trustee for, the qualified financial institution, if any, documenting discussions, both before and after the disbursement of the loan proceeds, with each recipient's accounting, financial and executive personnel with respect to the proposed and actual use of the loan proceeds and his analysis of the annual financial statements of the qualified recipient including an analysis of the statement of sources and uses of funds. After the loan disbursement, such discussions and review shall occur annually during the term of the loan. Such report shall include the conclusion that in such officer's opinion there is no reasonable ground for belief that the qualified recipient is improperly utilizing the funds.

(iii) *Requirements in the case of a financial intermediary.* Where a qualified financial institution lends funds to a financial intermediary which are on-lent to a qualified recipient—

(A) The obligation to maintain the documentation described in paragraph (c)(13)(ii)(A) or (B) of this section shall apply only to the financial intermediary and not to the qualified financial institution and the provisions of paragraph (c)(13)(ii)(A) or (B) of this section shall be read so as to impose on the financial intermediary any obligation imposed on the qualified financial institution.

(B) The financial intermediary shall forward annually to the qualified financial institution a copy of the documentation it is required to maintain in its records pursuant to the provisions of this paragraph (c)(13)(iii) and shall notify the Assistant Commissioner (International), the Commissioner of Financial Institutions of Puerto Rico (or his delegate) and the qualified financial institution pursuant to paragraph (c)(14) of this section upon becoming aware that a loan has ceased to be an investment in active business assets or a development project under this section. The qualified financial institution must maintain in its records and have available for inspection the documentation furnished by the financial intermediary pursuant to this paragraph (c)(13)(iii)(B).

(C) The qualified financial institution shall cause one of its officers (or one of the officers of its agent or trustee, if any) to prepare a written report documenting his analysis of the documentation furnished by the financial intermediary pursuant to paragraph (c)(13)(iii)(B) of this section, his discussions, both before and after the disbursement of the loan proceeds, with the financial intermediary's accounting, financial and executive personnel with respect to the proposed and actual use of the loan proceeds, and his analysis of the annual financial statements of the qualified recipient including an analysis of the statement of sources and uses of funds. After the loan disbursement, such discussions and review shall occur annually during the term of the loan. Such report shall include the conclusion that in such officer's opinion there is no reasonable ground for belief that the qualified recipient is improperly utilizing the funds.

(14) *Procedures for notices and certifications.* Notices and certifications to the Assistant Commissioner (International) required under paragraphs (c)(11), (12) and (13) of this section shall be addressed to the attention of the Assistant Commissioner (International), Office of Taxpayer Service and Compliance, IN:C, 950 L'Enfant Plaza South, SW., Washington, DC 20024. Notices and certifications to the Commissioner of Financial Institutions of Puerto Rico required under paragraphs (c)(11), (12), and (13) of this section shall be addressed as follows: Commissioner of Financial Institutions, GPO Box 70324, San Juan, Puerto Rico 00936.

(15) *Effective date.* This paragraph (c) is effective May 13, 1991. It is applicable to investments by a possessions corporation in a financial institution that are used by a financial institution for investments in accordance with a specific authorization granted by the Commissioner of Financial Institutions of Puerto Rico (or his delegate) after September 22, 1989. However, the taxpayer may choose to apply §1.936–10T(c) for periods before June 12, 1991.

[T.D. 8350, 56 FR 21927, May 13, 1991]

§ 1.936–11 New lines of business prohibited.

(a) *In general.* A possessions corporation that is an existing credit claimant, as defined in section 936(j)(9)(A) and this section, that adds a substantial new line of business during a taxable year, or that has a new line of business that becomes substantial during the taxable year, loses its status as an existing credit claimant for that year and all years subsequent.

(b) *New line of business*—(1) *In general.* A new line of business is any business activity of the possessions corporation that is not closely related to a pre-existing business of the possessions corporation. The term *closely related* is defined in paragraph (b)(2) of this section. The term *pre-existing business* is defined in paragraph (b)(3) of this section.

(2) *Closely related.* To determine whether a new activity is closely related to a pre-existing business of the possessions corporation all the facts and circumstances must be considered, including those set forth in paragraphs (b)(2)(i)(A) through (G) of this section.

