T.D. 8778

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Termination of Puerto Rico and Possession Tax Credit; New Lines of Business Prohibited

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations that provide guidance regarding the addition of a substantial new line of business by a possessions corporation that is an existing credit claimant. These temporary regulations reflect changes made by the Small Business Job Protection Act of 1996. The text of these temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in REG–115446–97, page 23.

DATES: These regulations are effective September 18, 1998.

Applicability: These regulations apply to taxable years of a possessions corporation beginning after August 19, 1998.

FOR FURTHER INFORMATION CONTACT: Patricia A. Bray or Elizabeth Beck, (202) 622-3880, or Jacob Feldman, (202) 622-3830 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 1601(a) of the Small Business Job Protection Act of 1996, Public Law 104–188, 110 Stat. 1755 (1996), amended the Internal Revenue Code by adding section 936(j). Section 936(j) generally repeals the Puerto Rico and possession tax credit for taxable years beginning after December 31, 1995. However, the section provides grandfather rules under which a corporation that is an existing credit claimant would be eligible to claim credits for a transition period. The Puerto Rico and possession tax credit will phase out for these existing credit claimants ending with the last taxable year beginning before January 1, 2006.

For taxable years beginning after December 31, 1995 and before January 1, 2006, the Puerto Rico and possession tax credit applies only to a corporation that qualifies as an existing credit claimant (as defined in section 936(j)(9)(A)). The determination of whether a corporation is an existing credit claimant is made separately for each possession. A possessions corporation that adds a substantial new line of business (other than in a qualifying acquisition of all the assets of a trade or business of an existing credit claimant) after October 13, 1995, ceases to be an existing credit claimant as of the beginning of the taxable year during which such new line of business is added. Therefore, a possessions corporation that ceases to be an existing credit claimant either because it has added a substantial new line of business, or because a new line of business becomes substantial, during a taxable year may not claim the Puerto Rico and possessions tax credit for that taxable year or any subsequent taxable year.

Explanation of Provisions

This document provides temporary regulations that interpret section 936(j)(9)(B). In particular, temporary regulation §1.936–11T adopts principles similar to those in §1.7704–2(c) and (d) (transition rules for existing publicly traded partnerships) for determining whether a corporation has added a substantial new line of business.

Paragraph (a) of §1.936–11T states the general rule that, if a possessions corporation that is an existing credit claimant, as defined in section 936(j)(9)(A), adds a substantial new line of business during a taxable year, it will cease to be an existing credit claimant as of the close of the taxable year ending before the date of such addition. The paragraph also generally describes the subjects discussed in the other paragraphs in §1.936–11T.

Paragraph (b) addresses the meaning of the term *new line of business.* The temporary regulation generally follows the approach of §1.7704–2(d)(1), providing the general rule derived from §1.7704–2(d)(2) that explains when a business activity is a *pre-existing business*, and from §1.7704–2(d)(3) that defines when that activity is *closely related* to a pre-existing business. Paragraph (b)(1) provides that a new line of business is any activity of the possessions corporation that is not closely related to a pre-existing business of the possessions corporation.

Paragraph (b)(2) explains that, except as provided in paragraph (b)(2)(ii), all the facts and circumstances (including factors A through H in paragraph (b)(2)(i)) must be considered to determine whether a new activity is closely related to a pre-existing business of the possessions corporation. Paragraph (b)(2)(i) applies the same eight factors considered in §1.7704–2(d)(3), except that the temporary regulation provides that in applying factor H, the possessions corporation may use either the new North American Industry Classification System Code (NAICS code) or the Standard Industrial Classification Code (SIC code).

Factor (H) is whether the United States Bureau of the Census assigns the activity the same six-digit NAICS code (or four-digit SIC code) as the pre-existing business. In the case of a pre-existing business or activity that is listed under a NAICS code of 99999, Unclassified establishments, or under a miscellaneous category (most NAICS codes ending in a “9” are miscellaneous categories), the similarity in NAICS codes is ignored as a factor in determining whether the activity is closely related to the pre-existing business. The dissimilarity of the NAICS codes is considered in determining whether the activity is closely related to the pre-existing business. For purposes of this section, NAICS codes must be set forth in the North American Industry Classification System Manual, United States, that is in effect for the taxable year during which a new line of business is added.

