabilitation services.

(ii) *Inpatient care*. The term *inpatient care* means care requiring an overnight stay in a hospital, hospice, or residential medical care facility, as the case may be.

(iii) *Documentation and production requirements*. In order to satisfy the documentation and production requirements of this paragraph, an individual must, with respect to each qualifying medical treatment, prepare (or obtain), maintain, and, upon a request by the Commissioner (or the person responsible for tax administration in the relevant possession), make available within 30 days of such request:

(A) Records that provide—

(*1*) The patient's name and relationship to the individual (if the medical treatment is provided to a person other than the individual);

(*2*) The name and address of the hospital, hospice, or residential medical care facility where the medical treatment was provided;

(*3*) The name, address, and telephone number of the physician who provided the medical treatment;

(*4*) The date(s) on which the medical treatment was provided; and

(*5*) Receipt(s) of payment for the medical treatment;

(B) Signed certification by the providing or supervising physician that the medical treatment was qualified medical treatment within the meaning of paragraph (c)(4)(i) of this section, and setting forth—

(*1*) The patient's name;

(*2*) A reasonably detailed description of the medical treatment provided by (or under the supervision of) the physician;

(*3*) The dates on which the medical treatment was provided; and

(*4*) The medical facts that support the physician's certification and determination that the treatment was medically necessary; and

(C) Such other information as the Commissioner may prescribe by notice, form, instructions, or other publication (see §601.601(d)(2) of this chapter).

(5) *Significant connection*. For purposes of paragraph (c)(1)(iv) of this section—

(i) The term *significant connection to the United States* means—

(A) A permanent home in the United States;

(B) Current registration to vote in any political subdivision of the United States; or

(C) A spouse or child (as defined in section 152(f)(1)) who has not attained the age of 18 whose principal place of abode is in the United States other than—

(*1*) A child who is in the United States because the child is living with a custodial

parent under a custodial decree or multiple support agreement; or

(*2*) A child who is in the United States as a student (as defined in section 152(f)(2)).

(ii) *Permanent home*— (A) *General rule*. For purposes of paragraph (c)(5)(i)(A) of this section, except as provided in paragraph (c)(5)(ii)(B) of this section, the term *permanent home* has the same meaning as in §301.7701(b)–2(d)(2) of this chapter.

(B) *Exception for rental property*. If an individual or the individual's spouse owns property and rents it to another person at any time during the taxable year, then notwithstanding that the rental property may constitute a permanent home under §301.7701(b)–2(d)(2) of this chapter, it is not a permanent home under this paragraph (c)(5)(ii) unless the taxpayer uses any portion of it as a residence during the taxable year under the principles of section 280A(d). In applying the principles of section 280A(d) for this purpose, an individual is treated as using the rental property for personal purposes on any day determined under the principles of section 280A(d)(2) or on any day that the rental property (or any portion of it) is not rented to another person at fair rental for the entire day. The rental property is not used for personal purposes on any day on which the principal purpose of the use of the rental property is to perform repair or maintenance work on the property. Whether the principal purpose of the use of the rental property is to perform repair or maintenance work is determined in light of all the facts and circumstances including, but not limited to, the following: the amount of time devoted to repair and maintenance work, the frequency of the use for repair and maintenance purposes during a taxable year, and the presence and activities of companions.

(iii) For purposes of this paragraph (c)(5), the term *spouse* does not include a spouse from whom the individual is legally separated under a decree of divorce or separate maintenance.

(d) *Tax home test*— (1) *General rule*. Except as provided in paragraph (d)(2) of this section, an individual satisfies the requirements of this paragraph (d) for a taxable year if that individual did not have a tax home outside the relevant possession during any part of the taxable year. For purposes of section 937 and this section, an individual's tax home is determined under the principles of section 911(d)(3) without regard to the second sentence thereof. Thus, under section 937, an individual's tax home is considered to be located at the individual's regular or principal (if more than one regular) place of business. If the individual has no regular or principal place of business because of the nature of the business, or because the individual is not engaged in carrying on any trade or business within the meaning of section 162(a), then the individual's tax home is the individual's regular place of abode in a real and substantial sense.

(2) *Exceptions*— (i) *Year of move*. See paragraph (f) of this section for a special rule applicable to an individual who becomes or ceases to be a *bona fide* resident of the relevant possession during a taxable year.

(ii) *Special rule for seafarers*. For purposes of section 937 and this section, an individual is not considered to have a tax home outside the relevant possession solely by reason of employment on a ship or other seafaring vessel that is predominantly used in local and international waters. For this purpose, a vessel is considered to be predominantly used in local and international waters if, during the taxable year, the aggregate amount of time it is used in international waters and in the waters within three miles of the relevant possession exceeds the aggregate amount of time it is used in the territorial waters of the United States, another possession, and a foreign country.

(iii) *Special rule for students and government officials*. Any days described in paragraphs (c)(3)(ii)(D) and (E) of this section are disregarded for purposes of determining whether an individual has a tax home outside the relevant possession under paragraph (d)(1) of this section during any part of the taxable year.

(e) *Closer connection test*— (1) *General rule*. Except as provided in paragraph (e)(2) of this section, an individual satisfies the requirements of this paragraph (e) for a taxable year if that individual did not have a closer connection to the United States or a foreign country than to the relevant possession during any part of the taxable year. For purposes of this paragraph (e)—

(i) The principles of section 7701(b)(3)(B)(ii) and §301.7701(b)–2(d) of this chapter apply (without regard to the final sentence of §301.7701(b)–2(b) of this chapter); and

(ii) An individual's connections to the relevant possession are compared to the aggregate of the individual's connections with the United States and foreign countries.

(2) *Exception for year of move*. See paragraph (f) of this section for a special rule applicable to an individual who becomes or ceases to be a *bona fide* resident of the relevant possession during a taxable year.

(f) *Year of move*— (1) *Move to a possession*. For the taxable year in which an individual's residence changes to the relevant possession, the individual satisfies the requirements of paragraphs (d)(1) and (e)(1) of this section if—

(i) For each of the 3 taxable years immediately preceding the taxable year of the change of residence, the individual is not a *bona fide* resident of the relevant possession;

(ii) For each of the last 183 days of the taxable year of the change of residence, the individual does not have a tax home outside the relevant possession or a closer connection to the United States or a foreign country than to the relevant possession; and

(iii) For each of the 3 taxable years immediately following the taxable year of the change of residence, the individual is a *bona fide* resident of the relevant possession.

(2) *Move from a possession*— (i) *General rule*. Except for a *bona fide* resident of Puerto Rico to whom §1.933–1(b) and paragraph (f)(2)(ii) of this section apply, for the taxable year in which an individual ceases to be a *bona fide* resident of the relevant possession, the individual satisfies the requirements of paragraphs (d)(1) and (e)(1) of this section if—

(A) For each of the 3 taxable years immediately preceding the taxable year of the change of residence, the individual is a *bona fide* resident of the relevant possession;

(B) For each of the first 183 days of the taxable year of the change of residence, the individual does not have a tax home outside the relevant possession or a closer connection to the United States or a foreign country than to the relevant possession; and

(C) For each of the 3 taxable years immediately following the taxable year of the change of residence, the individual is not a *bona fide* resident of the relevant possession.

(ii) *Year of move from Puerto Rico*. Notwithstanding an individual's failure to satisfy the presence, tax home, or closer connection test prescribed under paragraph (b)(1) of this section for the taxable year, the individual is a *bona fide* resident of Puerto Rico for that part of the taxable year described in paragraph (f)(2)(ii)(E) of this section if the individual—

(A) Is a citizen of the United States;

(B) Is a *bona fide* resident of Puerto Rico for a period of at least 2 taxable years immediately preceding the taxable year;

(C) Ceases to be a *bona fide* resident of Puerto Rico during the taxable year;

(D) Ceases to have a tax home in Puerto Rico during the taxable year; and

(E) Has a closer connection to Puerto Rico than to the United States or a foreign country throughout the part of the taxable year preceding the date on which the individual ceases to have a tax home in Puerto Rico.

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

Example 1. Presence test. W, a U.S. citizen, lives for part of the taxable year in a condominium, which she owns, located in Possession P. W also owns a house in State N where she lives for 120 days every year to be near her grown children and grandchildren. W is retired and her income consists solely of pension payments, dividends, interest, and Social Security benefits. For 2006, W is only present in Possession P for a total of 175 days because of a 70 day vacation to Europe and Asia. Thus, for taxable year 2006, W is not present in Possession P for at least 183 days, is present in the United States for more than 90 days, and has a significant connection to the United States by reason of her permanent home. However, under paragraph (c)(1)(iii) of this section, W still satisfies the presence test of paragraph (c) of this section with respect to Possession P because she has no earned income in the United States and is present for more days in Possession P than in the United States.

