

Three Assistant Commissioners, all in the classified civil service, are authorized, and will be available, to perform such functions as may be assigned to them. The intention of the Secretary of the Treasury under the comprehensive reorganization is to utilize one Assistant Commissioner to assist the Commissioner of Internal Revenue in supervising the operations of the district offices, another Assistant Commissioner to aid in the preparation of technical rulings and decisions, and the third Assistant Commissioner to supervise for the Commissioner the inspection activities of the Bureau.

Two additional advantages will be obtained when the reorganization around this new framework is completed.

First, the strong inspection service which the Secretary is establishing will keep the work of the Bureau under close and continuous observation. Working under the direct control of the Commissioner of Internal Revenue, it will be responsible for promptly detecting and investigating any irregularities.

Second, the new pattern of organization will strengthen and clarify lines of responsibility throughout the Bureau thus simplifying and making more effective and uniform the management control of the organization. This is essential in any effort to provide our principal revenue collection agency the best possible administration.

In order to eliminate Presidential appointment and senatorial confirmation with respect to the Assistant General Counsel for the Bureau of Internal Revenue and in order to provide a method of appointment comparable to that obtaining in the case of other assistant general counsel of the Department of the Treasury, plan No. 1 abolishes that office and provides in lieu thereof a new office of Assistant General Counsel with appointment under the classified civil service.

The success of the reorganization of the Bureau of Internal Revenue will to a considerable extent depend upon the ability to attract the best qualified persons to the key positions throughout the Bureau. In order to do so it is necessary to make provision for more adequate salaries for such key positions. Plan No. 1 establishes in the Bureau of Internal Revenue a maximum of 70 offices with titles determined by the Secretary of the Treasury. Those offices are in addition to the offices with specific titles also provided for in plan No. 1 and to any positions established under other authority vested in the Department of the Treasury. The compensation of these officials will be fixed under the Classification Act of 1949, as amended, but without regard to the numerical limitations on positions set forth in section 505 of that act. This provision will enable the Chairman of the Civil Service Commission, or the President, as the case may be, to fix rates of pay for those offices in excess of the rates established in the Classification Act of 1949 for grade GS-15 whenever the standards of the classification laws so permit.

All organizational changes under plan No. 1 will be put into effect as soon as it is possible to do so without disrupting the continued collection of revenue. Plan No. 1 will in any event be effective in its entirety no later than December 1, 1952.

The taking effect of the reorganizations provided for in Reorganization Plan No. 1 of 1952 will make possible many benefits in improved organization and operations which may be expected to produce substantial savings in future years. Those savings should not be expected to be reflected in an immediate reduction in expenditure by the Bureau of Internal Revenue but in an improved service to the public and a more efficient collection of revenue.

It should be emphasized that abolition by plan No. 1 of the offices of collectors and others will in no way prejudice any right or potential right of any taxpayer. The abolition of offices by plan No. 1 will not abolish any rights, privileges, powers, duties, immunities, liabilities, obligations, or other attributes of those offices except as they relate to matters of appointment, tenure, and compensation inconsistent with plan No. 1. Under the Reorganization Act of 1949, all of these attributes of office will attach to the office to which the functions of the abolished office are delegated by the Secretary of the Treasury.

After investigation, I have found and hereby declare that each reorganization included in Reorganization Plan No. 1 of 1952 is necessary to accomplish one or more of the purposes set forth in section 214 of the Reorganization Act of 1949.

I have found and hereby declare that it is necessary to include in the accompanying Reorganization Plan No. 1, by reason of reorganizations

made hereby, provisions for the appointment and compensation of the officers specified therein. The rates of compensation fixed for these officers are not in excess of those which I have found to prevail in respect of comparable officers in the executive branch.

I cannot emphasize too strongly the importance which should be attached to the reorganization plan that I am now transmitting to the Congress. The fair and efficient administration of the Federal internal-revenue laws is of vital concern to every citizen. All of us have a right to insist that the Bureau of Internal Revenue be provided with the finest organization that can be devised. All of us are entitled to have that organization manned by personnel who get their jobs and keep them solely because of their own integrity and competence. This reorganization plan will be a major step in achieving those objectives.

HARRY S. TRUMAN

## § 7805. Rules and regulations

(a) **Authorization.**—Except where such authority is expressly given by this title to any person other than an officer or employee of the Treasury Department, the Secretary shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

(b) **Retroactivity of regulations.**—

(1) **In general.**—Except as otherwise provided in this subsection, no temporary, proposed, or final regulation relating to the internal revenue laws shall apply to any taxable period ending before the earliest of the following dates:

(A) The date on which such regulation is filed with the Federal Register.

(B) In the case of any final regulation, the date on which any proposed or temporary regulation to which such final regulation relates was filed with the Federal Register.

(C) The date on which any notice substantially describing the expected contents of any temporary, proposed, or final regulation is issued to the public.

(2) **Exception for promptly issued regulations.**—Paragraph (1) shall not apply to regulations filed or issued within 18 months of the date of the enactment of the statutory provision to which the regulation relates.

(3) **Prevention of abuse.**—The Secretary may provide that any regulation may take effect or apply retroactively to prevent abuse.

