

Section 863.—Special Rules for Determining Source

26 CFR 1.863-3: Allocation and apportionment of income from certain sales of inventory.

T.D. 8687

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

Source of Income From Sales of Inventory and Natural Resources Produced in One Jurisdiction and Sold in Another Jurisdiction

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains regulations governing the source of income from sales of natural resources or other inventory produced in the United States and sold outside the United States or produced outside the United States and sold in the United States. This document affects persons who produce natural resources or other inventory in the United States and sell outside the United States, or produce natural resources or other inventory outside the United States and sell in the United States.

EFFECTIVE DATE: December 30, 1996.

Applicability: Taxpayers may apply these regulations for taxable years beginning after July 11, 1995, and on or before December 30, 1996.

FOR FURTHER INFORMATION CONTACT: Anne Shelburne, (202) 622-3880 (not a toll free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this final regulation has been reviewed and approved by the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1476. Responses to this collection of information are mandatory.

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 control number.

The estimated average annual burden per respondent is approximately 2.6 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224, and the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC, 20503.

Books or records relating to this 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.

Background

This document contains final regulations to be added to the Income Tax Regulations (26 CFR part 1) under section 863 of the Internal Revenue Code (Code). The final regulations provide rules for allocating and apportioning income between U.S. and foreign sources from natural resources and other inventory produced in the United States and sold outside the United States, or produced outside the United States and sold in the United States.

On December 11, 1995, proposed regulations [INTL-0003-95 (1996-1 C.B. 831)] were published in the **Federal Register** (60 FR 63478). The IRS received written comments on the proposed regulations and held a public hearing on April 10, 1996. Having considered the comments and the statements made at the hearing, the IRS and the Treasury Department adopt the proposed regulations as modified by this Treasury decision. The comments and revisions are discussed below.

Explanation of Provisions

I. Allocation of gross income from sales of natural resources under section 863(a)

Section 1.863-1(b) of the proposed regulations relate to the rules governing natural resources. The proposed regulations provide three methods for determining the amount of United States or foreign source income from sales of

natural resources. One method (derived from the existing regulations) sources income in its entirety to the location of the natural resources, and applies where the taxpayer does not engage in substantial additional production beyond production of the natural resources. The second method, the export terminal rule, splits sales income at the export terminal, sourcing gross receipts equal to the fair market value at the export terminal to the location of the natural resources, and gross receipts in excess of that amount either to the place of sale or according to the rules in § 1.863-3, depending on the circumstances. The third method requires taxpayers performing additional production in the country where the natural resources are located, to split gross receipts at the point of the additional production, sourcing gross receipts equal to the fair market value prior to that point to the location of the natural resources and gross receipts in excess of that amount according to the rules in § 1.863-3.

1. Implications of the Tenth Circuit's Order in *Phillips*

Section 1.863-1(b)(1)(i) of the proposed regulations sources certain income from natural resources in its entirety to the location of the resources. The preamble to the proposed regulations states that Treasury and the IRS would consider the Tenth Circuit's unpublished opinion in its Order and Judgment in *Phillips Petroleum v. Comm'r*, 97 T.C. 30 (1991), 101 T.C. 78 (1993), *aff'd. without published opinion*, 70 F.3d 1282 (10th Cir., 1995), in finalizing the regulations. In *Phillips*, the Tax Court ruled § 1.863-1(b)'s natural resource regulation, generally sourcing income from U.S. natural resources in its entirety to the United States, invalid to the extent it conflicted with the Court's interpretation of section 863(b)(2). That section provides that gains, profits and income from the sale of inventory property produced within and sold without the United States (or vice versa) shall be treated as derived partly from sources within and partly from sources without the United States. The Tenth Circuit affirmed the Tax Court.

In view of *Phillips*, the final regulations modify the proposed regulations to eliminate the 100 percent allocation rule, making the determination of the source of income subject instead to the export terminal rule. Thus, gross receipts equal

to the fair market value of the product at the export terminal are allocated to the location of the farm, mine, well, deposit or uncut timber, with the source of gross receipts from such sales in excess of the product's fair market value at the export terminal allocated to the country of sale.

Several commentators requested that any change to the natural resource rules made in light of *Phillips* be done in proposed form, providing opportunity to comment on the regulations. However, because the final regulations merely eliminate the rule which required a single source of income for sales of natural resources, and because Treasury and the IRS believe that there has been adequate opportunity to comment on the proposed regulations' export terminal rule, the natural resources rules are issued in final form.

2. Availability of the 50/50 method for natural resources

Several commentators wrote that there is no basis for treating natural resources differently than other inventory. Therefore, producers of natural resources should be permitted to determine the source of their income under the 50/50 method described in § 1.863-3(b)(1). They point to legislation enacted in the Tax Reform Act of 1986, arguing that Congress, in enacting section 865 to govern personal property sales, drew no distinction between sales of natural resources and sales of other inventory. Commentators have also pointed to section 865(b), enacted in 1993, providing that income from sales of U.S. softwood must be U.S. source in its entirety. They conclude that Congress was aware of the Tax Court's decision in *Phillips*, overruling *Phillips* only for softwood, but intending that all other natural resources be sourced under the 50/50 method.

Treasury and the IRS do not believe that Congress in the 1986 Act evidenced an intent to source all income from sales of natural resources under the 50/50 method. Rather, Congress merely referred to the 50/50 method to generally describe the methods for sourcing income from certain types of inventory sales. In addition, the legislative history to the 1993 Act, requiring income from softwood sales to be allocated in its entirety to the United States, does not suggest that Congress intended to overturn the longstanding regime governing sales of other natural resources. Moreover, the Small Business Job Protection

Act of 1996, Public Law 104-188 (August 20, 1996) (the 1996 Act), further clarifies that the Service is not required to apply the 50/50 method. Prior to the 1996 Act, section 865(b) provided that income from inventory sales was to be sourced under sections 861(a)(6), 862(a)(6), and 863(b). The 1996 Act, in section 1704(f)(4)(A), amended Code section 865(b)(2) by striking 863(b) and inserting 863. The Act makes this amendment effective as if included in amendments made by section 1211 of the Tax Reform Act of 1986 (Public Law 99-514). This technical correction to the 1986 Act clarifies that Treasury has broad authority to provide rules sourcing income from sales of inventory under section 863, and is not restricted to any particular method.

Treasury and the IRS also believe longstanding distinctions have been made in the tax treatment of natural resources and other property, both in our tax laws and in our tax treaties. Most treaties, for example, grant primary or exclusive taxing jurisdiction to the country where natural resources are located. Thus, income from sales of natural resources is treated differently than income derived from sales of other inventory, which is normally subject to the business profits article of a treaty. See, e.g., Article 6 of the United States Model Income Tax Convention (September 20, 1996), which provides that income from real property, "including income from agriculture and forestry" may be taxed by the country where the resources are located.