Example 2. Presence test. T, a U.S. citizen, was born and raised in State A, where his mother still lives in the house in which T grew up. T is a sales representative for a company based in Possession V. T lives with his wife and minor children in their house in Possession V. T is registered to vote in Possession V and not in the United States. In 2006, T spends 120 days in State A and another 120 days in foreign countries. When traveling on business to State A, T often stays at his mother's house in the bedroom he used when he was a child. T's stays are always of short duration, and T asks for his mother's permission before visiting to make sure that no other guests are using the room and that she agrees to have him as a guest in her house at that time. Therefore, under paragraph (c)(5)(ii) of this section, T's mother's house is not a permanent home of T. Assuming that no other accommodations in the United States constitute a permanent home with respect to T, then under paragraphs (c)(1)(iv) and (c)(5) of this section, T has no significant connection to the United States. Accordingly, T satisfies the presence test of paragraph (c) of this section for taxable year 2006.

Example 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 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 in 2006. When not at sea, S resides with his wife at a house they own in Possession G. The fishing vessel upon which S works departs and arrives at various ports in Possession G, other possessions, and foreign countries, but is in international and local waters (within the meaning of paragraph (d)(2) of this section) for 225 days in 2006. Under paragraph (d)(2) of this section, for taxable year 2006, S will not be considered to have a tax home outside Possession G for purposes of section 937 and this section solely by reason of S's employment on board the fishing vessel.

Example 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 as her permanent address on forms and documents. P satisfies the presence test of paragraph (c) of this section with respect to both Possession Q and Possession I, because, among other reasons, under paragraph (c)(1)(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 possessions generally are not treated as foreign countries). Therefore, P is a *bona fide* resident of Possession I for purposes of the Internal Revenue Code.

Example 6. Closer connection to United States than to possession. Z, a U.S. citizen, relocates to Possession V in a prior taxable year to start an investment consulting and venture capital business. Z's wife and two teenage children remain in State C to allow the children to complete high school. Z travels back to the United States regularly to see his wife and children, to engage in business activities, and to take vacations. He has an apartment available for his full-time use in Possession V, but he remains a joint owner of the residence in State C where his wife and children reside. Z and his family have automobiles and personal belongings such as furniture, clothing, and jewelry located at both residences. Although Z is a member of the Possession V Chamber of Commerce, Z also belongs to and has current relationships with social, political, cultural, and religious organizations in State C. Z receives mail in State C, including brokerage statements, credit card bills, and bank advices. Z conducts his personal banking activities in State C. Z holds a State C driver's license and is registered to vote in State C. Based on the totality of the particular facts and circumstances pertaining to Z, Z is not a *bona fide* resident of Possession V because he has a closer connection to the United States than to Possession V and therefore fails to satisfy the requirements of paragraphs (b)(1) and (e) of this section.

Example 7. Year of move to possession. D, a U.S. citizen, files returns on a calendar year basis. From January 2003 through May 2006, D resides in State R. In June 2006, D moves to Possession N, purchases a house, and accepts a permanent position with a local employer. D's principal place of business from July 1 through December 31, 2006 is in Possession N, and during that period (which totals at least 183 days) D does not have a closer connection to the United States or a foreign country than to Possession N. For the remainder of 2006, and throughout years 2007 through 2009, D continues to live and work in Possession N and maintains a closer connection to Possession N than to the United States or any foreign country. D satisfies the tax home and closer connection tests for 2006 under paragraphs (d)(2), (e)(2), and (f)(1) of this section. Accordingly, assuming that D also satisfies the presence test in paragraph (c) of this section, D is a *bona fide* resident of Possession N for all of taxable year 2006.

Example 8. Year of move from possession (other than Puerto Rico). J, a U.S. citizen, files returns on a calendar year basis. From January 2007 through December 2009, J is a *bona fide* resident of Possession C because she satisfies the requirements of paragraph (b)(1) of this section for each year. J continues to reside in Possession C until September 6, 2010, when she accepts new employment and moves to State H. J's principal place of business from January 1 through September 5, 2010 is in Possession C, and during that period (which totals at least 183 days) J does not have a closer connection to the United States or a foreign country than to Possession C. For the remainder of 2010 and throughout years 2011 through 2013, D continues to live and work in State H and is not a *bona fide* resident of Possession C. J satisfies the tax home and closer connection tests for 2010 with respect to Possession C under paragraphs (d)(2)(i), (e)(2), and (f)(2)(i) of this section. Accordingly, assuming that J also satisfies the presence test of paragraph (c) of this section, J is a *bona fide* resident of Possession C for all of taxable year 2010.

Example 9. Year of move from Puerto Rico. R, a U.S. citizen who files returns on a calendar year basis satisfies the requirements of paragraphs (b) through (e) of this section for years 2006 and 2007. From January through April 2008, R continues to reside and maintain his principal place of business in and closer connection to Puerto Rico. On May 5, 2008, R moves and changes his principal place of

business (tax home) to State N and later that year establishes a closer connection to the United States than to Puerto Rico. R does not satisfy the presence test of paragraph (c) for 2008 with respect to Puerto Rico. Moreover, because R had a tax home outside of Puerto Rico and establishes a closer connection to the United States in 2008, R does not satisfy the requirements of paragraph (d)(1) or (e)(1) of this section for 2008. However, because R was a *bona fide* resident of Puerto Rico for at least two taxable years before his change of residence to State N in 2008, he is a *bona fide* resident of Puerto Rico from January 1 through May 4, 2008 under paragraphs (b)(5) and (f)(2)(ii) of this section. See section 933(2) and §1.933–1(b) for rules on attribution of income.

(h) *Information reporting requirement*. The following individuals are required to file notice of their new tax status in such time and manner as the Commissioner may prescribe by notice, form, instructions, or other publication (see §601.601(d)(2) of this chapter):

(1) Individuals who take the position for U.S. tax reporting purposes that they qualify as *bona fide* residents of a possession for a tax year subsequent to a tax year for which they were required to file Federal income tax returns as citizens or residents of the United States who did not so qualify.

(2) Citizens and residents of the United States who take the position for U.S. tax reporting purposes that they do not qualify as *bona fide* residents of a possession for a tax year subsequent to a tax year for which they were required to file income tax returns (with the Internal Revenue Service, the tax authorities of a possession, or both) as individuals who did so qualify.

(3) *Bona fide* residents of Puerto Rico or a section 931 possession (as defined in §1.931–1T(c)(1)) who take a position for U.S. tax reporting purposes that they qualify as *bona fide* residents of that possession for a tax year subsequent to a tax year for which they were required to file income tax returns as *bona fide* residents of the United States Virgin Islands or a section 935 possession (as defined in §1.935–1T(a)(3)(i)).

(i) *Effective date*. Except as provided in this paragraph (i), this section applies to taxable years ending after January 31, 2006. Paragraph (h) of this section also applies to a taxpayer's 3 taxable years immediately preceding the taxpayer's first taxable year ending after October 22, 2004. Taxpayers also may choose to apply this section in its entirety to all taxable years ending after October 22, 2004 for which the statute of limitations under section 6511 is open.

§1.937–1T [Removed]

Par. 9. Section 1.937–1T is removed.

PART 602 — OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 10. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 11. In §602.101, paragraph (b) is amended by removing the entry for "1.937–1T" and adding a new entry for "1.937–1" 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.
* * * * *	
1.937–1	1545–1930
* * * * *	

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Approved January 20, 2006.

Eric Solomon,
Acting Deputy Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on January 30, 2006, 8:45 a.m., and published in the issue of the Federal Register for January 31, 2006, 71 F.R. 4996)

Section 1400F.—Renewal Community Capital Gain

May a taxpayer under § 1400F of the Internal Revenue Code exclude from gross income any qualified capital gain from the sale or exchange of a qualified community asset that is in the expanded area of a renewal community and that is held for more than 5 years? See Rev. Proc. 2006-16, page 539.

Section 1400I.—Commercial Revitalization Deduction

May a commercial revitalization agency retroactively allocate commercial revitalization expenditure amounts under § 1400I(d) of the Internal Revenue Code for a qualified revitalization building placed in service after December 31, 2001, in the expanded area of a renewal community, and how does the recipient of this allocation elect the commercial revitalization deduction under § 1400I(a)? See Rev. Proc. 2006-16, page 539.

Section 1400J.—Increase in Expensing Under Section 179

Is § 179 property that is qualified renewal property and placed in service in the expanded area of a renewal community eligible for the increased § 179 expensing provided by § 1400J of the Internal Revenue Code? See Rev. Proc. 2006-16, page 539.

Section 7701.—Definitions

26 CFR 301.7701–2: Business entities; definitions.

T.D. 9246

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 301

Clarification of Definitions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations defining the terms *corporation* and *domestic* in circumstances in which a business entity is created or organized in

more than one jurisdiction. These regulations affect business entities that are created or organized under the laws of more than one jurisdiction.

DATES: *Effective Date:* These regulations are effective January 30, 2006.

