sale is attributable to sales activity. After reducing the gross sales price by cost of goods sold, \$20 of the gross income is treated as attributable to production activity (\$100–\$80).

(ii) P also sells cloth in country X to A, a unrelated foreign retail outlet, for \$110. Because P elected the IFP method and the cloth is substantially similar to the cloth sold to D, the IFP fairly established in the sales to D must be used to determine the amount attributable to production activity in the sale to A. Accordingly, \$100 of the gross sales price is treated as attributable to production activity and \$10 (\$110–\$100) is attributable to sales activity. After reducing the gross sales price by cost of goods sold, \$20 of the gross income is treated as attributable to production activity (\$100 – \$80) and \$10 is attributable to sales activity.

Example 2. Scope of IFP Method. (i) USCo manufactures three dissimilar products. USCo elects to apply the IFP method. In year 1, an IFP can be established for sales of product X, but not for products Y and Z. In year 2, an IFP cannot be established for any of USCo's products. In year 3, an IFP can be established for products X and Y, but not for

product Z.

(ii) In year 1, USCo must apply the IFP method to sales of product X. In year 2, although USCo's IFP election remains in effect, USCo is not required to apply the IFP election to any products. In year 3, USCo is required to apply the IFP method to sales of products X and Y.

(3) Books and records method. A taxpayer may elect to determine the amount of its gross income from Section 863 Sales that is attributable to production and sales activities for the taxable year based upon its books of account if it has received in advance the permission of the District Director having audit responsibility over its tax return. The taxpayer must establish to the satisfaction of the District Director that the taxpayer, in good faith and unaffected by considerations of tax liability, will regularly employ in its books of account a detailed allocation of receipts and expenditures which clearly reflects the amount of the taxpaver's income from production and sales activities. If a taxpayer receives permission to apply the books and records method, but does not comply with a material condition set forth by the District Director, the District Director may, in its discretion, revoke permission to use the books and records method. The source of gross income treated as attributable to production activity under this method may be determined under the rules of paragraph (c)(1) of this section, and the source of gross income attributable to sales activity will be determined under the rules of paragraph (c)(2) of this section.

(c) Determination of the source of gross income from production activity and sales activity—(1) Income

attributable to production activity—(i) Production only within the United States or only within foreign countries— (A) Source of income. Where the taxpayer's production assets are located only within the United States or only within a foreign country, the income attributable to production activity is sourced where the taxpayer's production assets are located. For rules regarding the source of income when production assets are located both within the United States and within one or more foreign countries, see paragraph (c)(1)(ii) of this section. For purposes of this section, production activity means an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages inventory. See § 1.864-1.

(B) Definition of production assets. For purposes of this section, production assets include only tangible and intangible assets owned by the taxpayer that are directly used by the taxpayer to produce inventory described in paragraph (a) of this section. Production assets do not include assets that are not directly used to produce inventory described in paragraph (a) of this section. Thus, production assets do not include such assets as accounts receivables, intangibles not related to production of inventory (e.g., marketing intangibles, including trademarks and customer lists), transportation assets, warehouses, the inventory itself, raw materials, or work-in-process. In addition, production assets do not include cash or other liquid assets (including working capital), investment assets, prepaid expenses, or stock of a subsidiary. A partner will be treated as owning its proportionate share of the partnership's production assets, determined by reference to the partner's distributive share of partnership income for the year attributable to such production assets.

(C) Location of production assets. For purposes of this section, a tangible production asset will be considered located where the asset is physically located. An intangible production asset will be considered located where the tangible production assets owned by the taxpayer to which it relates are located.

(ii) Production both within the United States and within foreign countries—(A) Source of income. Where the taxpayer's production assets are located both within the United States and within one or more foreign countries, income from sources without the United States will be determined by multiplying the income attributable to production activity by a fraction, the numerator of which is the average adjusted basis of production assets that are located in one or more foreign countries and the

denominator of which is the average adjusted basis of all production assets in foreign countries and in the United States. The remaining income is treated as from sources within the United States.

(B) Adjusted basis of production assets. For purposes of paragraph (c)(1)(ii)(A) of this section, the adjusted basis of an asset is determined under section 1011. The average adjusted basis is computed by averaging the adjusted basis of the asset at the beginning and end of the taxable year, unless by reason of material changes during the taxable year such average does not fairly represent the average for such year. In this event, the average adjusted basis will be determined upon a more appropriate basis. If production assets are used to produce inventory sold in Section 863 Sales and are also used to produce other property during the taxable year, the portion of its adjusted basis that is included in the fraction described in paragraph (c)(1)(ii)(A) of this section will be determined under any method that reasonably reflects the portion of the assets that produces inventory sold in Section 863 Sales. For example, the portion of such an asset that is included in the formula may be determined by multiplying the asset's average adjusted basis by a fraction, the numerator of which is the gross receipts from sales of inventory from Section 863 Sales produced by the asset, and the denominator of which is the gross receipts from all property produced by that asset. For purposes of this section, a taxpayer's basis in production assets held through a partnership shall be determined by reference to the partnership's adjusted basis in its assets (including a partner's special basis adjustment, if any, under section 743).

(iii) *Examples*. The following examples illustrate the rules of this paragraph (c)(1):

Example 1. Source of production income. (i) A, a U.S. corporation, produces widgets that are sold both within the United States and within a foreign country. The initial manufacture of all widgets occurs in the United States. The second stage of production of widgets that are sold within a foreign country is completed within the country of sale. A's U.S. plant and machinery which is involved in the initial manufacture of the widgets has an average adjusted basis of \$200. A also owns warehouses used to store work-in-process. A owns foreign equipment with an average adjusted basis of \$25. A's gross receipts from all sales of widgets is \$100, and its gross receipts from export sales of widgets is \$25. Assume that apportioning average adjusted basis using gross receipts is reasonable. Assume A's cost of goods sold from the sale of widgets in the foreign countries is \$13 and thus, its gross