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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9921]

RIN 1545-BP16

Source of Income from Certain Sales of Personal Property

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations modifying the rules for determining the source of income from sales of inventory produced within the United States and sold without the United States or vice versa. These final regulations also contain new rules for determining the source of income from sales of personal property (including inventory) by nonresidents that are attributable to an office or other fixed place of business that the nonresident maintains in the United States. Finally, these final regulations modify certain rules for determining whether foreign source income is effectively connected with the conduct of a trade or business within the United States.

DATES: Effective Date: These final regulations are effective on **[INSERT DATE OF PUBLICATION IN FEDERAL REGISTER]**.

Applicability Dates: For dates of applicability, see §§1.863-1(f), 1.863-2(c), 1.863-3(g), 1.863-8(h), 1.864-5(e), 1.864-6(c)(4), and 1.865-3(g).

FOR FURTHER INFORMATION CONTACT: Brad McCormack at (202) 317-6911 (not a toll free number).

## SUPPLEMENTARY INFORMATION:

### **Background**

The Tax Cuts and Jobs Act, Public Law 115-97, 131 Stat. 2054, 2208 (2017) (the “Act”), enacted on December 22, 2017, amended section 863(b) of the Internal Revenue Code (“Code”). On December 30, 2019, the Department of the Treasury (“Treasury Department”) and the IRS published proposed regulations (REG-100956-19) under sections 863, 864, 865, 937, and 1502 in the **Federal Register** (84 FR 71836) (the “proposed regulations”). A public hearing on the proposed regulations was held on June 3, 2020. All written comments received in response to the proposed regulations are available at <https://www.regulations.gov> or upon request. Terms used but not defined in this preamble have the meaning provided in these final regulations.

### **Summary of Comments and Explanation of Revisions**

#### I. Overview

The final regulations retain the overall approach of the proposed regulations, with certain revisions. This Summary of Comments and Explanation of Revisions section discusses those revisions as well as comments received in response to the solicitation of comments in the notice of proposed rulemaking. Comments outside the scope of this rulemaking are generally not addressed but may be considered in connection with future guidance projects.

#### II. Comments on and Revisions to Proposed §1.863-1 -- Allocation of Gross Income Under Section 863(a) and Proposed §1.863-3 -- Allocation and Apportionment of Income from Certain Sales of Inventory

The Act amended section 863 of the Code, which provides special sourcing rules for determining the source of income, including income partly from within and partly from without the United States. Specifically, the Act amended section 863(b) to allocate

or apportion income from the sale or exchange of inventory property produced (in whole or in part) by a taxpayer within the United States and sold or exchanged without the United States or produced (in whole or in part) by the taxpayer without the United States and sold or exchanged within the United States (collectively, “Section 863(b)(2) Sales”) solely on the basis of production activities with respect to that inventory. Before the Act, section 863(b) provided that income from Section 863(b)(2) Sales would be treated as derived partly from sources within and partly from sources without the United States without providing the basis for such allocation or apportionment. Consistent with the Act’s changes to section 863(b), the proposed regulations amended §1.863-3 in order to properly allocate or apportion gross income from Section 863(b)(2) Sales based solely on production activity.

Under §1.863-3(c)(1)(ii)(A) (which has been redesignated in the final regulations as §1.863-3(c)(2)(i)), where the taxpayer’s production assets are located both within and without the United States, the amount of income from sources without the United States is determined by multiplying all the income attributable to the taxpayer’s production activities by a fraction, the numerator of which is the average adjusted basis of production assets that are located without the United States and the denominator of which is the average adjusted basis of all the production assets located within and without the United States.

For purposes of applying this formula, the adjusted basis of production assets is determined under section 1011, which is adjusted under section 1016 for depreciation deductions allowed. The Act also amended section 168(k) to allow an additional first-year depreciation deduction of 100 percent of the basis of certain property placed in

service after September 27, 2017, and before January 1, 2023. Therefore, certain new and used production assets placed in service and used predominantly within the United States during this period may have an adjusted basis of zero. However, production assets either placed in service or used predominantly without the United States, or both, do not qualify for this accelerated depreciation and must be depreciated using the straight-line method under the alternative depreciation system (“ADS”) of section 168(g)(2). In light of the Act’s change to section 168(k) to allow accelerated depreciation in some circumstances, the proposed regulations provided a new rule for computing the adjusted basis of production assets for purposes of applying the allocation formula in §1.863-3.

A. Income attributable to sales activity

Section 1.863-3, as in effect before this Treasury Decision, provided rules and corresponding methods for allocating or apportioning gross income from Section 863(b)(2) Sales between production activity and sales activity. To implement the changes to section 863(b) under the Act, the proposed regulations proposed removing §1.863-3(c)(2) which allocates and apportions income attributable to sales activity.

One comment argued that removing §1.863-3(c)(2) could lead to double taxation when a foreign jurisdiction imposes taxation on the sales activity. The Act amended section 863(b) to source income from the sale by a taxpayer of inventory produced by that taxpayer based only on production activity. Under the Code, sales activity is no longer a relevant factor for allocating and apportioning such income. Therefore, the final regulations remove §1.863-3(c)(2). But see part V of this Summary of Comments

and Explanation of Revisions section for a discussion of the interaction with income tax treaties.

Another comment suggested that two aspects of §1.863-3(c)(2) have continued relevance even after the Act's changes to section 863(b)(2). First, §1.863-3(c)(2) has a special rule modifying the rule in §1.861-7(c) that generally sources income from the sale of personal property based on the place of sale. Under §1.861-7(c), a sale is generally treated as consummated in the place where the rights, title, and interest of the seller in the property are transferred to the buyer. However, if a taxpayer wholly produces inventory in the United States and sells it for use, consumption, or disposition in the United States, §1.863-3(c)(2) presumes that the place of sale is in the United States, even if title passes outside the United States. The comment recommended the final regulations include a similar rule and expand it to inventory wholly or partly produced in the United States that is acquired by a related party and resold for use, consumption, or disposition in the United States with title passing outside the United States. The comment observed that in the absence of such a rule, the sale by the related party would generate foreign source income, notwithstanding the fact that the inventory was produced wholly or partly in the United States and ultimately sold for use, consumption, or disposition in the United States.

The final regulations do not adopt this comment. The place of sale rule of §1.861-7(c) already contains a broad anti-abuse rule that would apply to any sales transactions "arranged in a particular manner for the primary purpose of tax avoidance," which may cover certain related party arrangements about which the comment is concerned. Section 482 also applies to require that compensation paid between related

parties is consistent with the arm's length standard and will take into account the business functions and assets of, and risks assumed by, the related party intermediary. The Treasury Department and the IRS continue to study issues related to the distribution among related entities of the business functions, assets, and risks that generate business income, including sales income, and may address these issues in future guidance, particularly with respect to the sourcing of income from certain digital transactions.

Second, the comment observed that §1.863-3(c)(2) treats inventory as wholly produced in the United States for purposes of determining whether the place of sale is presumed to be in the United States if only minor assembly, packaging, repackaging, or labeling occurs outside the United States. The comment recommended including this rule as part of proposed §1.863-3(c)(1)(i). The final regulations adopt this comment in §1.863-3(c)(1)(i) by incorporating the "principles of §1.954-3(a)(4)" (other than §1.954-3(a)(4)(iv)). Section 1.954-3(a)(4) provides rules for determining when a corporation has manufactured, produced, or constructed personal property. Under §1.954-3(a)(4)(iii), packaging, repackaging, labeling, or minor assembly operations do not constitute the manufacture, production, or construction of property. Accordingly, under the final regulations, these principles apply for purposes of determining whether a taxpayer's activities constitute production activity under §1.863-3(c)(1)(i) as well. See part II.B. of this Summary of Comments and Explanation of Revisions section.

#### B. Definition of production activities

Proposed §1.863-1(b)(2) provided the rule for sourcing gross receipts from the sale of natural resources where the taxpayer performs production activities in addition to

its ownership of a farm, mine, oil or gas well, other natural deposit, or uncut timber.

Section 1.863-1(b)(3)(ii) defines such “additional production activities” by reference to the “principles of §1.954-3(a)(4).”

Under section 951(a)(1)(A), a United States shareholder of a controlled foreign corporation (“CFC”) includes in gross income its pro rata share of the CFC’s subpart F income for the CFC’s taxable year which ends with or within the taxable year of the shareholder. Section 952(a)(2) defines the term subpart F income to include foreign base company income. Section 954(a)(2) defines foreign base company income to include foreign base company sales income (“FBCSI”) for the taxable year. Section 954(d)(1) defines FBCSI to mean income derived by a CFC in connection with certain related party transactions. Section 1.954-3(a)(4) provides an exception to FBCSI when a CFC manufactures property that it sells. One comment supported defining “additional production activities” by reference to “the principles of §1.954-3(a)(4),” as described in §1.863-1(b)(3)(ii), and requested that §§1.863-3 and 1.865-3 include a similar cross reference.

The final regulations adopt this recommendation, in part. Specifically, under the final regulations, §§1.863-3 and 1.865-3 incorporate the principles of §1.954-3(a)(4), with the exception of the rules regarding a “substantial contribution to the manufacturing of personal property” under §1.954-3(a)(4)(iv). See §§1.863-3(c)(1)(i) and 1.865-3(d)(2). The final regulations also modify §1.863-1(b)(3)(ii) to incorporate the principles of §1.954-3(a)(4), other than the “substantial contribution to the manufacturing of personal property” under §1.954-3(a)(4)(iv). The substantial contribution rules were added to §1.954-3(a)(4) in T.D. 9438 (December 29, 2008) after the adoption of §1.863-

1(b)(3)(ii) in T.D. 8687 (November 27, 1996). While the Treasury Department and the IRS agree with the comment that the principles of §1.954-3(a)(4) may generally be helpful in determining the location of production activity for sourcing purposes, the substantial contribution rules of §1.954-3(a)(4)(iv) are concerned with whether there is production activity and do not address the geographic location of that production activity, which is relevant for sourcing under sections 861, 863, and 865. Additionally, the substantial contribution rules are premised on treating a corporation as engaged in production activities even if it is not engaged in the direct use of production assets (other than oversight assets), while §1.863-3 focuses on sourcing income based on the location of a corporation's production assets that are used for production activities. See §1.863-3(c)(1)(ii) (which has been redesignated in the final regulations as §1.863-3(c)(2)). In this regard, there is not a clear metric for quantifying production arising from substantial contribution activities, even if such activities are properly identified, in order to assign production activities to a particular geographic location for purposes of determining the place of production under sections 861, 863, and 865. Therefore, the final regulations provide that the principles of §1.954-3(a)(4), other than the substantial contribution rules in §1.954-3(a)(4)(iv), apply in determining whether production activities exist.