Applicability Dates: For the dates of applicability of these regulations, see §§301.7701–2(e)(3) and 301.7701–5(c).

FOR FURTHER INFORMATION CONTACT: Thomas Beem, (202) 622–3860 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On August 12, 2004, the IRS and Treasury issued temporary regulations (T.D. 9153, 2004–2 C.B. 517), 69 FR 49809, and a notice of proposed rulemaking (REG–124872–04, 2004–2 C.B. 533), 69 FR 49840, regarding the classification of business entities that are created or organized under the laws of more than one jurisdiction (*dually chartered entities*).

Under the provisions of the temporary and proposed regulations, classification of a dually chartered entity involves two independent determinations: (1) whether the entity is a corporation; and (2) whether the entity is domestic or foreign. The entity is a corporation under §301.7701–2T(b)(9) if its form of organization in any one of the jurisdictions in which it is created or organized would cause it to be treated as a corporation under §301.7701–2(b). The entity is domestic under §301.7701–5T if it is organized as any kind of entity in the United States or under the law of the United States or of any State. The temporary regulations were effective for all entities existing on or after August 12, 2004.

The public hearing concerning the proposed regulations was canceled because no requests to speak were received. However, the IRS and Treasury received several written comments on the temporary and proposed regulations, which are discussed below.

Explanation of Provisions

A. *Dates of Application*

The preamble to the temporary and proposed regulations notes that the IRS and Treasury consider the regulations to be a clarification of the entity classification rules as they existed prior to the issuance of the temporary and proposed regulations (*pre-existing regulations*). This belief is based on the view that, even absent these regulations, a proper application of the pre-existing regulations produces the same result as the rules of the temporary and proposed regulations. Some commentators suggest that this discussion in the preamble to the temporary and proposed regulations indicates that the regulations apply prior to August 12, 2004, and thus the rules are retroactive in their effect.

Also, all of the commentators note that while the temporary and proposed rules are a reasonable interpretation of the statute and the pre-existing regulations, other reasonable interpretations of the pre-existing regulations are also possible and that some taxpayers classified their dually chartered entities under those other interpretations. Therefore, the commentators question whether it is appropriate to view the temporary and proposed regulations as a clarification of the existing regulations. Further, the commentators state that where taxpayers have reasonably relied on an alternative interpretation of the existing regulations, the immediate application of the temporary regulations cause an unexpected change in the classification of those taxpayers' dually chartered entities, often with adverse tax consequences. Moreover, the commentators point out that the tax costs of converting a dually chartered entity from this unexpected classification to the taxpayer's desired classification could be significant and could, in some instances, effectively prevent the taxpayer from undertaking the conversion. For these reasons, all the commentators object to the effective date provisions of the temporary regulations and they request that the final regulations provide either a transition period before the rules take effect, or a rule that exempts dually chartered entities that were in existence on August 12, 2004, from the application of the rules.

Neither the temporary regulations nor these final regulations are retroactive. The earliest date that any entity is subject to these regulations is August 12, 2004. For periods prior to the date these final regulations apply (*i.e.*, prior to August 12, 2004), the classification of dually chartered entities is governed by the pre-existing regulations. Further, based upon the comments discussed above, but without any inference intended as to the proper interpretation of the pre-existing regulations, the IRS and Treasury conclude that, while the final regulations generally are effective as of August 12, 2004, a transition rule is appropriate. The transition rule provides that for dually chartered entities existing on August 12, 2004, the provisions of this final regulation apply as of May 1, 2006. The IRS and Treasury recognize that taxpayers eligible for the transition rule may have completed transactions after August 12, 2004, relying upon the temporary regulations and therefore these taxpayers may rely upon the final regulations as of August 12, 2004.

B. *Effect on Dually Chartered Entities Not Organized Anywhere as Per Se Corporations*

Several commentators state that it is unclear whether §301.7701–2T(b)(9) applies in the case of a dually chartered entity not created or organized in any jurisdiction in a manner that would cause it to be treated as a *per se* corporation. A *per se* corporation is an entity described in §301.7701–2(b)(1), (3), (4), (5), (6), (7), or (8), and thus is not an eligible entity as defined in §301.7701–3(a). A *per se* corporation is, therefore, ineligible to elect its classification.

Even though a dually chartered entity is not created or organized anywhere in a manner that would cause it to be classified as a *per se* corporation, it is still necessary to classify the entity. For example, a dually chartered entity may be organized in one jurisdiction in manner that would result in a default classification as a corporation and in another jurisdiction in a manner that would result in a default classification as a partnership. Absent an election, a rule is necessary to resolve the conflicting default classifications. Therefore, the regulation and examples have been modified to clarify that the rules apply even in circumstances in which the entity is not organized anywhere in a manner that would make it a *per se* corporation.

Several commentators state that even if a dually chartered entity is not created or organized in any jurisdiction as a *per se* corporation, §301.7701–2T(b)(9) could be interpreted as making the entity a *per se* corporation in some circumstances and

thus prohibiting the entity from electing its classification. According to these commentators, this occurs because the literal language of the regulation only considers an entity's default classification at the time of its formation and ignores any entity classification election under §301.7701–3 that would otherwise apply to the entity at the time the entity classification determination is made. The regulations are not intended to operate in that manner. Therefore, a sentence is added to §301.7701–2(b)(9) of the final regulations to clarify that a dually chartered entity that is an eligible entity in each jurisdiction in which it is created or organized will continue to be considered an eligible entity under §301.7701–3(a). In addition, the examples were modified to illustrate this provision.

The proposed regulations under section 7701 are adopted as modified by this Treasury decision and the preceding temporary regulations are removed.

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, and because these regulations do not impose a collection of information on small entities, the provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the temporary and proposed regulations that preceded these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comments on its impact on small business.

Drafting Information

The principal author of these regulations is Thomas Beem of the Office of Associate Chief Counsel (International). However, other personnel from IRS and Treasury participated in their development.

* * * * *

Amendments to the Regulations

Accordingly, 26 CFR part 301 is amended as follows:

PART 301 — PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read, in part, as follows:

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

Par. 2. In §301.7701–1, paragraph (d) is revised to read as follows:

§301.7701–1 Classification of organizations for federal tax purposes.

* * * * *

(d) *Domestic and foreign business entities*. See §301.7701–5 for the rules that determine whether a business entity is domestic or foreign.

* * * * *

§301.7701–1T [Removed]

Par. 3. Section 301.7701–1T is removed.

Par. 4. In §301.7701–2, paragraphs (b)(9) and (e)(3) are revised to read as follows:

§301.7701–2 Business entities; definitions.

* * * * *

(b)(9) *Business entities with multiple charters*. (i) An entity created or organized under the laws of more than one jurisdiction if the rules of this section would treat it as a corporation with reference to any one of the jurisdictions in which it is created or organized. Such an entity may elect its classification under §301.7701–3, subject to the limitations of those provisions, only if it is created or organized in each jurisdiction in a manner that meets the definition of an eligible entity in §301.7701–3(a). The determination of a business entity's corporate or non-corporate classification is made independently from the determination of whether the entity is domestic or foreign. See §301.7701–5 for the rules that determine whether a business entity is domestic or foreign.

(ii) *Examples*. The following examples illustrate the rule of this paragraph (b)(9):

Example 1. (i) *Facts*. X is an entity with a single owner organized under the laws of Country A as an entity that is listed in paragraph (b)(8)(i) of this section. Under the rules of this section, such an entity is a corporation for Federal tax purposes and under §301.7701–3(a) is unable to elect its classification. Several years after its formation, X files a certificate of domestication in State B as a limited liability company (LLC). Under the laws of State B, X is considered to be created or organized in State B as an LLC upon the filing of the certificate of domestication and is therefore subject to the laws of State B. Under the rules of this section and §301.7701–3, an LLC with a single owner organized only in State B is disregarded as an entity separate from its owner for Federal tax purposes (absent an election to be treated as an association). Neither Country A nor State B law requires X to terminate its charter in Country A as a result of the domestication, and in fact X does not terminate its Country A charter. Consequently, X is now organized in more than one jurisdiction.

(ii) *Result*. X remains organized under the laws of Country A as an entity that is listed in paragraph (b)(8)(i) of this section, and as such, it is an entity that is treated as a corporation under the rules of this section. Therefore, X is a corporation for Federal tax purposes because the rules of this section would treat X as a corporation with reference to one of the jurisdictions in which it is created or organized. Because X is organized in Country A in a manner that does not meet the definition of an eligible entity in §301.7701–3(a), it is unable to elect its classification.

