

milk” or “nonfat milk or nonfat milk and ultrafiltered nonfat milk” in the ingredient statements. We invite comment on this consideration and whether such declarations would indicate that fluid UF milk or fluid UF nonfat milk may be an ingredient, but not as predominant as milk or nonfat milk, and also enable manufacturers to avoid relabeling costs if they use varying amounts of fluid UF milk or fluid UF nonfat milk. Please discuss whether such declarations would be informative (or, conversely, potentially misleading to consumers) and please explain your reasoning.

3. We also are interested in issues related to the costs of printing different product labels and the logistics involved in label changes when fluid UF milk and fluid UF nonfat milk are sometimes used as ingredients in the production of a manufacturer’s standardized cheese or cheese product. For example, what impacts, if any, would a label statement of “milk or milk and ultrafiltered milk” or “nonfat milk or nonfat milk and ultrafiltered nonfat milk” have on labeling costs? How would these costs compare if fluid UF milk and fluid UF nonfat milk are declared only when used in the standardized cheese or cheese product? Please explain your reasoning.

4. Ultrafiltered milk is being used in a greater number of food products than in the past. There are dairy products in the marketplace, which appear to have gained consumer acceptance, where “ultrafiltered milk” has appeared in the statement of identity or declared in the ingredient statement on the product label. Are there any situations where retailers or consumers would not purchase standardized cheeses or cheese products labeled as containing “ultrafiltered milk” as an ingredient? Please describe such situations and provide any recent consumer data or market analyses you may have to explain your reasoning.

Dated: December 19, 2019.

**Lowell J. Schiller,**

*Principal Associate Commissioner for Policy.*

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## DEPARTMENT OF THE TREASURY

### Internal Revenue Service

#### 26 CFR Part 1

[REG–100956–19]

RIN 1545–BP16

#### Source of Income From Certain Sales of Personal Property

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Notice of proposed rulemaking.

**SUMMARY:** This document contains proposed regulations modifying the rules for determining the source of income from sales of inventory produced within the United States and sold without the United States or vice versa. These proposed regulations also contain new rules for determining the source of income from sales of personal property (including inventory) by nonresidents that are attributable to an office or other fixed place of business that the nonresident maintains in the United States. Finally, these proposed regulations modify certain rules for determining whether foreign source income is effectively connected with the conduct of a trade or business within the United States.

**DATES:** Comments and requests for a public hearing must be received by February 28, 2020.

**ADDRESSES:** Submit electronic submissions via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (indicate IRS and REG–100956–19) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (“Treasury Department”) and the IRS will publish for public availability any comment received to its public docket, whether submitted electronically or in hard copy. Send hard copy submissions to: CC:PA:LPD:PR (REG–100956–19), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044.

**FOR FURTHER INFORMATION CONTACT:**

Concerning the proposed regulations Brad McCormack, (202) 317–6911 or Anisa Afshar, (202) 317–4999; concerning submissions of comments and requests for a public hearing, Regina L. Johnson, (202) 317–6901 (not toll free numbers).

**SUPPLEMENTARY INFORMATION:**

## Background

These regulations (the “proposed regulations”) contain proposed amendments to 26 CFR part 1 revising the rules under section 863 of the Internal Revenue Code (the “Code”) for determining the source of gross income from sales of certain property, and under section 864 for treating foreign source income as effectively connected with the conduct of a trade or business within the United States. Conforming revisions are made to current regulations that reference section 863. The proposed regulations also provide guidance under section 865(e)(2) and (3) regarding the source of income from the sale of personal property, including inventory property, within the meaning of section 865(i)(1) (“inventory”), by nonresidents.

The Tax Cuts and Jobs Act, Pub. L. 115–97 (2017) (the “Act”), enacted on December 22, 2017, amended section 863 of the Code, which provides special rules for determining the source of income, including income partly from within and partly from without the United States. Specifically, section 14303 of the Act amended section 863(b) to allocate or apportion income from the sale or exchange of inventory property produced (in whole or in part) by a taxpayer within and sold or exchanged without the United States or produced (in whole or in part) by the taxpayer without and sold or exchanged within the United States (collectively, “Section 863(b)(2) Sales”) solely on the basis of production activities with respect to that inventory. Before the Act, section 863(b) provided that income from Section 863(b)(2) Sales would be treated as derived partly from sources within and partly from sources without the United States without providing the basis for such allocation or apportionment.

Current § 1.863–3 provides rules for allocating or apportioning gross income from Section 863(b)(2) Sales. Those rules provide several methods for determining the amount of gross income from Section 863(b)(2) Sales that is attributable to production activity and the amount of gross income attributable to sales activity, with different rules then applying to source the portion of the income derived from production activity versus sales activity. See current § 1.863–3(b). Current § 1.863–3(f) provides rules for gains, profits, and income that are treated as derived partly from sources within the United States and partly from sources within a possession of the United States (generally referred to herein as a “U.S. territory”).

With respect to production activity, current § 1.863–3(c)(1)(ii) provides a formula for allocating or apportioning gross income where there is production activity both within and without the United States. Current § 1.863–3(c)(1)(ii)(A) determines the amount of income from sources without the United States by multiplying all the income attributable to taxpayer's production activities by a fraction, the numerator of which is the average adjusted basis of production assets that are located outside the United States and the denominator of which is the average adjusted basis of all the production assets located within and without the United States. For purposes of applying this formula, the adjusted basis of production assets is determined under section 1011, which is adjusted under section 1016 for depreciation deductions allowed. Section 13201 of the Act amended section 168(k) to allow an additional first-year depreciation deduction of 100 percent of the basis of certain property placed in service after September 27, 2017, and before January 1, 2023. Therefore, certain new and used production assets placed in service and used predominantly within the United States during this period may have an adjusted basis of zero. After December 31, 2022, qualifying property placed in service before January 1, 2027 (or, in the case of certain property, January 1, 2028), is still subject to accelerated depreciation for an amount equal to the applicable percentage of the basis of the property. Section 168(k)(1) and (6). However, production assets placed in service or used predominantly without the United States, or both, do not qualify for this accelerated depreciation and must be depreciated using the straight line method under the alternative depreciation system ("ADS") of section 168(g)(2). See section 168(g)(1)(A).

Section 865, added to the Code as part of the Tax Reform Act of 1986, Pub. L. 99–514 (1986) (the "TRA"), provides rules for sourcing sales of personal property. The general rule of section 865(a)(1) is that income from a sale of personal property is sourced based on the residence of the seller. Section 865(b) excepts inventory from this rule and sources income from the sale of inventory generally based on either the place of sale (for purchased inventory under section 861(a)(6) or 862(a)(6)) or based on the allocation and apportionment rules of section 863 (for inventory produced by the taxpayer). The place of sale rules typically depend upon the location where title to the

inventory passes from the seller to the buyer. See § 1.861–7(c).

Section 865(c) provides special rules for sourcing gain from the sale of depreciable personal property. Under section 865(c)(1), gain from the sale of depreciable personal property that is not in excess of depreciation adjustments is allocated between sources within and without the United States by treating the same proportion of such gain as sourced within the United States as the United States depreciation adjustments (as defined in section 865(c)(3)) with respect to such property bear to the total depreciation adjustments, and by treating the remaining portion of such gain as sourced without the United States. Under section 865(c)(2), gain in excess of the depreciation adjustments is sourced as if such property were inventory.

Section 865(e)(2) provides a further overlay to these rules with respect to all sales of personal property (including inventory) by nonresidents, as that term is defined in section 865(g)(1)(B), attributable to an office or other fixed place of business in the United States. Section 865(e)(2)(A) generally provides that income from any sale of personal property attributable to such an office or other fixed place of business is sourced in the United States. An exception is provided in section 865(e)(2)(B) for a sale of inventory for use, disposition, or consumption outside the United States if a foreign office of the nonresident "materially participated" in the sale. Section 865(e)(3) provides that the "principles of section 864(c)(5) shall apply" to determine whether a nonresident has an office or other fixed place of business and whether a sale is attributable to such office or other fixed place of business. Where applicable, section 865(e)(2) applies "[n]otwithstanding any other provisions" of subchapter N, part I, including sections 863(b), 861(a)(6), and 862(a)(6).

Section 864(c) provides the general rules for determining whether income is treated as effectively connected with the conduct of a trade or business within the United States. Nonresident alien individuals, foreign corporations, and bona fide residents of a U.S. territory ("non-U.S. persons") engaged in a trade or business within the United States are generally subject to U.S. net basis taxation on income that is effectively connected with that trade or business. Section 864(c)(2) provides that income described in section 871(a)(1) or (h) or section 881(a) or (c), as well as U.S. source capital gains or losses, are determined to be effectively connected or not based on two tests—whether the

income is "derived from assets" used in the non-U.S. person's trade or business or whether the activities of the trade or business were a "material factor" in the realization of the income. Section 864(c)(3) generally treats U.S. source income not described in section 864(c)(2) as effectively connected with a non-U.S. person's trade or business within the United States. Section 864(c)(4)(B) sets forth additional rules that treat certain foreign source income as effectively connected with the conduct of a U.S. trade or business if a non-U.S. person has an office or other fixed place of business within the United States to which the income is attributable, including income from certain sales of inventory as described in section 864(c)(4)(B)(iii).

Section 864(c)(5)(A) provides rules for determining whether a non-U.S. person has an office or other fixed place of business to which section 864(c)(4)(B) may apply as the result of the presence of an agent in the United States, and section 864(c)(5)(B) provides a threshold requirement for determining whether any income is attributable to such an office or other fixed place of business. Once it is determined that an office or other fixed place of business in the United States exists and income is attributable thereto, section 864(c)(5)(C) provides that the amount of income so attributable is generally the amount that is properly allocable to the office or other fixed place of business. Section 864(c)(5)(C) further provides that, with respect to certain sales of inventory described in section 864(c)(4)(B)(iii), the amount attributable to the office or fixed place of business cannot exceed the income that would otherwise have been U.S. source had the sale been made in the United States. As noted, the principles of section 864(c)(5) apply in the context of section 865(e)(2) pursuant to section 865(e)(3).