#### C. Measuring adjusted basis of production assets

For inventory produced both within and without the United States, the proposed regulations continued to allocate or apportion the gross income between U.S. and foreign sources based on the formula in §1.863-3(c)(1)(ii)(A) (redesignated as proposed §1.863-3(c)(2)(i)). This formula determined the amount of foreign source income by

multiplying the total gross income by a fraction, the numerator of which is the average adjusted basis of production assets 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 gross income is from U.S. sources.

In light of the Act's changes to section 168(k), proposed §1.863-3(c)(2)(ii) measured the adjusted basis of the U.S. production assets for purposes of this formula based on the alternative depreciation system ("ADS") of section 168(g)(2). The preamble to the proposed regulations observed that such rule allows the basis of both U.S. and non-U.S. production assets to be measured consistently on a straight-line method over the same recovery period, and requested comments on using ADS for this purpose or alternatives for measuring relative U.S. and non-U.S. production assets.

One comment suggested that some taxpayers such as partnerships and S corporations would face administrative burdens if they had to maintain separate ADS books that they may not otherwise maintain if section 951A(d)(3) or 250(b)(2)(B) do not apply to them. The comment observed that the Act, in contrast to those other sections, does not mandate the use of ADS in the section 863(b) context. The comment requested that the final regulations maintain the existing rule of §1.863-3(c)(1)(ii)(B) measuring the basis under section 1011 (as adjusted by section 1016), either as the principal rule or, alternatively, at the election of the taxpayer.

The final regulations do not adopt this comment. The Treasury Department and the IRS have determined that the use of ADS for this purpose will prevent the Act's modifications to section 168(k) (resulting in accelerated depreciation) from inappropriately skewing the apportionment formula under §1.863-3(c)(2)(i) in favor of

foreign source income. While the Act does not mandate the use of ADS for this purpose, the Treasury Department and the IRS have authority to mandate the use of ADS under sections 863(a) and 7805 and have determined that the use of ADS is necessary to accurately measure the place of production using adjusted basis, as other basis measurements might inappropriately inflate foreign production activities.

### III. Comments on and Revisions to Proposed §1.865-3 -- Source of Gross Income from Sales of Personal Property (Including Inventory Property) by a Nonresident Attributable to an Office or Other Fixed Place of Business in the United States

Section 865 provides rules for sourcing income from sales of personal property. Section 865(e)(2) applies with respect to all sales of personal property (including inventory) by a nonresident, as that term is defined in section 865(g)(1)(B), attributable to an office or other fixed place of business in the United States. Section 865(e)(2)(A) generally provides that income from any sale of personal property attributable to such an office or other fixed place of business is sourced in the United States. An exception is provided in section 865(e)(2)(B) for a sale of inventory for use, disposition, or consumption outside the United States if a foreign office of the nonresident “materially participated” in the sale. Section 865(e)(3) provides that the “principles of section 864(c)(5) shall apply” to determine whether a nonresident has an office or other fixed place of business and whether a sale is attributable to such office or other fixed place of business. Where applicable, section 865(e)(2) applies “[n]otwithstanding any other provisions” of subchapter N, part I, including sections 863(b), 861(a)(6), and 862(a)(6). The proposed regulations under §1.865-3 clarified the application of the principles of section 864(c)(5) in the context of section 865(e)(2) and provided that sales of inventory property produced outside the United States and sold through an office maintained by the nonresident in the United States must be sourced in the United States in part.

Proposed §1.865-3(e) also included a cross-reference to the rules for allocating and apportioning expenses to gross income effectively connected with the conduct of a trade or business in the United States in §§1.882-4 and 1.882-5. Since those regulations apply only to foreign corporations, one comment requested that the final regulations also refer to §1.873-1 to cover nonresident alien taxpayers subject to proposed §1.865-3. In response to this comment, the final regulations broaden the cross-references to include sections 882(c)(1) and 873(a) for purposes of allocating and apportioning expenses. See §1.865-3(e).

The final regulations also reorder and revise parts of §1.865-3 in a non-substantive manner solely for purposes of improving clarity and ease of application. The revision also helps to clarify that §1.865-3 applies only if a nonresident maintains an office or other fixed place of business in the United States to which a sale of personal property is attributable. Otherwise, the source of the income, gain, or loss from the sale will be determined under other applicable provisions of section 865, such as section 865(b) through (d).

The final regulations also retain, with certain modifications, the rules for determining the portion of gross income from sales and production activities under §1.865-3(d). Under the proposed regulations, the “50/50 method,” described in §1.865-3(d)(2)(i), was the default method because it was “an appropriate and administrable way” to apply section 865(e)(2), but the proposed regulations also allowed nonresidents to elect a books and records method that would “more precisely” reflect their gross income from both sales and production activities, if any, in the United States, provided the nonresidents met certain requirements for maintaining their books of account under

proposed §1.865-3(d)(2)(ii)(B)(1) through (3). See 84 FR 71836, 71843. Under the final regulations, the 50/50 method continues to be the default method and taxpayers continue to be permitted to elect the books and records method. However, the Treasury Department and the IRS have determined that, where taxpayers have demonstrated the ability to use their books of account to determine their U.S. source gross income under the books and records method, a limitation is appropriate to prevent a nonresident from returning to the less precise 50/50 method solely to obtain a better tax result. In addition, the Treasury Department and the IRS have determined that revising the election to provide that it remains in effect until revoked would reduce the risk to taxpayers of inadvertently failing to include the election with their Federal income tax return. Accordingly, under the final regulations, an election to apply the books and records method continues until revoked and may not be revoked, without the consent of the Commissioner, for any taxable year beginning within 48 months of the end of the taxable year in which the election was made.

The final regulations also revise §1.864-5 to clarify the interaction with section 865(e)(2) and (3) and the promulgation of §1.865-3. Gross income, gain, or loss from the sale of personal property treated as from sources within the United States under §1.865-3 will generally be effectively connected with the conduct of a trade or business in the United States to the extent provided in section 864(c), other than section 864(c)(4) or (5). Gross income, gain, or loss from the sale of personal property treated as from sources without the United States under §1.865-3 is not described in §1.864-5(b) and thus will generally not be effectively connected with the conduct of a trade or business in the United States.

The rules of §§1.864-5, 1.864-6, and 1.864-7 continue to apply, however, in determining whether foreign source income of nonresident aliens and foreign corporations that does not arise from the sale of personal property described in §1.865-3(c) is effectively connected with the conduct of a trade or business in the United States. The rules of §§1.864-5, 1.864-6, and 1.864-7 also continue to apply in determining whether foreign source income from the sale of inventory by nonresident aliens, who would be residents under section 865(g)(1)(A), is effectively connected with the conduct of a trade or business in the United States.

#### IV. Comments on the Rules for Determining the Location or Existence of Production Activity

The proposed regulations did not modify the rules in §1.863-3 for determining the location or existence of production activity for purposes of determining the sourcing of income derived from the sale of inventory. Section 1.863-3(c)(1)(i)(A) (which has been redesignated in the final regulations as §1.863-3(c)(1)(i)) provides the rule for sourcing of income where production occurs only within the United States or only within foreign countries. That paragraph generally limits the scope of “production activities” to only “those conducted directly by the taxpayer.” Similarly, §1.863-3(c)(1)(i)(B) (which has been redesignated in the final regulations as §1.863-3(c)(1)(ii)) provides that production assets are those “owned directly by the taxpayer that are directly used by the taxpayer to produce inventory.” Section 1.863-3(c)(1)(ii) (which has been redesignated in the final regulations as §1.863-3(c)(2)) provides the rule for the sourcing of income where production occurs both within and without the United States, and, as discussed in part II.C of this Summary of Comments and Explanation of Revisions section, allocates gross income based on the relative adjusted basis of production assets located within

and without the United States, respectively.

The final regulations clarify the determination of the adjusted basis of production assets under §1.863-3(c)(1)(ii)(B) (which has been redesignated in the final regulations as §1.863-3(c)(2)(ii)(A)). Under the final regulations, the adjusted basis of production assets for a taxable year is determined by averaging the basis of the assets at the beginning and end of the year, except in the event that a change during the year would cause the average to “materially distort” the calculation for sourcing of income attributable to production activity under §1.863-3(c)(1)(ii)(A) (which has been redesignated in the final regulations as §1.863-3(c)(2)(i)). This clarification uses certain concepts from §1.861-9(g)(2)(i)(A) to further explain when a change might “materially distort” the calculation. For example, the rule applies when an event such as a late-year disposition of substantially all the U.S. production assets of a corporation would cause a material distortion in the corporation’s calculation of the split between U.S. and foreign production activities.

One comment provided a range of suggestions to modify the rules of proposed §§1.863-3(c) and 1.865-3(d). This comment suggested that the rules of proposed §§1.863-3(c) and 1.865-3(d) were adequate, in general, where a taxpayer independently manufactured its own inventory, but inadequate with respect to other business models that rely on limited risk contract manufacturers or where multiple members of a group each perform only limited manufacturing functions in various jurisdictions. The comment observed that apportionment of gross income using the relative adjusted basis of production assets may not reflect high value-adding core production and risk management functions and ownership of production assets by

unrelated contract manufacturers.

The comment suggested expanding the scope of covered production activities and ownership of production assets to include activities conducted and assets owned by related parties and unrelated agents of the taxpayer. The comment also recommended that these rules include any activities that constitute a “substantial contribution” within the meaning of §1.954-3(a)(4)(iv) to better conform to the rules under subpart F. See part II.B of this Summary of Comments and Explanation of Revisions section. In addition, the comment suggested that §1.863-3 should not allocate and apportion gross income using only the relative adjusted basis of production assets located within and without the United States, and recommended allocation and apportionment based on other metrics, such as the location of personnel involved in the production activities or personnel costs. The comment suggested that these modifications could, alternatively, be rebuttable presumptions that a taxpayer could overcome by showing that allocating and apportioning gross income based on adjusted basis or some other approach provides a more appropriate result under the taxpayer’s facts.