Example 2. (i) *Facts*. Y is an entity that is incorporated under the laws of State A and has two shareholders. Under the rules of this section, an entity incorporated under the laws of State A is a corporation for Federal tax purposes and under §301.7701–3(a) is unable to elect its classification. Several years after its formation, Y files a certificate of continuance in Country B as an unlimited company. Under the laws of Country B, upon filing a certificate of continuance, Y is treated as organized in Country B. Under the rules of this section and §301.7701–3, an unlimited company organized only in Country B that has more than one owner is treated as a partnership for Federal tax purposes (absent an election to be treated as an association). Neither State A nor Country B law requires Y to terminate its charter in State A as a result of the continuance, and in fact Y does not terminate its State A charter. Consequently, Y is now organized in more than one jurisdiction.

(ii) *Result*. Y remains organized in State A as a corporation, an entity that is treated as a corporation under the rules of this section. Therefore, Y is a corporation for Federal tax purposes because the rules of this section would treat Y as a corporation with reference to one of the jurisdictions in which it is created or organized. Because Y is organized in State A in a manner that does not meet the definition of an eligible entity in §301.7701–3(a), it is unable to elect its classification.

Example 3. (i) *Facts*. Z is an entity that has more than one owner and that is recognized under the laws of Country A as an unlimited company organized in Country A. Z is organized in Country A in a manner that meets the definition of an eligible entity in §301.7701–3(a). Under the rules of this section and §301.7701–3, an unlimited company organized only in Country A with more than one owner is treated as a partnership for Federal tax purposes (absent an election to be treated as an association). At the time Z

was formed, it was also organized as a private limited company under the laws of Country B. Z is organized in Country B in a manner that meets the definition of an eligible entity in §301.7701–3(a). Under the rules of this section and §301.7701–3, a private limited company organized only in Country B is treated as a corporation for Federal tax purposes (absent an election to be treated as a partnership). Thus, Z is organized in more than one jurisdiction. Z has not made any entity classification elections under §301.7701–3.

(ii) *Result*. Z is organized in Country B as a private limited company, an entity that is treated (absent an election to the contrary) as a corporation under the rules of this section. However, because Z is organized in each jurisdiction in a manner that meets the definition of an eligible entity in §301.7701–3(a), it may elect its classification under §301.7701–3, subject to the limitations of those provisions.

Example 4. (i) *Facts*. P is an entity with more than one owner organized in Country A as a general partnership. Under the rules of this section and §301.7701–3, an eligible entity with more than one owner in Country A is treated as a partnership for federal tax purposes (absent an election to be treated as an association). P files a certificate of continuance in Country B as an unlimited company. Under the rules of this section and §301.7701–3, an unlimited company in Country B with more than one owner is treated as a partnership for federal tax purposes (absent an election to be treated as an association). P is not required under either the laws of Country A or Country B to terminate the general partnership in Country A, and in fact P does not terminate its Country A partnership. P is now organized in more than one jurisdiction. P has not made any entity classification elections under §301.7701–3.

(ii) *Result*. P's organization in both Country A and Country B would result in P being classified as a partnership. Therefore, since the rules of this section would not treat P as a corporation with reference to any jurisdiction in which it is created or organized, it is not a corporation for federal tax purposes.

* * * * *

(e) * * *

(3)(i) *General rule*. Except as provided in paragraph (e)(3)(ii) of this section, the rules of paragraph (b)(9) of this section apply as of August 12, 2004, to all business entities existing on or after that date.

(ii) *Transition rule*. For business entities created or organized under the laws of more than one jurisdiction as of August 12, 2004, the rules of paragraph (b)(9) of this section apply as of May 1, 2006. These entities, however, may rely on the rules of paragraph (b)(9) of this section as of August 12, 2004.

* * * * *

§301.7701–2T [Removed]

Par. 5. Section 301.7701–2T is removed.

Par. 6. Section 301.7701–5 is revised to read as follows:

§301.7701–5 Domestic and foreign business entities.

(a) *Domestic and foreign business entities*. A business entity (including an entity that is disregarded as separate from its owner under §301.7701–2(c)) is domestic if it is created or organized as any type of entity (including, but not limited to, a corporation, unincorporated association, general partnership, limited partnership, and limited liability company) in the United States, or under the law of the United States or of any State. Accordingly, a business entity that is created or organized both in the United States and in a foreign jurisdiction is a domestic entity. A business entity (including an entity that is disregarded as separate from its owner under §301.7701–2(c)) is foreign if it is not domestic. The determination of whether an entity is domestic or foreign is made independently from the determination of its corporate or non-corporate classification. See §§301.7701–2 and 301.7701–3 for the rules governing the classification of entities.

(b) *Examples*. The following examples illustrate the rules of this section:

Example 1. (i) *Facts*. Y is an entity that is created or organized under the laws of Country A as a public limited company. It is also an entity that is organized as a limited liability company (LLC) under the laws of State B. Y is classified as a corporation for Federal tax purposes under the rules of §§301.7701–2, and 301.7701–3.

(ii) *Result*. Y is a domestic corporation because it is an entity that is classified as a corporation and it is organized as an entity under the laws of State B.

Example 2. (i) *Facts*. P is an entity with more than one owner organized under the laws of Country A as an unlimited company. It is also an entity that is organized as a general partnership under the laws of State B. P is classified as a partnership for Federal tax purposes under the rules of §§301.7701–2, and 301.7701–3.

(ii) *Result*. P is a domestic partnership because it is an entity that is classified as a partnership and it is organized as an entity under the laws of State B.

(c) *Effective date*.—(1) *General rule*. Except as provided in paragraph (c)(2) of this section, the rules of this section apply as of August 12, 2004, to all business entities existing on or after that date.

(2) *Transition rule*. For business entities created or organized under the laws of more than one jurisdiction as of August 12, 2004, the rules of this section apply as of May 1, 2006. These entities, however, may rely on the rules of this section as of August 12, 2004.

§301.7701–5T [Removed]

Par. 7. Section 301.7701–5T is removed.

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Approved January 17, 2006.

Eric Solomon,
Acting Deputy Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on January 27, 2006, 8:45 a.m., and published in the issue of the Federal Register for January 30, 2006, 71 F.R. 4815)

Part III. Administrative, Procedural, and Miscellaneous

Tax Avoidance Using Notional Principal Contracts

Notice 2006–16

SECTION 1. PURPOSE

This notice clarifies Notice 2002–35, 2002–1 C.B. 992, by illustrating certain transactions that are not the same as or substantially similar to the transaction described in Notice 2002–35, and thus are not "listed transactions" for purposes of §§ 6111 and 6112 of the Internal Revenue Code (Code) and § 1.6011–4(b)(2) of the Income Tax Regulations. This notice also modifies Notice 2002–35 by providing a safe harbor from the disclosure requirement otherwise imposed by § 1.6011–4 for taxpayers that have, solely as a result of their direct or indirect interest in a pass-through entity, participated in a transaction that is the same as or substantially similar to the transaction described in Notice 2002–35 (as clarified by section 3.01 of this notice).

This notice responds to concerns expressed by commentators that the difficulty in identifying transactions that are the same as or substantially similar to the transaction described in Notice 2002–35 has caused taxpayers to file large numbers of disclosure statements on Form 8886, *Reportable Transaction Disclosure Statement*, for common transactions, such as total return swaps, that are entered into for *bona fide* non-tax purposes. This notice is intended to narrow the scope of reportable transactions that might be perceived to be substantially similar to the transaction described in Notice 2002–35, and is intended to reduce the number of Form 8886 filings. This notice should not be construed as expanding the scope or potential application of Notice 2002–35 in any way. Specifically, no inference is intended regarding whether transactions not described in Section 3.01 are or are not required to be reported under Notice 2002–35.

SECTION 2. BACKGROUND

Notice 2002–35 identifies as a listed transaction under § 1.6011–4(b)(2) a transaction that uses a notional principal contract (NPC) to claim current deductions for periodic payments made by a taxpayer while disregarding the accrual of a right to receive offsetting payments in the future. The specific facts of the listed transaction are set forth in Notice 2002–35.

On February 26, 2004, the Treasury Department and the IRS published in the Federal Register (REG–166012–02, 2004–1 C.B. 655 [69 FR 8886]) proposed regulations (hereinafter the "Contingent NPC Proposed Regulations") under § 446(b) of the Code. Section 1.446–3(g)(6) of the Contingent NPC Proposed Regulations describes an accounting method for contingent nonperiodic payments under an NPC. That method requires that contingent nonperiodic payments be spread over the term of the NPC. Section 1.446–3(i) of the Contingent NPC Proposed Regulations also provides an elective mark-to-market regime for certain NPCs with nonperiodic payments.

The preamble to the Contingent NPC Proposed Regulations states; "With respect to NPCs that provide for contingent nonperiodic payments and that are in effect or entered into on or after 30 days after [February 26, 2004], if a taxpayer has not adopted a method of accounting for these NPCs, the taxpayer must adopt a method that takes contingent nonperiodic payments into account over the life of the contract under a reasonable amortization method, which may be, but need not be, a method that satisfies the specific rules in these proposed regulations."