(i) *Factors.* The following factors will help to establish that a new activity is closely related to a pre-existing business activity of the possessions corporation—

(A) The new activity provides products or services very similar to the products or services provided by the pre-existing business;

(B) The new activity markets products and services to the same class of customers;

(C) The new activity is of a type that is normally conducted in the same business location;

(D) The new activity requires the use of similar operating assets;

(E) The new activity's economic success depends on the success of the pre-existing business;

(F) The new activity is of a type that would normally be treated as a unit with the pre-existing business' in the business accounting records; and

(G) The new activity and the pre-existing business are regulated or licensed by the same or similar governmental authority.

(ii) *Safe harbors.* An activity is not a new line of business if—

(A) If the activity is within the same six-digit North American Industry Classification System (NAICS) code (or four-digit Standard Industrial Classification (SIC) code). The similarity of the NAICS or SIC codes may not be relied upon to determine whether the activity is closely related to a pre-existing business where the code indicates a miscellaneous category;

(B) If the new activity is within the same five-digit NAICS code (or three-digit SIC code) and the facts relating to the new activity also satisfy at least three of the factors listed in paragraphs (b)(2)(i)(A) through (G) of this section; or

(C) If the pre-existing business is making a component product or end-product form, as defined in §1.936–5(a)(1),Q&A1, and the new business activity is making an integrated product, or an end-product form with fewer excluded components, that is not within the same six-digit NAICS code (or four-digit SIC code) as the pre-existing business solely because the component product and the integrated product (or two end-product forms) have different end-uses.

(3) *Pre-existing business*—(i) *In general.* Except as provided in paragraph (b)(3)(ii) of this section, a business activity is a pre-existing business of the existing credit claimant if—

(A) The existing credit claimant was actively engaged in the activity within the possession on or before October 13, 1995; and

(B) The existing credit claimant had elected the benefits of the Puerto Rico and possession tax credit pursuant to an election which was in effect for the taxable year that included October 13, 1995.

(ii) *Acquisition of an existing credit claimant.* (A) If all the assets of one or more trades or businesses of a corporation of an existing credit claimant are acquired by an affiliated or non-affiliated existing credit claimant which carries on the business activity of the predecessor existing credit claimant, the acquired business activity will be treated as a pre-existing business of the acquiring corporation. A non-affiliated acquiring corporation will not be bound by any section 936(h) election made by the predecessor existing credit claimant with respect to that business activity.

(B) Where all of the assets of one or more trades or businesses of a corporation of an existing credit claimant are acquired by a corporation that is not an existing credit claimant, the acquiring corporation may make a section 936(e) election for the taxable year in which the assets are acquired with the following effects—

(*1*) The acquiring corporation will be treated as an existing

(*2*) The activity will be considered a pre-existing business of the acquiring corporation;

(*3*) The acquiring corporation will be deemed to satisfy the rules of section 936(a)(2) for the year of acquisition; and

(*4*) After making an election under section 936(e), a non-affiliated acquiring corporation will not be bound by elections under sections 936(a)(4) and (h) made by the predecessor existing credit claimant.

(C) For purposes of this section the assets of a trade or business are determined at the time of acquisition provided that the transferee actively conducts the trade or business acquired.

(D) A mere change in the stock ownership of a possessions corporation will not affect its status as an existing credit claimant for purposes of this section.

(4) *Leasing of Assets.* (i) The leasing of assets (and employees to operate leased assets) will not, for purposes of this section, be considered a new line of business of the existing credit claimant if—

(A) the existing credit claimant used the leased assets in an active trade or business for at least five years;

(B) the existing credit claimant does not through its own officers or staff of employees perform management or operational functions (but not including operational functions performed through leased employees) with respect to the leased assets; and

(C) the existing credit claimant does not perform marketing functions with respect to the leasing of the assets.

(ii) Any income from the leasing of assets not considered a new line of business pursuant to paragraph (b)(4)(i) of this section will not be income from the active conduct of a trade or business (and, therefore, the existing credit claimant may not receive a possession tax credit with respect to such income).

(5) *Timing rule.* The tests for a new line of business in this paragraph (whether the new activity is closely related to a pre-existing business) are applied only at the end of the taxable year during which the new activity is added.

(c) *Substantial*—(1) *In general.* A new line of business is considered to be substantial as of the earlier of—

(i) The taxable year in which the possessions corporation derives more than 15 percent of its gross income from that new line of business (gross income test); or

(ii) The taxable year in which the possessions corporation directly uses in that new line of business more than 15 percent of its assets (assets test).