Another comment suggested that the existing allocation and apportionment rules that rely on the relative adjusted basis of production assets encourage businesses to move (or locate additional) production assets outside the United States. Specifically, the comment expressed concern that treating income from the sale of inventory produced, in whole or in part, in the United States as U.S. source income might result in double taxation if the income is also subject to tax in a foreign jurisdiction, since the U.S. source income would be excluded from the numerator of the section 904 limitation, reducing the section 904 limitation, and potentially limiting the U.S. taxpayer’s ability to

use its foreign tax credits. The comment requested replacing these rules with a more comprehensive formula, preferably one that minimizes the risk of double taxation. The comment did not suggest an alternative formula and observed that further legislation may be necessary in this regard.

The Treasury Department and the IRS appreciate the various concerns presented by these comments and suggested revisions. The final regulations do not adopt these comments, but the Treasury Department and the IRS may consider these recommendations as part of a more comprehensive review of the sourcing rules for production activity (for purposes of both §1.863-3 and §1.865-3) in a future notice of proposed rulemaking. Additionally, the anti-abuse rule in §1.863-3(c)(1)(iii) (which has been redesignated in the final regulations as §1.863-3(c)(3)) already applies to make appropriate adjustments where taxpayers enter into or structure certain transactions with a principal purpose of reducing U.S. tax liability under §1.863-3, including by using production assets owned by a related party. To clarify the application of this rule, the final regulations provide that the anti-abuse rule applies to transactions inconsistent with the purpose of §1.863-3(b) or (c), and adds as an example that the anti-abuse rule may cover acquisitions of domestic production assets by related partnerships (or subsidiaries thereof) with a principal purpose of reducing the transferor's U.S. tax liability by treating income from the sale of inventory property as subject to section 862(a)(6) rather than section 863(b). The Treasury Department and the IRS continue to request comments regarding potential approaches to determine the location or existence of production activity or other modifications to §1.863-3 that may be appropriate.

#### V. Comments on Income Tax Treaties

The preamble to the proposed regulations included a statement about how proposed §1.865-3 interacted with U.S. income tax treaties under which the business profits of foreign treaty residents may be taxable in the United States only if the profits are attributable to a permanent establishment in the United States. The preamble to the proposed regulations stated, “[w]ith respect to taxpayers entitled to the benefits of an income tax treaty, the amount of profits attributable to a U.S. permanent establishment will not be affected by these regulations.” See 84 FR 71836, 71844.

One comment supported the preamble’s statement and requested that, consistent with the statement in the preamble, the final regulations not apply to Section 863(b)(2) Sales in a manner that results in double taxation to U.S. taxpayers engaged in business operations through a permanent establishment in a treaty jurisdiction, notwithstanding the Act’s change to section 863(b). The comment also requested that competent authority relief be provided in this regard. These regulations do not affect the ability of a taxpayer to rely on treaty provisions to mitigate or relieve double taxation, including treaty provisions that permit a taxpayer to make a request to the competent authority for assistance pursuant to a mutual agreement procedure article of an applicable income tax treaty.

#### VI. Comment on Proposed Applicability Date

The proposed regulations were proposed to apply to taxable years ending on or after December 23, 2019, although taxpayers and their related parties could generally apply the rules in their entirety for taxable years beginning after December 31, 2017, and ending before December 23, 2019. One comment requested that the final regulations apply to taxable years ending after December 31, 2019, because some

taxpayers have consistently relied on the existing methods of §1.863-3(b) for many years. The final regulations do not adopt this comment. Under section 7805(b)(1)(B), a final regulation can apply to any taxable period ending on or after the date on which the proposed regulation to which such final regulation relates was filed with the **Federal Register**, which for these final regulations was December 23, 2019. The final regulations implement the Act's statutory change to section 863(b), which was effective for taxable years beginning after December 31, 2017. To provide certainty to taxpayers and avoid a multiplicity of different interpretations of the statute, the Treasury Department and the IRS have determined that it is appropriate for the final regulations to apply as closely as possible to the effective date of the statutory change.

#### **Applicability Date**

The final regulations generally apply to taxable years ending on or after December 23, 2019. Taxpayers may choose to apply the final regulations for any taxable year beginning after December 31, 2017, and ending before December 23, 2019, provided that the taxpayer and all persons that are related to the taxpayer (within the meaning of section 267 or 707) apply the final regulations in their entirety and, once applied, the taxpayer and all persons related to the taxpayer (within the meaning of section 267 or 707) continue to apply the final regulations in their entirety for all subsequent taxable years. See section 7805(b)(7). Alternatively, taxpayers may rely on the proposed regulations for any taxable year beginning after December 31, 2017, and ending on or before September 29, 2020, provided that the taxpayer and all persons that are related to the taxpayer (within the meaning of section 267 or 707) rely on the proposed regulations in their entirety and provided that the taxpayer and all

persons that are related to the taxpayer (within the meaning of section 267 or 707) have not applied the final regulations to any preceding year.

## **Special Analyses**

These regulations are not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations.

### **I. Paperwork Reduction Act**

The Paperwork Reduction Act of 1995 (44 U.S.C. 3501-3520) (“PRA”) generally requires that a federal agency obtain the approval of OMB before collecting information from the public, whether such collection of information is mandatory, voluntary, or required to obtain or retain a benefit.

The final regulations include a collection of information in §1.865-3(d)(2)(ii)(B). Section 1.865-3(d)(2)(ii)(B) allows a nonresident, as defined in section 865(g)(1)(B), whose inventory sales are described in §1.865-3(d)(2) (relating to inventory produced by the nonresident) to elect to allocate the profit from such sales to its U.S. office using a books and records method under §1.865-3(d)(2)(ii), rather than using a default “50/50 method” under §1.865-3(d)(2)(i). If the collection of information in §1.865-3(d)(2)(ii)(B) applies to a nonresident, the nonresident must maintain detailed records of its receipts and expenditures attributable to its sales and production activities to support the allocation of its income, gain, or loss to its sales activities in the United States under the principles of section 482. See §1.865-3(d)(2)(ii)(B)(2). The nonresident must also prepare an explanation of how the allocation was determined. See §1.865-

3(d)(2)(ii)(B)(3). The nonresident must make an election to apply the books and records method under §1.865-3(d)(2)(ii) by attaching a statement to its original timely filed Federal income tax return (including extensions) that it elects to apply the books and records method under §1.865-3(d)(2)(ii)(A) and has prepared the records described in §1.865-3(d)(2)(ii)(B)(2) and (3). The nonresident must make available the explanation and records upon request of the Commissioner, within 30 days or some other time period as agreed between the Commissioner and the nonresident. See §1.865-3(d)(2)(ii)(B)(3).

The reporting burdens associated with the collection of information in §1.865-3(d)(2)(ii)(B) will be reflected in the Form 14029, Paperwork Reduction Act Submission, that the Treasury Department and the IRS will submit to OMB for tax returns in the Forms 1120-F, U.S. Income Tax Return of a Foreign Corporation, and Forms 1040-NR, U.S. Nonresident Alien Income Tax Return. In particular, the reporting burden associated with the information collection in §1.865-3(d)(2)(ii)(B) will be included in the burden estimate for OMB control numbers 1545-0123 and 1545-0074. OMB control number 1545-0123 represents a total estimated burden time for all forms and schedules for corporations of 3.344 billion hours and total estimated monetized costs of \$61.558 billion (\$2019). OMB control number 1545-0074 represents a total estimated burden time, including all other related forms and schedules for individuals, of 1.717 billion hours and total estimated monetized costs of \$33.267 billion (\$2019). Table 1 summarizes the status of the PRA submissions of the Treasury Department and the IRS related to Forms 1120-F and 1040-NR.

The overall burden estimate provided by the Treasury Department and the IRS to OMB in the PRA submissions for OMB control numbers 1545-0123 and 1545-0074 are aggregate amounts related to the U.S. Business Income Tax Return and the U.S. Individual Income Tax Return, along with any associated forms. The burden estimates in these PRA submissions, however, do not account for any burden imposed by §1.865-3(d)(2)(ii)(B). The Treasury Department and the IRS have not identified the estimated burden for the collections of information in §1.865-3(d)(2)(ii)(B) because there are no burden estimates specific to §1.865-3(d)(2)(ii)(B) currently available. The burden estimates in the PRA submissions that the Treasury Department and the IRS will submit to OMB will in the future include, but not isolate, the estimated burden related to the collection of information in §1.865-3(d)(2)(ii)(B).

The Treasury Department and the IRS have included the burdens related to the PRA submissions for OMB control numbers 1545-0123 and 1545-0074 in the PRA analysis for other regulations issued by the Treasury Department and the IRS related to the taxation of cross-border income. The Treasury Department and the IRS encourage users of this information to take measures to avoid overestimating the burden that the collection of information in §1.865-3(d)(2)(ii)(B), together with other international tax provisions, imposes. Moreover, the Treasury Department and the IRS also note that the Treasury Department and the IRS estimate PRA burdens on a taxpayer-type basis rather than a provision-specific basis because an estimate based on the taxpayer-type most accurately reflects taxpayers' interactions with the forms.

The Treasury Department and the IRS request comments on the forms that reflect the information collection burdens related to the final regulations, including

estimates for how much time it would take to comply with the paperwork burden described above for each relevant form and ways for the IRS to minimize the paperwork burden. Proposed revisions (if any) to these forms that reflect the information collection contained in §1.865-3(d)(2)(ii)(B) will be made available for public comment at <https://apps.irs.gov/app/picklist/list/draftTaxForms.html> and will not be finalized until after these forms have been approved by OMB under the PRA.

Table 1. Summary of Information Collection Request Submissions Related to Forms 1120-F and Forms 1040-NR.

