inventory sold in a sale establishing an IFP. A sale will not be considered to establish an IFP if sales activity for the relevant product is significant in relation to all of the activities for that product. The IRS and Treasury intend to supersede Notice 89–10 upon publication of final regulations.

The proposed regulations would also eliminate the existing rule permitting taxpayers to otherwise establish an IFP by showing to the satisfaction of the District Director that a sale reasonably reflecting the income attributable to production exists. This "otherwise established" IFP is rarely, if ever, used. American Law Institute, International Aspects of United States Income Taxation 31 (1987). The IRS and Treasury solicit comments from taxpayers on the continued utility of the otherwise established IFP.

The proposed regulations omit the reference in the existing regulation to a sales branch. A taxpayer may elect to use the IFP method even if it does not maintain a sales branch in a foreign country.

c. Books and Records Method

The proposed regulations retain the books and records method of the existing regulations, permitting taxpayers to request permission from the District Director to use their books and records to determine the income attributable to production and sales activities. The District Director will consider a taxpayer's request if the taxpayer maintains a detailed allocation of receipts and expenditures, clearly reflecting the amount of income from production and sales activities.

The books and records method is rarely, if ever, used. American Law Institute, International Aspects of United States Income Taxation, 31 (1987). The IRS and Treasury solicit comments from taxpayers on the continued utility of the books and records method, or whether the books and records method should be replaced by another method of economic sourcing.

3. Determination of Source of Gross Income

Unlike the current regulations which provide specific rules for determining the source of income attributable to production activity and sales activity only for purposes of the 50/50 method, the proposed regulations adopt rules applicable to each of the three methods. Under the proposed regulations, once gross income attributable to production activity and sales activity has been determined under one of the methods described in paragraph (b), the source of

the income is determined separately for each type of income under paragraph (c). The source of gross income attributable to production activity is determined under paragraph (c)(1), based on the location of production assets, and the source of gross income attributable to sales activity is determined under paragraph (c)(2) based on the location of the sale.

a. Source of Gross Income Attributable to Production Activity

The proposed regulations generally adopt the approach set forth in the current regulations under the 50/50 method, but with modifications and clarifications.

Under § 1.863–3(c)(1), the source of income attributable to production activity is determined based on the location of the taxpayer's production assets. Thus, if a taxpayer manufactures inventory exclusively in the United States, all of its income attributable to production activity will be considered from sources within the United States. The rules described below are intended to apply only to taxpayers that produce inventory both within and without the United States.

Under the proposed regulations, the source of a taxpayer's income from production activities is determined by reference to the taxpayer's production assets, instead of all of its assets that produce income from Section 863 Sales. The IRS and Treasury believe that this change is appropriate to ensure that the source of production income corresponds to the location of production activity. Production assets are defined to include tangible and intangible property owned by the taxpayer that are used to produce inventory sold in Section 863 Sales. Any property not directly used to produce inventory is excluded. Thus, accounts receivable and marketing intangibles are excluded because they are sales assets and not production assets. Other assets excluded because they do not directly produce inventory are transportation assets, warehouses, inventory, work-in-process, raw materials, cash, investment assets, and stock of a subsidiary. Working capital is excluded to avoid uncertainty arising from determinations of the appropriate amount of working capital. In addition, working capital would generally be apportioned pro rata in accordance with a taxpayer's production assets. As under the current regulations, leased assets are excluded; only assets owned by the taxpayer are included.

The proposed regulations also provide specific rules for determining where a production asset is located. Tangible assets are located where the assets are used by the taxpayer. Intangible Assets are located where the tangible production assets to which they relate are located.

Where production takes place both within the United States and within a foreign country, the regulations apply a property fraction to apportion production income between U.S. and foreign sources. The taxpayer's foreign source gross production income is determined by multiplying its gross production income by a fraction, the numerator of which is the taxpayer's production assets located within a foreign country, and the denominator of which is the taxpayer's production assets located both within the united States and within a foreign country.

The current regulations generally include assets in the property formula at fair market value. The proposed regulations modify this rule to provide that an asset must be included in the property formula at its average adjusted basis (see section 1011). The IRS and Treasury believe that this change to adjusted basis will significantly simplify the application of this formula for both taxpayers and the IRS.

The proposed regulations also contain more detailed guidance than the current regulations for determining the amounts to be included in the property fraction. For example, the proposed regulations would require that if the asset is used to produce inventory sold in Section 863 Sales and is also used to produce other property, the basis of the asset must be prorated to account for such other uses.

The purpose of the property formula is to attribute the source of the taxpayer's production income to the location of its production activity. The IRS and Treasury are concerned that taxpayers may be able to affect the location of assets without changing the sit us of economic activity. Accordingly, comments are solicited about whether there should be rules to prevent manipulation of this formula in a manner inconsistent with the purpose of the regulation.

b. Source of Gross Income Attributable to Sales Activity

The source of gross income that is attributable to sales activity is determined under paragraph (c)(2). As under the current regulations, the source of this income is generally based on where a sale takes place. See § 1.861–7(c). Accordingly, if a U.S. producer sells its goods in a foreign country, the income attributable to sales activity is generally foreign source income.