The legislative history to section 863's predecessor, section 217(e) of the Revenue Act of 1921, also reflects an intention that natural resources be treated differently from other property. The House version of section 217 (H.R. 8245, 67th Cong., 1st Sess. (Aug. 20, 1921)) included a provision sourcing income from natural resources in its entirety to the location of the resources. However, based on testimony raising the possibility of a case where such a single source rule should not apply, the Senate struck the provision that allocated all of the income from natural resources to a single country. (H.R. 8245 (67th Cong., 1st Sess. (November 4, 1921)); Hearings Before The Committee on Finance, United States Senate, H.R. 8245, 67th Cong., 1st Sess. (September 1 to October 1, 1921), at 309-310. A provision similar to that considered by the House, but with flexibility available for unusual

cases, was then added to the regulations promulgated in 1922.

Thus, Treasury and the IRS believe that income from natural resources should be sourced differently than income from other sales of inventory.

3. Clarification of language in § 1.863-2

In response to a comment, the final regulations are modified to clarify that the source of income from sales of natural resources must be determined solely under the rules set forth in § 1.863-1(b) of the final regulations. Treasury and the IRS clarified this point in corrections to the proposed regulations, published on August 27, 1996, in the **Federal Register** (61 FR 44023).

4. Additional production activities

The proposed regulations define additional production activities in § 1.863-1(b)(3)(ii) as substantial production activities performed by the taxpayer in addition to activities relating to the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber. The proposed regulations provide that generally the principles of § 1.954-3(a)(4) apply in determining whether an activity qualifies as such additional production. However, in no case will activities that prepare the natural resource itself for export, including those that are designed to facilitate transportation of the natural resource to or from the export terminal, be considered additional production. Thus, the proposed regulations in an example indicate liquefaction of natural gas would not constitute additional production activities.

Liquefaction is the process of liquefying natural gas so that it can be transported by tanker for sales abroad. Several commentators urged us to reconsider our position, arguing that liquefaction is an expensive, complex activity. Treasury and the IRS, however, continue to believe that liquefaction is an activity preparing the natural resource itself for export within the meaning of § 1.863-1(b)(3)(ii) of the final regulations, and that it is appropriate to exclude such activities from the definition of additional production. Even though liquefaction may be an expensive, complex process, liquefied natural gas retains its character as a natural resource, so that liquefaction should be treated no differently than other processes that prepare natural resources for export.

Several commentators requested that the regulations more precisely define the processes that constitute production of natural resources, to better differentiate those activities described in § 1.863-1(b)(1) of the proposed regulations, as being from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber, from those that qualify as additional production activities within the meaning of § 1.863-1(b)(3)(ii) of the proposed regulations. In particular, a commentator requested that the final regulations specifically address this issue in the case of mining. In response to this comment, the final regulations include an example describing certain mining processes that would not qualify as additional production activities in the case of copper.

5. Treatment of partnerships

The proposed regulations provide that, in applying the rules in § 1.863-3 of the proposed regulations, a partner would be treated as engaged in the production activity of its partnership. However, that provision was not extended to § 1.863-1 of the proposed regulations, which generally provides rules for determining the source of income from sales of natural resources. The final regulations provide rules for transactions involving partners and partnerships, which apply in the same manner to sales of natural resources and to sales of other inventory. See II. 3. of this preamble for a discussion of those rules.

6. Genetically-engineered agricultural products

One commentator requested that final regulations state that natural resources do not include products, such as certain seeds, where the premium value of the product is derived from genetic traits produced by biotechnology or traditional methods, and the seeds themselves are not grown for consumption. The inherent nature of products as agricultural products, however, does not change because they may be subject to research and development. Because they remain natural resources, Treasury and the IRS rejected this comment.

II. Allocation and apportionment of income from sales of inventory other than natural resources

Section 1.863-3 of the proposed regulations provides rules for allocating and apportioning income from inventory

sales other than natural resources where the taxpayer produces property in the United States and sells outside the United States, or produces property outside the United States and sells in the United States (Section 863 Sales). The proposed regulations provide three methods: the 50/50 method, the independent factory price method, and the books and records method.

1. Sales in international waters or in space

Consistent with the existing regulations, the proposed regulations limit the methods in § 1.863-3 to sales within a foreign country. The preamble, however, requests comments on whether the regulation should be expanded to cover sales made in international waters or in space. Although the statute refers to sales outside the United States, Treasury and the IRS expressed concern in that preamble that expanding the scope of the regulations to include all such sales could lead to abuses where, for example, a taxpayer produced goods in the United States, passed title to those goods outside the United States, and then sold the goods to U.S. customers. In considering whether to expand the scope of the final regulations to include such sales, Treasury and the IRS requested comments on whether to include an exception to the title passage rule for sales of goods produced in the United States and destined for the U.S. market.

In response to comments and consistent with the preamble to the proposed regulations, the final regulations expand the scope of the existing and proposed regulations to include sales outside the United States. Moreover, to prevent abuse from this expanded rule, the final regulations provide that sales of goods wholly produced in the United States and sold for use, consumption, or disposition in the United States, will be considered to take place in the United States. Income from such sales will be treated as from U.S. sources. The final regulations rely on rules in § 1.864-6(b)(3)(ii) (relating to the determination of whether foreign source income is effectively connected with a U.S. trade or business under section 864(c)(4)(iii)), for determining the country of use, consumption, or disposition. Also, property will be treated as wholly produced in the United States for this purpose if it is subject to no more than packaging, repackaging, labeling, or other minor assembly operations outside the United States. See also § 1.861-7(c) to deter-

mine the source of income in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance.

Treasury and the IRS are considering whether the rules of the final regulations are appropriate where a product is produced in one country but is destined for use either on the high seas or in space. Until additional guidance is provided, taxpayers may rely upon the general rules of the final regulations for these cases.

2. Segregation and aggregation of sales

Once a taxpayer selects a method under § 1.863-3(b) for dividing gross income derived from Section 863 Sales between production activity and sales activity, § 1.863-3(a) of the proposed regulations provide that a taxpayer must separately apply that method to Section 863 Sales in the United States and to Section 863 Sales outside the United States. The proposed regulations also provide in § 1.863-3(a) that taxpayers must determine the source of gross income under paragraph (c) and taxable income under paragraph (d) by aggregating all Section 863 Sales to which a method described in paragraph (b) applies.

The final regulations clarify that the rules of paragraphs (c) and (d) apply separately to Section 863 Sales in the United States and to Section 863 Sales outside the United States, so that taxpayers are required to aggregate all Section 863 Sales under paragraphs (c) and (d) after the taxpayer has first separately applied the method under paragraph (b) to Section 863 Sales in the United States and to Section 863 Sales outside the United States.

3. Transactions with partnerships

The proposed regulations provide in § 1.863-3(a) that a taxpayer's production activity includes production activities conducted through a partnership of which the taxpayer is a partner either directly or through one or more partnerships. One commentator recommended that final regulations extend the partnership rules to natural resources. However, the commentator suggested that an aggregate approach to partnerships should apply only in cases where the partnership, instead of selling the property and distributing the proceeds to the partner, distributes the property to a partner. In response to the comments, the final regulations modify the proposed regulations. Under the final regulations, the

aggregate approach applies to a partnership's production or sales activity only for two purposes. First, the aggregate approach applies for purposes of determining the source of a partner's distributive share of partnership income. Thus, if a partnership engages in the production of inventory property in the United States and sells such property outside the United States, a partner will be considered to have produced and sold that inventory property in the same manner as the partnership when determining the source of its distributive share of such sales income. Second, the aggregate approach applies for purposes of sourcing income from the sale of inventory property that is transferred in kind from or to a partnership. Thus, for example, where the partnership makes an in kind distribution of inventory property to its partners, the source of the partner's income from the sale of such property is determined based on both its own activity and on the partnership's activity. Similarly, the aggregate approach applies in cases where a partner contributes inventory produced by it to its partnership, if the partnership then sells the inventory (e.g., as a distributor or after further processing).

