

Proposed Rules

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This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-251985-96]

RIN 1545-AU79

Source of Income From Sales of Inventory Partly From Sources Within a Possession of the United States; Also, Source of Income Derived From Certain Purchases From a Corporation Electing Section 936

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations under section 863 governing the source of income from sales of inventory produced in the United States and sold in a possession of the United States or produced in a possession of the United States and sold in the United States. It also contains proposed regulations under section 863 governing the source of income from sales of inventory purchased in a possession of the United States and sold in the United States. This document affects persons who produce (in whole or in part) inventory in the United States and sell in a possession, or produce (in whole or in part) inventory in a possession and sell in the United States, as well as persons who purchase inventory in a possession and sell in the United States. This document also contains proposed regulations under section 936 governing the source of income of a taxpayer from the sale in the United States of property purchased from a corporation that has an election under section 936 in effect. This document also provides notice of a public hearing on these proposed regulations.

DATES: Comments and outlines of oral comments to be presented at the public hearing scheduled for January 29, 1998,

at 10 a.m. must be received by January 8, 1998.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (INTL-0003-95), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-251985-96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC, or electronically, via the IRS Internet site at: <http://www.irs.ustreas.gov/prod/taxregs/comments.html>. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Anne Shelburne, (202) 622-3880; concerning submissions and the hearing, Ms. Evangelista Lee, (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget (OMB) for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)).

Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224. Comments on the collection of information should be received by December 9, 1997. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information

may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information requirements are in proposed § 1.863-3(f)(6). This information is required by the IRS to monitor compliance with the federal tax rules for determining the source of income from the sale of inventory produced in the United States and sold in a possession of the United States or produced in a possession of the United States and sold in the United States, or from the sale of inventory purchased in a possession of the United States and sold in the United States. The likely respondents are taxpayers who produce inventory in the United States and sell in a possession, or who produce inventory in a possession and sell in the United States, or who purchase inventory in a possession and sell in the United States. Responses to this collection of information are required to properly determine the source of a taxpayer's income from such sales.

Books or records relating to a 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.

Estimated total annual reporting burden: 500 hours. The estimated annual burden per respondent varies from 1 hour to 5 hours, depending on individual circumstances, with an estimated average of 2.5 hours.

Estimated number of respondents: 200.

Estimated annual frequency of responses: One time per year.

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 assigned by the Office of Management and Budget.

Background

These proposed regulations contain rules under section 863 relating to the source of income from cross-border sales of certain property. These regulations also contain rules under

section 936 relating to the source of income of a taxpayer from the sale in the United States of property purchased from a corporation that has an election under section 936 in effect. These regulations are proposed to be effective for taxable years beginning 30 days after publication of final regulations.

Explanation of Provisions

I. Income Partly From Sources Within a Possession

A. Current Regulations

Section 863 authorizes the Secretary to promulgate regulations allocating or apportioning to sources within or without the United States all items of gross income, expenses, losses, and deductions other than those items specified in sections 861(a) and 862(a).

Guidance to determine the source of possession income is divided into two types of transactions: transactions described in section 863(b)(2) for property produced in the United States and sold in a possession (or vice versa), and transactions described in section 863(b)(3) for property purchased in a possession and sold in the United States (collectively, Section 863 Possession Sales).

Section 1.863-3 of the income tax regulations contains rules for determining the source of income derived from sales of certain property. These regulations were published in the **Federal Register** on November 29, 1996 (61 FR 60540), and the prior regulations were renumbered §§ 1.863-3A and 1.863-3AT. The new regulations retain the prior rules for Section 863 Possession Sales by providing in paragraph § 1.863-3(f) that taxpayers must apply the rules of § 1.863-3A(c) in allocating and apportioning income derived from sources partly within the United States and partly within a possession of the United States. These proposed regulations would modify the existing rules for allocating and apportioning income between the United States and a possession.