<b>Form</b>	<b>Type of Filer</b>	<b>OMB Number(s)</b>	<b>Status</b>
Form 1040-NR	Individual (NEW Model)	1545-0074	Approved by OIRA 1/30/2020 until 1/31/2021.
	Link: <a href="https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201909-1545-021">https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201909-1545-021</a>		
Form 1120-F	Business (NEW Model)	1545-0123	Approved by OIRA 1/30/2020 until 1/31/2021.
	Link: <a href="https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201907-1545-001">https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201907-1545-001</a>		

## II. Regulatory Flexibility Act

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that these final regulations will not have a significant economic impact on a substantial number of small entities. Although data are not readily available to assess the number of small entities potentially affected, any economic impact of these regulations is unlikely to be significant. Specifically, the regulations in §§1.863-1 and 1.863-3 (with conforming changes in cross-referencing regulations) implement the statutory change made to section 863(b) by the Act. This change affects sales of inventory property by any taxpayer where the taxpayer produces the inventory (in whole

or in part) within the United States and sells that inventory without the United States, or vice versa. The change in sourcing for those entities is attributable to the change in section 863(b) made by the Act. Sections 1.863-1 and 1.863-3 merely implement the statutory change with limited additional guidance. The Treasury Department and the IRS do not anticipate that any differences between the changes in section 863(b) made by the Act and the changes in §§1.863-1 and 1.863-3 made by these regulations will have a significant economic impact on a substantial number of small entities.

The other regulations in this publication (other than changes to ensure consistency with section 863(b)) are the final regulations in §§1.864-5, 1.864-6, and 1.865-3. These regulations solely affect non-U.S. taxpayers, which are not subject to the Regulatory Flexibility Act.

Pursuant to section 7805(f) of the Code, the proposed regulations preceding these final regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small businesses. No comments were received.

### III. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of \$100 million in 1995 dollars, updated annually for inflation. These regulations do not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

#### IV. Executive Order 13132: Federalism

Executive Order 13132 (entitled “Federalism”) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. These regulations do not have federalism implications and do not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

#### **Drafting Information**

The principal author of the regulations is Brad McCormack of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in the development of the regulations.

#### **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

#### **Adoption of Amendments to the Regulations**

Accordingly, 26 CFR part 1 is amended as follows:

#### PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry for §1.865-3 in numerical order.

The addition reads in part as follows:

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

\* \* \* \* \*

Section 1.865-3 also issued under 26 U.S.C. 865(j).

\* \* \* \* \*

Par. 2. Section 1.863-0 is revised to read as follows:

**§1.863-0 Table of contents.**

This section lists captions contained in §§1.863-1 through 1.863-10.

§1.863-1 Allocation of gross income under section 863(a).

- (a) In general.
- (b) Natural resources.
  - (1) In general.
  - (2) Additional production activities.
  - (3) Definitions.
    - (i) Production activity.
    - (ii) Additional production activities.
  - (4) Determination of fair market value.
  - (5) Determination of gross income.
  - (6) Tax return disclosure.
  - (7) Examples.
    - (i) Example 1. No additional production, foreign source gross receipts.
    - (ii) Example 2. No additional production, U.S. source gross receipts.
    - (iii) Example 3. Production in United States, foreign sales.
    - (iv) Example 4. Production and sales in United States.
    - (v) Example 5. Additional production.
  - (c) Determination of taxable income.
    - (d) Scholarships, fellowship grants, grants, prizes, and awards.
      - (1) In general.
      - (2) Source of income.
        - (i) United States source income.
        - (ii) Foreign source income.
        - (iii) Certain activities conducted outside the United States.
    - (3) Definitions.
    - (4) Effective dates.
      - (i) Scholarships and fellowship grants.
      - (ii) Grants, prizes and awards.
  - (e) Residual interest in a REMIC.
    - (1) REMIC inducement fees.
    - (2) Excess inclusion income and net losses.
  - (f) Applicability date.

§1.863-2 Allocation and apportionment of taxable income.

- (a) Determination of taxable income.
- (b) Determination of source of taxable income.
- (c) Applicability date.

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

- (a) In general.
    - (1) Scope.
    - (2) Cross references.
  - (b) Sourcing based solely on production activities.
  - (c) Determination of the source of gross income from production activity.
    - (1) Production only within the United States or only within foreign countries.
  - (i) Source of income.
    - (ii) Definition of production assets.
    - (iii) Location of production assets.
      - (2) Production both within and without the United States.
  - (i) Source of income.
    - (ii) Adjusted basis of production assets.
  - (A) In general.
  - (B) Production assets used to produce other property.
  - (3) Anti-abuse rule.
  - (4) Examples.
    - (i) Example 1. Source of gross income.
    - (ii) Example 2. Location of intangible property.
    - (iii) Example 3. Anti-abuse rule.
  - (d) Determination of source of taxable income.
  - (e) Income partly from sources within a possession of the United States.
    - (1) In general.
    - (2) Allocation or apportionment for Possession Production Sales.
    - (3) Allocation or apportionment for Possession Purchase Sales.
      - (i) Determination of source of gross income from Possession Purchase Sales.
      - (ii) Determination of source of gross income from business activity.
        - (A) Source of gross income.
        - (B) Business activity.
        - (C) Location of business activity.
          - (1) Sales activity.
          - (2) Cost of goods sold.
          - (3) Expenses.
          - (4) Examples.
            - (i) Example 1: Purchase of goods manufactured in possession.
            - (ii) Example 2: Purchase of goods manufactured outside possession.
  - (5) Special rules for partnerships.
- (f) Special rules for partnerships.
  - (1) General rule.
  - (2) Exceptions.
    - (i) In general.
    - (ii) Attribution of production assets to or from a partnership.
      - (iii) Basis.
  - (3) Examples.
    - (i) Example 1. Distributive share of partnership income.
    - (ii) Example 2. Distribution in kind.

(g) Applicability dates.

§1.863-4 Certain transportation services.

- (a) General.
- (b) Gross income.
- (c) Allocation of costs or expenses.
- (d) Items not included as costs or expenses.
  - (1) Taxes and interest.
  - (2) Other business activity and general expenses.
  - (3) Personal exemptions and special deductions.
- (e) Property used while within the United States.
  - (1) General.
  - (2) Average property.
  - (3) Current assets.
- (f) Taxable income.
  - (1) General.
  - (2) Interest and taxes.
  - (3) General expenses.
  - (4) Personal exemptions.
  - (5) Special deductions.
- (g) Allocation based on books of account.

§1.863-6 Income from sources within a foreign country.

§1.863-7 Allocation of income attributable to certain notional principal contracts under section 863(a).

- (a) Scope.
  - (1) Introduction.
  - (2) Effective/applicability date.
- (b) Source of notional principal contract income.
  - (1) General rule.
  - (2) Qualified business unit exception.
  - (3) Effectively connected notional principal contract income.
- (c) Election.
  - (1) Eligibility and effect.
  - (2) Time for making election.
  - (3) Manner of making election.
- (d) Example.
- (e) Cross references.

§1.863-8 Source of income derived from space and ocean activity under section 863(d).

- (a) In general.
- (b) Source of gross income from space and ocean activity.
  - (1) Space and ocean income derived by a United States person.
  - (2) Space and ocean income derived by a foreign person.
- (i) In general.

- (ii) Space and ocean income derived by a controlled foreign corporation.
- (iii) Space and ocean income derived by foreign persons engaged in a trade or business within the United States.
- (3) Source rules for income from certain sales of property.
  - (i) Sales of purchased property.
  - (ii) Sales of property produced by the taxpayer.
    - (A) General.
    - (B) Production only in space or international water, or only outside space and international water.
    - (C) Production both in space or international water and outside space and international water.
- (4) Special rule for determining the source of gross income from services.
- (5) Special rule for determining source of income from communications activity (other than income from international communications activity).
  - (c) Taxable income.
  - (d) Space and ocean activity.
    - (1) Definition.
      - (i) Space activity.
      - (ii) Ocean activity.
    - (2) Determining a space or ocean activity.
      - (i) Production of property in space or international water.
      - (ii) Special rule for performance of services.
        - (A) General.
        - (B) Exception to the general rule.
    - (3) Exceptions to space or ocean activity.
  - (e) Treatment of partnerships.
  - (f) Examples.
    - (1) Example 1. Space activity—activity occurring on land and in space.
    - (2) Example 2. Space activity.
    - (3) Example 3. Services as space activity—de minimis value attributable to performance occurring in space.
    - (4) Example 4. Space activity.
    - (5) Example 5. Space activity.
    - (6) Example 6. Space activity—treatment of land activity.
    - (7) Example 7. Use of intangible property in space.
    - (8) Example 8. Performance of services.
    - (9) Example 9. Separate transactions.
    - (10) Example 10. Sale of property in international water.
    - (11) Example 11. Sale of property in space.
    - (12) Example 12. Sale of property in space.
    - (13) Example 13. Source of income of a foreign person.
    - (14) Example 14. Source of income of a foreign person.
  - (g) Reporting and documentation requirements.
    - (1) In general.
    - (2) Required documentation.
    - (3) Access to software.

- (4) Use of allocation methodology.
- (h) Applicability date.

§1.863-9 Source of income derived from communications activity under section 863(a), (d), and (e).

- (a) In general.
- (b) Source of international communications income.
  - (1) International communications income derived by a United States person.
  - (2) International communications income derived by foreign persons.
    - (i) In general.
    - (ii) International communications income derived by a controlled foreign corporation.
    - (iii) International communications income derived by foreign persons with a fixed place of business in the United States.
    - (iv) International communications income derived by foreign persons engaged in a trade or business within the United States.
- (c) Source of U.S. communications income.
- (d) Source of foreign communications income.
- (e) Source of space/ocean communications income.
- (f) Source of communications income when taxpayer cannot establish the two points between which the taxpayer is paid to transmit the communication.
- (g) Taxable income.
- (h) Communications activity and income derived from communications activity.
  - (1) Communications activity.
    - (i) General rule.
    - (ii) Separate transaction.
  - (2) Income derived from communications activity.
  - (3) Determining the type of communications activity.
    - (i) In general.
    - (ii) Income derived from international communications activity.
    - (iii) Income derived from U.S. communications activity.
    - (iv) Income derived from foreign communications activity.
    - (v) Income derived from space/ocean communications activity.
  - (i) Treatment of partnerships.
  - (j) Examples.
  - (k) Reporting and documentation requirements.
    - (1) In general.
    - (2) Required documentation.
    - (3) Access to software.
    - (4) Use of allocation methodology.
  - (l) Effective date.

§1.863-10 Source of income from a qualified fails charge.

- (a) In general.
- (b) Qualified business unit exception.
- (c) Effectively connected income exception.
- (d) Qualified fails charge.