The entity approach applies for all other purposes. For example, where a partnership manufactures inventory property and sells the property to one of its partners, the source of that partner's income from the resale of the property is determined without regard to the partnership's manufacturing activity. Consistent with this modification, the final regulations also specify that assets owned by a partnership (or a partner) are not deemed owned by the partner (or the partnership) unless the aggregate approach applies to the transaction at issue.

4. Taxable income method

In response to comments, § 1.863-2(b) of the proposed regulations is clarified to provide that taxpayers may elect the principles of § 1.863-3(b)(1) and (c) to determine the source of taxable income (rather than gross income) from sales of inventory property.

5. Independent factory price (IFP) method

One commentator requested clarification that the sale establishing an IFP must be sourced under the IFP method only if a taxpayer elects the IFP method. The proposed and final regulations intend this result. The IFP method applies

to either the sale establishing the IFP or to a sale applying the IFP only if the taxpayer elects the IFP method.

The proposed regulations eliminated the provision in existing regulations permitting taxpayers to establish an IFP by methods other than by sales to independent distributors. The preamble, however, requested comments on the continued utility of such a provision. Two commentators recommended that the provision be retained and expanded to permit taxpayers to establish an IFP by any method that is appropriate under section 482. The commentators stated that any evidence acceptable for proving an arm's length price under section 482 should be acceptable as an IFP. The commentators also stated that taxpayers who cannot use the IFP method must use the 50/50 method, and that the 50/50 method may not produce an equitable result for nonresidents importing goods into the United States.

After further consideration, Treasury and the IRS have decided to finalize the regulations on this point as proposed. No convincing evidence has been presented for the need of a broad-based rule permitting taxpayers to establish an IFP by any method that would otherwise be appropriate under section 482 when they can use books and records to demonstrate a more appropriate sourcing result. In view of the absence of a clearly identified benefit for taxpayers and the availability of the books and records method, Treasury and the IRS believe that expansion of the IFP rule is not justified.

6. Books and records

Under both the existing and proposed regulations, taxpayers can request permission from the District Director to use a taxpayer's books and records to allocate or apportion income between U.S. and foreign sources if this method more clearly reflects the taxpayer's income. The preamble to the proposed regulations requests comments on retaining the books and records method. Two commentators asked for retention of this method because instances may arise where a taxpayer does not have third party sales, thereby making the IFP method unavailable. In such cases, a taxpayer may find it advantageous to determine the source of its income on the basis of its books and records. These comments were accepted. The final regulations retain the books and records

method, subject to an election and prior approval of the method by the District Director.

7. Determination of source of gross income from production activities

a. Definition of production assets

i. Contract manufacturing

Under the proposed regulations, production assets are limited to those owned directly by the taxpayer that are directly used by the taxpayer to produce the relevant inventory. These rules are intended to insure that taxpayers do not attribute the assets or activities of related or unrelated parties manufacturing under contract with the taxpayer. One commentator asked that the definition of production assets be expanded to include production assets owned by related or unrelated contract manufacturers. The commentator contends that by limiting production assets to those owned by the taxpayer, the regulations source income differently depending upon the form in which the taxpayer conducts business. Treasury and the IRS, however, believe it is appropriate to limit production assets in the apportionment formula to assets owned by the taxpayer and used by the taxpayer to produce the inventory. In addition, taxpayers generally do not know the contract manufacturer's basis in its production assets. Further, it would be very difficult to draw a clear line between contract manufacturers and other suppliers. Thus, Treasury and the IRS do not believe the source of a taxpayer's income should take into account activities of others or assets owned by others with whom the taxpayer has manufacturing arrangements. The final regulations clarify, however, that this rule does not override the single entity rules set forth under § 1.1502-13 (dealing with members of an affiliated group filing on a consolidated basis), or the rules under § 1.863-3(g) dealing with partnerships.

ii. Accounts receivable

One commentator also asserted that accounts receivable should be included as a production asset. This comment was rejected. The production formula is intended to approximate the location of the taxpayer's production activity. Thus, assets not directly involved in production should not be included.

b. Anti-abuse rule

The preamble to the proposed regulations indicated that the purpose of the property fraction is to attribute the source of production income to the

location of production activity. Treasury and the IRS, however, were concerned that taxpayers would attempt to artificially affect the location of assets to manipulate the rules, and so solicited comments on whether an anti-abuse rule was needed. No comments were received that objected to such anti-abuse rule. After further considering the issue, Treasury and the IRS have included an anti-abuse rule in the final regulations to prevent taxpayers from manipulating the property formula to achieve inappropriate results. Therefore, the anti-abuse rule provides that if a taxpayer has entered into or structured one or more transactions with a principal purpose of reducing its U.S. tax liability by affecting the formula in a manner inconsistent with the purpose of the regulation, the District Director may make appropriate adjustments so that the source of the taxpayer's income from production activity more clearly reflects the source of that income. An example in the regulations demonstrates circumstances where the anti-abuse rule may apply. In that example, with a principal purpose of reducing its U.S. tax liability, the taxpayer leases all of its U.S. property so that it owns only property located in a foreign country. The example concludes that the District Director may ignore a sale-leaseback transaction to more clearly reflect the source of the taxpayer's production income.

8. Determination of taxable income

One commentator requested that the calculation of taxable income, when applying the 50/50 method along with the research and experimental (R&E) expense allocation rules in § 1.861-17, be clarified. The commentator suggests that the last sentence of § 1.863-3(d) of the proposed regulations can be read to conflict with the R&E set aside in § 1.861-17. The final regulations clarify that the R&E set aside remains available to taxpayers using the 50/50 method.

9. Reporting requirements

The proposed regulations, in § 1.863-3(e), require a taxpayer to fully explain the methodology used to determine the source of income, the circumstances justifying use of that method, the extent that sales are aggregated, and the amount of income so allocated. One commentator wrote that the reporting requirements in § 1.863-3(e) of the proposed regulations are unnecessary and excessively burdensome. The regulations clarify that the requirement is limited to

a statement attached to the tax return, explaining the methodology used, the circumstances justifying that use, the aggregation of sales, and the amount of income allocated. Treasury and the IRS believe the reporting requirements in § 1.863-3(e) of the proposed regulations are reasonable, and serve legitimate administrative purposes.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the rules of this section principally impact large multinationals who pay foreign taxes on substantial foreign operations and therefore the rules will impact very few small entities. Moreover, in those few instances where the rules of this section impact small entities, the economic impact on such entities is not likely to be significant. Accordingly, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Anne Shelburne, Office of Associate Chief Counsel (International). 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 as follows:

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

Section 1.863-2 also issued under 26 U.S.C. 863.