#### Explanation of Provisions

Consistent with the Act's changes to section 863(b)(2), these proposed regulations amend § 1.863–3 in order to properly allocate or apportion gross income from Section 863(b)(2) Sales based solely on production activity, and remove the methods for allocating or apportioning gross income between production and sales activity. In addition, because of the Act's change to section 168(k) to allow accelerated depreciation in some circumstances, these proposed regulations provide a new rule for computing the adjusted basis of production assets for purposes of applying the formula for allocating or apportioning gross income where there is production activity both within and

without the United States. These proposed regulations also contain conforming amendments to other regulations that allocate or apportion income between production and sales activity. In addition, these proposed regulations make minor changes to §§ 1.937-2, 1.937-3, and 1.1502-13 to update relevant cross references and examples.

These regulations also add proposed § 1.865-3 to clarify the proper scope and application of section 865(e)(2), as well as the interaction between section 865(e)(2) and section 865(c) regarding the sourcing of income from the sale of certain depreciable personal property. The proposed regulations also clarify the interaction between the section 865(e)(2) rules and the rules governing effectively connected income under section 864(c)(4)(B)(iii) and (c)(5). The proposed regulations amend § 1.864-6(c), the current rules for determining the amount of foreign source effectively connected income attributable to an office or other fixed place of business within the United States, to be consistent with the proposed sourcing rules applicable to produced inventory sales under section 865(e)(2).

### **I. Modification of Current § 1.863-3 and Other Regulations To Reflect the Amendments of Section 863(b) and Section 168(k)**

#### *A. Proposed Changes to § 1.863-3 To Reflect the Amendment of Section 863(b)*

Before amendment by the Act, section 863(b)(2) provided that gains, profits, and income from Section 863(b)(2) Sales were sourced partly from sources within and partly from sources without the United States, but did not prescribe a particular method of allocating or apportioning between these two sources. Accordingly, current § 1.863-3 provides allocation or apportionment methods for Section 863(b)(2) Sales. Under those regulations, a taxpayer must allocate or apportion gross income from Section 863(b)(2) Sales between production activity and sales activity using one of three methods described in current § 1.863-3(b): The 50/50 method described in paragraph (b)(1), the independent factory price (“IFP”) method described in paragraph (b)(2), or the books and records method described in paragraph (b)(3). Current § 1.863-3(d) provides rules for allocating and apportioning expenses to gross income from Section 863(b)(2) Sales, including a requirement to apportion expenses pro rata based on the source of gross income where the 50/50 method has been used. Current § 1.863-3(e) provides rules for

electing one of these methods and the related information that a taxpayer must disclose on a tax return.

The Act amended section 863(b) to source income from Section 863(b)(2) Sales solely on the basis of the production activity with respect to the inventory sold, and as a result sales activity is no longer a relevant factor for allocating or apportioning income under that section. Therefore, these proposed regulations remove the three methods in paragraph (b) and the related election rules in paragraph (e). Proposed § 1.863-3(b) requires sourcing of Section 863(b)(2) Sales based solely on the location of production activities, consistent with section 863(b)(2), as amended. Given the elimination of the 50/50 method, the proposed regulations no longer provide for the apportionment of expenses based solely on relative gross income from U.S. and foreign sources. Instead, the proposed regulations provide that expenses are allocated and apportioned based on the generally-applicable rules in §§ 1.861-8 through 1.861-17.

#### *B. Proposed Changes to § 1.863-3(e)*

Proposed § 1.863-3(e) (which replaces current § 1.863-3(f)) does not provide a specific rule for sourcing gross income derived from the sale of inventory produced (in whole or in part) by the taxpayer within the United States and sold within a U.S. territory, or produced (in whole or in part) by a taxpayer in a U.S. territory and sold within the United States. Instead, proposed § 1.863-3(e) provides a cross-reference directing taxpayers to source such income under the rules provided by proposed § 1.863-3(c). Proposed § 1.863-3(e) modifies the rule for sourcing gross income derived from the purchase of personal property within a U.S. territory and its sale within the United States under section 863(b)(3). Consistent with proposed § 1.863-3(b), proposed § 1.863-3(e) removes the books and records method provided by current § 1.863-3(f)(3)(i)(B). Instead, proposed § 1.863-3(e)(3)(i) requires sourcing such income based solely upon the taxpayer’s business activity.

#### *C. Proposed Changes to § 1.863-3 To Reflect the Amendment of Section 168(k)*

Notwithstanding the changes to section 863(b) required by the Act, there remains a need for rules to allocate or apportion gross income from Section 863(b)(2) Sales between U.S. and foreign sources where, with respect to inventory, there is production activity both within and without the United States. The proposed regulations retain

the existing rules in current § 1.863-3(c)(1)(ii) for sourcing gross income from production activity where there is production activity both within and without the United States. The proposed regulations do not amend current § 1.863-3(c)(1)(ii)(A), which determines the amount of foreign source income in such cases by multiplying the total gross income from Section 863(b)(2) Sales by a fraction, the numerator of which is the average adjusted basis of production assets located outside the United States and the denominator of which is all production assets within and without the United States. The remaining income is treated as U.S. source.

Because of the Act’s change to section 168(k) to allow accelerated depreciation in some circumstances, the Treasury Department and the IRS have determined that a new rule is needed in current § 1.863-3(c)(1)(ii)(B) for computing the adjusted basis of production assets for purposes of the formula for allocating or apportioning gross income where there is production activity both within and without the United States. Absent a change to the rules of current § 1.863-3(c)(1)(ii)(B), the Act’s modifications to the depreciation treatment of U.S. production assets will have the unintended effect of skewing the apportionment formula in favor of foreign source income because non-U.S. production assets (relative to U.S. production assets) will generally have a higher adjusted basis. Therefore, these proposed regulations modify the measurement of the basis of U.S. production assets under current § 1.863-3(c)(1)(ii)(B) for purposes of the apportionment formula of proposed § 1.863-3(c)(2)(i). The proposed regulations measure the basis of U.S. production assets based on ADS under section 168(g)(2) so that the basis of both U.S. and non-U.S. production assets is measured consistently on a straight line method over the same recovery period.

The Treasury Department and the IRS have determined that requiring the use of ADS for purposes of proposed § 1.863-3 is consistent with other provisions of the Act that require the use of ADS. For example, sections 951A(d)(3) and 250(b)(2)(B) (by cross reference to section 951A(d)) both require the use of ADS for purposes of determining qualified business asset investment to calculate global intangible low-taxed income and foreign-derived intangible income, respectively. The use of ADS is also consistent with the interest allocation rules in § 1.861-9(i)(1)(i). Nevertheless, the Treasury Department and the IRS request

comments regarding the suitability of using ADS for these purposes and whether there is a more appropriate way to compare U.S. and non-U.S. production assets for purposes of proposed § 1.863–3, such as the relative U.S. and non-U.S. production assets reported on the taxpayer's financial statements.

The proposed regulations do not otherwise modify the rules in current § 1.863–3 for determining the location or existence of production activity, a topic the Treasury Department and the IRS may address in future guidance. The Treasury Department and the IRS request comments regarding other potential approaches to determine the location or existence of production activity or other modifications to current or proposed § 1.863–3 that may be appropriate.

#### *D. Proposed Changes to Other Regulations Under Section 863 To Reflect the Changes to § 1.863–3*

The proposed regulations also modify current § 1.863–1, current § 1.863–2, and current § 1.863–8 to reflect the changes to current § 1.863–3. Proposed § 1.863–1(b) provides special rules for allocating or apportioning gross income from the sale of natural resources, which can be a subset of inventory generally. See proposed § 1.863–2(b). Current § 1.863–1(b)(1) provides a general “export terminal” rule that allocates sales income at the export terminal, sourcing gross receipts equal to the fair market value of the natural resources at the export terminal to the location of the farm, mine, well, deposit, or uncut timber, and gross receipts in excess of that amount either to the place of sale or according to the rules in § 1.863–3, depending on the circumstances.

Current § 1.863–1(b)(2) provides a special rule for taxpayers performing additional production activities before the relevant product is shipped from the export terminal. The gross receipts are allocated between sources within and without the United States based on the fair market value of the product immediately before the additional production activities. Gross receipts equal to the fair market value of the natural resources immediately before the additional production activities are sourced to the location of the farm, mine, well, deposit or uncut timber, and the gross receipts in excess of that fair market value are sourced based on § 1.863–3.

As it is generally no longer appropriate under section 863(b)(2) to allocate or apportion any gross income from sales of inventory, including

natural resources, to sales activity, the proposed regulations modify current § 1.863–1(b) to remove the export terminal rule so that, where there is no additional production activity with respect to the natural resource, all gross income from sales of natural resources inventory is based on the location of the farm, mine, oil or gas well, other natural deposit, or uncut timber from which the natural resource is derived. In other words, where there are no additional production activities, the location of the farm, mine, oil or gas well, other natural deposit, or uncut timber is considered the place of production generally.<sup>1</sup>

Where there are additional production activities with respect to the natural resource either within or without the jurisdiction from which the natural resource is derived, the gross income is allocated or apportioned first to the jurisdiction where the farm, mine, oil or gas well, other natural deposit, or uncut timber is located, in an amount equal to the fair market value of the product before the additional production activities. Any income in excess of that fair market value is then allocated or apportioned between sources within and without the United States under proposed § 1.863–3 principles based on the location of the assets used in the additional production activities. See proposed § 1.863–1(b)(2).

In the case of sales of natural resources by a nonresident that are attributable to an office or other fixed place of business in the United States of such nonresident, the foregoing rules are subject to the rules of section 865(e)(2) and proposed § 1.865–3.