- (e) Designated security.
- (g) Effective/applicability date.

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

**§1.863-0A Table of contents.**

This section lists captions contained in §§1.863-3A and 1.863-3AT.

§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.
  - (2) Definition.
- (b) Income partly from sources within a foreign country.
  - (1) General.
  - (2) Allocation or apportionment.
- (c) Income partly from sources within a possession of the United States.
  - (1) General.
  - (2) Allocation or apportionment.
  - (3) Personal property produced and sold.
  - (4) Personal property purchased and sold.

§1.863-3AT Income from the sale of personal property derived partly from within and partly from without the United States (temporary).

- (a) [Reserved].
- (b) Income partly from sources within a foreign country.
  - (1) [Reserved].
  - (2) Allocation or apportionment.
- (c)(1) through (4) [Reserved].

Par. 4. Section 1.863-1 is amended as follows:

- a. In paragraph (a):
  - i. Revising the third sentence.
  - ii. Removing “§1.863-3(g)” and adding in its place “§1.863-3(f)”.
- b. Revising paragraph (b)(1).
- c. In paragraph (b)(2):
  - i. Removing “prior to export terminal” from the heading and adding in its place “activities”.

- ii. Removing “before the relevant product is shipped from the export terminal” from the first sentence.
- iii. Adding “oil or gas” before “well” and “other natural” before “deposit” in the second sentence.
- d. Removing “§§1.1502-13 or 1.863-3(g)(2)” from paragraph (b)(3)(i) and adding in its place “§1.1502-13 or 1.863-3(f)(2)”.
- e. In paragraph (b)(3)(ii):
  - i. Adding “uncut” before “timber” in the first sentence.
  - ii. Adding “(except for §1.954-3(a)(4)(iv))” at the end of the second sentence.
  - iii. Removing “to or from the export terminal” from the third sentence.
- f. Removing paragraph (b)(3)(iii).
- g. In paragraph (b)(6), removing “this paragraph (b)” from the first sentence and adding in its place “paragraph (b)(2) of this section”.
- h. Designating Examples 1, 2, 3, 4, and 5 of paragraph (b)(7) as paragraphs (b)(7)(i) through (v).
  - i. Revising newly designated paragraphs (b)(7)(i) through (v).
  - j. In paragraph (f):
    - i. Revising the heading.
    - ii. Adding three sentences at the start of the paragraph.

The revisions and additions read as follows:

**§1.863-1 Allocation of gross income under section 863(a).**

(a) \* \* \* See also section 865(b) for rules for sourcing income from the sale of inventory property, within the meaning of section 865(i)(1) (inventory), generally, and

section 865(e)(2) and §1.865-3 for sourcing income from the sale of personal property (including inventory) by a nonresident that is attributable to the nonresident's office or other fixed place of business in the United States. \* \* \*

(b) Natural resources--(1) In general. Notwithstanding any other provision of this part, except to the extent provided in paragraph (b)(2) of this section or §1.865-3, gross receipts from the sale outside the United States of products derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or uncut timber within the United States shall be treated as from sources within the United States, and gross receipts from the sale within the United States of products derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or uncut timber outside the United States shall be treated as from sources without the United States.

\* \* \* \* \*

(7) \* \* \*

(i) Example 1. No additional production, foreign source gross receipts. U.S. Mines, a domestic corporation, operates a copper mine and mill in Country X. U.S. Mines extracts copper-bearing rocks from the ground and transports the rocks to the mill where the rocks are ground and processed to produce copper-bearing concentrate. The concentrate is transported to a port where it is dried in preparation for export, stored, and then shipped to purchasers in the United States. Because, under the facts and circumstances, none of U.S. Mines' activities constitute additional production activities, within the meaning of paragraph (b)(3)(ii) of this section, paragraph (b)(2) of this section does not apply, and under paragraph (b)(1) of this section, gross receipts

from the sale of the concentrate will be treated as from sources without the United States.

(ii) Example 2. No additional production, U.S. source gross receipts. U.S. Gas, a domestic corporation, extracts natural gas within the United States, and transports the natural gas to a Country X port where it is liquefied in preparation for shipment. The liquefied natural gas is then transported via freighter and sold without additional production activities in a foreign country. Under paragraph (b)(3)(ii) of this section, liquefaction of natural gas is not an additional production activity because liquefaction prepares the natural gas for transportation. Therefore, under paragraph (b)(1) of this section, gross receipts from the sale of the liquefied natural gas will be treated as from sources within the United States.

(iii) Example 3. Production in United States, foreign sales. U.S. Gold, a domestic corporation, mines gold in Country X, produces gold jewelry using production assets located in the United States, and sells the jewelry in Country Y. Assume that the fair market value of the gold before the additional production activities in the United States is \$40x and that U.S. Gold ultimately sells the gold jewelry in Country Y for \$100x. Under paragraph (b)(2) of this section, \$40x of U.S. Gold's gross receipts will be treated as from sources without the United States, and the remaining \$60x of gross receipts will be treated as from sources within the United States under §1.863-3.

(iv) Example 4. Production and sales in United States. U.S. Oil, a domestic corporation, extracts oil in Country X, transports the oil via a pipeline to the United States, refines the oil using production assets located in the United States, and sells the refined product in the United States to unrelated persons. Assume that the fair market

value of the oil before refinement in the United States is \$80x and U.S. Oil ultimately sells the refined product for \$100x. Under paragraph (b)(2) of this section, \$80x of gross receipts will be treated as from sources without the United States, and the remaining \$20x of gross receipts will be treated as from sources within the United States under §1.863-3.

(v) Example 5. Additional production. The facts are the same as in paragraph (b)(7)(i) of this section (the facts in Example 1), except that U.S. Mines also operates a smelter in Country X. The concentrate output from the mill is transported to the smelter where it is transformed into smelted copper. The smelted copper is exported to purchasers in the United States. Under the facts and circumstances, all the processes applied to make copper concentrate are considered mining. Therefore, under paragraph (b)(2) of this section, gross receipts equal to the fair market value of the concentrate at the smelter will be treated as from sources without the United States. Under the facts and circumstances, the conversion of the concentrate into smelted copper is an additional production activity in a foreign country within the meaning of paragraph (b)(3)(ii) of this section. Therefore, the source of U.S. Mines's excess gross receipts will be determined under §1.863-3, pursuant to paragraph (b)(2) of this section.

\* \* \* \* \*

(f) Applicability date. Paragraph (b) of this section applies to taxable years ending on or after December 23, 2019. However, a taxpayer may apply paragraph (b) of this section in its entirety for taxable years beginning after December 31, 2017, and ending before December 23, 2019, provided that the taxpayer and all persons related to the taxpayer (within the meaning of section 267 or 707) apply paragraph (b) of this

section and §§1.863-2(b), 1.863-3, 1.863-8(b)(3)(ii), 1.864-5(a) and (b), 1.864-6(c)(2), and 1.865-3 in their entirety for the taxable year, and once applied, the taxpayer and all persons related to the taxpayer (within the meaning of section 267 or 707) continue to apply these regulations in their entirety for all subsequent taxable years. For regulations generally applicable to taxable years ending before December 23, 2019, see §1.863-1 as contained in 26 CFR part 1 revised as of April 1, 2020. \* \* \*

Par. 5. Section 1.863-2 is amended as follows:

a. In paragraph (a) introductory text:

i. Removing “(and that is treated as derived partly from sources within and partly from sources without the United States)” from the third sentence.

ii. Adding a colon after the word “income” at the end of the paragraph.

b. Revising paragraph (b).

c. Revising paragraph (c).

The revisions read as follows:

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

\* \* \* \* \*

(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 or apportioned to sources within and without the United States pursuant to §§1.863-1, 1.863-3, 1.863-4, 1.863-8, and 1.863-9. 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, §1.863-3 for other sales of inventory

property, and §1.863-8 for source of gross income from space and ocean activity. Section 1.865-3 may apply instead of the provisions in this section to source gross income from sales of personal property (including inventory property) by nonresidents attributable to an office or other fixed place of business in the United States. 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(e).

(c) Applicability date. Except as provided in this paragraph (c), this section applies to taxable years beginning after December 30, 1996. Paragraph (b) of this section applies to taxable years ending on or after December 23, 2019. However, a taxpayer may apply paragraph (b) of this section in its entirety for taxable years beginning after December 31, 2017, and ending before December 23, 2019, provided that the taxpayer and all persons related to the taxpayer (within the meaning of section 267 or 707) apply paragraph (b) of this section and §§1.863-1(b), 1.863-3, 1.863-8(b)(3)(ii), 1.864-5(a) and (b), 1.864-6(c)(2), and 1.865-3 in their entirety for the taxable year, and once applied, the taxpayer and all persons related to the taxpayer (within the meaning of section 267 or 707) continue to apply these regulations in their entirety for all subsequent taxable years. For regulations generally applicable to taxable years ending before December 23, 2019, see §1.863-2 as contained in 26 CFR part 1 revised as of April 1, 2020.

Par. 6. Section 1.863-3 is revised as follows:

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

(a) In general--(1) Scope. Subject to the rules of §1.865-3, paragraphs (a) through (d) of this section apply to determine the source of income derived from the sale

of inventory property (inventory) that a taxpayer produces (in whole or in part) within the United States and sells without the United States, or that a taxpayer produces (in whole or in part) without the United States and sells within the United States (collectively, Section 863(b)(2) Sales). See section 865(i)(1) for the definition of inventory.

Paragraph (b) of this section provides that the source of gross income from Section 863(b)(2) Sales is based solely on the production activities with respect to the inventory. Paragraph (c) of this section describes how to determine source based on production activity, including when inventory is produced partly within the United States and partly without the United States. Paragraph (d) of this section determines taxable income from Section 863(b)(2) Sales. Paragraph (e) of this section applies to determine the source of certain income derived from a possession of the United States. Paragraph (f) of this section provides special rules for partnerships for all sales subject to §§1.863-1 through 1.863-3. Paragraph (g) of this section provides applicability dates for the rules in this section.

(2) Cross references. To determine the source of income derived from the sale of personal property (including inventory) by a nonresident that is attributable to the nonresident's office or other fixed place of business in the United States under section 865(e)(2) and §1.865-3(c), the rules of §1.865-3 apply, and the rules of this section do not apply except to the extent provided in §1.865-3. 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, as defined in §1.863-8(d)(1)(i), or international water, as defined in §1.863-8(d)(1)(ii), 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.