Section 1.863-3 also issued under 26 U.S.C. 863.

Section 1.863-4 also issued under 26 U.S.C. 863.

Section 1.863-6 also issued under 26 U.S.C. 863. * * *

Par. 2. Sections 1.863-3 and 1.863-3T are redesignated as §§ 1.863-3A and 1.863-3AT, respectively, and an undesignated center heading is added preceding the redesignated sections to read as follows:

Regulations Applicable to Taxable Years Prior to December 30, 1996

Par. 3. Section 1.863-0 is added to read as follows:

§ 1.863-0 Table of contents.

This section lists captions contained in §§ 1.863-1, 1.863-2, and 1.863-3.

§ 1.863-1 Allocation of gross income.

- (a) In general.
- (b) Natural resources.
 - (1) In general.
 - (2) Additional production prior to export terminal.
 - (3) Definitions.
 - (i) Production activity.
 - (ii) Additional production activities.
 - (iii) Export terminal.
 - (4) Determination of fair market value.
 - (5) Determination of gross income.
 - (6) Tax return disclosure.
 - (7) Examples.
- (c) Determination of taxable income.
- (e) Effective dates.

§ 1.863-2 Allocation and apportionment of taxable income.

- (a) Determination of taxable income.
- (b) Determination of source of taxable income.
- (c) Effective dates.

§ 1.863-3 Allocation and apportionment of income from certain sales of inventory.

- (a) In general.
 - (1) Scope
 - (2) Special rules
 - (b) Methods to determine income attributable to production activity and sales activity.
 - (1) 50/50 method.
 - (i) Determination of gross income.
 - (ii) Example.
 - (2) IFP method.
 - (i) Establishing an IFP.
 - (ii) Applying the IFP method.
 - (iii) Determination of gross income.
 - (iv) Examples.

(3) Books and records method.

(c) Determination of the source of gross income from production activity and sales activity.

(1) Income attributable to production activity.

(i) Production only within the United States or only within foreign countries.

(A) Source of income.

(B) Definition of production assets.

(C) Location of production assets.

(ii) Production both within the United States and within foreign countries.

(A) Source of income.

(B) Adjusted basis of production assets.

(iii) Anti-abuse rule.

(iv) Examples.

(2) Income attributable to sales activity.

(d) Determination of source of taxable income.

(e) Election and reporting rules.

(1) Elections under paragraph (b) of this section.

(2) Disclosure on tax return.

(f) Income partly from sources within a possession of the United States.

(g) Special rules for partnerships.

(h) Effective dates.

Par. 4. In § 1.863-1, paragraphs (a), (b) and (c) are revised and paragraph (e) is added to read as follows:

§ 1.863-1 Allocation of gross income.

(a) *In general.* Items of gross income other than those specified in section 861(a) and section 862(a) will generally be separately allocated to sources within or without the United States. See § 1.863-2 for alternate methods to determine the income from sources within or without the United States in the case of items specified in § 1.863-2(a). See also sections 865(b) and (e)(2). In the case of sales of property involving partners and partnerships, the rules of § 1.863-3(g) apply.

(b) *Natural resources*—(1) *In general.* Notwithstanding any other provision, except to the extent provided in paragraph (b)(2) of this section, gross receipts from the sale outside the United States of products derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber within the United States, must be allocated between sources within and without the United States based on the fair market value of the product at the export terminal (as defined in paragraph (b)(3)(iii) of this section). Notwithstanding any other pro-

vision, except to the extent provided in paragraph (b)(2) of this section, gross receipts from the sale within the United States of products derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber outside the United States must be allocated between sources within and without the United States based on the fair market value of the product at the export terminal. For place of sale, see §§ 1.861-7(c) and 1.863-3(c)(2). The source of gross receipts equal to the fair market value of the product at the export terminal will be from sources where the farm, mine, well, deposit, or uncut timber is located. The source of gross receipts from the sale of the product in excess of its fair market value at the export terminal (excess gross receipts) will be determined as follows—

(i) If the taxpayer engages in additional production activities subsequent to shipment from the export terminal and outside the country of sale, the source of excess gross receipts must be determined under § 1.863-3. For purposes of applying § 1.863-3, only production assets used in additional production activity subsequent to the export terminal are taken into account.

(ii) In all other cases, excess gross receipts will be from sources within the country of sale. This paragraph (b)(1)(ii) applies to a taxpayer that engages in additional production activities in the country of sale, as well as to a taxpayer that does not engage in additional production activities at all.

(2) *Additional production prior to export terminal.* Notwithstanding any other provision of this section, gross receipts from the sale of products derived by a taxpayer who performs additional production activities as defined in paragraph (b)(3)(ii) of this section before the relevant product is shipped from the export terminal are allocated between sources within and without the United States based on the fair market value of the product immediately prior to the additional production activities. The source of gross receipts equal to the fair market value of the product immediately prior to the additional production activities will be from sources where the farm, mine, well, deposit, or uncut timber is located. The source of gross receipts from the sale of the product in excess of the fair market value immediately prior to the additional production activities must be determined under § 1.863-3. For purposes of applying

§ 1.863-3, only production assets used in the additional production activities are taken into account.

(3) *Definitions*—(i) *Production activity.* For purposes of this section, production activity means an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages inventory. See § 1.864-1. Except as otherwise provided in §§ 1.1502-13 or 1.863-(g)(2), only production activities conducted directly by the taxpayer are taken into account.

(ii) *Additional production activities.* For purposes of this section, additional production activities are substantial production activities performed directly by the taxpayer in addition to activities from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber. Whether a taxpayer's activities constitute additional production activities will be determined under the principles of § 1.954-3(a)(4). However, in no case will activities that prepare the natural resource itself for export, including those that are designed to facilitate the transportation of the natural resource to or from the export terminal, be considered additional production activities for purposes of this section.

(iii) *Export terminal.* Where the farm, mine, well, deposit, or uncut timber is located without the United States, the export terminal will be the final point in a foreign country from which goods are shipped to the United States. If there is no such final point in a foreign country (e.g., the property is extracted and produced on the high seas), the export terminal will be the place of production. Where the farm, mine, well, deposit, or uncut timber is located within the United States, the export terminal will be the final point in the United States from which goods are shipped from the United States to a foreign country. The location of the export terminal is determined without regard to any contractual terms agreed to by the taxpayer and without regard to whether there is an actual sale of the products at the export terminal.

(4) *Determination of fair market value.* For purposes of this section, fair market value depends on all of the facts and circumstances as they exist relative to a party in any particular case. Where the products are sold to a related party in a transaction subject to section 482, the determination of fair market value

under this section must be consistent with the arm's length price determined under section 482.

(5) *Determination of gross income.* To determine the amount of a taxpayer's gross income from sources within or without the United States, the taxpayer's gross receipts from sources within or without the United States determined under this paragraph (b) must be reduced by the cost of goods sold properly attributable to gross receipts from sources within or without the United States.