(4) **Correction of procedural defects.**—The Secretary may provide that any regulation may apply retroactively to correct a procedural defect in the issuance of any prior regulation.

(5) **Internal regulations.**—The limitation of paragraph (1) shall not apply to any regulation relating to internal Treasury Department policies, practices, or procedures.

(6) **Congressional authorization.**—The limitation of paragraph (1) may be superseded by a legislative

grant from Congress authorizing the Secretary to prescribe the effective date with respect to any regulation.

(7) **Election to apply retroactively.**—The Secretary may provide for any taxpayer to elect to apply any regulation before the dates specified in paragraph (1).

(8) **Application to rulings.**—The Secretary may prescribe the extent, if any, to which any ruling (including any judicial decision or any administrative determination other than by regulation) relating to the internal revenue laws shall be applied without retroactive effect.

(c) **Preparation and distribution of regulations, forms, stamps, and other matters.**—The Secretary shall prepare and distribute all the instructions, regulations, directions, forms, blanks, stamps, and other matters pertaining to the assessment and collection of internal revenue.

(d) **Manner of making elections prescribed by Secretary.**—Except to the extent otherwise provided by this title, any election under this title shall be made at such time and in such manner as the Secretary shall prescribe.

(e) **Temporary regulations.**—

(1) **Issuance.**—Any temporary regulation issued by the Secretary shall also be issued as a proposed regulation.

(2) **3-year duration.**—Any temporary regulation shall expire within 3 years after the date of issuance of such regulation.

(f) **Review of impact of regulations on small business.**—

(1) **Submissions to small business administration.**—After publication of any proposed or temporary regulation by the Secretary, the Secretary shall submit such regulation to the Chief Counsel for Advocacy of the Small Business Administration for comment on the impact of such regulation on small business. Not later than the date 4 weeks after the date of such submission, the Chief Counsel for Advocacy shall submit comments on such regulation to the Secretary.

(2) **Consideration of comments.**—In prescribing any final regulation which supersedes a proposed or temporary regulation which had been submitted under this subsection to the Chief Counsel for Advocacy of the Small Business Administration—

(A) the Secretary shall consider the comments of the Chief Counsel for Advocacy on such proposed or temporary regulation, and

(B) the Secretary shall discuss any response to such comments in the preamble of such final regulation.

(3) **Submission of certain final regulations.**—In the case of the promulgation by the Secretary of any final regulation (other than a temporary regulation) which does not supersede a proposed regulation, the requirements of paragraphs (1) and (2) shall apply, except that—

(A) the submission under paragraph (1) shall be made at least 4 weeks before the date of such promulgation, and

(B) the consideration (and discussion) required under paragraph (2) shall be made in connection with the promulgation of such final regulation.

(Aug. 16, 1954, c. 736, 68A Stat. 917; Oct. 4, 1976, Pub.L. 94-455, Title XIX, § 1906(b)(13)(A), 90 Stat. 1834; July 1, 1984, Pub.L. 98-369, Div. A, Title I, § 43(b), 98 Stat. 578, Nov. 10, 1988, Pub.L. 100-647, Title VI, § 6232(a), 102 Stat. 3734; Nov. 5, 1990, Pub.L. 101-508, Title XI, § 11621(a), 114 Stat. 1988-503; July 30, 1996, Pub.L. 104-168, Title XI, § 1101(a), 110 Stat. 1468; July 22, 1998, Pub.L. 105-206, Title III, § 3704, 112 Stat. 777.)

#### HISTORICAL AND STATUTORY NOTES

##### Effective Dates

1996 Acts. Section 1101(b) of Pub.L. 104-168 provided that: "The amendment made by subsection (a) [amending this section] shall apply with respect to regulations which relate to statutory provisions enacted on or after the date of the enactment of this Act [July 30, 1996]."

1990 Act. Section 11621(b) of Pub.L. 101-508 provided that: "The amendment made by subsection (a) [amending subsec. (f) of this section] shall apply to regulations issued after the date which is 30 days after the date of the enactment of this Act [Nov. 5, 1990]."

1988 Act. Section 6232(b) of Pub.L. 100-647 provided that: "The amendments made by this section [enacting subsecs. (e), (f) of this section] shall apply to any regulation issued after the date which is 10 days after the date of the enactment of this Act [Nov. 10, 1988]."

1984 Act. Amendment by Pub.L. 98-369 applicable to taxable years ending after July 18, 1984, see section 44 of Pub.L. 98-369, set out as a note under section 1271 of this title.

1976 Act. Amendment by section 1906(b)(13)(A) of Pub.L. 94-455 effective the first day of the first month which begins more than 90 days after Oct. 4, 1976, see section 1906(d) of Pub.L. 94-455, set out as a note under section 6013 of this title.

##### Internet Availability of Documents

Section 2003(d) of Pub.L. 105-206 provided that: "In the case of taxable periods beginning after December 31, 1998, the Secretary of the Treasury or the Secretary's delegate shall establish procedures for all tax forms, instructions, and publications created in the most recent 5-year period to be made available electronically on the Internet in a searchable database at approximately the same time such records are available to the public in paper form. In addition, in the case of taxable periods beginning after December 31, 1998, the Secretary of the Treasury or the Secretary's delegate shall, to the extent practicable, establish procedures for other taxpayer guidance to be made available electronically on the Internet in a searchable database at approximately the same time such guidance is available to the public in paper form."