Current § 1.863–8(b)(3)(ii) provides a special rule for allocating and apportioning income under section 863(d) derived from sales of property (including inventory) produced by a taxpayer if the property is produced or sold, at least in part, in space or international water. This rule requires the taxpayer to allocate gross income from such sales between production and sales activity under a 50/50 method, whereby half of the taxpayer's gross income will be considered income allocable to production activity and the remaining half of such gross income will be considered income allocable to sales activity. As it is generally no longer appropriate under section

863(b)(2) to allocate or apportion any gross income from sales of inventory produced by a taxpayer (including production in space or international water) to sales activity, the proposed regulations modify current § 1.863–8(b)(3)(ii) to remove the 50/50 method and replace it with a rule that allocates gross income solely on the basis of production activity.

#### *E. Proposed Changes to Regulations Under Section 1502 To Reflect the Changes to § 1.863–3*

To reflect section 863(b)(2), as amended by the Act, and the proposed regulations' amendments to § 1.863–3, the proposed regulations also amend example 14 of § 1.1502–13(c)(7)(ii)(N). This example illustrates the interaction between the intercompany transaction rules under current § 1.1502–13 and the sourcing rules in section 863. As revised by the proposed regulations, the example continues to illustrate the same matching principles for intercompany transactions under proposed § 1.1502–13 while updating the facts and analysis to reflect the changes in section 863(b)(2) and § 1.863–3.

## **II. Proposed Rules for Sales of Personal Property by Nonresidents**

### *A. Proposed Source Rules Under § 1.865–3 To Take Into Account Section 863(b)*

#### **1. Interaction of Section 863(b), as Amended, With Section 865(e)(2)**

In light of the changes made by the Act to section 863(b), the Treasury Department and the IRS are concerned that nonresident taxpayers may take an improper position that these changes override the application of section 865(e)(2) as it applies to sales<sup>2</sup> of inventory<sup>3</sup> produced by a nonresident taxpayer and sold through a U.S. sales office, despite the fact that section 865(e)(2) applies “[n]otwithstanding any other provisions in [sections 861 through 865].” To address this improper interpretation of section 865(e)(2), and to provide guidance for the application of section 865(e)(2) in general, the proposed regulations add proposed § 1.865–3.

Section 865, enacted in 1986 as part of the TRA, provides special sourcing rules for sales of personal property. In particular, section 865(e)(2) provides that “[n]otwithstanding any other provisions of this part,” if a nonresident has an office or other fixed place of business in the United States, “income

<sup>1</sup> Treasury Decision 8687, 1996–2 C.B. 47, added the export terminal rule in current § 1.863–1(b) partly in response to the decision in *Phillips Petroleum Co. v. Commissioner*, 97 T.C. 30 (1991), *aff'd without published opinion*, 70 F.3d 1282 (10th Cir. 1995). These proposed regulations follow *Phillips Petroleum* in treating natural resources, once extracted, in the same way as other types of inventory and therefore subject to section 863(b)(2), as amended.

<sup>2</sup> As defined in section 865(i)(2).

<sup>3</sup> Inventory property, as defined in section 865(i)(1).

from any sale of personal property (including inventory property) attributable to such office or other fixed place of business” is U.S. source. Accordingly, to the extent that inventory income described in section 863(b)(2) is considered to be derived from a sale by a nonresident attributable to an office or other fixed place of business in the United States, section 865(e)(2) must be given effect in determining the source of the income.

For purposes of section 865(e)(2), section 865(e)(3) provides that the “principles of section 864(c)(5)” apply in determining “whether a taxpayer has an office or other fixed place of business” and “whether a sale is attributable” thereto. As described in the Background section of this preamble, section 864(c)(5)(A) provides rules for determining whether a non-U.S. person has an office or other fixed place of business to which section 864(c)(4)(B) may apply as the result of the presence of an agent in the United States, section 864(c)(5)(B) provides a threshold requirement for determining whether any income is attributable to such an office or other fixed place of business, and section 864(c)(5)(C) addresses the extent to which the income, gain, or loss is attributable to an office or other fixed place of business and includes a limitation that for sales of inventory, the income attributable to an office or other fixed place of business within the United States cannot exceed “the income which would be derived from sources within the United States if the sale or exchange were made in the United States.”

Section 865(e)(2) may properly be read to treat all income from a sale of personal property by a nonresident as U.S. source so long as the sale is “attributable” to the nonresident’s office or other fixed place of business in the United States. By its terms, section 865(e)(3) does not necessarily change this result because it references section 864(c)(5) only for purposes of (1) determining whether a taxpayer has an office or other fixed place of business and (2) whether a sale is attributable to such office or other fixed place of business. Section 865(e)(3) does not by its terms reference section 864(c)(5) for determining the amount of income attributable to such office or other fixed place of business. On this basis, section 865(e) may fairly be read to override section 863(b) where Section 863(b)(2) Sales of a nonresident are attributable to an office or other fixed place of business in the United States, with the result that all of the income from such sales is sourced within the United States.

On the other hand, section 865 concerns the source of income, gain, and loss, and section 865(e)(3) refers to “the principles of section 864(c)(5),” which determines “income, gain or loss” attributable to an office or other fixed place of business in the United States (as noted in subparagraphs 864(c)(5)(B) and 864(c)(5)(C), which operate together). On this basis, the Treasury Department and the IRS have determined that section 864(c)(5) may serve not only as the basis to attribute a sale to an office or other fixed place of business in the United States within the meaning of section 865(e)(2), but also as the basis, in the context of section 865(e)(2) as applicable to Section 863(b)(2) Sales, for allowing a limitation on the amount of income and gain from sales of inventory property attributable to such office or other fixed place of business and, therefore, sourced in the United States. In particular, as relevant here, section 864(c)(5)(C) limits the amount of “income, gain, or loss” from sales that meet the “material factor” threshold of section 864(c)(5)(B) to the amount of income “properly allocable” to the office or other fixed place of business in the United States<sup>4</sup> (which is a lesser amount of income than would be allocated based on such sale under a literal reading of section 865(e)(2) (the entire amount of income)).

The last clause of section 864(c)(5)(C) also imposes a limitation in the case of sales described in section 864(c)(4)(B)(iii) (sales outside the United States made through an office or other fixed place of business in the United States) that “the income which shall be treated as attributable to an office or other fixed place of business within the United States shall not exceed the income which would be derived from sources within the United States if the sale or exchange were made in the United States.” Before the enactment of section 865(e)(2), which generally caused such sales to result in U.S. source income and hence fall outside the scope of section 864(c)(4)(B)(iii), this clause was intended to limit the application of section 864(c)(4)(B) to income from sales activities, thus excluding income from production activities. The clause did not determine how much income was attributable to sales versus

production activities. Following the Act, which did not amend section 865(e)(2), the Treasury Department and the IRS continue to believe that this clause has no relevance to the determination of how much income is attributable to sales activities or to sales governed by section 865(e)(2).

By incorporating the principles of section 864(c)(5), section 865(e)(3) thus authorizes regulations that would bifurcate the income from a sale of inventory property produced by a nonresident outside the United States and sold through an office or other fixed place of business in the United States so that only the “properly allocable” amount of income from that sale is attributable to an office or other fixed place of business in the United States and treated as U.S. source. In such a case, this amount reflects the nonresident’s sales activity, not its production activities, with respect to the personal property sale, which is the portion of the income that Congress intended to treat as U.S. source when it enacted section 865(e)(2) in 1986.<sup>5</sup> H.R. Rep. No. 99–426, at 360–61 (1985).

The 1986 legislative history of section 865(e)(2) shows that Congress intended, by enacting that provision, to repeal (in certain cases) the title passage rule that formerly controlled the source of the “sales income” from the sale of personal property, regardless of where the “sales activities” occurred. *See* H.R. Rep. No. 99–426, at 360 (1985) (providing that “[a]lthough the title passage rule operates clearly, it is manipulable”); *see also* S. Rep. No. 99–313, at 330–33 (1986). The legislative history shows that Congress rather sought to tax “income derived from sales” based on the “location of the economic activity generating the income.” *See* S. Rep. No. 99–313, at 330 (1986); H.R. Rep. No. 99–426, at 360 (1985). “If the seller maintains a fixed place of business outside the seller’s country of residence which materially participates in a sale, . . . the committee generally believes that the level of economic activity with respect to the sale that is associated with that place of business is high enough such that the location of that place of business should govern the source of the sales income.” H.R. Rep. No. 99–426, at 360–61 (1985). These statements show, both individually and

<sup>4</sup> Section 864(c)(5)(C) actually states “the income, gain or loss property [sic] allocable thereto.” Based on the legislative history behind The Foreign Investors Tax Act, Public Law 89–809 (1966), which added section 864(c) to the Code, the use of “property” in the final bill appears to be a typographical error. The Senate Report that added this provision used the word “properly” not “property.” *See* S. Rep. No. 1707 at 1275 (1966).

<sup>5</sup> In the case of inventory property purchased outside the United States (other than in a U.S. territory of the United States) and sold through an office or other fixed place of business in the United States, section 863(b) has no application and hence, regardless of where title passage occurs, all of the income is considered attributable to such office or other fixed place of business and sourced in the United States.

in the aggregate, that Congress enacted section 865(e)(2) with a focus upon sourcing income from sales activity based on the economic location of the activity, rather than the location of title passage. The principles of section 864(c)(5) (and in particular subparagraph (C) thereof) give effect to this intent through section 865(e)(3) by limiting the application of section 865(e)(2) to sales income properly allocable to the office or other fixed place of business in the United States.

