section 863. Because the consolidated group refines the oil outside the country of extraction, it may be that peculiar conditions of production and sale exist, and the exclusive sourcing rules of paragraph (b)(1) do not apply. Thus, the taxpayer would generally determine the source of its income under the 50/50 method described in § 1.863-3(b)(2) Example 2. Under this method, 50 percent of the consolidated group's income would be U.S. source income based on the place of sale. However, this calculation may understate the appropriate amount of the taxpayer's foreign source income because the value of the oil as extracted may represent more than 50 percent of the total value of the product that is finally sold in the United States. The preamble to the regulations under § 1.1502-13 indicated that the IRS and Treasury would consider amending the regulations under section 863 to address these concerns.

Accordingly, the IRS and Treasury are issuing proposed regulations under section 863 to clarify ambiguities in the existing regulation and to address concerns created by the new § 1.1502–13 regulations.

C. Proposed Regulations

Section 1.863–1(b) provides special rules for determining the source of income from the sale of products derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber, within the United States and the sale of these products without the United States. The proposed regulations also provide special rules for determining the source of income from the sale of products derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber, without the United States and the sale of these products within the United States. The export terminal rule of paragraph (b)(1) provides that the source of gross receipts from the sale of such products equal to the fair market value of the product immediately prior to export (referred to in the proposed regulations as the export terminal) is determined according to where the farm, mine, oil or gas well, other natural deposit or timber is located. Separate rules are provided for determining the source of any gross receipts in excess of the fair market value of the product at the export terminal. Paragraph (b)(2) provides an exception to the approach of paragraph (b)(1) where, prior to export, the taxpayer engages in substantial production activities in addition to activities related to the ownership or operation of a farm, mine,

oil or gas well, other natural deposit, or timber.

1. Export Terminal Rule

Under the export terminal rule of paragraph (b)(1), gross receipts derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber, and sale of the products derived therefrom, are allocated between sources within and without the United States based on the fair market value of the product at the export terminal. The export terminal is the last point from which the product is sent from the United States to a foreign country or the last point from which goods are sent from a foreign country to the United States. For example, if a U.S. corporation extracts oil in one foreign country, sends the crude oil to a port in a second foreign country via pipeline, and delivers the oil to a U.S. refinery by ship, the export terminal would be the port in the second foreign country where the crude oil was loaded onto the

Under the export terminal rule, the source of gross receipts equal to the fair market value of the product at the export terminal is determined by the location of the farm, mine, well, deposit, or uncut timber. The source of gross receipts in excess of the fair market value of the product at the export terminal (excess gross receipts) is determined according to whether the taxpayer engages in any additional production activity following export. A taxpayer will be treated as performing production activities in addition to the activities of owning or operating a farm, mine, oil or gas well, other natural deposit, or timber based on the principles of § 1.954–3(a)(4). However, activities that prepare the natural resource itself for export, including those that are designed to facilitate the transportation of the natural resource to or from the export terminal, will not be considered additional production activities. Thus, § 1.863-1 Example 2 illustrates that liquefaction of natural gas would not constitute additional production activities. In addition, activities such as delimbing and debarking trees, sorting grain, and treating and stabilizing oil would ordinarily not constitute additional production activities. In contrast, the transformation of timber into furniture is not done to prepare the natural resource itself for export, and would constitute additional production activity. Production activities are defined in § 1.863-1(b)(3)(i).

If no additional production occurs following export, paragraph (b)(1)(i) requires that the source of the excess gross receipts be determined according to where the farm, mine, well, deposit, or uncut timber is located.

However, under paragraph (b)(1)(ii), if the taxpayer engages in additional production activities after the export terminal and outside the country of sale, the source of excess gross receipts is determined under the rules of § 1.863-3. For example, if a U.S. corporation extracts oil in a foreign country, refines the oil in the United States, and sells the refined product in another foreign country, the source of gross receipts in excess of the fair market value of the product when it is exported from the first foreign country must be determined under one of the three methods described in § 1.863-3 (i.e., the 50/50 method as described in $\S 1.863-3(b)(1)$, the IFP method described in § 1.863-3(b)(2), or, if permitted by the District Director, the books and records method as described in § 1.863-3(b)(3)).

In any case not described in either paragraph (b)(1) (i) or (ii) of the proposed regulations, the source of the excess gross receipts is determined according to the place of sale pursuant to paragraph (b)(1)(iii). This rule would apply, for example, in the case where the taxpayer engages in additional production activities in the country of sale

Paragraph (b)(1) addresses the concerns of U.S. corporations involved in the production of natural resources abroad and the application of the new § 1.1502–13 consolidated return regulations, by allowing them to treat the value of the natural resources at the point of export as income from sources where the farm, mine, well, deposit, or uncut timber is located. This rule has no effect on the rules governing foreign oil and gas extraction income under section 907(c)(1).

On November 28, 1995, the Tenth Circuit affirmed the Tax Court decision in *Phillips Petroleum* v. *Comm'r*, 97 T.C. 30 (1991), which held existing § 1.863–1(b)(1) invalid to the extent it allocates income from the sale of U.S. natural resources solely to sources within the United States. *Phillips Petroleum* v. *Comm'r*, No. 94–9021 (10th Cir. Nov. 28, 1995). The IRS and Treasury will consider the implications of this decision when finalizing these proposed regulations.

2. Additional Production Prior to Export Terminal

Paragraph (b)(2) provides a special rule for determining the source of income where a taxpayer performs substantial additional production activities before the product leaves the export terminal. Under paragraph (b)(2),