1. Property Produced and Sold

Currently, income derived from sales of inventory produced in the United States and sold in a possession of the United States or produced in a possession of the United States and sold in the United States (Possession Production Sales), is allocated or apportioned between the United States and a possession according to one of three methods. Such income is allocated under the independent factory price method, apportioned under an apportionment method, or, with permission of the District Director,

allocated or apportioned on the basis of the taxpayer's books and records.

Under the current regulations, if an independent factory or production price (IFP) exists for Possession Production Sales, taxpayers must use the IFP method to determine the income attributable to production activities in both the sale establishing the IFP and in sales of similar products.

If an IFP does not exist, the current possessions regulations provide that the taxable income from Possession Production Sales is first computed and then apportioned between the United States and the possession. One-half of the taxable income is apportioned on the basis of the taxpayer's property within the United States and within the possession. In applying the property fraction, the taxpayer's property includes property held or used to produce income derived from Possession Production Sales. The other half of the taxpayer's taxable income is apportioned between U.S. and possession sources on the basis of the business of the taxpayer within the United States and within the possession. Currently, business of the taxpayer is measured by the sum of certain expenses, including amounts paid for labor, and the purchase of certain supplies, plus receipts from Possession Production Sales. Finally, as a third method, the existing regulations allow a taxpayer to request permission from the District Director to use the taxpayer's books and records to allocate or apportion income to sources within or without the United States if those books reflect more clearly than the other methods the taxable income derived from sources within the United States.

2. Property Purchased and Sold

The second type of possession transaction governed by the existing regulations is the sale of inventory purchased in a possession and sold in the United States (Possession Purchase Sales) as described in section 863(b)(3). Under the current regulations, the income from such sales is divided between the United States and possession sources under one of two methods. The income can be apportioned, or, with permission of the District Director, allocated or apportioned on the basis of the taxpayer's books and records.

Under the apportionment method, taxable income is first determined, and then apportioned by a fraction, the numerator being the business of the taxpayer in the United States, the denominator being the total business of the taxpayer in the United States and in the possession. The fraction is

computed in the same manner as the business fraction discussed previously, except that such expenses, purchases, and sales are limited to those attributable to Possession Purchase Sales.

B. Issues Under Current Regulations

The IRS and Treasury believe the rules for allocating and apportioning income between the United States and the possessions of the United States should be amended to reflect certain changes made to the regulations under § 1.863-3 governing cross-border sales of inventory involving the United States and a foreign country (other than those involving possessions). Thus, for example, under the apportionment method provided in the proposed regulations, the property and business activity fractions apportioning income between the United States and a possession are modified to apportion gross income attributable to an activity, rather than to apportion net income.

The IRS and Treasury also believe certain ambiguities exist in the current regulations. The possessions rules were originally promulgated in 1926, and may not reflect current business practices. The current regulations use examples to illustrate methods for allocating or apportioning income between the United States and a possession, and should be modified to state rules.

Further, although the apportionment method for allocating Possession Production Sales income under the existing possessions regulations treats half of the income as production income, the production formula is not necessarily limited to production assets. The current inclusion of sales assets in the formula apportioning production income results in excessive income being allocated to sales activities. The production income formula should only take into account assets directly involved in production of inventory. In addition, the IRS and Treasury have reexamined the business activity fraction, and have concluded it should be revised to more clearly reflect the taxpayer's business other than production. The current fraction, for example, omits certain investments or expenses, such as marketing and advertising expenses, although income attributable in part to such expenses or investments is then included in the income apportioned by the fraction. The current regulations also take into account production expenses in the business activity fraction apportioning income from Possession Production Sales. The Service and Treasury believe that this is inappropriate in the context

of Possession Production Sales because the business activity fraction is not intended to determine the source of income attributable to production activity. In the proposed regulations, the fraction apportioning Possession Production Sales is renamed the business sales activity fraction and excludes factors reflecting production activity.