Before the issuance of these proposed regulations, the Treasury Department and the IRS had never issued formal guidance on the sourcing rules of section 865(e)(2) in the case of inventory property produced outside the United States and sold within the United States. Nevertheless, in light of the statutory text of section 865(e)(2) and (3) (as well as section 864(c)(5)(C) by reference) and the legislative history of these provisions, in practice, the IRS has historically interpreted section 865(e)(2) to include a limitation that treated as U.S. source only the sales income allocable to the office or other fixed place of business in the United States reflecting the sales activity from the transaction. *See, e.g.*, 1996 Field Service Advice (FSA) LEXIS 68 (Sept. 24, 1996); 1996 FSA LEXIS 465 (Feb. 29, 1996). This historical interpretation utilized the rules of section 863(b) before amendment by the Act (referenced in current § 1.864-6(c)) to determine the amount of income allocable to the office or other fixed place of business in the United States, thereby allowing taxpayers to apply, among other rules, a 50/50 split between U.S. source income (allocable to the office or other fixed place of business in the United States and reflective of sales activity) and foreign source income (reflective of production activity) for sales subject to section 865(e)(2) (the “50/50 method”). The IRS has historically allowed the 50/50 method for establishing the amount allocable to the office or other fixed place of business in the United States (and the sales activity) under section 864(c)(5). Section 865(e)(3) incorporates into section 865(e)(2) the principles of section 864(c)(5), and so the 50/50 method approximated the effect of applying the principles of section 864(c)(5) under section 865(e)(2).

Although the Act amended section 863(b), it made no changes to section 865(e)(2), which does not explicitly reference or depend upon section 863. The 2018 Blue Book notes the absence of any change to section 865(e)(2). *See* 2018 Blue Book at 397 n.1798. Consistent with historical IRS practice, in its description of prior law, the 2018

Blue Book explains that although sections 863(b) and 865(e)(2) may appear to conflict, in the case of a nonresident manufacturing property without the United States for sale within the United States, the result is that “the income generally is partly U.S.-source and partly foreign-source.”<sup>6</sup> *Id.* at 328 n.1519.

Further, despite the changes to section 863(b) in the Act, structurally, the bifurcated approach is maintained, and section 863(b)(2) continues to refer to inventory that is produced within the United States and sold without the United States, or produced without the United States and sold within the United States. The statutory provision preserves the distinction between sales and production economic activity. If Congress intended to eliminate the sales versus production dichotomy for all purposes, it presumably would have deleted those phrases as the new flush language (that any sale of manufactured inventory property is sourced in whole based on the location of production activities) would have made them surplusage.

In light of Congress’s decision to retain the underlying structure of section 863(b)(2) and append the flush language as an overlay, the IRS’s longstanding interpretation of the relationship of sections 863(b)(2) and 865(e)(2) under pre-Act law, and the fact that section 865(e)(2) was left unaltered by the Act, the Treasury Department and the IRS have determined that the relationship between section 863(b)(2) and section 865(e)(2) should not be interpreted differently before and after the Act. Thus, section 865(e)(2) should continue to apply to inventory property sales income “properly allocable” to an office or other fixed place of business in the United States (reflecting sales activity rather than production activity) just as before the Act.

As noted, the Treasury Department and the IRS understand that some nonresident taxpayers may be taking the position that, applied after the Act, the last clause of section 864(c)(5)(C) (limiting the income treated as attributable to an office or other fixed place of business in the United States to the amount that would be U.S. source if the sale were made in the United States) causes the income from the sale of inventory produced outside the United

<sup>6</sup>This statement appears to conflict with another statement in the 2018 Blue Book with respect to prior law to the effect that the application of section 865(e)(2) to a sale of personal property made by a nonresident attributable to its office or fixed place of business in the United States results in all income from the sale being sourced in the United States. *Id.* at 396–97.

States and subject to section 865(e)(2) to be foreign source to the same extent that it would be foreign source under section 863(b), standing alone, which would cause the sourcing of both the sales and production income from the disposition to be based on the location of production activities. Such a reading cannot be correct, because it would inappropriately construe a provision (section 865(e)(2)) intended as a separate restriction on the source rule under section 863(b)(2) (and which literally can be read as entirely overriding that rule) to be determined solely by reference to the terms of such source rule itself (rather than at most in a manner giving effect to both rules). Further, such a construction would cause section 865(e)(2) to have no effect with respect to sales of inventory that are also described in section 863(b)(2), contrary to longstanding statutory construction principles. *See, e.g., Watt v. Alaska*, 451 U.S. 259, 267 (1981) (statutes should be read to give effect to each if it can be done so while preserving their sense and purpose).

Moreover, such a reading would, in effect, import the change in section 863(b) from the Act into section 865(e)(2), which Congress did not do. As noted, section 865(e)(2) applies “[n]otwithstanding any other provisions.” Section 865(e)(3) applies the “principles” of section 864(c)(5), which reflects the sometimes imprecise fit between sections 864(c)(5) and 865(e)(2), such as the fact that section 864(c)(5) refers to “income, gain or loss,” rather than a “sale,” attributable to an office or other fixed place of business in the United States. The relevant principles referenced in section 865(e)(3) are those that apply for purposes of determining the income, gain, or loss attributable to an office or fixed place of business in the United States. As discussed previously in this section of the Explanation of Provisions, the last clause of section 864(c)(5)(C) is not relevant to that determination and therefore is not relevant to the application of sections 863(b) or 865(e)(2). The principles of section 864(c)(5) are those self-contained in the words of the provision itself (“properly allocable”), and not the limitation provided in the last clause of section 864(c)(5)(C) that serves a different purpose. The amendment to section 863(b)(2) did not change the traditional analysis regarding the attribution of inventory sales to an office or other fixed place of business in the United States.

In light of the foregoing, these proposed regulations clarify the application of the principles of section

864(c)(5) in the context of section 865(e)(2) and provide that sales of inventory produced outside the United States and sold through an office maintained by the nonresident in the United States must be sourced in the United States in part.

## 2. Overview of the Proposed Regulations Under Section 865(e)(2)

Section 865(e)(2) sources the amount of income from sales described in section 865(e)(2)(A) to which the exception in section 865(e)(2)(B) does not apply (Section 865(e)(2) Sales) that is determined to be properly allocable to the nonresident's office or other fixed place of business in the United States under the principles of section 864(c)(5)(C) as referenced by section 865(e)(3). In cases where a sale of personal property is not a Section 865(e)(2) Sale, other sourcing provisions continue to apply.

Proposed § 1.865-3(a) sets forth the general rule in section 865(e)(2)(A), and proposed § 1.865-3(b) sets forth the exception in section 865(e)(2)(B) and cross-references the rules of § 1.864-6(b)(3) to determine if a foreign office materially participated in the sale. Proposed § 1.865-3(c) sets forth the rules for determining whether a nonresident has an office or other fixed place of business in the United States by incorporating the principles of § 1.864-7, and whether a sale of personal property is attributable to that office or other fixed place of business in the United States by incorporating the principles of § 1.864-6(b) and (c), as amended.

Proposed § 1.865-3(d) then provides rules for determining the amount of income that is treated as U.S. source; the rules depend on whether the property sold is inventory (including property treated as inventory under section 865(c)(2)) or other personal property of a nonresident sold in a sale attributable to an office or other fixed place of business in the United States of the nonresident. Proposed § 1.865-3(d) provides separate source rules for income from sales of inventory subject to section 865(e)(2), dependent on whether the nonresident produced the inventory (either the default 50/50 method in paragraph (d)(2)(i) or the elective books and records method in paragraph (d)(2)(ii)), or purchased the inventory, 100 percent U.S. source income in paragraph (d)(3). Proposed § 1.865-3(d)(2)(ii) provides the books and records method that a taxpayer can elect to apply in lieu of the default 50/50 method, including the rules for making that election and the records that must be provided to the

Commissioner upon request. To the extent income from either type of inventory sale is treated as U.S. source under proposed § 1.865-3(d)(2) or (3), the income will generally be effectively connected with the conduct of a U.S. trade or business under section 864(c)(3).

Proposed § 1.865-3(e) provides a cross reference to the rules in §§ 1.882-4 and 1.882-5, which determine the amount of expenses that are properly allocated and apportioned to gross income effectively connected with the conduct of a trade or business in the United States.

## 3. The Proposed Rules for Non-Inventory Property

Section 864(c)(2) applies to determine whether U.S. source gain from the sale of non-inventory property and other capital assets by a non-U.S. person is effectively connected with the conduct of a U.S. trade or business. The proposed regulations implement section 865 and provide source rules for determining whether gain is U.S. source for purposes of section 864(c)(2).

In the case of income derived from the sale of depreciable personal property, section 865(c) distinguishes between gain not in excess of depreciation adjustments and gain in excess of depreciation adjustments, and bifurcates the gain not in excess of depreciation adjustments pro rata to depreciation deductions allowable in computing taxable income from sources within the United States and without the United States. Section 865(c)(1). Gain in excess of depreciation is sourced as if such property were inventory property. Section 865(c)(2) and proposed § 1.865-3(d)(4). See section II.A.4 of this Explanation of Provisions for discussion of the sourcing of inventory property. The legislative history of section 865(c), which was enacted at the same time as section 865(e)(2), indicates that Congress intended to create a special rule for depreciable personal property to source the income derived from the sale of depreciable personal property, to the extent of prior depreciation deductions, under a recapture principle. Under this rule, gain from the sale of depreciable personal property, to the extent of prior depreciation deductions, is sourced within the United States in proportion to the extent of the depreciation deductions that were previously allocated against U.S. source income. On the other hand, the gain, to the extent of prior depreciation deductions, is sourced without the United States in proportion to the extent of the depreciation deductions that were previously allocated against foreign

source income. See H.R. Rep. No. 99-426, at 364 (1985); S. Rep. No. 99-313, at 331-32 (1986); Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (Pub. L. 99-514), JCS-10-87, at 63 (1987). Thus, Congress intended to apply the recapture rule to source gain, not in excess of depreciation, from a sale of depreciable personal property (as opposed to sourcing that gain based on the location of the taxpayer's office).