Similarly, in the case of a pre-existing business or activity that is listed under a SIC code of 9999, Nonclassifiable Establishments, or under a miscellaneous category (most SIC codes ending in a “9” are miscellaneous categories), the similarity in SIC codes is ignored as a factor in determining whether the activity is closely related to the pre-existing business. The dissimilarity of the SIC codes is considered as a factor in determining whether the activity is closely related to the pre-existing business. The SIC codes are set forth in the Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual, that is in effect for the taxable year during which a new line of business is added.

Paragraph (b)(2)(ii) provides safe harbors for determining whether an activity is closely related to a pre-existing business in three cases. First, an activity will be closely related to a pre-existing business if the activity is within the same six-digit NAICS code or four-digit SIC code as the pre-existing business. Second, an activity will be closely related to a pre-existing business if the activity is within the same five-digit NAICS code or three-digit SIC code as the pre-existing business and the facts related to the new activity satisfy at least three of the factors in paragraphs (b)(2)(i)(A) through (G) of this section. Third, an activity will be closely related to a pre- existing business 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 activity is making an integrated product (or 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 the two end-product forms) have different end-uses.

Paragraph (b)(3) provides that a business activity of a possessions corporation is considered to be a pre-existing business if the possessions corporation was actively engaged in the activity within the possession on or before October 13, 1995, and the possessions corporation 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.

Paragraph (b)(3)(ii) explains how the acquisition of all of the assets or the stock of an existing credit claimant can affect the determination of whether an activity is a pre-existing business. It is intended that an activity that is a pre-existing business of an existing credit claimant and that continues to be carried on in the possession by any affiliated or non-affiliated existing credit claimant should continue to be characterized as a pre-existing activity since all the assets and activity remain in the possession and no new activity is introduced there. 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.

Where all of the assets related to a pre-existing activity of an existing credit claimant are acquired by a corporation that is not an existing credit claimant, but that continues the activity in the possession, the regulation provides that if the acquiring corporation makes an election under section 936(e) for the taxable year of the acquisition, the acquired activity will be treated as a pre-existing activity of the acquiring corporation, and the acquiring corporation will be treated as an existing credit claimant. The acquiring corporation will be deemed to satisfy the rules of section 936(a)(2) for the year of acquisition.

In the case of an acquisition of all the assets of a non-affiliated existing credit claimant, the acquiring corporation will not be bound by its predecessor's elections under sections 936(a)(4) and (h) regarding that business activity.

A mere change in the ownership of a possessions corporation will not affect its status as an existing credit claimant for purposes of determining whether an activity is closely related to a pre-existing business.

Paragraph (b)(4) provides that the test for a new line of business is only applied at the time the new activity is added (as opposed to the test of whether a new line of business is substantial, which is applied annually under paragraph (c) of this section).

Paragraph (c)(1) provides the general rule for determining when a new line of business becomes substantial. The paragraph explains that, for purposes of section 936 and section 30A, a new line of business of a possessions corporation is treated as substantial in the first taxable year in which it satisfies either of the following two tests: (1) the possessions corporation derives more than 15 percent of its gross income for the taxable year from that line of business (the gross income test); or (2) the possessions corporation directly uses in that line of business more than 15 percent of its total assets (the assets test). This position generally reflects the rules of §1.7704–2(c)(1).

For purposes of the gross income test, paragraph (c)(2) provides that the denominator is the amount that is the gross income of the possessions corporation for the current taxable year, while the numerator is the gross income of the new line of business for the current taxable year. The gross income test must be applied at the end of each taxable year. The income is not to be annualized when a new activity begins late in the taxable year. Testing should occur on a company-by-company basis, if a consolidated group election was made pursuant to section 936(i)(5). In the case of a new line of business acquired through the purchase of all of the assets of an existing credit claimant, the gross income test for the acquiring corporation for the year of the acquisition includes only the income from the date of acquisition through the end of the taxable year that includes the date of acquisition.