[Provisions of this note, enacted by section 2003(f) of Pub.L. 105-206, effective July 22, 1998, see section 2003(f) of Pub.L. 105-206, set out as a note under section 6061 of this title.]

#### § 7806. Construction of title

(a) **Cross references.**—The cross references in this title to other portions of the title, or other provisions of

Source of income

gross income from all sources shall, for purposes of origin tax credit, be treated as income from the United States to the extent of such investment...
the extent exceeding...
dividends for the...
allowable under...
(a)(2)(B) effective...
corporation after...
domestic corp...
corporation begins...
contribution to make...
contribution for a tax yr. 1962...
or for the period...
(a)(2)(C) effective...
tax yrs end after...

without the United States...
out United States...
me shall be treated...
United States...
from sources within...
in 861(a)(1)...
ved from sources with...
ction 861(a)(2)...
onal services performed...

any located within...
in such property, b...
use of or for the...
United States patents, copy...
rights, good will, trad...
and other like propert...
on the sale or exchange...
the United States...
rived from the purch...
the meaning of secur...
ates and its sale or b...

than that derived...
as provided in section...
from the disposition...
est (as defined in...
s located in the Virg...

without United States...
specified in subsection...
ses, losses, and other...
allocated thereto, and...
or other deductions...
ome item or class of...
all be treated in full...
the United States...
not itemize deduction...
ction shall be consid...
be allocated to some...

substituted "865(i)(1)"...
ve for tax yrs begin...
repeated subsec (c) after...
shows

Source of income

For source of amounts attributable to certain assets and vest...
will see section 861(e).
P.L. 100-647, Sec. 1012(aa)(3)(A) and (4), provides
T) Certain amendments not to apply to the extent inconsistent...
with treaties. The following amendments made by the Reform Act...
shall not apply to the extent the application of such amendments...
would be contrary to any treaty obligation of the United States in...
effect on the date of the enactment of the Reform Act:
(A) The amendments made by section 1211 of the Reform Act...
to the extent—
(i) such amendments apply in the case of an individual treated...
as a resident of a foreign country under a treaty obligation of the...
United States as so in effect, or
(ii) such amendments relate to income of a non-resident from...
the sale or exchange of inventory property which would otherwise...
be sourced under section 865(e)(2) of the 1986 Code."

(4) Treatment of technical corrections. For purposes of...
paragraphs (2) and (3), any amendment made by this title shall be...
treated as if it had been included in the provision of the Reform...
Act to which such amendment relates.
P.L. 100-647, Sec. 4009, provides rules for the allocation of re-...
search and experimental expenditures. Sec. 4009 of this Act is re-...
produced in the note following Code Sec. 861.
P.L. 100-647, Sec. 1012(aa)(3)(A), provides that amendments...
made by Sec. 1211 of P.L. 99-514 shall not apply to the extent...
that the application of such amendments would be contrary to any...
treaty obligation of the U.S. in effect on 10/22/86 to the extent as...
provided in Secs. 1012(aa)(3)(A)(i) and (ii) which read as follows:
(i) such amendments apply in the case of an individual treated...
as a resident of a foreign country under a treaty obligation of the...
United States as so in effect, or
(ii) such amendments relate to income of a non-resident from...
the sale or exchange of inventory property which would otherwise...
be sourced under section 865(e)(2) of the 1986 Code"

In 74 P.L. 99-514, Sec. 1046(b)(12), substituted "standard deduc-...
tion" for "zero bracket amount" in subsec (b), effective for tax...
yrs begin after 12/31/86.
P.L. 99-514, Sec. 1211(b)(1)(C), substituted "inventory property...
(within the meaning of section 865(i)(1))" for "personal property"...
in para. (a)(6), effective for tax yrs begin after 12/31/86. For spe-...
cial rule see Sec. 1211(c)(2) of this Act reproduced in note follow-...
ing Code Sec. 865. For provisions on modifications of regulations for...
research and experimental expenditures, see Sec. 1216 of this...
Act, reproduced in note following Code Sec. 861.
P.L. 99-514, Sec. 13211, amended Sec. 126(c) of P.L. 98-369...
by substituting "1986" for "1985" and by substituting "4th" for...
"3rd" each place it appeared (see below).
In 74 P.L. 98-369, Sec. 126, (as amended by Sec. 13211 of P.L...
99-514, see above) provides
"SEC. 126 ALLOCATION UNDER SECTION 861 OF RESEARCH AND EX-...
PERIMENTAL EXPENDITURES"

(i) In general.—For purposes of section 861(b), section 862(b),...
and section 863(b) of the Internal Revenue Code of 1954, all...
amounts allowable as a deduction for qualified research and exper-...
imental expenditures shall be allocated to income from sources...
within the United States and deducted from such income in deter-...
mining the amount of taxable income from sources within the...
United States.
(b) Qualified research and experimental expenditures.—For pur-...
poses of this section—
(1) In general.—The term "qualified research and experimen-...
tal expenditures" means amounts—
(A) which are research and experimental expenditures within...
the meaning of section 174 of such Code, and
(B) which are attributable to activities conducted in the United...
States.
(2) Treatment of depreciation, etc.—Rules similar to the rules...
of subsection (c) of section 174 of such Code shall apply.

(c) Effective Dates.—
(i) In general.—This section shall apply to taxable years begin-...
ning after August 13, 1983, and on or before August 1, 1986.
(ii) Special rule.—If the taxpayer's 4th taxable year beginning...
after August 13, 1983 is not described in paragraph (1), this sec-...
tion shall apply also to such 4th taxable year.
In 71 P.L. 97-34, Sec. 831(a)(2), deleted "and" at the end of...
para. (a)(5) substituted a semicolon for the period at the end of...
para. (a)(6), substituted "underwriting" for "underwriting" in para...
(a)(7) substituted "and" for the period at the end of para. (a)(7)...
and added para. (a)(8) effective for dispositions after 1/18/80 in...
tax yrs ending after 6/15/80.
In 77 P.L. 95-30, Sec. 102(b)(10), added the last sentence in sub-...
sec (b) effective for tax yrs begin after 12/31/76.
In 76 P.L. 94-455, Sec. 1036(b), added para. (a)(7), effective for...
tax yrs begin after 12/31/76.

P.L. 94-455, Sec. 1901(b)(2)(C), substituted "sale or ex-...
change" for "sale" in paras. (a)(3) and (6), effective for tax yrs...
begin after 12/31/76.
In 71 P.L. 92-178, Sec. 314(b), added subsec. (c)

Sec. 863. Special rules for determining source.

(a) Allocation under regulations.

Items of gross income, expenses, losses, and deductions, other than those specified in sections 861(a) and 862(a), shall be allocated or apportioned to sources within or without the United States, under regulations prescribed by the Secretary. Where items of gross income are separately allocated to sources within the United States, there shall be deducted (for the purpose of computing the taxable income therefrom) the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of other expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as taxable income from sources within the United States.

(b) Income partly from within and partly from without the United States.

In the case of gross income derived from sources partly within and partly without the United States, the taxable income may first be computed by deducting the expenses, losses, or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income; and the portion of such taxable income attributable to sources within the United States may be determined by processes or formulas of general application prescribed by the Secretary. Gains, profits, and income

- (1) from services rendered partly within and partly without the United States.
(2) from the sale or exchange of inventory property (within the meaning of section 865(i)(1)) produced (in whole or in part) by the taxpayer within and sold or exchanged without the United States, or produced (in whole or in part) by the taxpayer without and sold or exchanged within the United States, or
(3) derived from the purchase of inventory property (within the meaning of section 865(i)(1)) within a possession of the United States and its sale or exchange within the United States.

shall be treated as derived partly from sources within and partly from sources without the United States.

(c) Source rule for certain transportation income.

- (1) Transportation beginning and ending in the United States. All transportation income attributable to transportation which begins and ends in the United States shall be treated as derived from sources within the United States.
(2) Other transportation having United States connection.

- (A) In general 50 percent of all transportation income attributable to transportation which—
(i) is not described in paragraph (1), and
(ii) begins or ends in the United States, shall be treated as from sources in the United States.

(B) Special rule for personal service income. Subparagraph (A) shall not apply to any transportation income which is income derived from personal services performed by the taxpayer, unless such income is attributable to transportation which—

- (i) begins in the United States and ends in a possession of the United States, or

(ii) begins in a possession of the United States and ends in the United States.

(3) Transportation income. For purposes of this subsection, the term "transportation income" means any income derived from, or in connection with—

- (A) the use (or hiring or leasing for use) of a vessel or aircraft, or
- (B) the performance of services directly related to the use of a vessel or aircraft.

For purposes of the preceding sentence, the term "vessel or aircraft" includes any container used in connection with a vessel or aircraft.

(d) Source rules for space and certain ocean activities.

(1) In general. Except as provided in regulations, any income derived from a space or ocean activity—

- (A) if derived by a United States person, shall be sourced in the United States, and
- (B) if derived by a person other than a United States person, shall be sourced outside the United States.

(2) Space or ocean activity. For purposes of paragraph (1)—

(A) In general. The term "space or ocean activity" means—

- (i) any activity conducted in space, and
- (ii) any activity conducted on or under-water not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States.

Such term includes any activity conducted in Antarctica.

(B) Exception for certain activities. The term "space or ocean activity" shall not include—

- (i) any activity giving rise to transportation income (as defined in section 863(c)),
- (ii) any activity giving rise to international communications income (as defined in subsection (e)(2)), and
- (iii) any activity with respect to mines, oil and gas wells, or other natural deposits to the extent within the United States or any foreign country or possession of the United States (as defined in section 638).

For purposes of applying section 638, the jurisdiction of any foreign country shall not include any jurisdiction not recognized by the United States.

(e) International communications income.

(1) Source rules.

(A) United States persons. In the case of any United States person, 50 percent of any international communications income shall be sourced in the United States and 50 percent of such income shall be sourced outside the United States.

(B) Foreign persons.

(i) In general. Except as provided in regulations or clause (ii), in the case of any person other than a United States person, any international communications income shall be sourced outside the United States.