The current regulations also do not address issues in attributing to the United States or to the possession, the activities reflected in the business activity fraction. For example, the current regulations provide no guidance on whether a particular expense should be represented in the fraction as attributable to the United States or to a possession.

Accordingly, the IRS and Treasury are issuing proposed regulations under section 863 to make the possessions rules more consistent with the other regulations governing the source of income from cross-border sales of inventory, and to address certain ambiguities and problems in the existing regulations.

C. Proposed Regulations

Section 1.863-3(f) generally retains the methods of the current regulations for dividing income between the United States and a possession of the United States, with several modifications.

1. Methods to Allocate Gross Income to Activities of the Taxpayer

a. Property Produced and Sold

i. The Possession 50/50 Method

Consistent with the final regulations under § 1.863-3, paragraph (f)(2)(i)(A) of the proposed regulations makes the 50/50 method the general rule to allocate gross income from Possession Production Sales between production and business sales activity, so that the income from each type of activity can then be apportioned between U. S. and foreign sources. The taxpayer, however, may elect to apply the IFP method (described in paragraph (f)(2)(i)(B)), or, with the consent of the District Director, the books and records method (described in paragraph (f)(2)(i)(C)).

Under the possession 50/50 method, the proposed regulations allocate half of the taxpayer's gross income from Possession Production Sales to production activity and half to business sales activity. The income is then apportioned between U.S. and possession sources based on a property fraction and a business sales activity fraction. As described below, the proposed regulations make certain changes to the existing property fraction

and to the existing business activity fraction.

The proposed regulations apply the property fraction in § 1.863-3(c) to apportion the half of a taxpayer's income allocated to production activity. Thus, income is apportioned to the United States or to a possession based on the location of the taxpayer's production assets. In a change from the current regulations, and consistent with the changes made to the regulations under § 1.863-3(c), production assets are defined as tangible and intangible assets owned directly by the taxpayer that are directly used by the taxpayer to produce inventory sold in Possession Production Sales, instead of all its assets that produce income from Possession Production Sales. Production assets are included in the fraction at their adjusted tax basis.

The other half of the taxpayer's gross income is apportioned according to a business sales activity fraction. The portion of this income that is possession source income is determined by multiplying the income by a fraction, the numerator being the business sales activity of the taxpayer in the possession, and the denominator being the business sales activity of the taxpayer within the possession and outside the possession. The remaining income is sourced in the United States. Although some of the business sales activity factors not incurred in a possession may be incurred in a foreign country, Treasury and the Internal Revenue Service believe that the business sales activity fraction is only intended to source the business sales activity portion of Possession Production Sales outside the United States to the extent of business sales activity located in a possession.

The proposed regulations make some modifications to the factors in the fraction representing the business sales activity of the taxpayer. Business sales activity is measured by the sum of certain expenses, including amounts paid for labor, materials, advertising, and marketing (but excluding any expenses or other amounts that are nondeductible under section 263A, interest, and research and development), plus receipts for the sale of goods. This formula is intended to reflect better the business sales activity producing the income by including more of the factors responsible for producing that income. Cost of goods sold is also excluded from the business sales activity fraction apportioning income from Possession Production Sales, because such costs generally reflect production activity. Production activity is already represented in the

formula by the one-half of the taxpayer's income apportioned according to the location of production assets.

Finally, the proposed regulations provide more explicit guidance for attributing business sales activity between the United States and a possession. Expenses are allocated and apportioned between the United States and a possession based on the rules in §§ 1.861-8 through 1.861-14T. Gross sales are allocated to the United States or a possession based on the place of sale.

ii. The IFP Method

The proposed regulations make the IFP method elective, and thus eliminate any bias against taxpayers choosing to export through independent distributors. The regulations rely upon the revised regulations under § 1.863-3 for rules in applying the IFP method.

iii. Books and Records Method

The proposed regulations retain the books and records method of the existing regulations, permitting taxpayers to request permission from the District Director to use their books and records to determine the source of their income. The proposed regulations refer to revised § 1.863-3(b)(3) in applying the method to Possession Production Sales.

b. Property Purchased and Sold

i. The Business Activity Method

Paragraph (f)(3)(i)(A) makes the business activity method the general rule to apportion income from Possession Purchase Sales between the United States and a possession. The taxpayer may, however, elect to apply, with consent of the District Director, the books and records method.