Paragraph (c)(3) provides rules for applying the annual assets test. For purposes of the assets test, paragraph (c)(3) provides that the denominator is the adjusted tax bases of the total assets of the possessions corporation for the current taxable year, while the numerator is the adjusted tax bases of the total assets utilized in the new line of business for the current taxable year. Total assets include intangibles, cash and receivables. In order to provide for administrative convenience for both the taxpayer and the IRS and for greater certainty in the result, the test uses the adjusted tax bases of the applicable assets since these amounts are already reflected in the books and records of the possessions corporation.

Paragraph (c)(3)(ii) permits an exception to the assets test. A new line of business of a possessions corporation will not be treated as substantial as a result of the assets test if an event that is not reasonably anticipated causes the adjusted tax bases of the assets used in the new line of business to exceed 15 percent of the adjusted tax basis of the possessions corporation's total assets. 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 thus will not trigger this exception.

Paragraph (d) contains five examples that illustrate the rules of this temporary regulation.

Paragraph (e) provides that a possessions corporation that adds a significant new line of business during a taxable year may not claim the Puerto Rico and possession tax credit on its return for the taxable year in which the substantial new line of business is added or a new line of business becomes substantial.

Paragraph (f) provides that the temporary regulation will apply to taxable years of the possessions corporation beginning after August 19, 1998. However, taxpayers may elect to apply all of the provisions of the regulation for any open taxable years beginning after December 31, 1995. Once an election is made, the regulation will apply for all subsequent taxable years. The temporary regulations will not apply to the activities of pre-existing businesses for taxable years beginning before January 1, 1996.

Special Analyses

It has been determined that this temporary regulation is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Moreover, the rules contained in this Treasury decision provide taxpayers with immediate guidance necessary to comply with section 936(j)(9)(B), which was effective for taxable years beginning after December 31, 1995. In the absence of temporary regulations, the only guidance regarding what is a *new line of business* is a reference in the legislative history to the principles of §1.7704–2(d) of the regulations. The only guidance regarding what is *substantial* is a reference to §1.7704–2(c) in the Joint Committee Explanation (Blue Book) of Public Law 104–188. Although a possessions corporation might be able to construct a tax return position based on this information, the effect of misinterpretation is severe—disqualification as an existing credit claimant, without benefits for either the substantial new line of business or the pre-existing business. Taxpayers must have unambiguous guidance on which they can immediately rely in structuring their possession corporation business activities. For these reasons this temporary regulation is needed to ensure the efficient administration of the tax laws. Pursuant to section 7805(f) of the Internal Revenue Code, this temporary regulation will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its effect on small business.

Drafting Information

The principal author of these regulations is Patricia A. Bray of the Office of the Associate Chief Counsel (International), within the office of Chief Counsel, IRS. However, other personnel from the IRS and the Department of the Treasury participated in the development of these regulations.

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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 citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * * Section 1.936–11T also issued under 26 U.S.C. 936(j). ***

Par. 2. Section 1.936–11T is added to read as follows:

§1.936–11T New lines of business prohibited (temporary).

(a) *In general.* A possessions corporation that is an existing credit claimant, as defined in section 936(j)(9)(A), and 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, will cease to be an existing credit claimant as of the close of the taxable year ending before either such taxable year. The term *new line of business* is defined in paragraph (b) of this section. The term *substantial* is defined in paragraph (c) of this section. Paragraph (d) of this section provides examples illustrating paragraphs (a) through (c) of this section. Paragraph (e) of this section instructs a possessions corporation not to claim the Puerto Rico and possession tax credit on its return if it has added a substantial new line of business during the taxable year. Paragraph (f) of this section is the effective date provision.