Consistent with this legislative history, the Treasury Department and the IRS have determined that, to the extent a nonresident previously allocated depreciation deductions against foreign source income, in the event of a sale of such property through an office or other fixed place of business in the United States, the associated gain is not "properly allocable" to an office or other fixed place of business in the United States under the principles of section 864(c)(5), and therefore to such extent the sale (and gain) is not attributable to a nonresident's office or other fixed place of business in the United States under section 865(e)(2). Therefore, in the case of income subject to section 865(e)(2) from the sale of depreciable personal property, the amount of gain, not in excess of depreciation deductions, that is allocable to the nonresident's office or fixed place of business within the United States is the amount of gain that would be attributable to United States depreciation deductions under the recapture rule of section 865(c)(1). To the extent the gain exceeds prior U.S. and non-U.S. depreciation deductions, sections 865(c)(2) and 865(e)(2) apply and source that gain as if the property were inventory. Thus, the residual gain in excess of depreciation deductions is sourced under the rules of section 865(e)(2) as described in proposed § 1.865-3(d)(2) (for produced inventory, the 50/50 method and the books and records method) and (d)(3) (for purchased inventory, 100 percent U.S. source income).

## 4. The Proposed Rules for Inventory

With respect to inventory purchased and sold by a nonresident in a sale attributable to an office or other fixed place of business in the United States and subject to section 865(e)(2), none of the income from the sale is attributable to production activity, and therefore, unless the exception in section 865(e)(2)(B) applies, all of the income from the sale is properly allocable to the office or other fixed place of business in the United States. Thus, the proposed regulations clarify that in these cases section 865(e)(2) causes all of the gross

income derived from the disposition to be U.S. source. See § 1.865–3(d)(3).

With respect to inventory produced and sold by a nonresident in a sale attributable to an office or other fixed place of business in the United States and subject to section 865(e)(2), the Treasury Department and the IRS have determined that the disposition continues to give rise to gross income that is partly allocable to the nonresident's office or other fixed place of business in the United States (representative of the sales activity with respect to the transaction) and sourced under section 865(e)(2), with the remainder allocable to production activity and sourced under section 863(b). Therefore, these proposed regulations provide a rule specifically for Section 865(e)(2) Sales involving inventory produced by the nonresident that distinguishes generally between sales and production activities in determining the source of the income from sales of produced inventory and is consistent with the overall structure of subchapter N, part I (sections 861–865).

The Treasury Department and the IRS understand that Congress intended for the source rules to “operate clearly without the necessity for burdensome factual determinations.” H.R. Rep. No. 99–426, at 360 (1985). Additionally, it is noteworthy that the “principles” of section 864(c)(5)(C), rather than the exact rules thereof, apply in the section 865(e)(2) context. Finally, the Treasury Department and the IRS are mindful of the fact that section 865(e)(2) was not modified by the Act. Before the Act, by applying the principles of current § 1.863–3(b) to determine the amount of income allocable to the office or other fixed place of business in the United States, the 50/50 method allowed for a 50 percent U.S. source result with respect to sales of produced inventory.

Based on the foregoing considerations, these proposed regulations continue to apply the 50/50 method as the general rule to treat 50 percent of a nonresident's income with respect to produced inventory sold through an office or other fixed place of business in the United States as U.S. source income attributable to the sales activity of the office maintained by the nonresident. The remaining 50 percent of the income is allocated or apportioned between U.S. and foreign sources by applying section 863(b) and the regulations thereunder (as amended by these proposed regulations) based upon the location of production activities. Thus, where inventory is produced entirely outside the United States and sold through a U.S. sales office in a transaction subject to section

865(e)(2), 50 percent of the gross income is U.S. source income allocable to the U.S. sales office or other fixed place of business, and the remaining 50 percent is foreign source income.

In prescribing the 50/50 method for dividing gross income from Section 865(e)(2) Sales between production and sales activity, the Treasury Department and the IRS appreciate that this method may not correspond precisely to the economic genesis of the gross income with respect to the sales and production activity involved. Nevertheless, the Treasury Department and the IRS have determined that this is an appropriate and administrable way to give effect to the principles of section 864(c)(5) in allocating income to the office or other fixed place of business in the United States (and focusing on sales activity) when applying section 865(e)(2). First, the 50/50 method has historically been recognized as a reasonable method for allocating income between production and sales activity. Before the Act, section 863(b) specified that income from Section 863(b)(2) Sales “be treated as derived partly from sources within and partly from sources without the United States,” and imposed no standard for allocating or apportioning the income. As discussed, the 50/50 method was a commonly used and well-understood sourcing method that ensured some income was allocated or apportioned to sales activity and some to production activity under section 863(b). For example, in 1984 the Treasury Department stated that “[g]enerally, [income derived from the 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. The House, Senate, and Conference Committees each stated with respect to the TRA that “[under the 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.” H.R. Rep. No. 99–426, at 359 (1985); S. Rep. No. 99–313, at 329 (1986); H.R. Rep. No. 99–841, at 917 (1986) (“Conf. Rep.”). Finally, 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.” Joint Committee on Taxation, Factors Affecting International Competitiveness of the United States, JCS–6–91, at 148–149 (1991). Second, the 50/50 method

was the most administrable of the permissible means of applying section 865(e)(2) through the application of section 864(c)(5)(C) and current § 1.864–6(c)(2) before the Act. Therefore, these proposed regulations adopt the 50/50 method as the default method for allocating or apportioning gross income attributable to Section 865(e)(2) Sales between sources within and without the United States.

Nevertheless, the Treasury Department and the IRS are aware that some taxpayers may be able to more precisely allocate or apportion their gross income between sales and production activities based on their books of account. Taxpayers, at their election, have historically used such a “books and records” method under current § 1.863–3(b)(3) to allocate or apportion their gross income from sales of inventory between production and sales activities. Therefore, as an elective alternative to the default 50/50 method, taxpayers may continue to use a books and records method as provided in these proposed regulations. However, the proposed regulations include more detailed guidance regarding the requirements that must be met before a taxpayer will be permitted to use this method.

A taxpayer electing the books and records method must prepare and maintain records that are in existence when its return is filed regarding the allocation of gross income between sales and production activities in its books of account and indicate in a statement attached to its tax return that it elects to apply this method. As part of its records that exist when its return is filed, the taxpayer must include an explanation of how such allocation clearly reflects the taxpayer's income from production and sales activities under the principles of section 482. The Treasury Department and the IRS intend the taxpayer's explanation to allow a potential examiner to have a roadmap for understanding the method by which the taxpayer determined the allocation of gross income between the U.S. sales activities and the foreign production activities, respectively. The use of section 482 in the proposed regulations is not intended to imply that the taxpayer's explanation must satisfy the documentation requirements of section 6662(e) and § 1.6662–6(d). The taxpayer must make available its books and records for both its sales activities and its production activities and the related explanation upon request of the Commissioner. If a taxpayer fails to satisfy these requirements in full, the default 50/50 method will apply.



These proposed regulations, however, do not also provide for an elective IFP method as allowed by current § 1.863-3(b)(2). The Treasury Department and the IRS have determined that this method is applicable only in very narrow circumstances when an IFP exists and therefore has rarely been elected by taxpayers in practice. Any taxpayer that wishes to continue using an IFP could generally continue to reach a similar result by electing the books and records method and basing the allocation or apportionment in its books and records on the IFP. Nevertheless, the Treasury Department and the IRS request comments on whether the IFP or any other methods for allocating or apportioning gross income attributable to Section 865(e)(2) Sales between sources within and without the United States should be included in these regulations.

*B. Modification of Current § 1.864-6(c)(2) To Ensure Consistency With § 1.865-3*

Section 864(c)(4)(B)(iii) generally provides that income derived from the sale of inventory (outside the United States) by a non-U.S. person through an office or other fixed place of business in the United States may be effectively connected income, notwithstanding that it would be foreign source income under the title passage rules in § 1.861-7(c). It provides an exception for inventory sold for use or consumption outside the United States, similar to the exception in section 865(e)(2)(B).

Accordingly, sections 864(c)(4)(B)(iii) and 865(e)(2), as a statutory matter, appear to overlap in their treatment of sales of inventory by non-U.S. persons through an office or other fixed place of business in the United States. This was not the case, however, in 1986 because Congress removed section 864(c)(4)(B)(iii) from the Code when section 865(e)(2) was added. The Tax Reform Act of 1986, Public Law 99-514 (1986) (section 1211(a) added section 865, while section 1211(b)(2) removed section 864(c)(4)(B)(iii)). Two years later, however, in the Technical and Miscellaneous Revenue Act of 1988 (“TAMRA 1988”), Congress added section 864(c)(4)(B)(iii) back to the Code, with the Senate Report to TAMRA 1988 explaining that the provision was reinstated because it “is necessary to ensure that foreign persons who have a substantial presence in the United States, who may be treated as U.S. residents for source rule purposes but as nonresidents for general purposes, are taxed on income derived from sales of inventory property.” S. Rep. No. 100-445, at 239 (1988); see also Joint

Committee on Taxation, Description of the Technical Correction Act of 1988, JCS-10-88, at 250 (1988); TAMRA 1988 (section 1012(d)(7) restored section 864(c)(4)(B)(iii)).

The Treasury Department and the IRS have thus determined that where both provisions potentially could apply, as in the case of foreign corporations and most nonresident alien individuals, section 865(e)(2) takes precedence over section 864(c)(4)(B)(iii) because section 865(e)(2) applies “[n]otwithstanding any other provisions of this part.” Consistent with the TAMRA 1988 legislative history, the Treasury Department and the IRS have determined that section 864(c)(4)(B)(iii) applies solely to nonresident alien individuals (defined in section 7701(b)) who under section 865(g)(1) have a tax home (as defined in section 911(d)(3)) in the United States (and whose inventory sales thus would not be subject to section 865(e)(2) as those individuals would not be “nonresidents” under section 865(g)(1)(B)). Note that these nonresident alien individuals would be subject to section 864(c)(4)(B)(iii) and section 864(c)(5) only with respect to income from inventory sales that is determined to be foreign source after application of sections 861(a)(6), 862(a)(6), and 863(b) pursuant to section 865(b). Thus, for example, a nonresident alien individual engaged in a U.S. trade or business, with a tax home in the United States, who purchases inventory outside the United States and resells inventory attributable to a U.S. office (with title passing offshore) would have foreign source income under section 862(a)(6) (by reference from section 865(b)), but that foreign source income would then be subject to section 864(c)(4)(B)(iii) and section 864(c)(5) to determine the amount of the individual’s foreign source effectively connected income.