The proposed regulations retain the structure of the existing regulations by apportioning the taxpayer's income from Possession Purchase Sales on the basis of a business activity fraction. The portion of this income that is possession source income is determined by multiplying the income by a fraction, the numerator being the business of the taxpayer in the possession, and the denominator being the business of the taxpayer within the possession and outside the possession. The remaining income is sourced in the United States.

The business activity fraction is similar to that discussed previously, used to apportion the taxpayer's income in Possession Production Sales, except that the fraction applies only to expenses, cost of goods sold, and sales attributable to Possession Purchase Sales. In addition, the business activity

fraction apportioning Possession Purchase Sales includes amounts paid for cost of goods sold. Such costs are attributed to the possession, however, only to the extent the property purchased is manufactured, produced, grown, or extracted in the possession. Treasury and the Internal Revenue Service anticipate that if a taxpayer acts in the reasonable belief that the products were manufactured in the possession, the taxpayer could act on that basis in preparing its tax return. As modified, the business activity fraction reflects the view of Treasury and the Internal Revenue Service that section 863(b)(3)'s purchase rule was intended to apply only to purchase and resale transactions, where the goods purchased are created or derived from the possession.

ii. Books and Records Method

The proposed regulations retain the books and records method of the existing regulations, permitting taxpayers to request permission from the District Director to use their books and records to determine the source of their income. The proposed regulations refer to revised § 1.863-3(b)(3) in applying the method to Possession Purchase Sales.

2. Determination of Source of Gross Income

Unlike the current regulations which provide specific rules for determining the source of income attributable to production activity and business activity only for purposes of the 50/50 method, the proposed regulations adopt rules applicable to each of the methods. Under the proposed regulations, once gross income attributable to production activity, business activity, or sales activity has been determined under one of the prescribed methods, the source of the gross income is determined separately for each type of income. The source of gross income attributable to production activity (when applying the possession 50/50 method) is determined under paragraph (c)(1), based on the location of production assets. The source of gross income attributable to sales activity (when applying the IFP method or the books and records method) is determined under paragraph (c)(2), based generally on the location of the sale. The source of gross income attributable to business sales activity (when applying the possession 50/50 method) is determined under paragraph (f)(2)(ii)(B), based on expenses, and gross sales attributable to Possession Production Sales. The source of gross income attributable to business activity (when applying the business activity

method) is determined under paragraph (f)(3)(ii), based on expenses, cost of goods sold, and gross sales attributable to Possession Purchase Sales.

3. Determination of Source of Taxable Income

Once the source of gross income is determined under paragraph (f)(2) or (3), taxpayers then determine the source of taxable income. Under proposed paragraph (f)(4), taxpayers must allocate or apportion under §§ 1.861-8 through 1.861-14T the amounts of expenses, losses and other deductions to gross income determined under each of the prescribed methods. In the case of amounts of expenses, losses and other deductions allocated or apportioned to gross income determined under the IFP method or the books and records method, the taxpayer must apply the rules of §§ 1.861-8 through 1.861-14T to allocate or apportion these amounts between gross income from sources within the United States and within a possession. For expenses, losses and other deductions allocated or apportioned to gross income determined under the possessions 50/50 method, taxpayers must apportion expenses and other deductions pro rata based on the relative amounts of U.S. and possession source gross income. The research and experimental (R&E) expense allocation rules in § 1.861-17 apply to taxpayers using the 50/50 method, so that the R&E set aside (described in § 1.861-17) remains available to such taxpayers.