(ii) Special rule for income attributable to office or fixed place of business in the United States. In the case of any person (other than a United States person) who maintains an office or other fixed place of business in the United States, any international communications income attributable to such office or other fixed place of business shall be sourced in the United States.

(2) Definition. For purposes of this section, the term "international communications income" includes all income

derived from the transmission of communications from the United States to any foreign country (or possession of the United States) or from any foreign country (or possession of the United States) to the United States.

In '89, P.L. 101-239, Sec. 7811(b)(2), substituted "6501(X)" for "165(h)(1)", in paras. (b)(2) and (b)(3), effective for tax yrs. beginning after 12/31/86.

In '88, P.L. 100-647, Sec. 1012(c)(3)(A), amended the heading of Code Sec. 863 effective for tax yrs. beginning after 12/31/86. Prior to amendment, the heading read as follows:

"Sec. 863 Items not specified in sections 861 or 862."

—P.L. 100-647, Sec. 1012(f), substituted "foreign country (or possession of the United States)" for "foreign country" each place it appeared in para. (c)(2), effective for tax yrs. beginning after 12/31/86.

—P.L. 101-647, Sec. 1012(a)(3)(A), (B), and (a)(4), provided:

"(3) Certain amendments not to apply to the extent inconsistent with treaties. The following amendments made by the Reform Act shall not apply to the extent the application of such amendments would be contrary to any treaty obligation of the United States in effect on the date of the enactment of the Reform Act:

"(A) The amendments made by section 1211 of the Reform Act to the extent—

"(i) such amendments apply in the case of an individual treated as a resident of a foreign country under a treaty obligation of the United States as to an effect, or

"(ii) such amendments relate to income of a nonresident from the sale or exchange of inventory property which would otherwise be sourced under section 863(c)(2) of the 1986 Code.

"(B) The amendments made by section 1212(a) of the Reform Act, except for purposes of determining the amount of the foreign tax credit."

—P.L. 101-647, Sec. 4009, provides rules for the allocation of research and experimental expenditures. Sec. 4009 of this Act is reproduced in the note following Code Sec. 461.

In '84, P.L. 99-514, Sec. 1211(b)(1)(A) substituted "inventory property (within the meaning of section 863(h)(1))" for "personal property" in para. (b)(2) and (3), effective for tax yrs. beginning after 12/31/86. For special rule, see Sec. 1211(c)(2) of this Act [see P.L. 100-647, Sec. 1012(a)(3)(A), (B) and (a)(4), above] reproduced in note following Code Sec. 865.

—P.L. 99-514, Sec. 1212(a), amended para. (c)(2) of this Act, substituted "services" for "transportation or other services" in para. (b)(1), effective for tax yrs. beginning after 12/31/86, except as provided in Secs. 1212(f)(2) and (3) of this Act, which reads as follows:

"(2) Special rule for certain leased property.—The amendments made by subsection (a) and (d) [Sec. 1212] shall not apply to any income attributable to property held by the taxpayer on January 1, 1986, in a lease to which section 863(c)(2)(B) or 861(e) of the Internal Revenue Code of 1954 (as in effect on the day before the date of the enactment of this Act) applied.

"(3) Special rule for certain ships leased by the United States Navy.—

"(A) In general.—In the case of any property described in paragraph (B), paragraph (2) shall be applied by substituting "Navy" for "1986" each place it appears.

"(B) Property to which paragraph applies.—Property described in this subparagraph consists of 4 ships which are to be owned by the United States Navy and which are the subject of Internal Revenue Service rulings bearing the following dates and which involved the following amount of financing (respectively):

March 3, 1986	\$ 176,344,000
February 5, 1986	64,267,000
April 22, 1986	64,500,000
May 22, 1986	175,300,000

Prior to amendment, para. (c)(2) read as follows:

"(2) Transportation between United States and any possession.

"(A) In general. 50 percent of all transportation income attributable to transportation which—

"(i) begins in the United States and ends in a possession of the United States, or

"(ii) begins in a possession of the United States and ends in the United States,

shall be treated as derived from sources within the United States.

"(B) Special rule for certain leases of aircraft.—

"(i) the taxpayer owns an aircraft which is section 38 property and leases such aircraft to a United States person (other than a member of the same controlled group of corporations (as defined in section 1563) as the taxpayer), and

"(ii) such United States person is a regularly scheduled charterer.

*Edi under*

**Supplement No. 1 to § 740.11—Additional Restrictions on Use of License Exception GOV**

(a) Items for official use within the national territory by agencies of cooperating governments. \* \* \*

**PART 743—[AMENDED]**

5. Section 743.1 is amended:  
 a. By revising paragraph (b);  
 b. By adding a note immediately following paragraph (c)(2);  
 c. By revising paragraph (d); and  
 d. By adding a note immediately following paragraph (e)(1)(ii), to read as follows:

**§ 743.1 Wassenaar Arrangement.**

(b) *Requirements.* You must submit two (2) copies of each report required under the provisions of this section and maintain accurate supporting records (see § 762.2(b) of the EAR) for all exports of items specified in paragraph (c) of this section under any of the following License Exceptions authorized by part 740 of the EAR: License Exceptions GBS, CIV, TSR, LVS, CTP, GOV and KMI (under the provisions of § 740.8(b)(2)(ii) and (iii) only). Exports of technology and source code under License Exception TSR to foreign nationals in the U.S. should not be reported. For purposes of this part 743, "you" has the same meaning as "U.S. exporter", as defined in part 772 of the EAR.

