The proposed regulation would retain the language of the existing regulation, which only applies to sales that occur within a foreign country. The IRS and Treasury solicit comments as to whether the regulations should be expanded to apply to sales made in international waters or in space. The IRS and Treasury are concerned, however, that if such a change were made, a U.S. seller may try to use the 50/50 method by selling inventory in international waters to U.S. purchasers, even when the goods were destined for the United States. In view of these concerns, the IRS and Treasury also solicit comments as to whether the regulations should provide an exception to the title passage rule in the case of sales of goods produced in the United States and destined for use in the United States.

4. Determination of Source of Taxable Income

Once the amount and source of gross income are determined under paragraph (c), taxpayers then determine the source of their taxable income. Under proposed paragraph (d), taxpayers must allocate or apportion under §§ 1.861–8 through 1.861–14T the amounts of expenses, losses and other deductions to its gross income determined under each method described in paragraph (b). In the case of amounts of expenses, losses and other deductions allocated or 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 or apportion these amounts between gross income from sources within and without the United States. For amounts of expenses, losses and other deductions allocated or apportioned to gross income determined under the 50/50 method, taxpayers must apportion expenses and other deductions prorata based on the relative amounts of U.S. and foreign source gross income. These rules are consistent with existing regulations.

5. Election and Reporting Rules

Under paragraph (e) of the proposed regulations, a taxpayer must use the 50/50 method unless the taxpayer elects to use the IFP method, or elects the Books and Records method. The taxpayer makes the election by using the method on its tax return. Once The tax return is filed, the election is not revokable for that year. In addition, that method must be used in later taxable years unless the Commissioner or her delegate consents to a change. Permission to change methods in later years will not be withheld unless the change would

result in a substantial distortion of the source of income.

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

6. Conforming Changes

The proposed regulations make conforming changes to § 1.863-2 of the regulations. Under § 1.863-2, the taxpayer may elect to apply the 50/50 method to its net taxable income, instead of its gross income as specified in § 1.863–3. The proposed regulations clarify that income derived from the purchase of personal property within a possession of the United States and its sale within the United States is subject to these regulations only to the extent it is not excluded by § 1.936-6(a)(5), Q&A 7. Other changes to § 1.863-2 were intended to conform the language of the regulation to the changes in § 1.863–3.

Finally, the IRS and Treasury will reconsider the existing regulations issued under section 863 regarding transportation services and cable and telegraph services in light of the Tax Reform Act of 1986. Accordingly, the transportation rules contained in § 1.863–4 will only apply to services that are not described in section 863(c) and the telegraph and cable rules contained in § 1.863–5 are deleted. No inference is intended as to whether portions of the existing regulations continued to apply after the Tax Reform Act of 1986.

7. Proposed Effective Dates

These regulations are effective for taxable years beginning 30 days after publication of final regulations. However, taxpayers may apply these regulations for taxable years beginning after July 11, 1995, and before 30 days after publication of these regulations as final regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking 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. Accordingly, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small **Business Administration for comment** on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for April 10, 1996, at 10 a.m. in the IRS Auditorium. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments and an outline of topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by March 11, 1996.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

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 in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.863–1 also issued under 26 U.S.C. 863.

Section 1.863–2 also issued under 26 U.S.C. 863.

Section 1.863–3 also issued under 26 U.S.C. 863.

Section 1.863–4 also issued under 26 U.S.C. 863.

Section 1.863–6 also issued under 26 U.S.C. 863. * * * *

Par. 2. Sections 1.863–0 is added to read as follows: