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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.

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