Although the scope of section 864(c)(4)(B)(iii) is narrow, the Treasury Department and the IRS have determined that income from sales of inventory by these individuals should be taxable as effectively connected income to the same extent as if inventory sales by these individuals were governed by section 865(e)(2), depending on whether the inventory was either purchased abroad or produced abroad. Section 1.864-6(c)(2) is therefore modified so that it applies exclusively to this distinct class of nonresident aliens, those with a tax home in the United States who are not covered under section 865(e)(2). Further, in order for these individuals to be subject to tax to the same extent as other nonresident taxpayers under

section 865(e)(2), the proposed regulations remove any current references in § 1.864-6(c)(2) to section 863(b) and § 1.863-3, thereby clarifying that the rules of section 863(b) and § 1.863-3 do not apply in the context of section 864(c)(4)(B)(iii) to treat inventory sales as exclusively giving rise to foreign source income if the inventory sold was produced exclusively outside of the United States. The proposed regulations do not modify the treatment of sales by these individuals of intangible personal property described in § 1.864-5(b)(1) or of stock or securities described in § 1.864-5(b)(2), which continue to be governed by § 1.864-6(c)(1). Current and proposed § 1.864-6(c)(2) implement the rule in section 864(c)(5)(C) that applies solely to sales of personal property described in section 864(c)(4)(B)(iii) and § 1.864-5(b)(3).

These proposed regulations also may impact the determination of qualified business income for purposes of section 199A. Section 199A(c)(3)(A)(i) provides that “qualified items of income, gain, deduction, and loss” under section 199A(c)(3) are those items that are, among other things, effectively connected with the conduct of a trade or business in the United States within the meaning of section 864(c) (subject to certain modifications). The Treasury Department and the IRS continue to study the application of section 864(c) in the context of section 199A, and request comments on this topic.

*C. U.S. Income Tax Treaties*

The Treasury Department and the IRS are aware that under U.S. income tax treaties, the business profits of foreign treaty residents may be taxable in the United States only if the profits are attributable to a permanent establishment in the United States. With respect to taxpayers entitled to the benefits of an income tax treaty, the amount of profits attributable to a U.S. permanent establishment will not be affected by these regulations.

*Proposed Applicability Date*

The regulations are proposed to apply to taxable years ending on or after December 23, 2019. As proposed, the regulations will permit taxpayers to apply the rules therein in their entirety for taxable years beginning after December 31, 2017, and before these regulations apply.

In addition, taxpayers may rely on the rules in the proposed regulations for taxable years beginning after December 31, 2017, and before the final regulations are applicable, provided that the taxpayer and persons that are related

(within the meaning of section 267 or 707) to the taxpayer apply the proposed regulations in their entirety. For taxable years before these regulations apply, the IRS may, where appropriate, challenge certain positions described in this preamble, including that following the amendment to section 863(b)(2) income earned by nonresidents from sales of personal property produced outside the United States and sold through an office or other fixed place of business in the United States is 100 percent foreign source.

#### Special Analyses

The Administrator of the Office of Information and Regulatory Affairs (OIRA), Office of Management and Budget, has determined that this proposed rule is not a significant regulatory action, as that term is defined in section 3(f) of Executive Order 12866. Therefore, OIRA has not reviewed this proposed rule pursuant to section 6(a)(3)(A) of Executive Order 12866 and the April 11, 2018, Memorandum of Agreement between the Treasury Department and the Office of Management and Budget (“OMB”).

#### I. Regulatory Flexibility Act

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that these proposed regulations, if adopted, will not have a significant economic impact on a substantial number of small entities. Although data are not readily available to assess the number of small entities potentially affected, any economic impact of these regulations is unlikely to be significant. Specifically, the regulations in §§ 1.863–1 and 1.863–3 (with conforming changes in cross-referencing regulations) implement the statutory change made to section 863(b) by the Act. This change affects sales of inventory property by any taxpayer where the taxpayer produces the inventory (in whole or in part) within the United States and sells that inventory without the United States, or vice versa. The change in sourcing for those entities is attributable to the change in section 863(b) made by the Act. Proposed §§ 1.863–1 and 1.863–3 merely implement the statutory change with limited additional guidance. The Treasury Department and the IRS do not anticipate that any differences between the changes in section 863(b) made by the Act and the changes in proposed §§ 1.863–1 and 1.863–3 made by these proposed regulations will have a significant economic impact on a substantial number of small entities. Notwithstanding this certification, the Treasury Department and the IRS invite

comments on the impact of this rule on small entities.

The other regulations in this publication (other than changes to ensure consistency with section 863(b)) are the proposed regulations in §§ 1.864–6 and 1.865–3. These proposed regulations solely affect non-U.S. taxpayers, which are not subject to the Regulatory Flexibility Act.

Pursuant to section 7805(f), this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

#### II. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of \$100 million in 1995 dollars, updated annually for inflation. In 2019, that threshold is approximately \$154 million. These proposed regulations do not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

#### III. Executive Order 13132: Federalism

Executive Order 13132 (entitled “Federalism”) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. These proposed regulations do not have federalism implications and do not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

#### Comments and Requests for Public Hearing

Before the proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under **ADDRESSES**. The Treasury Department and the IRS request comments on all aspects of the proposed rules. See also sections I.C, II.A.4, and II.B of the Explanation of Provisions (requesting specific comments related to the suitability of using ADS, other

potential approaches to determine the location or existence of production activity, or other modifications to § 1.863–3 that may be appropriate; related to whether there are other suitable methods for allocating or apportioning income attributable to Section 865(e)(2) Sales between U.S. and foreign sources; and related to the impact of these proposed regulations on the determination of qualified business income for purposes of section 199A, respectively). All comments will be available at [www.regulations.gov](http://www.regulations.gov) or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

#### Drafting Information

The principal authors of the proposed regulations are Brad McCormack and Anisa Afshar of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS 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:
- 1. Revising the entries for §§ 1.863–1, 1.863–2, 1.863–3, and 1.863–8.
- 2. Adding an entry for § 1.865–3 in numerical order.
- 3. Revising the entries for §§ 1.937–2, 1.937–3, and 1.1502–13.

The revisions and addition read in part as follows:

**Authority:** 26 U.S.C. 7805 \* \* \*  
 Section 1.863–1 also issued under 26 U.S.C. 863(a).  
 Section 1.863–2 also issued under 26 U.S.C. 863(a).  
 Section 1.863–3 also issued under 26 U.S.C. 863(a).  
 \* \* \* \* \*  
 Section 1.863–8 also issued under 26 U.S.C. 863(a).  
 \* \* \* \* \*  
 Section 1.865–3 also issued under 26 U.S.C. 865(j).  
 \* \* \* \* \*  
 Section 1.937–2 also issued under 26 U.S.C. 937(b).

Section 1.937-3 also issued under 26 U.S.C. 937(b).

\* \* \* \* \*

Section 1.1502-13 also issued under 26 U.S.C. 1502.

\* \* \* \* \*

■ **Par. 2.** Section 1.863-1 is amended as follows:

- 1. In paragraph (a):
  - i. Revising the third sentence.
  - ii. Removing “§ 1.863-3(g)” and adding in its place “§ 1.863-3(f)”.
- 2. In paragraph (b)(1):
  - i. Removing “, must be allocated between sources within and without the United States based on the fair market value of the product at the export terminal (as defined in paragraph (b)(3)(iii) of this section)” from the first sentence and adding in its place “shall be treated as income from sources within the United States”.
  - ii. Revising the second sentence.
  - iii. Removing the third, fourth, and fifth sentences.
- 3. Removing paragraphs (b)(1)(i) and (ii).
- 4. In paragraph (b)(2):
  - i. Removing “prior to export terminal” from the heading and adding in its place “activities”.
  - ii. Removing “before the relevant product is shipped from the export terminal” from the first sentence.
- 5. Removing “§§ 1.1502-13 or 1.863-3(g)(2)” from paragraph (b)(3)(i) and adding in its place “§ 1.1502-13 or § 1.863-3(f)(2)”.
- 6. Removing “to or from the export terminal” from the third sentence of paragraph (b)(3)(ii).
- 7. Removing paragraph (b)(3)(iii).
- 8. In paragraph (b)(6), removing “this paragraph (b)” from the first sentence and adding in its place “paragraph (b)(2) of this section”.
- 9. Designating *Examples 1, 2, 3, 4, and 5* of paragraph (b)(7) as paragraphs (b)(7)(i) through (v).
- 10. Revising newly designated paragraphs (b)(7)(i) through (iv).
- 11. In newly designated paragraph (b)(7)(v):
  - i. Removing “*Example 1*” from the first sentence and adding “paragraph (b)(7)(i) of this section (*Example 1*)”.
  - ii. Removing “country” from the first sentence and adding in its place “Country”.
  - iii. Removing “Mine’s” from the seventh sentence and adding in its place “Mines”.

The revisions read as follows:

**§ 1.863-1 Allocation of gross income under section 863(a).**

(a) \* \* \* See also section 865(b) for rules for sourcing income from the sale of inventory property, within the

meaning of section 865(i)(1) (inventory), generally, and section 865(e)(2) and § 1.865-3 for sourcing income from the sale of personal property (including inventory) by a nonresident that is attributable to the nonresident’s office or other fixed place of business in the United States. \* \* \*

(b) \* \* \*

(1) \* \* \* Notwithstanding any other provision of this part, except to the extent provided in paragraph (b)(2) of this section or § 1.865-3, gross receipts from the sale within the United States of products derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber outside the United States shall be treated as attributable to production activities without the United States and therefore treated as income from sources without the United States.