(b) Sourcing based solely on production activities. Subject to the rules of §1.865-3, all income, gain, or loss derived from Section 863(b)(2) Sales is allocated and apportioned solely on the basis of the production activities with respect to the inventory.

(c) Determination of the source of gross income from production activity--(1) Production only within the United States or only within foreign countries--(i) 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. Whether a taxpayer's activities constitute production activity is determined under the principles of §1.954-3(a)(4) (except for §1.954-3(a)(4)(iv)). Subject to the provisions in §1.1502-13 or paragraph (f)(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, gross income 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)(2) 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.

(ii) Definition of production assets. Subject to the provisions of §1.1502-13 and paragraph (f)(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.

(iii) 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.

(2) Production both within and without the United States--(i) 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 gross income 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.

(ii) Adjusted basis of production assets--(A) In general. For purposes of paragraph (c)(2)(i) of this section, the adjusted basis of an asset is determined by using

the alternative depreciation system under section 168(g)(2). The adjusted basis of all production assets for purposes of paragraph (c)(2)(i) of this section is determined as though the production assets were subject to the alternative depreciation system set forth in section 168(g)(2) for the entire period that such property has been in service. The adjusted basis of the production assets is determined without regard to the election to expense certain depreciable assets under section 179 and without regard to any additional first-year depreciation provision (for example, section 168(k), (l), and (m), and former sections 1400L(b) and 1400N(d)). The average adjusted basis of assets is computed by averaging the adjusted basis at the beginning and end of the taxable year, unless by reason of changes during the taxable year, as might be the case in the event of a major acquisition or disposition of assets, the average would materially distort the calculation in paragraph (c)(2)(i) of this section. In this event, the average adjusted basis is determined upon a more appropriate basis that is weighted to reasonably reflect the period for which the assets are held by the taxpayer during the taxable year.

(B) Production assets used to produce other property. If a production asset is used to produce inventory sold in Section 863(b)(2) Sales and 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)(2)(i) of this section will be determined under any method that reasonably reflects the portion of the asset that produces inventory sold in Section 863(b)(2) 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(b)(2) Sales produced by the asset, and the denominator of which is the gross receipts from all property produced by that asset.

(3) Anti-abuse rule. The purpose of paragraph (b) of this section and this paragraph (c) is to attribute the source of the taxpayer's gross income from certain sales of inventory property 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 in a manner inconsistent with the purpose of paragraph (b) of this section or this paragraph (c), the Commissioner may make appropriate adjustments so that the source of the taxpayer's gross income more clearly reflects the location of production activity. For example, a taxpayer may be subject to the rule in this paragraph (c)(3) if domestic production assets are acquired by a related partnership (or a subsidiary of a related partnership) with a principal purpose of reducing its U.S. tax liability by claiming that the taxpayer's income from sales of inventory is subject to section 862(a)(6) rather than section 863(b).

(4) Examples. The following examples illustrate the rules of this paragraph (c):

(i) Example 1. Source of gross income--(A) Facts. 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, as determined using the alternative depreciation system under section 168(g)(2). 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.

(B) Analysis. A determines its gross income from sources without the United States by multiplying A's \$12 of gross income from sales of widgets in foreign countries 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 income from sources without the United States is \$4 ( $\$12 \times (\$25/\$75)$ ).

(ii) Example 2. Location of intangible property. Assume the same facts as in paragraph (c)(4)(i)(A) of this section (the facts in 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 gross income, A's patent, if it has an average adjusted basis, would be located in the United States.

(iii) Example 3. Anti-abuse rule--(A) Facts. Assume the same facts as in paragraph (c)(4)(i)(A) of this section (the facts in 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)(2) of this section, all of A's gross 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.

(B) Analysis. 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)(2)(i) of this section, A's income must be adjusted to more clearly reflect the source of that income. In this case, the Commissioner may redetermine the source of A's gross income by ignoring the sale-leaseback transactions.

(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 its expenses, losses, and other deductions to its respective amounts of gross income from sources within and without the United States from its Section 863(b)(2) Sales. See §§1.861-8 through 1.861-14T and 1.861-17.

(e) Income partly from sources within a possession of the United States--(1) In general. This paragraph (e) relates to certain sales that give rise to income, gain, or loss that is 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 (e) applies to determine the source of income derived from the sale of inventory produced (in whole or in part) by a taxpayer within the United States and sold within a possession of the United States, or produced (in whole or in part) by a taxpayer in a possession of the United States and sold within the United States (collectively, 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 (e) must apportion gross income from Section 863 Possession Sales under paragraph (e)(2) of this section (in the case of Possession Production Sales) or under paragraph (e)(3) of this section (in the case of Possession Purchase Sales). The source of taxable income from Section 863 Possession Sales is determined under paragraph (d) of this section.

(2) Allocation or apportionment for Possession Production Sales. The source of gross income from Possession Production Sales is determined under the rules of paragraph (c) of this section, except that the term possession of the United States is substituted for foreign country wherever it appears.

(3) Allocation or apportionment for Possession Purchase Sales--(i) Determination of source of gross income from Possession Purchase Sales. Gross income from Possession Purchase Sales is allocated in its entirety to the taxpayer's business activity, and is then apportioned between sources within the United States and sources within a possession of the United States under paragraph (e)(3)(ii) of this section.

(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 (e)(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 activity. Receipts from gross sales will be attributed to a possession in accordance with the principles of §1.861-7(c).

(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.

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

(i) Example 1. Purchase of goods manufactured in possession--(A) Facts. 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.

(B) Analysis. 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.

(ii) Example 2. Purchase of goods manufactured outside possession--(A) Facts. Assume the same facts as in paragraph (e)(4)(i)(A) of this section (the facts in Example 1), except that A manufactures X outside the possession.

(B) Analysis. 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.

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

(f) Special rules for partnerships--(1) General rule. For purposes of §1.863-1 and this section, a taxpayer's production activity does not include production 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 paragraphs (c)(3) or (f)(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 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 (f)(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)(2)(ii) 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.

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

(i) 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.

(ii) Example 2. Distribution in kind. Assume the same facts as in paragraph (f)(3)(i) of this section (the facts 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 this section. In applying paragraph (c) 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.

(g) Applicability dates. This section applies to taxable years ending on or after December 23, 2019. However, a taxpayer may apply this section in its entirety for taxable years beginning after December 31, 2017, and ending before December 23, 2019, provided that the taxpayer and all persons related to the taxpayer (within the meaning of section 267 or 707) apply this section and §§1.863-1(b), 1.863-2(b), 1.863-8(b)(3)(ii), 1.864-5(a) and (b), 1.864-6(c)(2), and 1.865-3 in their entirety for the taxable year, and once applied, the taxpayer and all persons related to the taxpayer (within the meaning of section 267 or 707) continue to apply these regulations in their entirety for all subsequent taxable years. For regulations generally applicable to taxable years ending before December 23, 2019, see §1.863-3 as contained in 26 CFR part 1 revised as of April 1, 2020.

Par. 7. Section 1.863-8 is amended as follows:

a. Revising paragraph (b)(3)(ii)(A).

- b. In paragraph (b)(3)(ii)(B):
  - i. Removing “income allocable to production activity” wherever it appears and adding in its place “gross income”.
  - ii. Removing “§1.863-3(c)(1)” from the second sentence and adding in its place “§1.863-3(c)”.
- c. In paragraph (b)(3)(ii)(C):
  - i. Removing “allocable to production activity” wherever it appears.
  - ii. Removing “allocated to production activity” from the fifth sentence.
  - iii. Removing “§1.863-3(c)(1)” from the fifth sentence and adding in its place “§1.863-3(c)”.
- d. Removing paragraph (b)(3)(ii)(D).
- e. In paragraph (c), removing “(b)(3)(ii)(C)” from the first sentence and adding in its place “(b)(3)(ii)”.
- f. Designating Examples 1 through 14 of paragraph (f) as paragraphs (f)(1) through (14).
- g. In newly designated paragraphs (f)(1) through (14), removing the period between the second and third level paragraph headings and adding an em-dash in its place.
- h. Removing “this Example 4” from newly designated paragraph (f)(4)(i) wherever it appears and adding in its place “paragraph (f)(4)(i) (Example 4)”.
- i. Removing “Example 4” from newly designated paragraph (f)(5)(i) and adding in its place “paragraph (f)(4)(i) of this section (the facts in Example 4)”.
- j. Revising newly designated paragraph (f)(6)(ii).

- k. Removing “Example 8” from newly designated paragraph (f)(9)(i) and adding in its place “in paragraph (f)(8)(i) of this section (the facts in Example 8)”.
- l. Removing “Example 8” from newly designated paragraph (f)(9)(ii) and adding in its place “paragraph (f)(8)(ii) of this section (the analysis in Example 8)”.
- m. Revising newly designated paragraph (f)(11)(ii).
- n. In paragraph (g)(1), removing “(b)(3)(ii)(C)” from the first sentence and adding in its place “(b)(3)(ii)”.
- o. In paragraph (g)(4) introductory text, removing “(b)(3)(ii)(C)” from the first sentence and adding in its place “(b)(3)(ii)”.
- p. In paragraph (h), adding three sentences at the end of the paragraph.

The revisions and additions read as follows:

**§1.863-8 Source of income derived from space and ocean activity under section 863(d).**

\* \* \* \* \*

(b) \* \* \*

(3) \* \* \*

(ii) Sales of property produced by the taxpayer--(A) General. If the taxpayer both produces property and sells such property and either the production (in whole or in part) or the sale takes place in space or international water, the taxpayer must allocate and apportion all income, gain, or loss derived from sales of such property solely on the basis of the production activities with respect to such property, and the source of that income will be determined under paragraph (b)(3)(ii)(B) or (C) of this section. To determine the source of income derived from the sale of personal property (including inventory) by a nonresident that is attributable to the nonresident’s office or other fixed

place of business in the United States under section 865(e)(2), the rules of §1.865-3 apply, and the rules of this section do not apply.

\* \* \* \* \*

(f) \* \* \*

(6) \* \* \*

(ii) Analysis. The collection of data and creation of images in space is characterized as the creation of property in space. Because S both produces and sells the data, the source of the gross income from the sale of the data is determined under paragraph (b)(3)(ii) of this section solely on the basis of the production activities. The source of S's gross income is determined under paragraph (b)(3)(ii)(C) of this section because production activities occur both in space and on land.

\* \* \* \* \*

(11) \* \* \*

(ii) Analysis. Because S's rights, title, and interest in the satellite pass to the customer in space, the sale takes place in space under §1.861-7(c), and the sale transaction is space activity under paragraph (d)(1)(i) of this section. The source of income derived from the sale of the satellite manufactured in the United States and sold in space is determined under paragraph (b)(3)(ii) of this section solely on the basis of the production activities with respect to the satellite.

\* \* \* \* \*

(h) \* \* \* Paragraph (b)(3)(ii) of this section applies to taxable years ending on or after December 23, 2019. However, a taxpayer may apply paragraph (b)(3)(ii) of this section in its entirety for taxable years beginning after December 31, 2017, and ending

before December 23, 2019, provided that the taxpayer and all persons related to the taxpayer (within the meaning of section 267 or 707) apply paragraph (b)(3)(ii) of this section and §§1.863-1(b), 1.863-2(b), 1.863-3, 1.864-5(a) and (b), 1.864-6(c)(2), and 1.865-3 in their entirety for the taxable year, and once applied, the taxpayer and all persons related to the taxpayer (within the meaning of section 267 or 707) continue to apply these regulations in their entirety for all subsequent taxable years. For regulations generally applicable to taxable years ending before December 23, 2019, see §1.863-8 as contained in 26 CFR part 1 revised as of April 1, 2020.

Par. 8. Section 1.864-5 is amended as follows:

- a. Adding a sentence to the end of paragraph (a);
- b. Revising the first sentence of paragraph (b) introductory text; and
- c. Adding paragraph (e).

The additions read as follows:

**§1.864-5 Foreign source income effectively connected with U.S. business.**

(a) \* \* \* To determine the source of income, gain or loss from the sale of personal property (including inventory property) attributable to an office or other fixed place of business in the United States by nonresidents, as defined in section 865(g)(1)(B), see §1.865-3.

(b) \* \* \* Income, gain, or loss from sources without the United States other than income described in paragraph (c) of this section or income from section 865(e)(2) sales, as defined in §1.865-3(c), shall be taken into account pursuant to paragraph (a) of this section in applying §§1.864-6 and 1.864-7 only if it consists of—

\* \* \* \* \*

(e) Applicability dates. Paragraphs (a) and (b) of this section apply to taxable years ending on or after December 23, 2019. However, a taxpayer may apply paragraphs (a) and (b) of this section in their entirety for taxable years beginning after December 31, 2017, and ending before December 23, 2019, provided that the taxpayer and all persons related to the taxpayer (within the meaning of section 267 or 707) apply paragraphs (a) and (b) of this section and §§1.863-1(b), 1.863-2(b), 1.863-3, 1.863-8(b)(3)(ii), 1.864-6(c)(2), and 1.865-3 in their entirety for the taxable year, and once applied, the taxpayer and all persons related to the taxpayer (within the meaning of section 267 or 707) continue to apply these regulations in their entirety for all subsequent taxable years. For regulations generally applicable to taxable years ending before December 23, 2019, see §1.864-5 as contained in 26 CFR part 1 revised as of April 1, 2020.

Par. 9. Section 1.864-6 is amended as follows:

- a. Revising paragraph (c)(2).
- b. Revising paragraph (c)(3).
- c. Adding paragraph (c)(4).

The revisions and additions read as follows:

**§1.864-6 Income, gain, or loss attributable to an office or other fixed place of business in the United States.**

\* \* \* \* \*

(c) \* \* \*

(2) Special limitation in case of sales of goods or merchandise through U.S. office. Notwithstanding paragraph (c)(1) of this section, the special rules described in this paragraph (c)(2) apply with respect to a sale of goods or merchandise specified in

§1.864-5(b)(3), to which paragraph (b)(3)(i) of this section does not apply. In the case of a nonresident alien with a tax home within the United States, as defined in section 911(d)(3), the amount of income from the sale of goods or merchandise that is properly allocable to the individual's U.S. office is determined under §1.865-3(d).

(3) Examples. The application of this paragraph (c) may be illustrated by the following examples--

(i) Example 1. Sales of produced inventory through a U.S. sales office.

Individual A, who is a nonresident alien within the meaning of section 7701(b)(1)(B) and has a tax home in the United States, manufactures machinery in a foreign country and sells the machinery outside the United States through A's sales office in the United States for use in foreign countries. A is not a nonresident within the meaning of section 865(g)(1)(B). Therefore, §1.865-3 does not apply to A's sale of the machinery, except to the extent provided in paragraph (c)(2) of this section. Title to the property sold is transferred to the foreign purchaser outside the United States, but no office or other fixed place of business of A in a foreign country materially participates in the sale made through A's U.S. office. By reason of its sales activities in the United States, A is engaged in business in the United States during the taxable year. During the taxable year, A derives a total income of \$250,000x from these sales. Under paragraph (c)(2) of this section, the amount of income that is allocable to A's U.S. office is determined under §1.865-3(d)(2). The taxpayer does not allocate income from the sale under the books and records method described in §1.865-3(d)(2)(ii). Thus, 50 percent of A's foreign source income of \$250,000x, plus any additional income allocable based on the location of production activities under §§1.865-3(d)(2)(i) and 1.863-3 (in this case, \$0x),

is effectively connected for the taxable year with the conduct of A's U.S. trade or business, or \$125,000x.

(ii) Example 2. Sales of inventory purchased and resold through a U.S. sales office by a nonresident alien with a tax home in the United States. Individual B, who is a nonresident alien within the meaning of section 7701(b)(1)(B) and has a tax home in the United States, has an office in a foreign country that purchases merchandise and sells it through B's sales office in the United States for use in various foreign countries, with title to the property passing outside the United States. B is not a nonresident within the meaning of section 865(g)(1)(B). Therefore, §1.865-3 does not apply to B's sale of the merchandise, except to the extent provided in paragraph (c)(2) of this section. No other office of B materially participates in these sales made through its U.S. office. By reason of its sales activities in the United States, B is engaged in business in the United States during the taxable year. During the taxable year, B derives income of \$300,000x from these sales made through its U.S. sales office. All of B's income from these sales is foreign source as B purchases the merchandise outside the United States and title to the merchandise also passes outside the United States. The amount of income properly allocable to B's U.S. office determined under §1.865-3(d)(3) is \$300,000x, and thus \$300,000x is effectively connected for the taxable year with the conduct of B's U.S. trade or business.

(iii) Example 3. Foreign sales office also materially participates in sale. The facts are the same as in paragraph (c)(3)(ii) of this section (the facts in Example 2), except that B also has an office in a foreign country that is a material factor in the realization of income from the sales made through B's U.S. office. No income from the

sale of merchandise is allocable to B's U.S. sales office for the taxable year, by reason of paragraph (b)(3)(i) of this section, and thus none of the \$300,000x is effectively connected for the taxable year with the conduct of B's U.S. trade or business.

(iv) Example 4. Sales of inventory purchased and resold through a U.S. sales office by a foreign corporation. The facts are the same as in paragraph (c)(3)(ii) of this section (the facts in Example 2), except that B is a foreign corporation. B is a nonresident within the meaning of section 865(g)(1)(B). The income from such sales will be sourced in accordance with §1.865-3(a) and (d)(3).

(4) Applicability date. Paragraph (c)(2) of this section applies to taxable years ending on or after December 23, 2019. However, a taxpayer may apply paragraph (c)(2) of this section in its entirety for taxable years beginning after December 31, 2017, and ending before December 23, 2019, provided that the taxpayer and all persons related to the taxpayer (within the meaning of section 267 or 707) apply paragraph (c)(2) of this section and §§1.863-1(b), 1.863-2(b), 1.863-3, 1.863-8(b)(3)(ii), 1.864-5(a) and (b), and 1.865-3 in their entirety for the taxable year, and once applied, the taxpayer and all persons related to the taxpayer (within the meaning of section 267 or 707) continue to apply these regulations in their entirety for all subsequent taxable years. For regulations generally applicable to taxable years ending before December 23, 2019, see §1.864-6 as contained in 26 CFR part 1 revised as of April 1, 2020.

Par. 10. Section 1.865-3 is added to read as follows:

**§1.865-3 Source of gross income from sales of personal property (including inventory property) by a nonresident attributable to an office or other fixed place of business in the United States.**

(a) In general. Notwithstanding any provision of section 861 through 865 or other regulations in this part, this section provides the sole sourcing rules for gross income,

gain, or loss from section 865(e)(2) sales. Gross income, gain, or loss from a section 865(e)(2) sale is U.S. source income to the extent that the gross income, gain, or loss is properly allocable to an office or other fixed place of business in the United States under paragraph (d) of this section.

(b) Exception for certain inventory sales for use, disposition or consumption outside the United States. A section 865(e)(2) sale does not include any sale of inventory property that is sold for use, disposition, or consumption outside the United States if an office or other fixed place of business of the nonresident in a foreign country materially participates in the sale. See §1.864-6(b)(3) to determine whether a foreign office materially participates in the sale and whether the property was destined for foreign use.

(c) Section 865(e)(2) sales. For purposes of this section, a “section 865(e)(2) sale” is a sale of personal property by a nonresident, including inventory property, other than a sale described in paragraph (b) of this section, that is attributable to an office or other fixed place of business in the United States under the principles of section 864(c)(5)(B) as prescribed in §1.864-6(b)(1) and (2). In determining whether a nonresident maintains an office or other fixed place of business in the United States, the principles of section 864(c)(5)(A) as prescribed in §1.864-7 apply, including the rules of paragraph (d) of that section regarding the office or other fixed place of business of a dependent agent of the nonresident. For purposes of this section, “inventory property” has the meaning provided in section 865(i)(1), and “nonresident” has the meaning provided in section 865(g)(1)(B).

(d) Amount of gross income, gain, or loss on sale of personal property properly allocable to a U.S. office--(1) In general. Except as otherwise provided in paragraphs (d)(2) through (4) of this section, the amount of gross income, gain, or loss from a section 865(e)(2) sale that is properly allocable to an office or other fixed place of business in the United States is determined under the principles of §1.864-6(c)(1).