(c) \* \* \*  
 (2) \* \* \*

*Note to paragraph (c)(2):* Exports of computers controlled under 4A003.b to destinations in Computer Tier 3 (see § 740.7(d)(1) of the EAR) should not be included in the reports required under paragraph (c) of this section. Reporting for computers under 4A003.b to Computer Tier 3 destinations should be reported under the post-shipment verification reporting provisions of § 740.7(d)(4)(v) or under § 742.12(b)(3)(iv) of the EAR.

(d) *Country Exceptions.* You must report each export subject to the provisions of this section, except for exports to Wassenaar member countries, as identified in Supplement No. 1 to part 743.

(e) \* \* \*  
 (i) \* \* \*  
 (ii) \* \* \*

*Note to paragraph (e)(1)(ii):* For exports of technology for which reports are required under § 743.1(c) of this section, the number of units in the shipment should be reported as one (1) for the initial export of the technology to a single ultimate consignee. Additional exports of the technology must be reported only when the type or scope of

technology changes or exports are made to other ultimate consignees. Additionally, do not report the release of technology or source code subject to the EAR to foreign nationals in the U.S.

\* \* \* \* \*

6. Part 743 is amended by adding a new Supplement No. 1 to read as follows:

**Supplement No. 1 to Part 743—Wassenaar Arrangement Member Countries**

- Argentina
- Australia
- Austria
- Belgium
- Bulgaria
- Canada
- Czech Republic
- Denmark
- Finland
- France
- Germany
- Greece
- Hungary
- Ireland
- Italy
- Japan
- Luxembourg
- Netherlands
- New Zealand
- Norway
- Poland
- Portugal
- Romania
- Russia
- Slovakia
- South Korea
- Spain
- Sweden
- Switzerland
- Turkey
- Ukraine
- United Kingdom
- United States

Dated: October 5, 1998.

**R. Roger Majak,**  
*Assistant Secretary for Export Administration.*  
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**DEPARTMENT OF THE TREASURY**

**Internal Revenue Service**

**26 CFR Parts 1 and 602**

[TD 8786]

RIN 1545-AU79

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

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Final regulations.

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

**DATES: Effective Date:** These regulations are effective November 13, 1998.

**Applicability Date:** These regulations apply to taxable years beginning on or after November 13, 1998.

**FOR FURTHER INFORMATION CONTACT:** Anne Shelburne, (202) 874-1305 (not a toll-free number).

**SUPPLEMENTARY INFORMATION:**

**Paperwork Reduction Act**

The collection of information contained in this final regulation has been reviewed and approved by the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-1556. Responses to this collection of information are mandatory.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The estimated average annual burden per respondent is approximately 2.5 hours.

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

Books or records relating to a collection of information must be

retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

### Background

This document contains final regulations under section 863 of the Internal Revenue Code (Code), providing rules to source income from cross-border sales of certain property, where the property is manufactured in a possession of the United States and sold in the United States, or vice versa, or purchased in a possession and sold in the United States. These regulations also contain rules under section 936 to source income of a taxpayer from the sale in the United States of property purchased from a corporation that has an election under section 936 in effect.

On October 10, 1997, proposed regulations (REG-251985-96) were published in the *Federal Register* (62 FR 52953). Having considered the comments, the IRS and the Treasury Department adopt the proposed regulations without significant change in this Treasury decision.

### Explanation of Provisions

#### *I. Income Partly From Sources Within a Possession*

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

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

#### *1. Methods for Allocating or Apportioning Gross Income From Section 863 Possession Sales*

*a. Property produced and sold.* Under the final regulations, income from sales of inventory produced in the United States and sold in a possession of the United States or produced in a possession and sold in the United States (collectively, Possession Production Sales), is allocated or apportioned according to one of three methods.

Paragraph (f)(2)(i)(A) of the regulations makes the 50/50 method the

general rule to allocate gross income from Possession Production Sales between production activity and business sales activity, so that the income from each type of activity can then be apportioned between U.S. and foreign sources. The taxpayer, however, may elect to apply the independent factory price (IFP) method (described in paragraph (f)(2)(i)(B)), or, with the consent of the District Director, the books and records method (described in paragraph (f)(2)(i)(C)).

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

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

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

Under the final regulations, as opposed to the current regulations, business sales activity is measured by the sum of certain expenses, including

amounts paid for labor, materials, advertising, and marketing (but excluding any expenses or other amounts that are nondeductible under section 263A, interest, and research and development), plus receipts for the sale of goods. This formula is intended to reflect better the business sales activity producing the income by including more of the factors responsible for producing that income. Also, cost of goods sold is now excluded from the business sales activity fraction apportioning income from Possession Production Sales, because such costs generally reflect production activity. Production activity is already represented in the formula by the one-half of the taxpayer's income apportioned according to the location of production assets.