(2) *Gross income test.* The denominator in the gross income test is the amount that is the gross income of the possessions corporation for the current taxable year, while the numerator is the amount that is the gross income of the new line of business for the current taxable year. The gross income test is applied at the end of each taxable year. For purposes of this test, if a new line of business is added late in the taxable year, the income is not to be annualized in that year. In the case of a new line of business acquired through the purchase of assets, the gross income of such new line of business for the taxable year of the acquiring corporation that includes the date of acquisition is determined from the date of acquisition through the end of the taxable year. In the case of a consolidated group election made pursuant to section 936(i)(5), the test applies on a company by company basis and not on a consolidated basis.

(3) *Assets test*—(i) *Computation.* The denominator is the adjusted tax basis of the total assets of the possessions corporation for the current taxable year. The numerator is the adjusted tax basis of the total assets utilized in the new line of business for the current taxable year. The assets test is computed annually using all assets including cash and receivables.

(ii) *Exception.* A new line of business of a possessions corporation will not be treated as substantial as a result of meeting the assets test if an event that is not reasonably anticipated causes assets used in the new line of business of the possessions corporation to exceed 15 percent of the adjusted tax basis of the possessions corporation's total assets. For example, an event that is not reasonably anticipated would include the destruction of plant and equipment of the pre-existing business due to a hurricane or other natural disaster, or other similar circumstances beyond the control of the possessions corporation. The expiration of a patent is not such an event and will not permit use of this exception.

(d) *Examples*. The following examples illustrate the rules described in paragraphs (a), (b), and (c) of this section. In the following examples, X Corp. is an existing credit claimant unless otherwise indicated:

Example 1. X Corp. is a pharmaceutical corporation which manufactured bulk chemicals (a component product). In March 1997, X Corp. began to also manufacture pills (e.g., finished dosages or an integrated product). The new activity provides products very similar to the products provided by the pre-existing business. The new activity is of a type that is normally conducted in the same business location as the pre-existing business. The activity's economic success depends on the success of the pre-existing business. The manufacture of bulk chemicals is in NAICS code 325411, Medicinal and Botanical Manufacturing, while the manufacture of the pills is in NAICS code 325412, Pharmaceutical Preparation Manufacturing. Although the products have a different end-use, may be marketed to a different class of customers, and may not use similar operating assets, they are within the same five-digit NAICS code and the activity also satisfies paragraphs (b)(2)(i)(A), (C), and (E) of this section. The manufacture of the pills by X Corp. will be considered closely related to the manufacture of the bulk chemicals. Therefore, X Corp. will not be considered to have added a new line of business for purposes of paragraph (b) of this section because it falls within the safe harbor rule of (b)(2)(ii)(B).

Example 2. X Corp. currently manufactures printed circuit boards in a possession. As a result of a technological breakthrough, X Corp. could produce the printed circuit boards more efficiently if it modified its existing production methods. Because demand for its products was high, X Corp. expanded when it modified its production methods. After these modifications to the facilities and production methods, the products produced through the new technology were in the same six-digit NAICS code as products produced previously by X Corp. See paragraph (b)(2)(ii)(A) of this section. Therefore, X Corp. will not be considered to have added a new line of business for purposes of paragraph (b) of this section because it falls within the safe harbor rule of (b)(2)(ii)(A).

Example 3. X Corp. has manufactured Device A in Puerto Rico for a number of years and began to manufacture Device B in Puerto Rico in 1997. Device A and Device B are both used to conduct electrical current to the heart and are both sold to cardiologists. There is no significant change in the type of activity conducted in Puerto Rico after the transfer of the manufacturing of Device B to Puerto Rico. Similar manufacturing equipment, manufacturing processes and skills are used in the manufacture of both devices. Both are regulated and licensed by the Food and Drug Administration. The economic success of Device B is dependent upon the success of Device A only to the extent that the liability and manufacturing prowess with respect to one reflects favorably on the other. Depending upon the heart abnormality, the cardiologist may choose to use Device A, Device B or both on a patient. The manufacture of Device B is treated as a unit with the manufacture of Device A in X Corp.'s accounting records. The manufacture of Device A is in the six-digit NAICS code 339112, Surgical and Medical Instrument Manufacturing. The manufacture of Device B is in the six-digit NAICS code 334510, Electromedical and Electrotherapeutic Apparatus Manufacturing. (The manufacture of Device A is in the four-digit SIC code 3845, Electromedical and Electrotherapeutic Apparatus. The manufacture of Device B is in the four-digit SIC code 3841, Surgical and Medical Instruments and Apparatus.) The safe harbor of paragraph (b)(2)(ii)(B) of this section applies because the two activities are within the same three-digit SIC code and Corp. X satisfies paragraphs (b)(2)(i)(A), (B), (C), (D), (F), and (G) of this section.

