

apportioning income, but instead rely on examples.

Second, the existing regulations raise important administrative concerns. For example, the IFP method requires an analysis of each of the taxpayer's sales transactions to identify an IFP. If one or more IFPs are so identified, a second analysis is required of each of the taxpayer's sales transactions to identify which transactions are similar to the IFP sale. In some cases, this process may require a review of a multitude of transactions. The IFP method may, therefore, be difficult for both taxpayers and the government to apply. The existing 50/50 method also presents administrative concerns. For example, the 50/50 method may require the taxpayer to determine the fair market value of each of its assets at the end of every tax year. Taxpayers have often commented to the IRS about the difficulties of determining the fair market value of their assets.

Third, the existing regulations result in disparate treatment of similarly situated taxpayers. Although an IFP must be used under current rules if one exists, the mandate applies only to taxpayers selling inventory to certain independent distributors. Taxpayers selling exclusively to related parties are not required to use the IFP method since the IRS may not establish an IFP based on such sales. Instead, these taxpayers use the 50/50 method to source their income from export sales. Thus, taxpayers selling inventory exclusively to related parties may be deemed to generate far more foreign source income than taxpayers selling a portion of their inventory to independent distributors, even though the two taxpayers may perform the same functions. The IRS and Treasury believe that this differing treatment of similarly situated taxpayers is not justified.

Fourth, the existing 50/50 method can result in apportionment of income that is inconsistent with the common understanding of that method. The 50/50 method is generally characterized as a method that would source export sales income one-half in the United States and one-half in a foreign country. For example, in 1984 the Treasury Department stated: "Generally, [income derived from manufacture and sale of property] is allocated one-half on the basis of the place of manufacture and half on the basis of the place of sale * * *". Treasury Department, Tax Reform for Fairness, Simplicity, and Economic Growth, Nov. 1984 at 364. In addition, Congress understands the 50/50 method to operate in this fashion. In 1986, the House, Senate and Conference Committees each stated: "[Under the

existing 50/50 method], half of such income generally is sourced in the country of manufacture, and half of the income is sourced on the basis of the place of sale". House Rep. No. 426, 99th Cong. 1st Sess. 359 (1985); S. Rep. No. 313, 99th Cong. 2d Sess. 329 (1986); H.R. Conf. Rep. No. 841, 99th Cong. 2d Sess. II-595 (1986). The staff of the Joint Committee on Taxation has referred to the 50/50 method as the "production/marketing split" and stated that under this method "50 percent of such income generally is attributed to the place of production * * *". Staff of the Joint Comm. on Taxation, Factors Affecting International Competitiveness of the United States 148 (1991).

The existing regulations may, however, allow taxpayers to use the 50/50 method to obtain results that are inconsistent with this common understanding. Under the existing regulations, 50 percent of the income is treated as sales income and sourced on the basis of title passage. The remaining 50 percent is treated as production income and sourced based on the location of assets. This half of the formula is not necessarily, however, limited to production assets. For example, goodwill and accounts receivables are counted as assets in allocating production income. The inclusion of sales assets in the formula allocating production income results in additional income being allocated to sales activities. The contribution of the sales assets to sales income should be reflected only in the 50 percent of the income that is allocated to sales and sourced under title passage. Thus, the production income formula should only take into account assets directly involved in the production of inventory.

B. Proposed Regulations

1. Overview

Section 1.863-3 provides rules for allocating and apportioning income from Section 863 Sales. Generally, § 1.863-3(b) provides three methods for determining the amount of gross income attributable to production activity and the amount of gross income attributable to sales activity. The source of gross income attributable to each activity is then determined under the rules of paragraph (c). Paragraph (d) provides rules to determine the source of taxable income. Reporting and election rules are set forth under paragraph (e) of the proposed regulations. The proposed regulations reserve on paragraph (f) (prior paragraph (c)), dealing with income partly from sources within a possession of the United States. The IRS and Treasury solicit comments from

taxpayers regarding changes that should be made to new paragraph (f) (if any) to conform to the other changes in § 1.863-3.

The proposed regulations generally apply an aggregate approach in taking into account a taxpayer's interest in a partnership. The IRS and Treasury solicit comments on the appropriate treatment of partnerships, including whether there should be special rules for limited partnerships, de minimis interests in partnerships, and tiered partnerships.

2. Methods To Determine Gross Income Attributable to Production Activity and Sales Activity

Section 1.863-3 generally retains the three methods of the current regulations for splitting income between production and sales activity, with several modifications.

a. 50/50 Method

The proposed regulations do not change the allocation of half of the taxpayer's income from Section 863 Sales to production activity and half to sales activity. As described below, the proposed regulations modify and clarify the determination of the location of assets. In addition, paragraph (b)(1) of the proposed regulations makes the 50/50 method the general rule to determine the amount of income attributable to production and sales activities. The taxpayer, however, may elect to apply the IFP method, described in paragraph (b)(2), or, with the consent of the District Director, the books and records method, described in paragraph (b)(3).

b. IFP Method

By making the IFP method elective, the proposed regulations significantly reduce administrative burdens related to its application and eliminate any bias against taxpayers choosing to export through independent distributors.

Under the proposed regulations, the taxpayer may elect to apply the IFP method if it is able to establish an IFP. As in the current regulations, an IFP is fairly established by actual sales of the taxpayer if the taxpayer regularly sells part of its output to wholly independent distributors or other selling concerns in such a way as to reasonably reflect the income attributable to production activity. Once the IFP is established, it can be used to determine the amount of income attributable to production activity in other Section 863 Sales if the inventory sold in the other sales is substantially similar in physical characteristics and function, and is sold at a similar level of distribution as the