Section 1.6011–4(c)(3)(i)(A) of the Income Tax Regulations provides that a taxpayer has participated in a listed transaction if the taxpayer's tax return reflects tax consequences or a tax strategy described in published guidance that lists the transaction under § 1.6011–4(b)(2). Section 1.6011–4(c)(3)(i)(A) also provides that a taxpayer has participated in a listed transaction if the taxpayer knows or has reason to know that the taxpayer's tax benefits are derived directly or indirectly from tax consequences or a tax strategy that is a listed transaction.

SECTION 3. DISCUSSION

.01 Transactions Excluded from the Scope of Notice 2002–35

An NPC that requires a counterparty to make a contingent nonperiodic payment, whether or not the nonperiodic payment consists of contingent and noncontingent components, is not a "listed transaction" for purposes of §§ 6111 and 6112, or for purposes of § 1.6011–4(b)(2), by reason of being the same as or substantially similar to the transaction described in Notice 2002–35 if:

a. The taxpayer uses a method of accounting for the NPC that takes the contingent nonperiodic payment into account over the life of the contract under a reasonable amortization method;
b. The taxpayer properly accounts for the NPC under § 475 of the Code;
c. The taxpayer properly accounts for the NPC under § 1.446–4;
d. The taxpayer properly accounts for the NPC as a § 1.988–5(a) hedge in connection with a qualified hedging transaction; or
e. The taxpayer properly accounts for the NPC under §1.988–2(e) (including the application of § 1.446–3(g)(4) as appropriate).

.02 Disclosure Requirement Safe Harbor

1. A taxpayer that, solely by reason of that taxpayer's direct or indirect interest in a pass-through entity, participated (within the meaning of § 1.6011–4(c)(3)(i)(A)) in a transaction that is the same as or substantially similar to the transaction described in Notice 2002–35 (as clarified by section 3.01 this notice) is not required under § 1.6011–4 to file a disclosure statement with respect to that transaction if the taxpayer meets the requirements of section 3.02(2) of this notice.
2. This section 3.02 will apply if a taxpayer receives acknowledgement that the pass-through entity has or will comply with its separate disclosure obligation under § 1.6011–4 with respect to a transaction described

in Notice 2002–35 (as clarified by section 3.01 of this notice), and if the taxpayer's only obligation under § 1.6011–4 to file a disclosure statement with respect to that transaction arises from the taxpayer's direct or indirect interest in that pass-through entity. The acknowledgment can be a copy of the Form 8886 filed (or to be filed) by the pass-through entity, and must be received by the taxpayer prior to the time set forth in § 1.6011–4(e) in which the taxpayer would otherwise be required to provide disclosure.

Taxpayers meeting the requirements of section 3.02 of this notice will not be treated as having participated in an undisclosed listed transaction for purposes of § 1.6664–2(c)(3)(ii).

.03 Continuing Disclosure Obligations

Transactions described in sections 3.01 or 3.02 of this notice may be described in § 1.6011–4(b)(3) through (b)(5) or (b)(7) and, notwithstanding this notice, may be subject to disclosure by taxpayers under § 1.6011–4(a), and subject to disclosure and list maintenance requirements by material advisors under §§ 6111 and 6112. For example, an NPC that results in a large loss for a taxpayer under § 165 may be subject to disclosure by the taxpayer under § 1.6011–4(b)(5), notwithstanding that under this notice it is not subject to disclosure under § 1.6011–4(b)(2).

SECTION 4. EFFECTIVE DATE

Section 3.01 of this notice is effective as of May 6, 2002. Section 3.02 of this notice is effective for disclosure statements that would otherwise be due on or after February 13, 2006.

SECTION 5. EFFECT ON OTHER DOCUMENTS

Notice 2002–35 is clarified and modified.

SECTION 6. CONTACT INFORMATION

For further information regarding this notice, contact Dale S. Collinson at (202) 622–3900 (not a toll-free number).

Weighted Average Interest Rate Update

Notice 2006–19

Sections 412(b)(5)(B) and 412(l)(7)(C)(i) of the Internal Revenue Code generally provide that the interest rates used to calculate current liability for purposes of determining the full funding limitation under § 412(c)(7) and the required contribution under § 412(l) must be within a permissible range around the weighted average of the rates of interest on 30-year Treasury securities during the four-year period ending on the last day before the beginning of the plan year.

Notice 88–73, 1988–2 C.B. 383, provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Code.

Section 417(e)(3)(A)(ii)(II) defines the applicable interest rate, which must be used for purposes of determining the minimum present value of a participant's benefit under § 417(e)(1) and (2), as the annual rate of interest on 30-year Treasury securities for the month before the date of distribution or such other time as the Secretary may by regulations prescribe. Section 1.417(e)–1(d)(3) of the Income Tax Regulations provides that the applicable interest rate for a month is the annual interest rate on 30-year Treasury securities as specified by the Commissioner for that month in revenue rulings, notices or other guidance published in the Internal Revenue Bulletin.

The rate of interest on 30-year Treasury securities for January 2006 is 4.59 percent. Pursuant to Notice 2002–26, 2002–1 C.B. 743, the Service has determined this rate as the monthly average of the daily determination of yield on the 30-year Treasury bond maturing in February 2031.

The following 30-year Treasury rates were determined for the plan years beginning in the month shown below.

For Plan Years Beginning in: Month	Year	30-Year Treasury Weighted Average	90% to 105% Permissible Range	90% to 110% Permissible Range
February	2006	4.84	4.35 to 5.08	4.35 to 5.32

Drafting Information

The principal authors of this notice are Paul Stern and Tony Montanaro of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, please contact the Employee Plans' taxpayer assistance telephone service at 1–877–829–5500 (a toll-free number), between the hours of 8:30 a.m. and 4:30 p.m. Eastern time, Monday through Friday. Mr. Stern may be reached at 1–202–283–9703. Mr. Montanaro may be reached at 1–202–283–9714. The telephone numbers in the preceding sentences are not toll-free.

26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.
(Also Part I, §§ 168, 179, 446, 1400F, 1400I, 1400J; 1.179–5, 1.446–1.)

Rev. Proc. 2006–16

SECTION 1. PURPOSE

This revenue procedure explains how a commercial revitalization agency may retroactively allocate commercial revitalization expenditure amounts for certain buildings located in the expanded area of a renewal community pursuant to § 1400E(g) of the Internal Revenue Code. This revenue procedure also explains how a taxpayer may make a commercial

revitalization deduction election under § 1400I(a) for these buildings and may deduct the increased § 179 expensing amount under § 1400J for certain § 179 property that is placed in service in the expanded area of a renewal community pursuant to § 1400E(g).

SECTION 2. BACKGROUND

.01 Section 1400E, as added by § 101(a) of the Community Renewal Tax Relief Act of 2000 ("CRTRA"), 2000–3 C.B. 239, 241, provides for the designation of certain communities as renewal communities. An area designated as a renewal community is eligible for certain tax incentives including a commercial revitalization deduction under § 1400I, increased expensing under § 179 pursuant to § 1400J, and gross income exclusion for capital gain from the sale of qualifying assets pursuant to § 1400F. A "renewal community" is defined in § 1400E(a)(1) as any area that is nominated by one or more local governments and the state or states in which the area is located for designation as a renewal community (the "nominated area") and that the Secretary of Housing and Urban Development ("HUD") designates as a renewal community.

.02 To be designated as a renewal community, § 1400E(c) requires that the nominated area meet certain criteria. Section 1400E(a)(4)(B) and (f)(4) provides that the designations of renewal communities were required to be made by December 31, 2001, using 1990 census data to determine the population and poverty rate criteria.

.03 Section 222(a) of the American Jobs Creation Act of 2004 (the "AJCA"), Pub. L. No. 108–357, 118 Stat. 1480 (October 22, 2004), amended § 1400E by adding § 1400E(g), which authorizes HUD, under certain circumstances and at the request of all governments that nominated an area as a renewal community, to add a contiguous census tract to a renewal community based generally on 2000 census data. Section 222(b) of the AJCA provides that § 1400E(g) is effective as if included in the amendments made by § 101 of the CRTRA.

.04 A taxpayer may make a commercial revitalization deduction election under § 1400I(a) for a qualified revitalization building (as defined in § 1400I(b)(1)) only to the extent that a commercial revitalization expenditure amount is allocated to the building under § 1400I by the commercial revitalization agency (as defined in § 1400I(d)(3)) for the state in which the building is located. Section 1400I allows a taxpayer to elect to recover the cost of a qualified revitalization building using a more accelerated method than is otherwise allowable under § 168. Pursuant to § 1400I(a), a taxpayer may elect either (1) to deduct one-half of any qualified revitalization expenditures (as defined in § 1400I(b)(2)) chargeable to a capital account with respect to any qualified revitalization building for the taxable year in which the building is placed in service, or (2) to amortize all of these expenditures ratably over the 120-month period beginning with the month in which the building is placed in service. Pursuant to § 1400I(c), the aggregate amount that may be treated as qualified revitalization expenditures with respect to any qualified revitalization building cannot exceed the lesser of (1) $10 million, or (2) the commercial revitalization expenditure amount allocated to the building under § 1400I by the commercial revitalization agency for the state in which the building is located.