4. Treatment of Gross Income Derived From Certain Purchases From a Corporation That Has an Election in Effect Under Section 936

The proposed regulations clarify that section 863 does not apply to determine the source of a taxpayer's gross income derived from a purchase of inventory 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(h)(5)(C) for the section 936 corporation.

5. Treatment of Partners and Partnerships

The proposed regulations rely on the rules in § 1.863-3(g) for determining the appropriate treatment in transactions involving partnerships. Under those rules, the aggregate approach applies to a partnership's production and sales activity for two purposes only. First, the aggregate approach applies in determining the character of a partner's distributive share of partnership income. Second, the aggregate approach

applies in sourcing income from sales of inventory property that is transferred in-kind from or to a partnership.

6. Election and Reporting Rules

Under paragraph (f)(6)(i) of the proposed regulations, a taxpayer must use the 50/50 method to determine the source of income from Possession Production Sales unless the taxpayer elects to use the IFP method, or elects the books and records method. For Possession Purchase Sales, a taxpayer must use the business activity method, unless the taxpayer elects the books and records method. The taxpayer makes an election by using the method on its timely filed original tax return. That method must be used in later taxable years unless the Commissioner or his delegate consents to a change. Permission to change methods in later years will not be withheld unless the change would result in a substantial distortion of the source of income.

A taxpayer must fully explain the methodology used in applying either paragraph (f)(2) or (3), and the amount of income allocated or apportioned to U.S. and foreign sources, in a statement attached to its tax return.

II. Income Derived From Certain Purchases From a Corporation That Has an Election in Effect Under Section 936

These proposed regulations clarify that where a taxpayer purchases a product from a corporation that has an election in effect under section 936, the source of the taxpayer's gross income derived from sales of that product (in whatever form sold) in the United States is U.S. source, if the taxpayer's income from sales of that product is taken into account to determine benefits under section 936(h)(5)(C)(i) for the section 936 corporation. The taxpayer's income is U.S. source without regard to whether a possession product is a component, end-product form, or integrated product. No inference should be drawn from the proposed effective date concerning the treatment of transactions involving sales of property purchased from a section 936 corporation entered into before the regulations are applicable.

Proposed Effective Dates

These regulations are proposed to be effective for taxable years beginning on or after the date that is 30 days after the date of publication of final regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking 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, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely (in the manner described under the ADDRESSES caption) to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for January 29, 1998, at 10 a.m., in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit comments and an outline of topics to be discussed and the time to be devoted to each topic (in the manner described under the ADDRESSES caption of this preamble) by January 8, 1998.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

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.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by revising the entry for "Section 1.863-3", removing the entry for "Sections 1.936-4 through 1.936-7", and adding entries in numerical order to read as follows:

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

Section 1.863-3 also issued under 26 U.S.C. 863(a) and (b), and 26 U.S.C. 936(h). * * *

Section 1.936-4 also issued under 26 U.S.C. 936(h).

Section 1.936-5 also issued under 26 U.S.C. 936(h).

Section 1.936-6 also issued under 26 U.S.C. 863(a) and (b), and 26 U.S.C. 936(h).

Section 1.936-7 also issued under 26 U.S.C. 936(h). * * *

Par. 2. Section 1.863-3 is amended as follows:

1. Paragraph (f) is revised.

2. Paragraph (h) is amended by adding a sentence at the end of the paragraph.

The revision and addition read as follows:

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

* * * * *

(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 (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) 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 (\$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 § 1.861–8(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 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. 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.

(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.

(h) *Effective dates.* * * * However, the rules of paragraph (f) of this section apply to taxable years beginning on or after the date that is 30 days after the date of publication of final regulations.

Par. 3. In § 1.936-6, paragraph (a)(5) Q&A 7a is added to read as follows:

§ 1.936-6 Intangible property income when an election out is made: Cost sharing and profit split options; covered intangibles.