\* \* \* \* \*

(7) \* \* \*

(i) *Example 1. No additional production.* U.S. Mines, a domestic corporation, operates a copper mine and mill in Country X. U.S. Mines extracts copper-bearing rocks from the ground and transports the rocks to the mill where the rocks are ground and processed to produce copper-bearing concentrate. The concentrate is transported to a port where it is dried in preparation for export, stored, and then shipped to purchasers in the United States. Because there is no additional production, paragraph (b)(3)(ii) of this section does not apply, and under paragraph (b)(1) of this section, gross receipts from the sale of the concentrate will be from sources without the United States.

(ii) *Example 2. No additional production.* U.S. Gas, a domestic corporation, extracts natural gas within the United States, and transports the natural gas to a Country X port where it is liquefied in preparation for shipment. The liquefied 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. Therefore, under paragraph (b)(1) of this section, gross receipts from the sale of the liquefied natural gas will be from sources within the United States.

(iii) *Example 3. Production in United States.* U.S. Gold, a domestic corporation, mines gold in Country X, produces gold jewelry using production assets located in the United States, and sells the jewelry in Country Y. Assume that the fair market value of the gold

before the additional production activities in the United States is \$40x and that U.S. Gold ultimately sells the gold jewelry in Country Y for \$100x. Under paragraph (b)(2) of this section, \$40x of U.S. Gold’s gross receipts will be allocated to sources without the United States, and the remaining \$60x of gross receipts will be U.S. source under § 1.863-3.

(iv) *Example 4. Production in United States.* U.S. Oil, a domestic corporation, extracts oil in Country X, transports the oil via a pipeline to the United States, refines the oil using production assets located 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 before refinement in the United States is \$80x and U.S. Oil ultimately sells the refined product for \$100x. Under paragraph (b)(2) of this section, \$80 of gross receipts will be allocated to sources without the United States, and the remaining \$20 of gross receipts will be allocated to sources within the United States.

\* \* \* \* \*

■ **Par. 3.** Section 1.863-2 is amended as follows:

- 1. Removing “(and that is treated as derived partly from sources within and partly from sources without the United States)” from the third sentence of paragraph (a) and adding a colon at the end of the paragraph.
- 2. Revising paragraph (b).

The revision reads as follows:

**§ 1.863-2 Allocation and apportionment of taxable income.**

\* \* \* \* \*

(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 or apportioned to sources within and without the United States pursuant to §§ 1.863-1, 1.863-3, 1.863-4, 1.863-8, and 1.863-9. 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 § 1.863-1 for natural resources and § 1.863-3 for all other sales of inventory property. Section 1.865-3 may apply instead of the provisions in this part to source gross income from sales of personal property (including inventory property) by nonresidents attributable to an office or other fixed place of business in the United States. To determine the source of income partly from sources within a possession of the United States, including income described in

paragraph (a)(3) of this section, see § 1.863-3(e).

\* \* \* \* \*

■ **Par. 4.** Section 1.863-3 is amended as follows:

- 1. Revising paragraphs (a) and (b).
- 2. Removing “and sales activity” from the heading in paragraph (c).
- 3. In paragraph (c)(1)(i)(A):
  - i. Removing “(g)(2)(ii)” and adding in its place “(f)(2)(ii)”;
  - ii. Removing “the income attributable to production activity” and adding in its place “gross income”; and
  - iii. Removing “(c)(1)(ii)” and adding in its place “(c)(2)”.
- 4. Removing “(g)(2)(ii)” from paragraph (c)(1)(i)(B) and adding in its place “(f)(2)(ii)”.
- 5. Removing “within the United States and within foreign countries” from the heading to paragraph (c)(1)(ii) and adding in its place “within and without the United States”.
- 6. Removing “income attributable to the taxpayer’s production activity” from paragraph (c)(1)(ii)(A) and adding in its place “gross income”.
- 7. In paragraph (c)(1)(iii):
  - i. Removing “(c)(1)” from the first and second sentences and adding in its place “(c)”;
  - ii. Removing “by manipulating the formula described in paragraph (c)(1)(ii)(A) of this section”;
  - iii. Removing “production income” and adding in its place “gross income”; and
  - iv. Removing “income from production activity” and adding in its place “gross income”.
- 8. Removing paragraph (c)(2) and the paragraph designation and heading for (c)(1);
- 9. In paragraphs (c)(i) through (iv), redesignating the paragraphs in the first column as the paragraphs in the second column:

Old paragraphs	New paragraphs
(c)(i) .....	(c)(1)
(c)(i)(A) .....	(c)(1)(i)
(c)(i)(B) .....	(c)(1)(ii)
(c)(i)(C) .....	(c)(1)(iii)
(c)(ii) .....	(c)(2)
(c)(ii)(A) .....	(c)(2)(i)
(c)(ii)(B) .....	(c)(2)(ii)
(c)(iii) .....	(c)(3)
(c)(iv) .....	(c)(4)

- 10. Revising newly redesignated paragraph (c)(2)(ii).
- 11. In newly redesignated paragraph (c)(4):
  - i. In the introductory text, removing “(c)(1)” and adding in its place “(c)”;
  - ii. Designating *Examples 1, 2, and 3* as paragraphs (c)(4)(i) through (iii).

- 12. In newly designated paragraph (c)(4)(i):
  - i. Removing “production” from the heading and adding in its place “gross”; and
  - ii. Redesignating paragraphs (c)(1)(i)(i) and (ii) as paragraphs (c)(4)(i)(A) and (B).
- 13. In newly redesignated paragraph (c)(4)(i)(A), removing the ninth sentence.
- 14. In newly redesignated paragraph (c)(4)(i)(B):
  - i. Removing “production”, “one half of”, and “or \$6,” from the first sentence;
  - ii. Removing “production” from the second sentence; and
  - iii. In the last sentence, removing “\$2” and “\$6” and adding in their places “\$4” and “\$12”, respectively.
- 15. In newly designated paragraph (c)(4)(ii):
  - i. Removing “*Example 1*” from the first sentence and adding in its place “in paragraph (c)(4)(i)(A) of this section (*Example 1*)”; and
  - ii. Removing “from production activity” from the second sentence.
- 16. In newly designated paragraph (c)(4)(iii), redesignating paragraphs (c)(4)(iii)(i) and (ii) as paragraphs (c)(4)(iii)(A) and (B).
- 17. In newly redesignated paragraph (c)(4)(iii)(A):
  - i. Removing “*Example 1*” from the first sentence and adding in its place “in paragraph (c)(4)(i)(A) of this section (*Example 1*)”; and
  - ii. Removing “(c)(1)(ii)” and “production income” from the fourth sentence and adding in their places “(c)(2)” and “gross income”, respectively.
- 18. In newly redesignated paragraph (c)(4)(iii)(B):
  - i. Removing “(c)(1)(ii)(A)” from the first sentence and adding in its place “(c)(2)(i)”;
  - ii. Removing “production income” from the second sentence and adding in its place “gross income”.
- 19. Revising paragraph (d).
- 20. Removing paragraph (e).
- 21. Redesignating paragraph (f) as paragraph (e).
- 22. Revising newly redesignated paragraphs (e)(1) and (2) and (e)(3)(i).
- 23. Removing “(f)(3)(ii)” from newly redesignated paragraph (e)(3)(ii)(B) introductory text and adding in its place “(e)(3)(ii)”.
- 24. Revising newly redesignated paragraph (e)(3)(ii)(C)(1).
- 25. Removing newly redesignated paragraph (e)(4).
- 26. Further redesignating paragraph (e)(3)(iii) as paragraph (e)(4).
- 27. In newly redesignated paragraph (e)(4):

- i. Removing “(f)(3)(ii)” from the introductory text and adding in its place “(e)(3)(ii)”;
- ii. Designating *Examples 1 and 2* as paragraphs (e)(4)(i) and (ii).
- 28. In newly designated paragraph (e)(4)(i), redesignating paragraphs (e)(4)(i)(i) and (ii) as paragraphs (e)(4)(i)(A) and (B).
- 29. In newly designated paragraph (e)(4)(ii), redesignating paragraphs (e)(4)(ii)(i) and (ii) as paragraphs (e)(4)(ii)(A) and (B).
- 30. In newly redesignated paragraph (e)(4)(ii)(A), removing “*Example 1*” and adding “paragraph (e)(4)(i)(A) of this section (*Example 1*)”.
- 31. Removing “(f)” from newly redesignated paragraph (e)(5) and adding in its place “(e)” and removing “(g)” and adding in its place “(f)”.
- 32. Removing newly redesignated paragraph (e)(6).
- 33. Redesignating paragraph (g) as paragraph (f).
- 34. In newly redesignated paragraph (f)(1), removing “(g)(2)” and adding in its place “(f)(2)”.
- 35. In newly redesignated paragraph (f)(2)(ii), removing “(g)(2)(i)” and adding in its place “(f)(2)(i)” and removing “(c)(1)(ii)(B)” and adding in its place “(c)(2)(ii)”.
- 36. Removing newly redesignated paragraph (f)(2)(iv).
- 37. In newly redesignated paragraph (f)(3):
  - i. Removing “(g)” from the introductory text and adding in its place “(f)”;
  - ii. Designating *Examples 1 and 2* as paragraphs (f)(3)(i) and (ii).
- 38. In newly designated paragraph (f)(3)(ii):
  - i. Removing “*Example 1*” from the first sentence and adding in its place “paragraph (f)(3)(i) of this section (*Example 1*)”;
  - ii. Removing “these regulations” in the fourth sentence and adding in its place “this section”;
  - iii. Removing the fifth sentence; and
  - iii. Removing “(1)” from the last sentence.
- 39. Redesignating paragraph (h) as (g) and revising newly redesignated paragraph (g).