.05 Under § 1400I(d), the commercial revitalization agency for each state is permitted to allocate up to $12 million of commercial revitalization expenditure amounts with respect to each renewal community located within the state for each calendar year after 2001 and before 2010. Pursuant to § 1400I(e), the allocation must be made pursuant to a qualified allocation plan (as defined in § 1400I(e)(2)) that is approved by the governmental unit of which the commercial revitalization agency is a part.

.06 Rev. Proc. 2003–38, 2003–1 C.B. 1017, provides the time and manner for a commercial revitalization agency to make allocations under § 1400I of the commercial revitalization expenditure amount for a qualified revitalization building that is placed in service in a renewal community and explains how a taxpayer may make a commercial revitalization deduction election under § 1400I(a). Pursuant to Rev. Proc. 2003–38, a commercial revitalization agency may make: (1) an allocation of commercial revitalization expenditure amounts for a qualified revitalization building in the calendar year in which that building is placed in service by the taxpayer (a "placed-in-service year allocation"; *see* section 4 of Rev. Proc. 2003–38); or (2) an allocation of commercial revitalization expenditure amounts for a qualified revitalization building that is not yet placed in service, but will be placed in service by a taxpayer not later than the close of the second calendar year following the calendar year in which the allocation is made, provided the taxpayer's basis in the project of which the building is a part (as of the later of the date that is 6 months after the date that the allocation is made or the close of the calendar year in which the allocation is made) is more than 10 percent of the taxpayer's reasonably expected basis in the project as of the close of the second calendar year following the calendar year in which the allocation is made (a "carryover allocation"; *see* section 6 of Rev. Proc. 2003–38).

.07 Section 179 provides that, in lieu of depreciation, a taxpayer may elect to deduct the cost of § 179 property (as defined in §179(d)(1)), up to a certain amount, placed in service by the taxpayer for the taxable year. The total cost of § 179 property that a taxpayer may elect to deduct under § 179 (the "dollar limit") is $24,000 for 2002, $100,000 for 2003, $102,000 for 2004, and $105,000 for 2005. However, the dollar limit is reduced (but not below zero) by the amount by which the cost of § 179 property placed in service by the taxpayer during the taxable year exceeded $200,000 for 2002, $400,000 for 2003, $410,000 for 2004, and $420,000 for 2005 (the "reduced dollar limit"). The election under § 179 is made within the time and in the manner provided in § 1.179–5 of the Income Tax Regulations.

.08 If § 179 property is also qualified renewal property, § 1400J(a) and § 1397A(a) modify the dollar limit and the reduced dollar limit for purposes of § 179. The dollar limit under § 179 is increased by the lesser of $35,000, or the cost of § 179 property that is qualified renewal property placed in service during the taxable year. Consequently, if a taxpayer placed in service in 2002, 2003, 2004, and 2005, § 179 property that is also qualified renewal property at a cost of $35,000, the dollar limit under § 179 is $59,000 for 2002, $135,000 for 2003, $137,000 for 2004, and $140,000 for 2005. Further, in determining the reduced dollar limit, a tax-

payer takes into account only 50 percent (instead of 100 percent) of the cost of qualified renewal property placed in service during the taxable year.

"Qualified renewal property" is defined in § 1400J(b) as any property to which § 168 applies (or would apply but for § 179) if the property was acquired by the taxpayer by purchase (as defined in § 179(d)(2)) after December 31, 2001, and before January 1, 2010, and the property would be qualified zone property (as defined in § 1397D) if references to renewal communities were substituted for references to empowerment zones in § 1397D. Accordingly, computer software described in § 179(d)(1)(A)(ii) to which § 167 applies (and not § 168) is not qualified renewal property.

.09 Section 1400F provides that gross income does not include any qualified capital gain (as defined in § 1400F(c)) from the sale or exchange of a qualified community asset (as defined in § 1400F(b)) held for more than 5 years.

SECTION 3. RETROACTIVE ALLOCATION OF COMMERCIAL REVITALIZATION EXPENDITURE AMOUNTS FOR A QUALIFIED REVITALIZATION BUILDING IN THE EXPANDED AREA

.01 *In general*. If HUD approves the expansion of the area of a renewal community pursuant to § 1400E(g) (the "expanded area" of a renewal community), the commercial revitalization agency for that renewal community may make a retroactive allocation described in section 3.04 of this revenue procedure of the "unallocated commercial revitalization expenditure amount" (as determined in section 3.02 of this revenue procedure) for the renewal community for 2002, 2003, 2004, or 2005, as applicable, for a qualified revitalization building in the expanded area of the renewal community. The general rules for making this retroactive allocation are provided in section 3.03 of this revenue procedure.

.02 *Unallocated commercial revitalization expenditure amount*.

(1) *In general*. For purposes of § 1400I(d)(1) and this revenue procedure, the aggregate amount that a commercial revitalization agency may allocate for 2002, 2003, 2004, or 2005, for any qualified revitalization building in the expanded area of a renewal community is the unallocated commercial revitalization expenditure amount for the renewal community for 2002, 2003, 2004, or 2005, as applicable.

(2) *Determination of amount*. The unallocated commercial revitalization expenditure amounts for 2002, 2003, 2004, and 2005, are determined as follows:

(a) *2002 calendar year*. Pursuant to section 8.01 of Rev. Proc. 2003–38, the $12 million commercial revitalization expenditure ceiling for 2003 for a renewal community is increased by any portion of the 2002 commercial revitalization expenditure ceiling for that renewal community that was not allocated in 2002 (after taking into account any aggregation and apportionment of the 2002 commercial revitalization expenditure ceiling made in accordance with section 8.02 of Rev. Proc. 2003–38). Accordingly, the unallocated commercial revitalization expenditure amount for any renewal community for 2002 is zero. But see section 3.04(1) of this revenue procedure for a retroactive commercial revitalization expenditure allocation allowable for certain qualified revitalization buildings placed in service in 2002.

(b) *2003 calendar year*. The unallocated commercial revitalization expenditure amount of a renewal community for 2003 is determined by reducing the renewal community's commercial revitalization expenditure ceiling for 2003 by the amounts previously allocated for 2003. For 2003, the commercial revitalization expenditure ceiling for a renewal community is $12 million plus the amount of the 2002 commercial revitalization expenditure ceiling for that renewal community that was not allocated in 2002 (after taking into account any aggregation and apportionment of the 2002 commercial revitalization expenditure ceiling made in accordance with section 8.02 of Rev. Proc. 2003–38).

For example, if State A has only one renewal community, RC, and only $7 million of the $12 million commercial revitalization expenditure ceiling for 2002 for RC was allocated for qualified revitalization buildings in RC in 2002, the commercial revitalization ceiling for 2003 for RC in State A is $17 million pursuant to section 8.01 of Rev. Proc. 2003–38. If $14 million of this $17 million was allocated for qualified revitalization buildings in RC in 2003, the unallocated commercial revitalization expenditure amount for 2003 for RC is $3 million.

(c) *2004 calendar year*. The unallocated commercial revitalization expenditure amount of a renewal community for 2004 is determined by reducing the $12 million commercial revitalization expenditure ceiling for the renewal community for 2004 by the amounts previously allocated for 2004.

(d) *2005 calendar year*. The unallocated commercial revitalization expenditure amount of a renewal community for 2005 is determined by reducing the $12 million commercial revitalization expenditure ceiling for the renewal community for 2005 by the amounts previously allocated for 2005.

(3) *Failed building amount*. For purposes of section 3.02(2) of this revenue procedure, the amounts previously allocated for 2002, 2003, 2004, or 2005, include any "failed building amount." A failed building amount is the amount of any allocation made in 2002, 2003, 2004, or 2005, as applicable, to a building or project that does not qualify as a qualified revitalization building within the period required by § 1400I and Rev. Proc. 2003–38. However, the failed building amount does not include the amount of a carryover allocation made before July 1 for which the taxpayer does not meet the 10-percent basis requirement by the close of the calendar year if the taxpayer notifies the renewal community or the commercial revitalization agency in that calendar year that the 10-percent basis requirement was not met. In the case of a placed-in-service year allocation, the failed building amount also does not include any amount that was allocated for a building if the taxpayer notifies, in the same calendar year in which the allocation was made, the renewal community or the commercial revitalization agency for that renewal community that the building was not placed in service by the taxpayer by the close of the calendar year for which the allocation was made.