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

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

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

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

The final regulations apportion the taxpayer's income from Possession Purchase Sales on the basis of a business activity fraction. The portion of this income that is possession source income is determined by multiplying the income by a fraction, the numerator being the business of the taxpayer in the possession, and the denominator being the business of the taxpayer within the possession and outside the possession.

The remaining income is sourced in the United States.

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

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

## 2. Determination of Source of Gross Income

Under the final regulations, once gross income attributable to production activity, business activity, or sales activity has been determined under one of the prescribed methods, the source of the gross income is determined separately for each type of income. The source of gross income attributable to production activity (when applying the possession 50/50 method) is determined under paragraph (c)(1), based on the location of production assets. The source of gross income attributable to sales activity (when applying the IFP method or the books and records method) is determined under paragraph (c)(2), based generally on the location of the sale. The source of gross income attributable to business sales activity (when applying the possession 50/50 method) is determined under paragraph (f)(2)(ii)(B), based on expenses and gross sales attributable to Possession Production Sales. The source of gross income attributable to business activity (when applying the business activity method) is determined under paragraph (f)(3)(ii), based on expenses, cost of

goods sold, and gross sales attributable to Possession Purchase Sales.

## 3. Determination of Source of Taxable Income

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

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

The final regulations clarify that section 863 does not apply to determine the source of a taxpayer's gross income derived from a purchase of inventory from a corporation that has an election in effect under section 936, if the taxpayer's income from sales of that inventory is taken into account to determine benefits under section 936(h)(5)(C) for the section 936 corporation.

## 5. Treatment of Partners and Partnerships

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

income. Second, the aggregate approach applies in sourcing income from sales of inventory property that is transferred in-kind from or to a partnership.

## 6. Election and Reporting Rules

Under paragraph (f)(6)(i) of the final regulations, a taxpayer must use the 50/50 method to determine the source of income from Possession Production Sales unless the taxpayer elects to use the IFP method, or elects the books and records method. For Possession Purchase Sales, a taxpayer must use the business activity method, unless the taxpayer elects the books and records method. The taxpayer makes an election by using the method on its timely filed original tax return. That method must be used in later taxable years unless the Commissioner or his delegate consents to a change. Permission to change methods in later years will be granted unless the change would result in a substantial distortion of the source of income.

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

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

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

## Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the rules of this section principally

impact large multinationals who pay foreign taxes on substantial foreign operations and therefore the rules will impact very few small entities. Moreover, in those few instances where the rules of this section impact small entities, the economic impact on such entities is not likely to be significant. Accordingly, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

#### Drafting Information

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

#### List of Subjects

##### 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

##### 26 CFR Part 602

Reporting and recordkeeping requirements.

#### Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

### PART 1—INCOME TAXES

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

**Authority:** 26 U.S.C. 7805 \* \* \*  
Section 1.863-3 also issued under 26 U.S.C. 863(a) and (b), and 26 U.S.C. 936(h). \* \* \*  
Section 1.936-4 also issued under 26 U.S.C. 936(h).  
Section 1.936-5 also issued under 26 U.S.C. 936(h).  
Section 1.936-6 also issued under 26 U.S.C. 863(a) and (b), and 26 U.S.C. 936(h).  
Section 1.936-7 also issued under 26 U.S.C. 936(h). \* \* \*

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

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

The revision and addition read as follows:

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

\* \* \* \* \*

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

(2) *Allocation or apportionment for Possession Production Sales—(i) Methods for determining the source of*

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

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

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

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

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

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

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

(ii) Possession Production Sales for the taxable period.

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

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

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

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

(3) *Allocation or apportionment for Possession Purchase Sales—(i) Methods for determining the source of gross income for Possession Purchase Sales—*

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

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

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

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

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

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

(3) Possession Purchase Sales for the taxable period.

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

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

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

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

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

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

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

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

(ii) To determine the source of U.S. Co.'s gross income, the \$100 gross income is allocated entirely to U.S. Co.'s business activity. Five dollars of U.S. Co.'s gross income is sourced in the possession. [Possession expenses (\$10) plus possession purchases (\$0) plus possession sales (\$0), divided by total expenses (\$10) plus total purchases (\$80) plus total sales (\$100).] The

\$80 purchase is not included in the numerator used to determine U.S. Co.'s business activity in the possession, since product X was not manufactured in the possession. The remaining \$95 is sourced in the United States.

(4) *Determination of source of taxable income.* Once the source of gross income has been determined under paragraph (f)(2) or (3) of this section, the taxpayer must properly allocate and apportion separately under §§ 1.861-8 through 1.861-14T the amounts of its expenses, losses, and other deductions to its respective amounts of gross income from Section 863 Possession Sales determined separately under each method described in paragraph (f)(2) or (3) of this section. In addition, if the taxpayer deducts expenses for research and development under section 174 that may be attributed to its Section 863 Possession Sales under § 1.861-17, the taxpayer must separately allocate or apportion expenses, losses, and other deductions to its respective amounts of gross income from each relevant product category that the taxpayer uses in applying the rules of § 1.861-17. Thus, in the case of gross income from Section 863 Possession Sales determined under the IFP method or books and records method, a taxpayer must apply the rules of §§ 1.861-8 through 1.861-14T to properly allocate or apportion amounts of expenses, losses and other deductions, allocated and apportioned to such gross income, between gross income from sources within and without the United States. However, in the case of gross income from Possession Production Sales determined under the possessions 50/50 method or gross income from Possession Purchase Sales computed under the business activity method, the amounts of expenses, losses, and other deductions allocated and apportioned to such gross income must be apportioned between sources within and without the United States pro rata based on the relative amounts of gross income from sources within and without the United States determined under those methods, except that the rules regarding the allocation and apportionment of research and experimental expenditures in § 1.861-17 shall apply to such expenditures of taxpayers using the 50/50 method.