(6) *Tax return disclosure.* A taxpayer that determines the source of its income under this paragraph (b) shall attach a statement to its return explaining the methodology used to determine fair market value under paragraph (b)(4) of this section, and explaining any additional production activities (as defined in paragraph (b)(3)(ii) of this section) performed by the taxpayer. In addition, the taxpayer must provide such other information as is required by § 1.863-3.

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

Example 1. No additional production. U.S. Mines, a U.S. corporation, operates a copper mine and mill in country X. U.S. Mines extracts copper-bearing rocks from the ground and transports the rocks to the mill where the rocks are ground and processed to produce copper-bearing concentrate. The concentrate is transported to a port where it is dried in preparation for export, stored and then shipped to purchasers in the United States. Because title to the property is passed in the United States and, under the facts and circumstances, none of U.S. Mine's activities constitutes additional production prior to the export terminal within the meaning of § 1.863-1(b)(3)(ii), under § 1.863-1(b)(1) and (b)(1)(ii), gross receipts equal to the fair market value of the concentrate at the export terminal will be from sources without the United States, and excess gross receipts will be from sources within the United States.

Example 2. No additional production. US Gas, a U.S. corporation, extracts natural gas within the United States, and transports the natural gas to a U.S. port where it is liquified in preparation for shipment. The liquified natural gas is then transported via freighter and sold without additional production activities in a foreign country. Liquefaction of natural gas is not an additional production activity because liquefaction prepares the natural gas for transportation from the export terminal. Therefore, under § 1.863-1(b)(1) and (b)(1)(ii), gross receipts equal to the fair market value of the liquified natural gas at the export terminal will be from sources within the United States, and excess gross receipts will be from sources without the United States.

Example 3. Sale in third country. US Gold, a U.S. corporation, mines gold in country X, produces gold jewelry in the United States, and sells the jewelry in country Y. Assume that the fair market value of the gold at the export terminal in

country X is \$40, and that US Gold ultimately sells the gold jewelry in country Y for \$100. Under § 1.863-1(b), \$40 of US Gold's gross receipts will be allocated to sources without the United States. Under § 1.863-1(b)(1)(i), the source of the remaining \$60 of gross receipts will be determined under § 1.863-3. If US Gold applies the 50/50 method described in § 1.863-3, \$20 of cost of goods sold is properly attributable to activities subsequent to the export terminal, and all of US Gold's production assets subsequent to the export terminal are located in the United States, then \$20 of gross income will be allocated to sources within the United States and \$20 of gross income will be allocated to sources without the United States.

Example 4. Production in country of sale. US Oil, a U.S. corporation, extracts oil in country X, transports the oil via pipeline to the export terminal in country Y, refines the oil in the United States, and sells the refined product in the United States to unrelated persons. Assume that the fair market value of the oil at the export terminal in country Y is \$80, and that US Oil ultimately sells the refined product for \$100. Under § 1.863-1(b)(1), \$80 of US Oil's gross receipts will be allocated to sources without the United States, and under § 1.863-1(b)(1)(ii) the remaining \$20 of gross receipts will be allocated to sources within the United States.

Example 5. Additional production prior to export. The facts are the same as in *Example 1*, except that U.S. Mines also operates a smelter in country X. The concentrate output from the mill is transported to the smelter where it is transformed into smelted copper. The smelted copper is exported to purchasers in the United States. Under the facts and circumstances, all of the processes applied to make copper concentrate are considered mining. Therefore, under § 1.863-1(b)(2), gross receipts equal to the fair market value of the concentrate at the smelter will be from sources without the United States. Under the facts and circumstances, the conversion of the concentrate into smelted copper is an additional production activity in a foreign country within the meaning of § 1.863-1(b)(3)(ii). Therefore, the source of U.S. Mine's excess gross receipts will be determined pursuant to § 1.863-1(b)(2).

(c) *Determination of taxable income.* The taxpayer's taxable income from sources within or without the United States will be determined under the rules of §§ 1.861-8 through 1.861-14T for determining taxable income from sources within the United States.

* * * * *

(e) *Effective dates.* The rules of paragraphs (a), (b) and (c) of this section will apply to taxable years beginning December 30, 1996. However, taxpayers may apply the rules of this section for taxable years beginning after July 11, 1995, and before December 30, 1996. For years beginning before December 30, 1996, see § 1.863-1 (as contained in 26 CFR part 1 revised as of April 1, 1996).

Par. 5. Section 1.863-2 is revised to read as follows:

§ 1.863-2 *Allocation and apportionment of taxable income.*

(a) *Determination of taxable income.* Section 863(b) provides an alternate method for determining taxable income from sources within the United States in the case of gross income derived from sources partly within and partly without the United States. Under this method, taxable income is determined by deducting from such gross income the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions that cannot definitely be allocated to some item or class of gross income. The income to which this section applies (and that is treated as derived partly from sources within and partly from sources without the United States) will consist of gains, profits, and income

(1) From certain transportation or other services rendered partly within and partly without the United States to the extent not within the scope of section 863(c) or other specific provisions of this title;

(2) From the sale of inventory property (within the meaning of section 865(i)) produced (in whole or in part) by the taxpayer in the United States and sold outside the United States or produced (in whole or in part) by the taxpayer outside the United States and sold in the United States; or

(3) Derived from the purchase of personal property within a possession of the United States and its sale within the United States, to the extent not excluded from the scope of these regulations under § 1.936-6(a)(5), Q&A 7.

(b) *Determination of source of taxable income.* Income treated as derived from sources partly within and partly without the United States under paragraph (a) of this section may be allocated to sources within and without the United States pursuant to § 1.863-1 or apportioned to such sources in accordance with the methods described in other regulations under section 863. To determine the source of certain types of income described in paragraph (a)(1) of this section, see § 1.863-4. To determine the source of gross income described in paragraph (a)(2) of this section, see § 1.863-1 for natural resources and see § 1.863-3 for other inventory. Taxpayers, at their election, may apply the principles of § 1.863-3(b)(1) and (c) to determine the source of taxable income (rather than gross income) from

sales of inventory property (other than natural resources). To determine the source of income partly from sources within a possession of the United States, including income described in paragraph (a)(3) of this section, see § 1.863-3(f).

(c) *Effective dates.* This section will apply to taxable years beginning December 30, 1996. However, taxpayers may apply the rules of this section for taxable years beginning after July 11, 1995, and before December 30, 1996. For years beginning before December 30, 1996, see § 1.863-2 (as contained in 26 CFR part 1 revised as of April 1, 1996).

Par. 6. Section 1.863-3 is added to read as follows:

§ 1.863-3 Allocation and apportionment of income from certain sales of inventory.

(a) *In general—(1) Scope.* Paragraphs (a) through (e) of this section apply to determine the source of income derived from the sale of inventory property (inventory), which a taxpayer produces (in whole or in part) within the United States and sells outside the United States, or which a taxpayer produces (in whole or in part) outside the United States and sells within the United States (Section 863 Sales). A taxpayer must divide gross income from Section 863 Sales between production activity and sales activity using one of the methods described in paragraph (b) of this section. The source of gross income from production activity and from sales activity must then be determined under paragraph (c) of this section. Taxable income from Section 863 Sales is determined under paragraph (d) of this section. Paragraph (e) of this section describes the rules for electing the methods described in paragraph (b) of this section and the information that a taxpayer must disclose on a tax return. Paragraph (f) of this section applies to determine the source of certain income derived from a possession of the United States. Paragraph (g) of this section provides special rules for partnerships for all sales subject to §§ 1.863-1 through 1.863-3. Paragraph (h) of this section provides effective dates for the rules in this section.