For example, suppose State B has one renewal community, RC1. In 2004, RC1 allocated its entire $12 million commercial revitalization expenditure ceiling as follows: (a) on June 1, 2004, RC1 made a carryover allocation of $4 million for a

qualified revitalization building, QRB1, in RC1, but the taxpayer failed to meet the 10-percent basis requirement by December 31, 2004, and notified RC1 in 2004 that the 10-percent basis requirement was not met; (b) on September 15, 2004, RC1 made a placed-in-service year allocation of $3 million for another qualified revitalization building, QRB2, in RC1, but the taxpayer notified RC1 on February 1, 2005, that QRB2 was not placed in service by December 31, 2004; and (c) on December 16, 2004, RC1 made a carryover allocation of $5 million for a third qualified revitalization building, QRB3, in RC1, but the taxpayer failed to meet the 10-percent basis requirement by June 16, 2005. The June 1, 2004, carryover allocation is not a failed building amount and is treated as not having been made for 2004 and, therefore, is included in the unallocated commercial revitalization expenditure amount for 2004 for RC1 (provided the $4 million was not re-allocated in 2004). The September 15, 2004, placed-in-service year allocation is a failed building amount and is treated as having been made for 2004 and, therefore, is not included in the unallocated commercial revitalization expenditure amount for 2004 for RC1. The December 16, 2004, carryover allocation is a failed building amount and is treated as having been made for 2004 and, accordingly, is not included in the unallocated commercial revitalization expenditure amounts for 2004 for RC1. Therefore, pursuant to sections 3.02(2)(c) and 3.02(3) of this revenue procedure, the unallocated commercial revitalization expenditure amount for 2004 for RC1 is $4 million.

.03 *General rules for making a retroactive allocation of the unallocated commercial revitalization expenditure amount*.

(1) *Retroactive allocation must be made for each building*. A separate retroactive allocation of the unallocated commercial revitalization expenditure amount (a "retroactive commercial revitalization expenditure allocation") must be made for each qualified revitalization building, whether new or substantially rehabilitated, placed in service in the expanded area of a renewal community. A retroactive commercial revitalization expenditure allocation is not permitted for a qualified revitalization building that is located outside the expanded area of a renewal community.

(2) *Aggregation and carryforward of the unallocated commercial revitalization expenditure amount are not permitted*. The unallocated commercial revitalization expenditure amount for any renewal community within a state for any given calendar year may not be allocated, in whole or in part, to another renewal community. If a commercial revitalization agency does not allocate all of the unallocated commercial revitalization expenditure amount for a renewal community for any given calendar year, the unused amounts may not be carried forward to a later year.

(3) *Qualified allocation plan must be in effect*. A retroactive commercial revitalization expenditure allocation for a qualified revitalization building in the expanded area of a renewal community can only be made if a qualified allocation plan (as defined in § 1400I(e)(2)) is in effect for the placed-in-service year of the building.

.04 *Types of retroactive commercial revitalization expenditure allocations allowed*.

(1) *Unallocated commercial revitalization expenditure amount for 2003*. Up to the unallocated commercial revitalization expenditure amount for 2003 for a renewal community, a commercial revitalization agency may make the following types of a retroactive commercial revitalization expenditure allocation to a taxpayer:

(a) A retroactive placed-in-service year allocation for a qualified revitalization building that was placed in service by the taxpayer in the expanded area of the renewal community in 2002 or 2003; or

(b) A retroactive carryover allocation for a qualified revitalization building that was placed in service by the taxpayer in the expanded area of the renewal community on or before December 31, 2005, provided the taxpayer's basis in the project of which the building is a part, as of June 30, 2004, is more than 10 percent of the taxpayer's reasonably expected basis in the project as of December 31, 2005.

(2) *Unallocated commercial revitalization expenditure amount for 2004*. Up to the unallocated commercial revitalization expenditure amount for 2004 for a renewal community, a commercial revitalization agency may make the following types of a retroactive commercial revitalization expenditure allocation to a taxpayer:

(a) A retroactive placed-in-service year allocation for a qualified revitalization building that was placed in service by the taxpayer in the expanded area of the renewal community in 2004; or

(b) A retroactive carryover allocation for a qualified revitalization building that will be placed in service by the taxpayer in the expanded area of the renewal community on or before December 31, 2006, provided the taxpayer's basis in the project of which the building is a part, as of June 30, 2005, is more than 10 percent of the taxpayer's reasonably expected basis in the project as of December 31, 2006.

(3) *Unallocated commercial revitalization expenditure amount for 2005*. Up to the unallocated commercial revitalization expenditure amount for 2005 for a renewal community, a commercial revitalization agency may make the following types of a retroactive commercial revitalization expenditure allocation to a taxpayer:

(a) A retroactive placed-in-service year allocation for a qualified revitalization building that was placed in service by the taxpayer in the expanded area of the renewal community in 2005; or

(b) A retroactive carryover allocation for a qualified revitalization building that will be placed in service by the taxpayer in the expanded area of the renewal community on or before December 31, 2007, provided the taxpayer's basis in the project of which the building is a part, as of June 30, 2006, is more than 10 percent of the taxpayer's reasonably expected basis in the project as of December 31, 2007.

(4) *Time and manner of making a retroactive commercial revitalization expenditure allocation*. A retroactive commercial revitalization expenditure allocation described in section 3.04(1), (2), or (3) of this revenue procedure:

(a) must be made by the later of the date that is (i) 9 months after the date that HUD approves the expanded area of the renewal community in which the qualified revitalization building is located, or (ii) November 27, 2006; and

(b) is made when an allocation document is completed, signed, and dated by an authorized official of the commercial revitalization agency. For a retroactive placed-in-service year allocation, this allocation document must contain the information described in section 4.02(2) of

Rev. Proc. 2003–38, the placed-in-service year of the qualified revitalization building, and the year of the unallocated commercial revitalization expenditure amount from which the allocation is made (that is, 2003, 2004, or 2005). For a retroactive carryover allocation, the allocation document must contain the information described in section 6.02(2) of Rev. Proc. 2003–38 and the year of the unallocated commercial revitalization expenditure amount from which the allocation is made (that is, 2003, 2004, or 2005). The agency must send a copy of the allocation document to the taxpayer receiving the retroactive commercial revitalization expenditure allocation no later than 60 calendar days following the date on which the allocation document is completed, signed, and dated by an authorized official of the commercial revitalization agency. Neither the original nor a copy of the allocation document is to be sent to the Internal Revenue Service.

.05 *HUD approval of expanded area after 2005*. If HUD approves an expanded area of a renewal community after 2005 pursuant to § 1400E(g), the commercial revitalization agency for that renewal community may be unable (due to time constraints), in the same calendar year in which HUD approval was made (the "HUD approval year"), to make a commercial revitalization expenditure allocation under section 4 or 6 of Rev. Proc. 2003–38 to a qualified revitalization building placed in service in the expanded area of that renewal community in the HUD approval year. In this case, the commercial revitalization agency may make a retroactive allocation of the unallocated commercial revitalization expenditure amount for that renewal community for the same year in which HUD approved the expanded area by following the rules in sections 3.02(2)(d), 3.02(3), 3.03, 3.04(3), and 3.04(4) of this revenue procedure, except that: (1) the year "2005" in sections 3.02(2)(d) and 3.04(3) is replaced with the HUD approval year, (2) the years "2002, 2003, 2004, or 2005" in section 3.02(3) are replaced with the HUD approval year, (3) the date "December 31, 2007" in section 3.04(3)(b) is replaced with December 31st of the second calendar year following the HUD approval year, and (4) the date "June 30, 2006" in section 3.04(3)(b) is replaced with June 30th of the calendar year following the HUD approval year.

For example, suppose State C has one renewal community, RC1. In October 2006, HUD approves the expanded area of RC1. Because the expanded area was approved by HUD late in the calendar year, RC1 is unable to make allocations in 2006 to any qualified revitalization building placed in service in 2006 in its expanded area. However, in 2006, RC1 allocated $10 million of its $12 million commercial revitalization expenditure ceiling for 2006 to qualified revitalization buildings placed in service in the original boundaries of RC1. Assuming there is not any failed building amount attributable to 2006, RC1's unallocated commercial revitalization expenditure amount for 2006 is $2 million. In accordance with this section 3.05 and section 3.04(3) of this revenue procedure, RC1 may allocate this $2 million to any qualified revitalization building that either (1) was placed in service by a taxpayer in the expanded area of RC1 in 2006, or (2) will be placed in service by a taxpayer in the expanded area of RC1 on or before December 31, 2008, provided the taxpayer's basis in the project of which the building is a part, as of June 30, 2007, is more than 10 percent of the taxpayer's reasonably expected basis in the project as of December 31, 2008. RC1 must make this allocation in accordance with section 3.04(4) of this revenue procedure.

SECTION 4. COMMERCIAL REVITALIZATION DEDUCTION ELECTION FOR A QUALIFIED REVITALIZATION BUILDING IN THE EXPANDED AREA

.01 *Return already filed for the placed-in-service year of a qualified revitalization building in the expanded area*.