(2) Produced inventory property. Gross income, gain, or loss from a section 865(e)(2) sale of inventory property that is produced by the nonresident seller is properly allocable to an office or other fixed place of business in the United States or to production activities in accordance with the “50/50 method” described in paragraph (d)(2)(i) of this section. However, in lieu of the 50/50 method, the nonresident seller may elect to allocate the gross income, gain, or loss under the “books and records method” described in paragraph (d)(2)(ii)(A) of this section, provided that the nonresident satisfies all of the requirements described in paragraph (d)(2)(ii)(B) of this section to the satisfaction of the Commissioner. Gross income allocable to production activities under this paragraph (d)(2) is sourced in accordance with §1.863-3. For purposes of this paragraph (d)(2), the term “produced” includes created, fabricated, manufactured, extracted, processed, cured, and aged, as determined under the principles of §1.954-3(a)(4) (except for §1.954-3(a)(4)(iv)). See section 864(a) and §1.864-1.

(i) The 50/50 method. Fifty percent of the gross income, gain, or loss from a section 865(e)(2) sale of inventory property that is produced by the nonresident seller is properly allocable to an office or other fixed place of business in the United States, and

the remaining 50 percent of the gross income, gain, or loss is properly allocable to production activities (the “50/50 method”).

(ii) Books and records method--(A) Method. Subject to paragraph (d)(2)(ii)(B) of this section, a nonresident may elect to determine the amount of its gross income, gain, or loss from the sale of inventory property produced by the nonresident seller that is properly allocable to production activities and sales activities for the taxable year based upon its books of account (the “books and records method”). The gross income, gain, or loss allocable to sales activities under this method is treated as properly allocable to an office or other fixed place of business in the United States and the remaining gross income, gain, or loss is treated as properly allocable to production activities.

(B) Election and reporting rules--(1) In general. A nonresident may not make the election described in paragraph (d)(2)(ii)(A) of this section unless the requirements of paragraphs (d)(2)(ii)(B)(2) through (4) of this section are satisfied. Once the election is made, the nonresident must continue to satisfy the requirements of paragraphs (d)(2)(ii)(B)(2) through (4) of this section until the election is revoked. If the nonresident fails to satisfy the requirements in paragraphs (d)(2)(ii)(B)(2) through (4) of this section to the satisfaction of the Commissioner, the Commissioner may, in its sole discretion, apply the 50/50 method described in paragraph (d)(2)(i) of this section.

(2) Books of account. The nonresident must establish that it, in good faith and unaffected by considerations of tax liability, regularly employs in its books of account a detailed allocation of receipts and expenditures that, under the principles of section 482, clearly reflects both the amount of the nonresident’s gross income, gain, or loss from its inventory sales that are attributable to its sales activities, and the amount of its gross

income, gain, or loss from its inventory sales that are attributable to its production activities. For purposes of this paragraph (d)(2)(ii)(B)(2), section 482 principles apply as if the office or other fixed place of business in the United States were a separate organization, trade, or business (and, thus, a separate controlled taxpayer) from the nonresident (whether or not payments are made between the United States office or other fixed place of business and the nonresident's other offices, and whether or not the nonresident itself would otherwise constitute an organization, trade, or business).

(3) Required records. The nonresident must prepare and maintain the records described in paragraph (d)(2)(ii)(B)(2) of this section, which must be in existence when its return is filed. The nonresident must also prepare an explanation of how the allocation clearly reflects the nonresident's gross income, gain, or loss from production and sales activities under the principles of section 482. The nonresident must make available the explanation and records of the nonresident (including for the office or other fixed place of business in the United States and the offices or branches that perform the production activities) upon request of the Commissioner, within 30 days, unless some other period is agreed upon between the Commissioner and the nonresident.

(4) Making and revoking the books and records method election; disclosure of election. Except as otherwise provided in publications, forms, instructions, or other guidance, a nonresident makes or revokes the election to apply the books and records method by attaching a statement to its original timely filed Federal income tax return (including extensions) providing that it elects, or revokes the election, to apply the books and records method described in paragraph (d)(2)(ii)(A) of this section. For

nonresidents making the election, the statement must provide that the nonresident has prepared the records described in paragraph (d)(2)(ii)(B)(2) and (3) of this section.

(5) Limitation on revoking the books and records method election. Once made, the books and records method election continues until revoked. An election cannot be revoked, without the consent of the Commissioner, for any taxable year beginning within 48 months of the last day of the taxable year for which the election was made.

(3) Purchased inventory property. All gross income, gain, or loss from a section 865(e)(2) sale of inventory property that is both purchased and sold by a nonresident is properly allocable to an office or other fixed place of business in the United States.

(4) Depreciable personal property. Gain from a section 865(e)(2) sale of depreciable personal property (as defined in section 865(c)(4)) is allocated under paragraphs (d)(4)(i) and (ii) of this section.

(i) The gain not in excess of the depreciation adjustments, if any, is properly allocable to an office or other fixed place of business in the United States to the same extent that the gain would be allocated to sources within the United States under the rules of section 865(c)(1). The remaining gain not in excess of the depreciation adjustments, if any, is allocated to sources without the United States in accordance with section 865(c)(1). However, notwithstanding the preceding sentences, if the property was predominantly used in the United States, within the meaning of section 865(c)(3)(B)(i), for a particular taxable year, all of the gain not in excess of depreciation for that year is properly allocable to the office or other fixed place of business in the United States.

(ii) The gain in excess of the depreciation adjustments, if any, is treated as if such gain was from the sale of inventory and the amount allocable to an office or fixed place of business in the United States is determined under paragraph (d)(2) or (3) of this section, as applicable.

(e) Determination of source of taxable income. For rules allocating and apportioning expenses to gross income effectively connected with the conduct of a trade or business of a foreign corporation in the United States (including gross income, gain, or loss sourced under this section), see section 882(c)(1). For rules allocating and apportioning expenses to gross income, gain, or loss effectively connected with the conduct of a trade or business of a nonresident alien in the United States (including gross income, gain, or loss sourced under this section), see section 873(a).

(f) Export trade corporations. This section does not apply for purposes of defining an export trade corporation under section 971(a).

(g) Applicability date. This section applies to taxable years ending on or after December 23, 2019. However, a nonresident may apply this section in its entirety for taxable years beginning after December 31, 2017, and ending before December 23, 2019, provided that the nonresident and all persons related to the nonresident (within the meaning of section 267 or 707) apply this section and §§1.863-1(b), 1.863-2(b), 1.863-3, 1.863-8(b)(3)(ii), 1.864-5(a) and (b), and 1.864-6(c)(2) in their entirety for the taxable year, and once applied, the nonresident and all persons related to the nonresident (within the meaning of section 267 or 707) continue to apply these regulations in their entirety for all subsequent taxable years.

## **§1.937-2 [Amended]**

Par. 11. In §1.937-2 amend paragraph (d) by removing “§1.863-3(f)” and adding in its place “§1.863-3(e)”.

## **§1.937-3 [Amended]**

Par. 12. In §1.937-3 amend paragraph (d) by removing “§1.863-3(f)” and adding in its place “§1.863-3(e)”.

Par. 13. Section 1.1502-13 is amended by revising paragraph (c)(7)(ii)(N) to read as follows:

### **§1.1502-13 Intercompany transactions.**

\* \* \* \* \*

(c) \* \* \*

(7) \* \* \*

(ii) \* \* \*

(N) Example (14): Source of income under section 863--(1) Intercompany sale--

(i) Facts. S manufactures inventory property solely in the United States and recognizes \$75x of income on sales to B in Year 1. B conducts further production activity on the inventory property solely in Country Y and then sells the inventory property to X in Country Y and recognizes \$25x of income on the sale to X, also in Year 1. Title passes from S to B, and from B to X, in Country Y. Assume that applying §1.863-3 on a single entity basis, including the formula for apportionment of multi-country production activities by reference to the basis of production assets, \$10x would be treated as foreign source income and \$90x would be treated as U.S. source income (that is, 10 percent of the production occurred outside the United States and 90 percent occurred

within the United States, as measured by the basis of assets used in production activities with respect to the property). Assume further that, on a separate entity basis, S would have \$0x of foreign source income and \$75x of U.S. source income and all of B's \$25x of income would be foreign source income.

(ii) Analysis. Under the matching rule, both S's \$75x intercompany item and B's \$25x corresponding item are taken into account in Year 1. In determining the source of S and B's income from the inventory property sales, the attributes of S's intercompany item and B's corresponding item are redetermined to the extent necessary to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation. See paragraph (c)(1)(i) of this section. On a single entity basis, S and B would have \$10x that would be treated as foreign source income and \$90x that would be treated as U.S. source income, but without application of this section (that is, on a separate entity basis), S would have \$75x of U.S. source income and B would have \$25x of foreign source income. Under paragraph (c)(4)(ii) of this section, a redetermined attribute must be allocated between S and B using a reasonable method. On a separate entity basis B would have only foreign source income and S would have only U.S. source income. Accordingly, under paragraph (c)(1)(i) of this section, \$15x of B's \$25x sales income that would be treated as foreign source income on a separate entity basis is redetermined to be U.S. source income.

(2) Sale of property reflecting intercompany services or intangibles--(i) Facts. S earns \$10x of income performing services in the United States for B. B capitalizes S's fees into the basis of inventory property that it manufactures in the United States and sells to an unrelated person in Year 1 at a \$90x profit, with title passing in Country Y.

Assume that on a single entity basis, \$100x is treated as U.S. source income and \$0x is treated as foreign source income. Further assume that on a separate entity basis, S would have \$10x of U.S. source income, and B would have \$90x of U.S. source income, with neither having any foreign source income.

(ii) Analysis. Under the matching rule, S's \$10x income and B's \$90x income are taken into account in Year 1. In determining the source of S and B's income, the attributes of S's intercompany item and B's corresponding item are redetermined to the extent necessary to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation. Because the results are the same on a single entity basis and a separate entity basis (\$100x of U.S. source income and \$0x of foreign source income), the attributes are not redetermined under paragraph (c)(1)(i) of this section.

Sunita Lough,  
Deputy Commissioner for Services and Enforcement.

Approved: September 21, 2020

David J. Kautter,  
Assistant Secretary of the Treasury (Tax Policy).