interest shall be allocated to the class of gross income and apportioned to the statutory grouping(s) or residual grouping of gross income to which the excess inclusion income was assigned.

(f) *Effective/applicability date.* Paragraph (e)(2) of this section applies for taxable years ending after August 1, 2006.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 8615, 60 FR 44275, Aug. 25, 1995; T.D. 8687, 61 FR 60545, Nov. 29, 1996; 61 FR 65323, Dec. 12, 1996; T.D. 9128, 69 FR 26041, May 11, 2004; T.D. 9272, 71 FR 43366, Aug. 1, 2006; T.D. 9415, 73 FR 40172, July 14, 2008]

**§ 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 after December 30, 1996. However, taxpayers may apply the rules of this section for taxable years beginning after July 11, 1995, and on or 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).

[T.D. 8687, 61 FR 60546, Nov. 29, 1996; 61 FR 65323, Dec. 12, 1996]

**§ 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). To determine the source of income from sales of property produced by the taxpayer, when the property is either produced in whole or in part in space or on or under water not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States (in international water), or is sold in space or international water, the rules of §1.863–8 apply, and the rules of this section do not apply except to the extent provided in §1.863–8. 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 independent 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, an 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. For rules regarding the source of income when production takes place, in whole or in part, in space or international water, the rules of §1.863–8 apply, and the rules of this section do not apply except to the extent provided in §1.863–8.

(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 principal 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 × $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×($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). Notwithstanding any other provision, for rules regarding the source of income when a sale takes place in space or international water, the rules of §1.863–8 apply, and the rules of this section do not apply except to the extent provided in §1.863–8. 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). Notwithstanding any other provision, for rules regarding the source of income when a sale takes place in space or international water, the rules of § 1.863–8 apply, and the rules of this section do not apply except to the extent provided in § 1.863–8.

(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*—(1) *In general.* This paragraph (f) relates to gains, profits, and income, which are treated as derived partly from sources within the United States and partly from sources within a possession of the

United States (Section 863 Possession Sales). This paragraph (f) applies to determine the source of income derived from the sale of inventory produced (in whole or in part) by the taxpayer within the United States and sold within a possession, or produced (in whole or in part) by a taxpayer in a possession and sold within the United States (Possession Production Sales). It also applies to determine the source of income derived from the purchase of personal property within a possession of the United States and its sale within the United States (Possession Purchase Sales). A taxpayer subject to this paragraph (f) must divide gross income from Section 863 Possession Sales using one of the methods described in either paragraph (f)(2)(i) of this section (in the case of Possession Production Sales) or paragraph (f)(3)(i) of this section (in the case of Possession Purchase Sales). Once a taxpayer has elected a method, the taxpayer must separately apply that method to the applicable category of Section 863 Possession Sales in the United States and to those in a possession. The source of gross income from each type of activity must then be determined under either paragraph (f)(2)(ii) or (3)(ii) of this section, as appropriate. The source of taxable income from Section 863 Possession Sales is determined under paragraph (f)(4) of this section. The taxpayer must apply the rules for computing gross and taxable income by aggregating all Section 863 Possession Sales to which a method in this section applies after separately applying that method to Section 863 Possession Sales in the United States and to Section 863 Possession Sales in a possession. This section does not apply to determine the source of a taxpayer's gross income derived from a sale of inventory purchased from a corporation that has an election in effect under section 936, if the taxpayer's income from sales of that inventory is taken into account to determine benefits under section 936 for the section 936 corporation. For rules to be applied to determine the source of such income, see §1.936–6(a)(5) Q&A 7a and 1.936–6(b)(1) Q&A 13.

(2) *Allocation or apportionment for Possession Production Sales*—(i) *Methods for determining the source of gross income for Possession Production Sales*—(A) *Possession 50/50 method.* Under the possession 50/50 method, gross income from Possession Production Sales is allocated between production activity and business sales activity as described in this paragraph (f)(2)(i)(A). Under the possession 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 (f)(2)(ii)(A) of this section. The remaining one-half of such gross income will be considered income attributable to business sales activity and the source of that income will be determined under the rules of paragraph (f)(2)(ii)(B) of this section.

(B) *IFP method.* In lieu of the possession 50/50 method, a taxpayer may elect the independent factory price (IFP) method. Under the IFP method, gross income from Possession Production Sales is allocated to production activity or sales activity using the IFP method, as described in paragraph (b)(2) of this section, if an IFP is fairly established under the rules of paragraph (b)(2) of this section. See paragraphs (f)(2)(ii)(A) and (C) of this section for rules for determining the source of gross income attributable to production activity and sales activity.

(C) *Books and records method.* A taxpayer may elect to allocate gross income using the books and records method described in paragraph (b)(3) of this section, if it has received in advance the permission of the District Director having audit responsibility over its return. See paragraph (f)(2)(ii) of this section for rules for determining the source of gross income.