* * * * *

(a) * * *

(5) * * *

Q. 7a: What is the source of the taxpayer's gross income derived from a sale in the United States of a possession product purchased by the taxpayer (or an affiliate) from a corporation that has an election in effect under section 936, if the income from such sale is taken into account to determine benefits under cost sharing for the section 936 corporation? Is the result different if the taxpayer (or an affiliate) derives gross income from a sale in the United States of an integrated product incorporating a possession product purchased by the taxpayer (or an affiliate) from the section 936 corporation, if the taxpayer (or an affiliate) processes the possession product or an excluded component in the United States?

A. 7a: Under either scenario, the income is U.S. source, without regard to whether the possession product is a component, end-product, or integrated product. Section 863 does not apply in determining the source of the taxpayer's income. This Q&A 7a is applicable for taxable years beginning on or after the date that is 30 days after the date of publication of final regulations.

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Michael P. Dolan,

Acting Commissioner of Internal Revenue.

[FR Doc. 97-26857 Filed 10-9-97; 8:45 am]

BILLING CODE 4830-01-P

ENVIRONMENTAL PROTECTION AGENCY

40 CFR Part 52

[CA 198-0056; FRL-5907-3]

Approval and Promulgation of Implementation Plans; California State Implementation Plan Revision, San Diego County Air Pollution Control District

AGENCY: Environmental Protection Agency (EPA).

ACTION: Proposed rule.

SUMMARY: EPA is proposing to approve revisions to the California State Implementation Plan (SIP) which concern the control of volatile organic compound (VOC) emissions from kelp processing and bio-polymer manufacturing operations.

The intended effect of proposing approval of this rule is to regulate emissions of VOCs in accordance with the requirements of the Clean Air Act, as amended in 1990 (CAA or the Act). EPA's final action will incorporate this rule into the federally approved SIP. In addition, final action on this rule will serve as a final determination that

deficiencies in the rule (identified by EPA in a limited approval/limited disapproval action on February 14, 1996) have been corrected and that any sanctions or Federal Implementation Plan (FIP) obligations are permanently stopped. An Interim Final Determination published in today's **Federal Register** will defer the imposition of sanctions until EPA takes final action. EPA has evaluated the rule and is proposing to approve the rule under provisions of the CAA regarding EPA action on SIP submittals, SIPs for national primary and secondary ambient air quality standards, and plan requirements for nonattainment areas.

DATES: Comments must be received on or before November 10, 1997.

ADDRESSES: Comments may be mailed to: Andrew Steckel, Rulemaking Office (AIR-4), Air Division, U.S. Environmental Protection Agency, Region IX, 75 Hawthorne Street, San Francisco, CA 94105-3901.

Copies of the rule and EPA's evaluation report of the rule are available for public inspection at EPA's Region 9 office during normal business hours. Copies of the submitted rule are also available for inspection at the following locations:

San Diego County Air Pollution Control District, 9150 Chesapeake Drive, San Diego, CA 92123-1096
California Air Resources Board, Stationary Source Division, Rule Evaluation Section, 2020 "L" Street, Sacramento, CA 95814.

FOR FURTHER INFORMATION CONTACT: Patricia A. Bowlin, Rulemaking Office (AIR-4), Air Division, U.S. Environmental Protection Agency, Region IX, 75 Hawthorne Street, San Francisco, CA 94105-3901, (415) 744-1188.

SUPPLEMENTARY INFORMATION:

I. Applicability

The rule being proposed for approval into the California SIP is San Diego County Air Pollution Control District (SDCAPCD) Rule 67.10, Kelp Processing and Bio-Polymer Manufacturing Operations. This rule was submitted by the California Air Resources Board (CARB) to EPA on August 1, 1997.

II. Background

On March 3, 1978, EPA promulgated a list of ozone nonattainment areas under the provisions of the Clean Air Act, as amended in 1977 (1977 CAA or pre-amended Act), that included the San Diego Area. 43 FR 8964; 40 CFR 81.305. On May 26, 1988, EPA notified the Governor of California, pursuant to section 110(a)(2)(H) of the pre-amended