(2) *Rules of application for Section 863 Sales.* Once a taxpayer has elected a method described in paragraph (b) of this section, the taxpayer must separately apply that method to Section 863 Sales in the United States and to Section

863 Sales outside the United States. In addition, the taxpayer must apply the rules of paragraphs (c) and (d) of this section by aggregating all Section 863 Sales to which a method described in paragraph (b) of this section applies, after separately applying that method to Section 863 Sales in the United States and to Section 863 Sales outside the United States. See section 865(i)(1) for the definition of inventory property. See also section 865(e)(2). See § 1.861-7(c) and paragraph (c)(2) of this section for the time and place of sale.

(b) *Methods to determine income attributable to production activity and sales activity—(1) 50/50 method—*

(i) *Determination of gross income.* Generally, gross income from Section 863 Sales will be apportioned between production activity and sales activity under the 50/50 method as described in this paragraph (b)(1). Under the 50/50 method, one-half of the taxpayer's gross income will be considered income attributable to production activity and the source of that income will be determined under the rules of paragraph (c)(1) of this section. The remaining one-half of such gross income will be considered income attributable to sales activity and the source of that income will be determined under the rules of paragraph (c)(2) of this section. In lieu of the 50/50 method, the taxpayer may elect to determine the source of income from Section 863 Sales under the IFP method described in paragraph (b)(2) of this section or, with the consent of the District Director, the books and records method described in paragraph (b)(3) of this section.

(ii) *Example.* The following example illustrates the rules of this paragraph (b)(1):

Example. 50/50 method. (i) P, a U.S. corporation, produces widgets in the United States. P sells the widgets for \$100 to D, an unrelated foreign distributor, in another country. P's cost of goods sold is \$40. Thus, P's gross income is \$60.

(ii) Pursuant to the 50/50 method, one-half of P's gross income, or \$30, is considered income attributable to production activity, and one-half of P's gross income, or \$30, is considered income attributable to sales activity.

(2) *IFP method—(i) Establishing an IFP.* A taxpayer may elect to allocate gross income earned from production activity and sales activity using the independent factory price (IFP) method described in this paragraph (b)(2) if an IFP is fairly established. An IFP is fairly established based on a sale by the taxpayer only if the taxpayer regularly sells part of its output to wholly inde-

pendent distributors or other selling concerns in such a way as to reasonably reflect the income earned from production activity. A sale will not be considered to fairly establish an IFP if sales activity by the taxpayer with respect to that sale is significant in relation to all of the activities with respect to that product.

(ii) *Applying the IFP method.* If the taxpayer elects to use the IFP method, the amount of the gross sales price equal to the IFP will be treated as attributable to production activity, and the excess of the gross sales price over the IFP will be treated as attributable to sales activity. If a taxpayer elects to use the IFP method, the IFP must be applied to all Section 863 Sales of inventory that are substantially similar in physical characteristics and function, and are sold at a similar level of distribution as the inventory sold in the sale fairly establishing an IFP. The IFP will only be applied to sales that are reasonably contemporaneous with the sale fairly establishing the IFP. An IFP cannot be applied to sales in other geographic markets if the markets are substantially different. If the taxpayer elects the IFP method, the rules of this paragraph will also apply to determine the division of gross receipts between production activity and sales activity in a Section 863 Sale that itself fairly establishes an IFP. If the taxpayer elects to apply the IFP method, the IFP method must be applied to all sales for which an IFP may be fairly established and applied for that taxable year and each subsequent taxable year. The taxpayer will apply either the 50/50 method described in paragraph (b)(1) of this section or the books and records method described in paragraph (b)(3) of this section to any other Section 863 Sale for which an IFP cannot be established or applied for each taxable year.

(iii) *Determination of gross income.* The amount of a taxpayer's gross income from production activity is determined by reducing the amount of gross receipts from production activity by the cost of goods sold properly attributable to production activity. The amount of a taxpayer's gross income from sales activity is determined by reducing the amount of gross receipts from sales activity by the cost of goods sold (if any) properly attributable to sales activity. The source of gross income from production activity is determined under the rules of paragraph (c)(1) of this section, and the source of gross income

from sales activity will be determined under the rules of paragraph (c)(2) of this section.

(iv) *Examples.* The following examples illustrate the rules of this paragraph (b)(2):

Example 1. IFP method. (i) P, a U.S. producer, purchases cotton and produces cloth in the United States. P sells cloth in country X to D, an unrelated foreign clothing manufacturer, for \$100. Cost of goods sold for cloth is \$80, entirely attributable to production activity. P does not engage in significant sales activity in relation to its other activities in the sales to D. Under these facts, the sale to D fairly establishes an IFP of \$100. Assume that P elects to use the IFP method. Accordingly, \$100 of the gross sales price is treated as attributable to production activity, and no amount of income from this sale is attributable to sales activity. After reducing the gross sales price by cost of goods sold, \$20 of the gross income is treated as attributable to production activity (\$100–\$80).

(ii) P also sells cloth in country X to A, a unrelated foreign retail outlet, for \$110. Because P elected the IFP method and the cloth is substantially similar to the cloth sold to D, the IFP fairly established in the sales to D must be used to determine the amount attributable to production activity in the sale to A. Accordingly, \$100 of the gross sales price is treated as attributable to production activity and \$10 (\$110–\$100) is attributable to sales activity. After reducing the gross sales price by cost of goods sold, \$20 of the gross income is treated as attributable to production activity (\$100–\$80) and \$10 is attributable to sales activity.

Example 2. Scope of IFP Method. (i) USCo manufactures three dissimilar products. USCo elects to apply the IFP method. In year 1, an IFP can be established for sales of product X, but not for products Y and Z. In year 2, an IFP cannot be established for any of USCo's products. In year 3, an IFP can be established for products X and Y, but not for product Z.

(ii) In year 1, USCo must apply the IFP method to sales of product X. In year 2, although USCo's IFP election remains in effect, USCo is not required to apply the IFP election to any products. In year 3, USCo is required to apply the IFP method to sales of products X and Y.

(3) *Books and records method.* A taxpayer may elect to determine the amount of its gross income from Section 863 Sales that is attributable to production and sales activities for the taxable year based upon its books of account if it has received in advance the permission of the District Director having audit responsibility over its tax return. The taxpayer must establish to the satisfaction of the District Director that the taxpayer, in good faith and unaffected by considerations of tax liability, will regularly employ in its books of account a detailed allocation of receipts and expenditures which clearly reflects the amount of the taxpayer's income from production and sales activities. If a taxpayer receives permission to apply the books and records method, but does not comply with a material condition set

forth by the District Director, the District Director may, in its discretion, revoke permission to use the books and records method. The source of gross income treated as attributable to production activity under this method may be determined under the rules of paragraph (c)(1) of this section, and the source of gross income attributable to sales activity will be determined under the rules of paragraph (c)(2) of this section.