Example 4. X Corp. has been manufacturing house slippers in Puerto Rico since 1990. Y Corp. is a U.S. corporation that is not affiliated with X Corp. and is not an existing credit claimant. Y Corp. has been manufacturing snack food in the United States. In 1997, X Corp. purchased the assets of Y Corp. and began to manufacture snack food in Puerto Rico. House slipper manufacturing is in the six-digit NAICS code 316212 (Four-digit SIC code 3142, House Slippers). The manufacture of snack foods falls under the six-digit NAICS code 311919, Other Snack Food Manufacturing (four-digit SIC code 2052, Cookies and Crackers (pretzels)). Because these activities are not within the same five or six digit NAICS code (or the same three or four-digit SIC code), and because snack food is not an integrated product that contains house slippers, the safe harbor of paragraph (b)(2)(ii) of this section cannot apply. Considering all the facts and circumstances, including the seven factors of paragraph (b)(2)(i) of this section, the snack food manufacturing activity is not closely related to the manufacture of house slippers, and is a new line of business, within the meaning of paragraph (b) of this section.

Example 5. X Corp., a calendar year taxpayer, is an existing credit claimant that has elected the profit-split method for computing taxable income. P Corp. was not an existing credit claimant and manufactured a product in a different five-digit NAICS code than the product manufactured by X Corp. In 1997, X Corp. acquired the stock of P Corp. and liquidated P Corp. in a tax-free liquidation under section 332, but continued the business activity of P Corp. as a new business segment. Assume that this new business segment is a new line of business within the meaning of paragraph (c) of this section. In 1997, X Corp. has gross income from the active conduct of a trade or business in a possession computed under section 936(a)(2) of $500 million and the adjusted tax basis of its assets is $200 million. The new business segment had gross income of $60 million, or 12 percent of the X Corp. gross income, and the adjusted basis of the new segment's assets was $20 million, or 10 percent of the X Corp. total assets. In 1997, X Corp. does not derive more than 15 percent of its gross income, or directly use more that 15 percent of its total assets, from the new business segment. Thus, the new line of business acquired from P Corp. is not a *substantial* new line of business within the meaning of paragraph (c) of this section, and the new activity will not cause X Corp. to lose its status as an existing credit claimant during 1997. In 1998, however, the gross income of X Corp. grew to $750 million while the gross income of the new line of business grew to $150 million, or 20% of the X Corp. 1998 gross income. Thus, in 1998, the new line of business is substantial within the meaning of paragraph (c) of this section, and X Corp. loses its status as an existing credit claimant for 1998 and all years subsequent.

(e) *Loss of status as existing credit claimant.* An existing credit claimant that adds a substantial new line of business in a taxable year, or that has a new line of business that becomes substantial in a taxable year, loses its status as an existing credit claimant for that year and all years subsequent.

(f) *Effective date*—(1) *General rule.* This section applies to taxable years of a possessions corporation beginning on or after January 25, 2000.

(2) *Election for retroactive application.* Taxpayers may elect to apply retroactively all the provisions of this section for any open taxable year beginning after December 31, 1995. Such election will be effective for the year of the election and all subsequent taxable years. This section will not apply to activities of pre-existing businesses for taxable years beginning before January 1, 1996.

[T.D. 8868, 65 FR 3815, Jan. 25, 2000]

§ 1.937–1 Bona fide residency in a possession.

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

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

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

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

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

(2) *Special rule for members of the Armed Forces.* A member of the Armed Forces of the United States who qualified as a bona fide resident of the relevant possession in a prior taxable year is deemed to have satisfied the requirements of paragraphs (c) through (e) of this section for a subsequent taxable year if such individual otherwise is unable to satisfy such requirements by reason of being absent from such possession or present in the United States during such year solely in compliance