the source of gross receipts equal to the fair market value of the product prior to the additional production activities is based on 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 products at the beginning of the additional production activities is determined under the rules of § 1.863–3.

## 3. Other Rules

The proposed regulation contains rules for determining the fair market value of relevant products. For this purpose, fair market value depends on all of the facts and circumstances as they exist relative to a party in any particular case. Thus, these rules for determining fair market value are consistent with the foreign oil and gas rules contained in  $\S 1.907(c)-1(b)(6)$ . In addition, fair market value determinations must be consistent with prices charged in sales, if any, to related parties in a transaction that is subject to section 482. For example, if a member of a U.S. consolidated group extracts natural resources in a foreign country and sells the natural resources to another member of the same group at the export terminal, the value of the natural resources determined at the export terminal should be the price charged by the producing member to the purchasing member for purposes of section 482.

Under paragraph (b)(5), a taxpayer's gross income from sources within or without the United States is determined by reducing its gross receipts from sources within or without the United States by the cost of goods sold properly attributable to such gross receipts. Under paragraph (c), a taxpayer's taxable income from U.S. or foreign sources must be determined under the rules of §§ 1.861–8 through 1.861–14T.

Under paragraph (b)(6), taxpayers must fully explain the methodology used, the facts describing substantial additional production activities (if any), and the determination of fair market value in a statement attached to the taxpayer's return. In addition, taxpayers must provide such other information as is required by § 1.863–3(e)(2).

Taxpayers may elect to apply the rules of these regulations for taxable years beginning after July 11, 1995. Otherwise, these regulations are effective for taxable years beginning 30 days after the publication of this regulation as a final regulation.

II. Inventory Other Than Natural Resources

## A. Current Regulations

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

Section 1.863–3 of the current regulations governs the source of income from the sale of inventory produced (in whole or in part) in the United States and sold in a foreign country, or produced (in whole or in part) in a foreign country and sold in the United States (Section 863 Sales). Section 1.863–3 provides three methods, set forth in the form of three examples, to determine the source of income from Section 863 Sales.

§ 1.861–3(b)(2) Example 1 of the current regulations illustrates how an independent factory or production price (IFP) applies to determine the income attributable to production (IFP method). An IFP generally is established if a taxpayer regularly sells part of its output to wholly independent distributors in such a way as to reasonably reflect the income attributable to production activity. If an IFP exists, taxpayers must use the IFP method to determine the income attributable to production activities in both the sale establishing the IFP and in sales of similar products. See Phillips Petroleum v. Comm'r, 97 T.C. 30 (1991), aff'd, No. 94-9021 (10th Cir. Nov. 28, 1995); Rev. Rul. 88-73 (1988-2 C.B. 173). Gross receipts in excess of the IFP are attributable to sales activity. Taxpayers can otherwise establish an IFP by showing to the satisfaction of the District Director that an IFP exists. Notice 89-10 (1989-1 C.B. 631) contains additional rules regarding the application of the IFP method. Section 1.863-3(b)(2) Example 1 of the current regulations does not provide explicit guidance as to how to determine the source of income attributable to production activities under the IFP method. However, the source of income attributable to sales activities is based generally on where title to the inventory passes to the purchaser as defined in § 1.861–7(c).

Section 1.863–3(b)(2) Example 2 of the current regulations divides a taxpayer's income from Section 863 Sales equally between production activity and sales activity (50/50 method). The source of income attributable to production activity is based on the location of the taxpayer's property. The portion of this production income attributable to sources within

the United States is determined by a fraction, the numerator of which is the taxpayer's property located within the United States used to produce income from Section 863 Sales, and the denominator of which is the taxpayer's property both within the United States and within a foreign country used to produce income from Section 863 Sales. The source of the taxpayer's income attributable to sales activity is based on where title to the inventory passes to the purchaser as defined in § 1.861–7(c).

Section 1.863–3(b)(2) Example 3 of the current regulations allows a taxpayer to request permission from the District Director to use the taxpayer's books and records to allocate income to sources within and without the United States if those books reflect more clearly than the other methods the taxable income derived from sources within the United States (books and records method).

## B. Issues Under Current Regulations

On July 12, 1995, the IRS and Treasury issued regulations under § 1.1502–13, treating members of a consolidated group as a single entity for purposes of determining the source of a taxpayer's income. The IRS and Treasury understand that the current section 863 regulations may raise questions when applied to certain consolidated groups on a single entity basis. The preamble to the regulations under § 1.1502-13 indicated that the IRS and Treasury would reevaluate part of the regulations under section 863. As part of this process, the IRS and Treasury also have reexamined the remainder of the existing section 863 regulations and have concluded that several additional changes are necessary.

First, the existing regulations were drafted more than 70 years ago, and have not been amended to reflect the evolution of business practices. As a result, the regulations have been the source of controversies in recent years. See Intel Corporation v. Comm'r, 100 T.C. 39 (1993), aff'd, No. 94–70105 (9th Cir. Oct. 16, 1995); Phillips Petroleum v. Comm'r, 97 T.C. 30 (1991), 101 T.C. 78, 104 (1993) ("there have been no cases interpreting [the 50/50 method] and no administrative pronouncements regarding its application since the regulation was promulgated in 1922 except for necessary inferences to be drawn from *Intel* \* \* \*''), *aff'd*, No. 94–9021 (10th Cir. Nov. 28, 1995). In part, these controversies may be due to the structure of the current regulations, which do not contain operative rules to describe the methods of allocating and