(c) *Determination of the source of gross income from production activity and sales activity—*(1) *Income attributable to production activity—*(i) *Production only within the United States or only within foreign countries—*(A) *Source of income.* For purposes of this section, production activity means an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages inventory. See § 1.864–1. Subject to the provisions in § 1.1502–13 or paragraph (g)(2)(ii) of this section, the only production activities that are taken into account for purposes of §§ 1.863–1, 1.863–2, and this section are those conducted directly by the taxpayer. Where the taxpayer's production assets are located only within the United States or only outside the United States, the income attributable to production activity is sourced where the taxpayer's production assets are located. For rules regarding the source of income when production assets are located both within the United States and without the United States, see paragraph (c)(1)(ii) of this section.

(B) *Definition of production assets.* Subject to the provisions of § 1.1502–13 and paragraph (g)(2)(ii) of this section, production assets include only tangible and intangible assets owned directly by the taxpayer that are directly used by the taxpayer to produce inventory described in paragraph (a) of this section. Production assets do not include assets that are not directly used to produce inventory described in paragraph (a) of this section. Thus, production assets do not include such assets as accounts receivables, intangibles not related to production of inventory (e.g., marketing intangibles, including trademarks and customer lists), transportation assets, warehouses, the inventory itself, raw materials, or work-in-process. In addition, production assets do not include cash or other liquid assets (including working capital), investment assets, prepaid expenses, or stock of a subsidiary.

(C) *Location of production assets.* For purposes of this section, a tangible

production asset will be considered located where the asset is physically located. An intangible production asset will be considered located where the tangible production assets owned by the taxpayer to which it relates are located.

(ii) *Production both within the United States and within foreign countries—*(A) *Source of income.* Where the taxpayer's production assets are located both within and without the United States, income from sources without the United States will be determined by multiplying the income attributable to the taxpayer's production activity by a fraction, the numerator of which is the average adjusted basis of production assets that are located outside the United States and the denominator of which is the average adjusted basis of all production assets within and without the United States. The remaining income is treated as from sources within the United States.

(B) *Adjusted basis of production assets.* For purposes of paragraph (c)(1)(ii)(A) of this section, the adjusted basis of an asset is determined under section 1011. The average adjusted basis is computed by averaging the adjusted basis of the asset at the beginning and end of the taxable year, unless by reason of material changes during the taxable year such average does not fairly represent the average for such year. In this event, the average adjusted basis will be determined upon a more appropriate basis. If production assets are used to produce inventory sold in Section 863 Sales and are also used to produce other property during the taxable year, the portion of its adjusted basis that is included in the fraction described in paragraph (c)(1)(ii)(A) of this section will be determined under any method that reasonably reflects the portion of the assets that produces inventory sold in Section 863 Sales. For example, the portion of such an asset that is included in the formula may be determined by multiplying the asset's average adjusted basis by a fraction, the numerator of which is the gross receipts from sales of inventory from Section 863 Sales produced by the asset, and the denominator of which is the gross receipts from all property produced by that asset.

(iii) *Anti-abuse rule.* The purpose of this paragraph (c)(1) is to attribute the source of the taxpayer's production income to the location of the taxpayer's production activity. Therefore, if the taxpayer has entered into or structured one or more transactions with a princi-

pal purpose of reducing its U.S. tax liability by manipulating the formula described in paragraph (c)(1)(ii)(A) of this section in a manner inconsistent with the purpose of this paragraph (c)(1), the District Director may make appropriate adjustments so that the source of the taxpayer's income from production activity more clearly reflects the source of that income.

(iv) *Examples.* The following examples illustrate the rules of this paragraph (c)(1):

Example 1. Source of production income. (i) A, a U.S. corporation, produces widgets that are sold both within the United States and within a foreign country. The initial manufacture of all widgets occurs in the United States. The second stage of production of widgets that are sold within a foreign country is completed within the country of sale. A's U.S. plant and machinery which is involved in the initial manufacture of the widgets has an average adjusted basis of \$200. A also owns warehouses used to store work-in-process. A owns foreign equipment with an average adjusted basis of \$25. A's gross receipts from all sales of widgets is \$100, and its gross receipts from export sales of widgets is \$25. Assume that apportioning average adjusted basis using gross receipts is reasonable. Assume A's cost of goods sold from the sale of widgets in the foreign countries is \$13 and thus, its gross income from widgets sold in foreign countries is \$12. A uses the 50/50 method to divide its gross income between production activity and sales activity.

(ii) A determines its production gross income from sources without the United States by multiplying one-half of A's \$12 of gross income from sales of widgets in foreign countries, or \$6, by a fraction, the numerator of which is all relevant foreign production assets, or \$25, and the denominator of which is all relevant production assets, or \$75 (\$25 foreign assets + (\$200 U.S. assets X \$25 gross receipts from export sales/\$100 gross receipts from all sales)). Therefore, A's gross production income from sources without the United States is \$2 ($\$6 \times (\$25/\$75)$).

Example 2. Location of intangible property. Assume the same facts as *Example 1*, except that A employs a patented process that applies only to the initial production of widgets. In computing the formula used to determine the source of income from production activity, A's patent, if it has an average adjusted basis, would be located in the United States.

Example 3. Anti-abuse rule. (i) Assume the same facts as *Example 1*. A sells its U.S. assets to B, an unrelated U.S. corporation, with a principal purpose of reducing its U.S. tax liability by manipulating the property fraction. A then leases these assets from B. After this transaction, under the general rule of paragraph (c)(1)(ii) of this section, all of A's production income would be considered from sources without the United States, because all of A's relevant production assets are located within a foreign country. Since the leased property is not owned by the taxpayer, it is not included in the fraction.

(ii) Because A has entered into a transaction with a principal purpose of reducing its U.S. tax liability by manipulating the formula described in paragraph (c)(1)(ii)(A) of this section, A's income must be adjusted to more clearly reflect the source of that income. In this case, the District Director

may redetermine the source of A's production income by ignoring the sale-leaseback transactions.

(2) *Income attributable to sales activity.* The source of the taxpayer's income that is attributable to sales activity will be determined under the provisions of § 1.861-7(c). However, notwithstanding any other provision, for purposes of section 863, the place of sale will be presumed to be the United States if personal property is wholly produced in the United States and the property is sold for use, consumption, or disposition in the United States. See § 1.864-6(b)(3)(ii) to determine the country of use, consumption, or disposition. Also, in applying this paragraph, property will be treated as wholly produced in the United States if it is subject to no more than packaging, repackaging, labeling, or other minor assembly operations outside the United States, within the meaning of § 1.954-3(a)(4)(iii) (property manufactured or produced by a controlled foreign corporation).

(d) *Determination of source of taxable income.* Once the source of gross income has been determined under paragraph (c) of this section, the taxpayer must properly allocate and apportion separately under §§ 1.861-8 through 1.861-14T the amounts of its expenses, losses, and other deductions to its respective amounts of gross income from Section 863 Sales determined separately under each method described in paragraph (b) of this section. In addition, if the taxpayer deducts expenses for research and development under section 174 that may be attributed to its Section 863 Sales under § 1.861-8(e)(3), the taxpayer must separately allocate or apportion expenses, losses, and other deductions to its respective amounts of gross income from each relevant product category that the taxpayer uses in applying the rules of § 1.861-8(e)(3)(i)(A). In the case of gross income from Section 863 Sales determined under the IFP method or the books and records method, the rules of §§ 1.861-8 through 1.861-14T must apply to properly allocate or apportion amounts of expenses, losses and other deductions allocated and apportioned to such gross income between gross income from sources within and without the United States. In the case of gross income from Section 863 Sales determined under the 50/50 method, the amounts of expenses, losses, and other deductions allocated and apportioned to such gross income must be apportioned between sources

within and without the United States pro rata based on the relative amounts of gross income from sources within and without the United States determined under the 50/50 method. Research and experimental expenditures qualifying under § 1.861-17 are allocated under that section, and are not allocated and apportioned pro rata under the 50/50 method.

(e) *Election and reporting rules—*
(1) *Elections under paragraph (b) of this section.* If a taxpayer does not elect a method specified in paragraph (b)(2) or (3) of this section, the taxpayer must apply the method specified in paragraph (b)(1) of this section. The taxpayer may elect to apply the method specified in paragraph (b)(2) of this section by using the method on a timely filed original return (including extensions). A taxpayer may elect to apply the method specified in paragraph (b)(3) of this section by using the method on a timely filed original return (including extensions), but only if the taxpayer has received permission from the District Director to apply that method. Once a method under paragraph (b) of this section has been used, that method must be used in later taxable years unless the Commissioner consents to a change. However, if a taxpayer elects to change to or from the method specified in paragraph (b)(3) of this section, the taxpayer must obtain permission from the District Director instead of the Commissioner. Permission to change methods from one year to another year will not be withheld unless the change would result in a substantial distortion of the source of the taxpayer's income.

(2) *Disclosure on tax return.* A taxpayer who uses one of the methods described in paragraph (b) of this section must fully explain in a statement attached to the return the methodology used, the circumstances justifying use of that methodology, the extent that sales are aggregated, and the amount of income so allocated.

(f) *Income partly from sources within a possession of the United States.* Taxpayers with income partly from sources within a possession of the United States must apply the rules of § 1.863-3A(c).

(g) *Special rules for partnerships—*
(1) *General rule.* For purposes of § 1.863-1 and this section, a taxpayer's production or sales activity does not include production and sales activities conducted by a partnership of which the taxpayer is a partner either directly or through one or more partnerships, ex-

cept as otherwise provided in paragraph (g)(2) of this section.

(2) *Exceptions*—(i) *In general*. For purposes of determining the source of the partner’s distributive share of partnership income or determining the source of the partner’s income from the sale of inventory property which the partnership distributes to the partner in kind, the partner’s production or sales activity includes an activity conducted by the partnership. In addition, the production activity of a partnership includes the production activity of a taxpayer that is a partner either directly or through one or more partnerships, to the extent that the partner’s production activity is related to inventory that the partner contributes to the partnership in a transaction described under section 721.

(ii) *Attribution of production assets to or from a partnership*. A partner will be treated as owning its proportionate share of the partnership’s production assets only to the extent that, under paragraph (g)(2)(i) of this section, the partner’s activity includes production activity conducted through a partnership. A partner’s share of partnership assets will be determined by reference to the partner’s distributive share of partnership income for the year attributable to such production assets. Similarly, to the extent a partnership’s activities include the production activities of a partner, the partnership will be treated as owning the partner’s production assets related to the inventory that is contributed in kind to the partnership. See paragraph (c)(1)(ii)(B) of this section for rules apportioning the basis of assets to Section 863 Sales.

(iii) *Basis*. For purposes of this section, in those cases where the partner is treated as owning its proportionate share of the partnership’s production assets, the partner’s basis in production assets held through a partnership shall be determined by reference to the partnership’s adjusted basis in its assets (including a partner’s special basis adjustment, if any, under section 743). Similarly, a partnership’s basis in a partner’s production assets is determined with reference to the partner’s adjusted basis in its assets.

(iv) *Separate application of methods*. If, under paragraph (g)(2) of this section, a partner is treated as conducting the activity of a partnership, and is treated as owning its proportionate share of a partnership’s production assets, a partner must apply the method it has elected under paragraph (b) of this section

separately to Section 863 Sales described in this paragraph (g) and all other Section 863 Sales.

(3) *Examples*. The following examples illustrate the rules of this paragraph (g):

Example 1. Distributive share of partnership income. A, a U.S. corporation, forms a partnership in the United States with B, a country X corporation. A and B each have a 50 percent interest in the income, gains, losses, deductions and credits of the partnership. The partnership is engaged in the manufacture and sale of widgets. The widgets are manufactured in the partnership’s plant located in the United States and are sold by the partnership outside the United States. The partnership owns the manufacturing facility and all other production assets used to produce the widgets. A’s distributive share of partnership income includes 50 percent of the sales income from these sales. In applying the rules of section 863 to determine the source of its distributive share of partnership income from the export sales of widgets, A is treated as carrying on the activity of the partnership related to production of these widgets and as owning a proportionate share of the partnership’s assets related to production of the widgets, based upon its distributive share of partnership income.

Example 2. Distribution in kind. Assume the same facts as in *Example 1* except that the partnership, instead of selling the widgets, distributes the widgets to A and B. A then further processes the widgets and then sells them outside the United States. In determining the source of the income earned by A on the sales outside the United States, A is treated as conducting the activities of the partnership related to production of the distributed widgets. Thus, the source of gross income on the sale of the widgets is determined under section 863 and these regulations. A applies the 50/50 method described in paragraph (b)(1) of this section to determine the source of income from the sales. In applying paragraph (c)(1) of this section, A is treated as owning its proportionate share of the partnership’s production assets based upon its distributive share of partnership income.

(h) *Effective dates*. The rules of this section apply to taxable years beginning December 30, 1996. However, taxpayers may apply these regulations for taxable years beginning after July 11, 1995, and before December 30, 1996. For years beginning before December 30, 1996, see §§ 1.863–3A and 1.863–3AT.

Par. 7. Section 1.863–4 is amended by revising the section heading and paragraph (a) to read as follows:

§ 1.863–4 *Certain transportation services.*

(a) *General*. A taxpayer carrying on the business of transportation service (other than an activity giving rise to transportation income described in section 863(c) or to income subject to other specific provisions of this title) between points in the United States and points outside the United States derives income partly from sources within and partly from sources without the United States.

§ 1.863–5 [Removed]

Par. 8. Section 1.863–5 is removed.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 9. The authority citation for part 602 continues to read as follows:
Authority: 26 U.S.C. 7805.

Par. 10. In § 602.101, paragraph (c) is amended by adding entries for 1.863–1 and 1.863–3A, and revising the entry for 1.863–3 to read as follows:

§ 602.101 *OMB Control numbers.*

(c)

CFR part or section where identified and described	Current OMB control No.
1.863–1	1545–1476
1.863–3	1545–1476
1.863–3A	1545–0126

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved November 25, 1996.

Donald C. Lubick,
Acting Assistant Secretary of Tax Policy.

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