(4) *Determination of fair market value.* For purposes of this section, fair market value depends on all of the facts and circumstances as they exist relative to a party in any particular case. Where the products are sold to a related party in a transaction subject to section 482, the determination of fair market value under this section must be consistent with the arm's length price determined under section 482.

(5) *Determination of gross income.* To determine the amount of a taxpayer's gross income from sources within or without the United States, the taxpayer's gross receipts from sources within or without the United States determined under this paragraph (b) must be reduced by the cost of goods sold properly attributable to gross receipts from sources within or without the United States.

(6) *Tax return disclosure.* A taxpayer that determines the source of its income under this paragraph (b) shall attach a statement to its return explaining the methodology used to determine fair market value under paragraph (b)(4) of this section, and explaining any additional production activities (as defined in paragraph (b)(3)(ii) of this section) performed by the taxpayer. In addition, the taxpayer must provide such other information as is required by § 1.863–3.

(7) *Examples.* The following examples illustrate the rules of this paragraph (b):

Example 1. No additional production. US Mines, a U.S. corporation, extracts coal in the United States and, without substantial additional production, sells the coal in a foreign country. Under § 1.863–1(b) and (b)(1)(i), all of US Mines' income will be from sources within the United States.

Example 2. Scope of additional production. US Gas, a U.S. corporation, extracts natural gas within the United States, and transports the natural gas to a U.S. port where it is liquified in preparation for shipment. The liquified natural gas is then transported via freighter and sold without additional production activities in a foreign country. Liquefaction of natural gas is not an additional production activity because liquefaction prepares the natural gas for transportation from the export terminal. Therefore, under § 1.863–1(b) and (b)(1)(i), all of US Gas' income will be from sources within the United States.

Example 3. Sale in third country. US Gold, a U.S. corporation, mines gold in country X, produces gold jewelry in the United States, and sells the jewelry in country Y. Assume that the fair market value of the gold at the export terminal in country X is $40, and that US Gold ultimately sells the gold jewelry in country Y for $100. Under § 1.863–1(b), $40 of US Gold's gross receipts will be allocated to sources without the United States. Under § 1.863–1(b)(1)(ii), the source of the remaining $60 of gross receipts will be determined under § 1.863–3. If US Gold applies the 50/50 method described in § 1.863–3, $20 of cost of goods sold is properly attributable to activities subsequent to the export terminal, and all of US Gold's production assets subsequent to the export terminal are located in the United States, then $20 of gross income will be allocated to sources within the United States and $20 of gross income will be allocated to sources without the United States.

Example 4. Production in country of sale. US Oil, a U.S. corporation, extracts oil in country X, transports the oil via pipeline to the export terminal in country Y, refines the oil in the United States, and sells the refined product in the United States to unrelated persons. Assume that the fair market value of the oil at the export terminal in country Y is $80, and that US Oil ultimately sells the refined product for $100. Under § 1.863–1(b)(1), $80 of US Oil's gross receipts will be allocated to sources without the United States, and under § 1.863–1(b)(1)(iii) the remaining $20 of gross receipts will be allocated to sources within the United States.

Example 5. Additional production prior to export. US Furniture, a U.S. corporation, cuts trees in the United States, converts the trees into lumber, uses the lumber to manufacture furniture in the United States, and sells the furniture in another country. Assume that the fair market value of the trees when the conversion into lumber begins is $40, and that US Furniture ultimately sells the furniture for $100. Because the conversion of the trees into lumber is an additional production activity within the United States within the meaning of § 1.863–1(b)(3)(ii), the source of US Furniture's income will be determined under § 1.863–1(b)(2). Thus, $40 of US Furniture's gross receipts will be allocated to sources within the United States. The source of the remaining $60 of gross receipts will be determined under § 1.863–3. If US Furniture applies the 50/50 method described in § 1.863–3(b)(1), $20 of cost of goods sold is properly attributable to the additional production activity, and all of US Furniture's production assets used in the additional production activity are located in the United States, then $20 of gross income will be allocated to sources within the United States and $20 of gross income will be allocated to sources without the United States.

(c) *Determination of taxable income.* The taxpayer's taxable income from sources within or without the United States will be determined under the rules of §§ 1.861–8 through 1.861–14T for determining taxable income from sources within the United States.

(d) *Effective dates.* The rules of this section will apply to taxable years beginning 30 days after publication of these regulations as final regulations. However, taxpayers may apply the rules of this section for taxable years beginning after July 11, 1995, and before 30 days after publication of these regulations as final regulations. For years beginning before 30 days after publication of these regulations as final regulations, see § 1.863–1 (as contained in 26 CFR part 1 revised as of April 1, 1995).

§ 1.863–2 Allocation and apportionment of taxable income.

(a) *Determination of taxable income.* Section 863(b) provides an alternate method for determining taxable income from sources within the United States in the case of gross income derived from sources partly within and partly without the United States. Under this method, taxable income is determined by deducting from such gross income the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions that cannot definitely be allocated to some item or class of gross income. The income to which this section applies (and that is treated as derived partly from sources within and partly from sources without the United States) will consist of gains, profits, and income—

(1) From certain transportation or other services rendered partly within and partly without the United States to the extent not within the scope of section 863(c) or other specific provisions of this title;

(2) From the sale of inventory property (within the meaning of section 865(i)) produced (in whole or in part) by the taxpayer in the United States and sold in a foreign country or produced (in whole or in part) by the taxpayer in a foreign country and sold in the United States; or

(3) Derived from the purchase of personal property within a possession of the United States and its sale within the United States, to the extent not excluded from the scope of these regulations under § 1.936–6(a)(5), Q&A 7.

(b) *Determination of source of taxable income.* Income treated as derived from sources partly within and partly without the United States under paragraph (a) of this section may be allocated to sources within and without the United States pursuant to § 1.863–1 or apportioned to such sources in accordance with the methods described in other regulations under section 863. To determine the source of certain types of income described in paragraph (a)(1) of this section, see § 1.863–4. To determine the source of gross income described in paragraph (a)(2) of this section, see § 1.863–3. However, the principles of § 1.863–3 (b)(1) and (c) may be applied to determine the source of taxable income from sales of inventory property. To determine the source of income described in paragraph (a)(3) of this section, see § 1.863–3(f).