(ii) *Determination of source of gross income from production, business sales, and sales activity*—(A) *Gross income attributable to production activity.* The source of gross income from production activity is determined under the rules of paragraph (c)(1) of this section, except that the term possession is substituted for foreign country wherever it appears.

(B) *Gross income attributable to business sales activity*—(*1*) *Source of gross income.* Gross income from the taxpayer's business sales activity is sourced in the possession in the same proportion that the amount of the taxpayer's business sales activity for the taxable year within the possession bears to the amount of the taxpayer's business sales activity for the taxable year both within the possession and outside the possession, with respect to Possession Production Sales. The remaining income is sourced in the United States.

(*2*) *Business sales activity*. For purposes of this paragraph (f)(2)(ii)(B), the taxpayer's business sales activity is equal to the sum of—

(*i*) The amounts for the taxable period paid for wages, salaries, and other compensation of employees, and other expenses attributable to Possession Production Sales (other than amounts that are nondeductible under section 263A, interest, and research and development); and

(*ii*) Possession Production Sales for the taxable period.

(*3*) *Location of business sales activity*. For purposes of determining the location of the taxpayer's business activity within a possession, the following rules apply:

(*i*) *Sales*. Receipts from gross sales will be attributed to a possession under the provisions of paragraph (c)(2) of this section.

(*ii*) *Expenses*. Expenses will be attributed to a possession under the rules of §§1.861–8 through 1.861–14T.

(C) *Gross income attributable to sales activity*. The source of the taxpayer's income that is attributable to sales activity, as determined under the IFP method or the books and records method, will be determined under the provisions of paragraph (c)(2) of this section.

(3) *Allocation or apportionment for Possession Purchase Sales*—(i) *Methods for determining the source of gross income for Possession Purchase Sales*—(A) *Business activity method*. Gross income from Possession Purchase Sales is allocated in its entirety to the taxpayer's business activity, and is then apportioned between U.S. and possession sources under paragraph (f)(3)(ii) of this section.

(B) *Books and records method*. A taxpayer may elect to allocate gross income using the books and records method described in paragraph (b)(3) of this section, subject to the conditions set forth in paragraph (b)(3) of this section. See paragraph (f)(2)(ii) of this section for rules for determining the source of gross income.

(ii) *Determination of source of gross income from business activity*—(A) *Source of gross income*. Gross income from the taxpayer's business activity is sourced in the possession in the same proportion that the amount of the taxpayer's business activity for the taxable year within the possession bears to the amount of the taxpayer's business activity for the taxable year both within the possession and outside the possession, with respect to Possession Purchase Sales. The remaining income is sourced in the United States.

(B) *Business activity*. For purposes of this paragraph (f)(3)(ii), the taxpayer's business activity is equal to the sum of—

(*1*) The amounts for the taxable period paid for wages, salaries, and other compensation of employees, and other expenses attributable to Possession Purchase Sales (other than amounts that are nondeductible under section 263A, interest, and research and development);

(*2*) Cost of goods sold attributable to Possession Purchase Sales during the taxable period; and

(*3*) Possession Purchase Sales for the taxable period.

(C) *Location of business activity*. For purposes of determining the location of the taxpayer's business activity within a possession, the following rules apply:

(*1*) *Sales*. Receipts from gross sales will be attributed to a possession under the provisions of paragraph (c)(2) of this section.

(*2*) *Cost of goods sold*. Payments for cost of goods sold will be properly attributable to gross receipts from sources within the possession only to the extent that the property purchased was manufactured, produced, grown, or extracted in the possession (within the meaning of section 954(d)(1)(A)).

(*3*) *Expenses*. Expenses will be attributed to a possession under the rules of §§1.861–8 through 1.861–14T.

(iii) *Examples*. The following examples illustrate the rules of paragraph (f)(3)(ii) of this section relating to the determination of source of gross income from business activity:

*Example 1.* (i) U.S. Co. purchases in a possession product X for $80 from A. A manufactures X in the possession. Without further production, U.S. Co. sells X in the United States for $100. Assume U.S. Co. has sales and administrative expenses in the possession of $10.

(ii) To determine the source of U.S. Co.'s gross income, the $100 gross income from sales of X is allocated entirely to U.S. Co.'s business activity. Forty-seven dollars of U.S. Co.'s gross income is sourced in the possession. [Possession expenses ($10) plus possession purchases (i.e., cost of goods sold) ($80) plus possessions sales ($0), divided by total expenses ($10) plus total purchases ($80) plus total sales ($100).] The remaining $53 is sourced in the United States.

*Example 2.* (i) Assume the same facts as in *Example 1,* except that A manufactures X outside the possession.

(ii) To determine the source of U.S. Co.'s gross income, the $100 gross income is allocated entirely to U.S. Co.'s business activity. Five dollars of U.S. Co.'s gross income is sourced in the possession. [Possession expenses ($10) plus possession purchases ($0) plus possession sales ($0), divided by total expenses ($10) plus total purchases ($80) plus total sales ($100).] The $80 purchase is not included in the numerator used to determine U.S. Co.'s business activity in the possession, since product X was not manufactured in the possession. The remaining $95 is sourced in the United States.