(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.* All the facts and circumstances must be considered, including paragraphs(b)(2)(i)(A) through (H) of this section, to determine whether a new activity is closely related to a pre-existing business of the possessions corporation, and thus is not a new line of business.

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

(B) The activity markets products and services to the same class of customers as that of the pre-existing business;

(C) The activity is of a type that is normally conducted in the same business location as the pre-existing business;

(D) The activity requires the use of similar operating assets as those used in the pre-existing business;

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

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

(G) If the activity and the pre-existing business are regulated or licensed, they are regulated or licensed by the same or similar governmental authority; and

(H) The United States Bureau of the Census assigns the activity the same six-digit North American Industry Classification System (NAICS) code or four-digit Industry Number Standard Identification code (SIC code) as the pre-existing business. In the case of a pre-existing business or activity that is listed under a NAICS code of 99999, Unclassified Establishments, or under a miscellaneous category (most NAICS codes that end in a "9" are miscellaneous categories), the similarity in NAICS codes is ignored as a factor in determining whether the activity is closely related to the pre-existing business. The dissimilarity of the NAICS code is considered in determining whether the activity is closely related to the pre-existing business. For purposes of this section, NAICS codes must be set forth in the North American Industry Classification System (United States) Manual that is in effect for the taxable year during which a new line of business is added. The official NAICS-United States Manual is available in both printed and electronic versions from the National Technical Information Service (NTIS) at 1-800-553-6847 or at the NTIS NAICS web site at <http://www.ntis.gov/naics>. In the case of a pre-existing business or activity that is listed under a SIC code of 9999, Nonclassifiable Establishments, or under a miscellaneous category (most SIC codes ending in "9" are miscellaneous categories), the similarity in SIC codes is ignored as a factor in determining whether the activity is closely related to the pre-existing business. The dissimilarity of the SIC codes is considered in determining whether the activity is closely related to the pre-existing business. The SIC codes are set forth in the Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual, that is in effect for the taxable year during which a new line of business is added. A printed version of the official SIC Manual is available from the National Technical Information Service (NTIS) at 1-800-553-6847.

(ii) *Safe harbors.* An activity is closely related to a pre-existing business and thus is not a new line of business in the following three cases—

(A) If the activity is within the same six-digit NAICS code (or four-digit SIC code);

(B) If both the pre-existing business activity and the new activity are within the same five-digit NAICS code (or three-digit SIC code) and the facts relating to the new activity satisfy at least three of the factors listed in paragraph (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) and (4) 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 has elected the benefits of the Puerto Rico and possession tax credit pursuant to an election which is in effect for the taxable year that includes October 13, 1995.

(ii) *Acquisition of all of the assets or stock of an existing credit claimant.* (A) If all the assets of a pre-existing business 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 a pre-existing business of an existing credit claimant are acquired by a corporation that is not an existing credit claimant, if the acquiring corporation makes a section 936(e) election for the taxable year in which the assets are acquired—

(*1*) The acquiring corporation will be treated as an existing credit claimant for the year of acquisition;

(*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) 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) *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.* For purposes of section 936 and section 30A, 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 that 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 that 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 possession 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 trigger 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. did not add a new line of business because it falls within the safe harbor rule of paragraph (b)(2)(ii)(B) of this section.

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 was high, X Corp. expanded its facilities to support the production of its current products 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.

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. Both devices are within the same business sector of the taxpayer's business. 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 electro- therapeutic Apparatus Manufacturing. (The manufacture of Device A is in the four-digit SIC code 3845, Electromedical and Electrotheraputic 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 eight 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. 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 as of December 31, 1997.

(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 as of the close of the taxable year ending before either such taxable year. In such case, the possession corporation must not claim the Puerto Rico and possession tax credit on its return for the taxable year in which the substantial new line of business is added or a new line of business becomes substantial.

(f) *Effective date*—(1) *General rule.* This section applies to taxable years of a possessions corporation beginning after August 19, 1998.

(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.

Michael P. Dolan,
Deputy Commissioner of Internal Revenue.

Donald C. Lubick,
Assistant Secretary of the Treasury.