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

(6) *Election and reporting rules—(i) Elections under paragraph (f)(2) or (3) of this section.* If a taxpayer does not elect one of the methods specified in

paragraph (f)(2) or (3) of this section, the taxpayer must apply the possession 50/50 method in the case of Possession Production Sales or the business activity method in the case of Possession Purchase Sales. The taxpayer may elect to apply a method specified in either paragraph (f)(2) or (3) of this section by using the method on a timely filed original return (including extensions). Once a method has been used, that method must be used in later taxable years unless the Commissioner consents to a change. Permission to change methods from one year to another year will be granted unless the change would result in a substantial distortion of the source of the taxpayer's income.

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

(h) *Effective dates.* \* \* \* However, the rules of paragraph (f) of this section apply to taxable years beginning on or after November 13, 1998.

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

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

\* \* \* \* \*

(a) \* \* \*  
(5) \* \* \*

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

A. 7a: Under either scenario, the income is U.S. source, without regard to whether the possession product is a component, end-product, or integrated product. Section 863 does not apply in determining the source of the taxpayer's income. This Q&A 7a is applicable for

taxable years beginning on or after November 13, 1998.

\* \* \* \* \*

**PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT**

Par. 4. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 5. In § 602.101, paragraph (c) is amended in the table by revising the entry for 1.863-3 to read as follows:

**§ 602.101 OMB Control numbers.**

\* \* \* \* \*

(c) \* \* \*

CFR part or section where	Current OMB identified and described control No.
1.863-3	1545-1476 1545-1556

Michael P. Dolan,  
Deputy Commissioner of Internal Revenue.

Approved: September 18, 1998.

Donald C. Lubick,  
Assistant Secretary of the Treasury for Tax Policy.  
[FR Doc. 98-27395 Filed 10-13-98; 8:45 am]  
BILLING CODE 4830-01-U

**DEPARTMENT OF THE INTERIOR**

**Office of Surface Mining Reclamation and Enforcement**

**30 CFR Part 915**  
[SPATS No. IA-005-FOR]

**Iowa Regulatory Program**

**AGENCY:** Office of Surface Mining Reclamation and Enforcement (OSM), Interior.

**ACTION:** Proposed rule; public comment period and opportunity for public hearing.

**SUMMARY:** OSM is announcing receipt of an amendment to the Iowa regulatory program (Iowa program) under the Surface Mining Control and Reclamation Act of 1977 (SMCRA). Iowa proposes to add revegetation success guidelines, entitled "Revegetation Success Standards and Statistically Valid Sampling Techniques," to its program. These guidelines include revegetation success standards, normal

husbandry practices, and statistically valid sampling procedures and techniques for determining revegetation success on areas being restored to various land uses. Iowa intends to revise its program to be consistent with the corresponding Federal regulations and to improve operational efficiency.

This document gives the times and locations that the Iowa program and the amendment to that program are available for public inspection, the comment period during which you may submit written comments on the amendment, and the procedures that will be followed for the public hearing, if one is requested.

**DATES:** We will accept written comments until 4:00 p.m., c.s.t., November 13, 1998. If requested, we will hold a public hearing on the amendment on November 9, 1998. We will accept requests to speak at the hearing until 4:00 p.m., c.s.t. on October 29, 1998.

**ADDRESSES:** You should mail or hand deliver written comments and requests to speak at the hearing to Perry L. Pursell, Mid-Continent Regional Coordinating Center, at the address listed below.

You may review copies of the Iowa program, the amendment, a listing of any scheduled public hearings, and all written comments received in response to this document at the addresses listed below during normal business hours, Monday through Friday, excluding holidays. You may receive one free copy of the amendment by contacting OSM's Mid-Continent Regional Coordinating Center.

Perry L. Pursell, Mid-Continent Regional Coordinating Center, Office of Surface Mining, Alton Federal Building, 501 Belle Street, Alton, Illinois 62002, Telephone: (618) 463-6460.

Iowa Department of Agriculture and Land Stewardship, Division of Soil Conservation, Henry A. Wallace Building, Des Moines, Iowa 50319, Telephone: (515) 281-6147.

**FOR FURTHER INFORMATION CONTACT:** Perry L. Pursell, Mid-Continent Regional Coordinating Center. Telephone: (618) 463-6460. Internet: ppursell@mcrwgw.osmre.gov.

**SUPPLEMENTARY INFORMATION:**

**I. Background on the Iowa Program**

On January 21, 1981, the Secretary of Interior conditionally approved the Iowa program, effective April 10, 1981. You can find background information on the Iowa program, including the Secretary's findings, the disposition of comments, and the conditions of approval in the January 21, 1981,