(1) *In general*. If a taxpayer receives a retroactive commercial revitalization expenditure allocation made in accordance with section 3 of this revenue procedure for a qualified revitalization building that was placed in service by the taxpayer in the expanded area of a renewal community and the taxpayer filed the federal tax return for the placed-in-service year of that building on or before the date the taxpayer received the retroactive commercial revitalization expenditure allocation, the taxpayer must make the commercial revitalization deduction election provided by § 1400I(a) for the building within the time and in the manner described in section 4.01(2) of this revenue procedure. The election is made by each person owning the qualified revitalization building (for example, by the member of a consolidated group, the partnership, or the S corporation that owns the building). The election only applies to the extent that a retroactive commercial revitalization expenditure allocation was timely made to the building by the commercial revitalization agency of the state in which the building is located. If the amount of that allocation exceeds the amount properly chargeable to a capital account for the building, the qualified revitalization expenditures eligible for the commercial revitalization deduction election are limited to the amount properly chargeable to a capital account for the building.

(2) *Time and manner for making the election*. A taxpayer described in section 4.01(1) of this revenue procedure may make the commercial revitalization deduction election for the qualified revitalization building in the renewal community's expanded area either by:

(a) filing an amended federal tax return(s) (or a qualified amended return(s) under Rev. Proc. 94–69, 1994–2 C.B. 804, if applicable) for the placed-in-service year and all subsequent affected taxable year(s), provided that the placed-in-service year and all subsequent taxable year(s) are open under the period of limitations for assessment under § 6501(a). The amended federal tax return(s) (or qualified amended return(s)) must include the adjustment to taxable income for the commercial revitalization deduction election and any collateral adjustments to taxable income or to the tax liability (for example, the amount of depreciation claimed in that taxable year under § 168 for the qualified revitalization building to which the election pertains). The amended federal tax return(s) (or qualified amended return(s)) should include the statement "Filed Pursuant to Rev. Proc. 2006–16" at the top of the amended return(s) (or qualified amended return(s)). In accordance with § 1.446–1(e)(3)(ii), section 2.04 of Rev. Proc. 2002–9, 2002–1 C.B. 327 (as modified and clarified by Announcement 2002–17, 2002–1 C.B. 561, modified and amplified by Rev. Proc. 2002–19, 2002–1 C.B. 696, amplified, clarified, and modi-

fied by Rev. Proc. 2002–54, 2002–2 C.B. 432, and modified by Rev. Proc. 2004–11, 2004–1 C.B. 311), and Rev. Rul. 90–38, 1990–1 C.B. 57, the Commissioner specifically grants consent to a taxpayer complying with the provisions of this section 4.01(2)(a) to make a retroactive change in method of accounting for the commercial revitalization deduction allowed under § 1400I(a); or

(b) obtaining the consent of the Commissioner under § 446(e) to change the taxpayer's method of accounting for the commercial revitalization deduction allowed under § 1400I(a) by filing a Form 3115, *Application for Change in Accounting Method*, with the taxpayer's federal tax return for the taxable year that includes the date on which the commercial revitalization agency makes the retroactive commercial revitalization expenditure allocation, or with the taxpayer's federal tax return for the first taxable year succeeding the taxable year that included the date on which the commercial revitalization agency made the retroactive commercial revitalization expenditure allocation. To obtain this consent, the taxpayer must follow the automatic change in method of accounting provisions in Rev. Proc. 2002–9 or any successor, with the following modifications:

(i) The scope limitations in section 4.02 of Rev. Proc. 2002–9 do not apply; and

(ii) For purposes of section 6.02(4)(a) of Rev. Proc. 2002–9, the taxpayer should include on line 1a of the Form 3115 the designated automatic accounting method change number for the change in method of accounting for depreciation made under this section 4. This number for this method change is 97.

.02 *Return not filed for the placed-in-service year of a qualified revitalization building in the expanded area.* If a taxpayer receives a retroactive commercial revitalization expenditure allocation made in accordance with section 3 of this revenue procedure for a qualified revitalization building that was or will be placed in service by the taxpayer in the expanded area of a renewal community and the taxpayer files the federal tax return for the placed-in-service year of that building after the date the taxpayer received the retroactive commercial revitalization expenditure allocation, the taxpayer must make the commercial revitalization deduction election provided by § 1400I(a) for the building by following the procedures in sections 7.01 and 7.02 of Rev. Proc. 2003–38.

.03 *Other rules applicable to the commercial revitalization deduction election.* Sections 7.03, 7.04, and 7.05 of Rev. Proc. 2003–38 (as modified by this revenue procedure) also apply to a taxpayer described in, or to the commercial revitalization deduction election made in accordance with, section 4.01 or 4.02 of this revenue procedure.

SECTION 5. SECTION 179 ELECTION FOR QUALIFIED RENEWAL PROPERTY PLACED IN SERVICE BY A TAXPAYER IN THE EXPANDED AREA IN 2002, 2003, 2004, OR 2005

An item of section 179 property (as defined in § 179(d)(1)) that is also qualified renewal property and is placed in service in the expanded area of a renewal community is eligible for the increased § 179 expensing provided by § 1400J. If this property is placed in service by a taxpayer in 2002, 2003, 2004, or 2005, and the taxpayer wants to make an election under § 179 to use the increased § 179 expensing, the taxpayer makes the election under § 179 (or, if necessary, revokes an election previously made under § 179) by filing an amended federal tax return(s) for the placed-in-service year and any affected subsequent taxable year, provided that the placed-in-service year and any affected subsequent taxable year(s) are open under the period of limitations for assessment under § 6501(a). This election (or the revocation of the election) must be made in the manner described in § 1.179–5(c)(2) (or in § 1.179–5(c)(3) in the case of a revocation of a previously made § 179 election).

SECTION 6. EXCLUSION FROM GROSS INCOME FOR A QUALIFIED COMMUNITY ASSET IN THE EXPANDED AREA OF A RENEWAL COMMUNITY

Any qualified capital gain (as defined in § 1400F(c)) from the sale or exchange of a qualified community asset (as defined in § 1400F(b)) that is in the expanded area of a renewal community and that is held for more than 5 years is excluded from gross income pursuant to § 1400F.

SECTION 7. EFFECTIVE DATE

This revenue procedure is effective: (1) under § 1400I, for a qualified revitalization building placed in service after December 31, 2001, in the expanded area of a renewal community; (2) under § 1400J, for a qualified renewal property placed in service after December 31, 2001, in the expanded area of a renewal community; and (3) under § 1400F, for a qualified community asset acquired after December 31, 2001, in the expanded area of a renewal community that is held for more than 5 years.

SECTION 8. EFFECT ON OTHER DOCUMENTS

.01 Rev. Proc. 2002–9 is modified and amplified to include the automatic change in method of accounting provided under section 4.01(2)(b) of this revenue procedure in the APPENDIX of Rev. Proc. 2002–9.

.02 Section 7.05 of Rev. Proc. 2003–38 is modified to read as follows: "If a taxpayer does not make the commercial revitalization deduction election for a qualified revitalization building within the time and in the manner prescribed in section 7.02 of this revenue procedure, the amount of depreciation allowable for that property must be determined under § 168 for the placed-in-service year and for all subsequent years. Thus, the commercial revitalization deduction election cannot be made by the taxpayer in any manner other than as set forth in section 7.02 of this revenue procedure (for example, through a request under § 446(e) to change the taxpayer's method of accounting), except as otherwise expressly provided by the Internal Revenue Code, the regulations under the Code, or other guidance published in the Internal Revenue Bulletin."

SECTION 9. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–2001.

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 OMB control number.

The collection of information in this revenue procedure is in section 3.04 of this revenue procedure. This information is required to obtain an allocation of commercial revitalization expenditure amounts for a qualified revitalization building in the expanded area of a renewal community. This information will be used by the Service to verify that the taxpayer is entitled to the commercial revitalization deduction. The collection of information is required to obtain a benefit. The likely respondents are state or local governments and business or other for-profit institutions.

The estimated total annual reporting burden is 150 hours.

The estimated annual burden per respondent varies from 1 to 4 hours, depending on individual circumstances, with an estimated average of 2.5 hours. The estimated number of respondents is 60.

The estimated annual frequency of responses is on occasion.

Books or 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.

DRAFTING INFORMATION

The principal author of this revenue procedure is Charles Magee of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure, contact Mr. Magee at (202) 622–3110 (not a toll-free call). For information regarding the renewal community employment credit under § 1400H, contact Karin Loverud at (202) 622–6080 (not a toll-free number).

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D. —Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
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Key to Abbreviations:

Ann	Announcement
CD	Court Decision
DO	Delegation Order
EO	Executive Order
PL	Public Law
PTE	Prohibited Transaction Exemption
RP	Revenue Procedure
RR	Revenue Ruling
SPR	Statement of Procedural Rules
TC	Tax Convention
TD	Treasury Decision
TDO	Treasury Department Order

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