(4) *Determination of source of taxable income.* Once the source of gross income has been determined under paragraph (f)(2) or (3) 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 Possession Sales determined separately under each method described in paragraph (f)(2) or (3) 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 Possession Sales under §1.861–17, 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 §1.861–17. Thus, in the case of gross income from Section 863 Possession Sales determined under the IFP method or books and records method, a taxpayer must apply the rules of §§1.861–8 through 1.861–14T 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. However, in the case of gross income from Possession Production Sales determined under the possessions 50/50 method or gross income from Possession Purchase Sales computed under the business activity 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 those methods, except that the rules regarding the allocation and apportionment of research and experimental expenditures in §1.861–17 shall apply to such expenditures of taxpayers using the 50/50 method.

(5) *Special rules for partnerships.* In applying the rules of this paragraph (f) to transactions involving partners and partnerships, the rules of paragraph (g) of this section apply.

(6) *Election and reporting rules*—(i) *Elections under paragraph (f)(2) or (3) of this section.* If a taxpayer does not elect one of the methods specified in paragraph (f)(2) or (3) of this section, the taxpayer must apply the possession 50/50 method in the case of Possession Production Sales or the business activity method in the case of Possession Purchase Sales. The taxpayer may elect to apply a method specified in either paragraph (f)(2) or (3) of this section by using the method on a timely filed original return (including extensions). Once a method has been used, that method must be used in later taxable years unless the Commissioner consents to a change. Permission to change methods from one year to another year will be granted unless the change would result in a substantial distortion of the source of the taxpayer's income.

(ii) *Disclosure on tax return.* A taxpayer who uses one of the methods described in paragraph (f)(2) or (3) of this section must fully explain in a statement attached to the tax return the methodology used, the circumstances justifying use of that methodology, the extent that sales are aggregated, and the amount of income so allocated.

(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, except 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 after December 30, 1996. However, taxpayers may apply these regulations for taxable years beginning after July 11, 1995, and on or before December 30, 1996. For years beginning before December 30, 1996, see §§1.863–3A and 1.863–3AT. However, the rules of paragraph (f) of this section apply to taxable years beginning on or after November 13, 1998.

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REGULATIONS APPLICABLE TO TAXABLE YEARS PRIOR TO DECEMBER 30, 1996

### § 1.863–3A Income from the sale of personal property derived partly from within and partly from without the United States.

(a) *General*—(1) *Classes of income.* Income from the sale of property to which paragraph (b) (2) and (3) of §1.863–2 applies is divided into two classes for purposes of this section, namely, income which is treated as derived partly from sources within the United States and partly from sources within a foreign country, and income which is treated as derived partly from sources within the United States and partly from sources within a possession of the United States.

(2) *Definition.* For purposes of this section, the word ''produced'' includes created, fabricated, manufactured, extracted, processed, cured, or aged. For determining the time and place of sale of personal property for purposes of this section, see paragraph (c) of §1.861–7.

(b) *Income partly from sources within a foreign country*—(1) *General.* This paragraph relates to gains, profits, and income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country, or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States. Pursuant to section 863(b) such items shall be treated as derived partly from sources within the United States and partly from sources within a foreign country.

(2) *Allocation or apportionment.* The taxable income from sources within the United States, in the case of the items to which this paragraph applies, shall be determined according to the examples set forth in this subparagraph. For such purposes, the deductions for the personal exemptions shall not be taken into account, but the special deductions described in paragraph (c) of §1.861–8 shall be taken into account.

*Example 1.* Where the manufacturer or producer regularly sells part of his output to wholly independent distributors or other selling concerns in such a way as to establish fairly an independent factory or production price—or shows to the satisfaction of the district director (or, if applicable, the Director of International Operations) that such an independent factory or production price has been otherwise established—unaffected by considerations of tax liability and the selling or distributing branch or department of the business is located in a different country from that in which the factory is located or the production carried on, the taxable income attributable to sources within the United States shall be computed by an accounting which treats the products as sold by the factory or productive department of the business to the distributing or selling department at the independent factory price so established. In all such cases the basis of the accounting shall be fully explained in a statement attached to the return for the taxable year.

*Example 2.* (i)–(ii) [Reserved]. For guidance, see §863–3T(b)(2) *Example* (2)(i) and (ii).

(iii) The term ''gross sales'', as used in this example, refers only to the sales of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States.

(iv) The term ''property'', as used in this example, includes only the property held or used to produce income which is derived from such sales. Such property should be taken at its actual value, which in the case of property valued or appraised for purposes of inventory, depreciation, depletion, or other purposes of taxation shall be the highest amount at which so valued or appraised, and which in other cases shall be deemed to