The revisions read as follows:

**§ 1.863-3 Allocation and apportionment of income from certain sales of inventory.**

(a) *In general*—(1) *Scope*. Subject to the rules of § 1.865-3, paragraphs (a) through (d) of this section apply to determine the source of income derived from the sale of inventory property (inventory) that a taxpayer produces (in whole or in part) within the United States and sells without the United

States, or that a taxpayer produces (in whole or in part) without the United States and sells within the United States (Section 863(b)(2) Sales). See section 865(i)(1) for the definition of inventory. Paragraph (b) of this section provides that the source of gross income from the sale or exchange of inventory in Section 863(b)(2) Sales is based solely on the production activities with respect to the inventory. Paragraph (c) of this section describes how to determine source based on production activity, including where inventory is produced partly within the United States and partly without the United States. Paragraph (d) of this section determines taxable income from Section 863(b)(2) Sales. Paragraph (e) of this section applies to determine the source of certain income derived from a possession of the United States. Paragraph (f) of this section provides special rules for partnerships for all sales subject to §§ 1.863-1 through 1.863-3. Paragraph (g) of this section provides applicability dates for the rules in this section.

(2) *Cross references.* To determine the source of income derived from the sale of personal property (including inventory) by a nonresident that is attributable to the nonresident's office or other fixed place of business in the United States under section 865(e)(2), the rules of § 1.865-3 apply, and the rules of this section do not apply. To determine the source of income from sales of property produced by the taxpayer, when the property is either produced in whole or in part in space or on or under water not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States (in international water), or is sold in space or international water, the rules of § 1.863-8 apply, and the rules of this section do not apply except to the extent provided in § 1.863-8.

(b) *Sourcing based solely on production activities.* Subject to the rules of § 1.865-3, all gain, profit, and income derived from Section 863(b)(2) Sales is allocated and apportioned solely on the basis of the production activities with respect to the inventory.

(c) \* \* \*  
(2) \* \* \*

(ii) *Adjusted basis of production assets—(A) In general.* For purposes of paragraph (c)(2)(i) of this section, the adjusted basis of an asset is determined by using the alternative depreciation system under section 168(g)(2). The adjusted basis of all production assets for purposes of paragraph (c)(2)(i) of this section is determined as though such production assets were subject to the alternative depreciation system set forth

in section 168(g)(2) for the entire period that such property has been in service. The adjusted basis of the production assets is determined without regard to the election to expense certain depreciable assets under section 179 and without regard to any additional first-year depreciation provision (for example, sections 168(k), 168(l), and 168(m), and former sections 1400L(b) and 1400N(d)). 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 is determined upon a more appropriate basis.

(B) *Production assets used to produce other property.* If a production asset is used to produce inventory sold in Section 863(b)(2) Sales and 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)(2)(i) of this section will be determined under any method that reasonably reflects the portion of the asset that produces inventory sold in Section 863(b)(2) 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(b)(2) Sales produced by the asset, and the denominator of which is the gross receipts from all property produced by that asset.

\* \* \* \* \*  
(d) *Determination of source of taxable income.* Once the source of gross income has been determined under paragraph (c) of this section, the taxpayer must properly allocate and apportion under §§ 1.861-8 through 1.861-14T and 1.861-17 its expenses, losses and other deductions to its respective amounts of gross income from sources within and without the United States from its Section 863(b)(2) Sales.

(e) *Income partly from sources within a possession of the United States—(1) In general.* This paragraph (e) relates to certain sales that give rise to gains, profits, and income that are treated as derived partly from sources within the United States and partly from sources within a possession of the United States (Section 863 Possession Sales). This paragraph (e) applies to determine the source of income derived from the sale of inventory produced (in whole or in part) by the taxpayer within the United

States and sold within a possession, or produced (in whole or in part) by a taxpayer in a possession and sold within the United States (Possession Production Sales). It also applies to determine the source of income derived from the purchase of personal property within a possession of the United States and its sale within the United States (Possession Purchase Sales). A taxpayer subject to this paragraph (e) must apportion gross income from Section 863 Possession Sales under paragraph (e)(2) of this section (in the case of Possession Production Sales) or using the business activity method described in paragraph (e)(3)(i) of this section (in the case of Possession Purchase Sales). The source of gross income from each type of activity from Possession Purchase Sales must then be determined under paragraph (e)(3)(ii) of this section. The source of taxable income from Possession Production Sales is determined under paragraph (c) of this section. The source of taxable income from Section 863 Possession Sales is determined under paragraph (d) of this section.

(2) *Allocation or apportionment for Possession Production Sales.* The source of gross income from Possession Production Sales is determined under the rules of paragraph (c) of this section, except that the term *possession* of the United States is substituted for *foreign country* wherever it appears.

(3) *Allocation or apportionment for Possession Purchase Sales—(i) Determination of source of gross income for Possession Purchase Sales.* Gross income from Possession Purchase Sales is allocated in its entirety to the taxpayer's business activity, and is then apportioned between sources within the United States and sources within a possession of the United States under paragraph (e)(3)(ii) of this section.

(ii) \* \* \*

(C) \* \* \*

(1) *Sales activity.* The source of the taxpayer's income that is attributable to sales activity will be determined under the provisions of § 1.861-7(c). Notwithstanding any other provision of this part, for rules regarding the source of income when a sale takes place in space or international water, the rules of § 1.863-8 apply, and the rules of this section do not apply except to the extent provided in § 1.863-8.

\* \* \* \* \*

(g) *Applicability dates.* This section applies to taxable years ending on or after December 23, 2019. However, taxpayers may apply this section in its entirety for taxable years beginning after December 31, 2017, and ending before

December 23, 2019, provided that the taxpayer and persons that are related (within the meaning of section 267 or 707) to the taxpayer apply this section in its entirety.

■ **Par. 5.** Section 1.863–8 is amended as follows:

■ 1. Revising paragraph (b)(3)(ii)(A).

■ 2. In paragraph (b)(3)(ii)(B), removing “allocable to production activity” wherever it appears and by removing “§ 1.863–3(c)(1)” from the second sentence and adding in its place “§ 1.863–3(c)”.

■ 3. In paragraph (b)(3)(ii)(C), removing “allocable to production activity” wherever it appears and by removing “§ 1.863–3(c)(1)” from the fifth sentence and adding in its place “§ 1.863–3(c)”.

■ 4. Removing paragraph (b)(3)(ii)(D).

■ 5. Designating *Examples 1* through *14* of paragraph (f) as paragraphs (f)(1) through (14).

■ 6. In newly designated paragraphs (f)(1) through (14), removing the period between the second and third level paragraph headings and adding an em-dash in its place.

■ 7. Removing “*Example 4*” from newly designated paragraph (f)(4)(i) and adding in its place “paragraph (f)(4)(i) (*Example 4*)”.

■ 8. Removing “*Example 4*” from newly designated paragraph (f)(5)(i) and adding in its place “paragraph (f)(4)(i) of this section (*Example 4*)”.

■ 9. Revising the first, second, and third sentences of newly designated paragraphs (f)(6)(ii).

■ 10. Removing “*Example 8*” from newly designated paragraph (f)(9)(i) and adding in its place “in paragraph (f)(8)(i) of this section (*Example 8*)”.

■ 11. Removing “*Example 8*” from newly designated paragraph (f)(9)(ii) and adding in its place “paragraph (f)(8)(i) of this section (*Example 8*)”.

■ 12. Revising newly designated paragraph (f)(11)(ii).

■ 13. In paragraph (g)(1), removing “(C)” from the first sentence.

■ 14. In paragraph (g)(4) introductory text, removing “(C)” from the first sentence.

The revisions read as follows:

**§ 1.863–8 Source of income derived from space and ocean activity under section 863(d).**

\* \* \* \* \*

(b) \* \* \*

(3) \* \* \*

(ii) *Sales of property produced by the taxpayer—(A) General.* If the taxpayer both produces property and sells such property, the taxpayer must allocate and apportion all gain, profit, and income derived from sales of such property solely on the basis of the production

activities with respect to such property, and the source of that income will be determined under paragraph (b)(3)(ii)(B) or (C) of this section. To determine the source of income derived from the sale of personal property (including inventory) by a nonresident that is attributable to the nonresident’s office or other fixed place of business in the United States under section 865(e)(2), the rules of § 1.865–3 apply, and the rules of this section do not apply.

\* \* \* \* \*

(f) \* \* \*

(6) \* \* \*

(ii) *Analysis.* The collection of data and creation of images in space is characterized as the creation of property in space. Because S both produces and sells the data, the source of the gross income from the sale of the data is determined under paragraph (b)(3)(ii) of this section (by reference to § 1.863–3(c)) solely on the basis of the production activities. The source of S’s gross income is determined under § 1.863–3(c)(2) because production activities occur both in space and on land. \* \* \*

(11) \* \* \*

(ii) *Analysis.* Because S’s rights, title, and interest in the satellite pass to the customer in space, the sale takes place in space under § 1.861–7(c), and the sale transaction is space activity under paragraph (d)(1)(i) of this section. The source of income derived from the sale of the satellite in space is determined under paragraph (b)(3)(ii) of this section (by reference to § 1.863–3(c)) solely on the basis of the production activities with respect to the satellite.

\* \* \* \* \*

■ **Par. 6.** Section 1.864–6 is amended by revising paragraphs (c)(2) and (3) and adding paragraph (c)(4) to read as follows:

**§ 1.864–6 Income, gain, or loss attributable to an office or other fixed place of business in the United States.**

\* \* \* \* \*

(c) \* \* \*

(2) *Special limitation in case of sales of goods or merchandise through U.S. office.* Notwithstanding paragraph (c)(1) of this section, the special rules described in this paragraph (c)(2) apply with respect to a sale of goods or merchandise specified in § 1.864–5(b)(3), to which paragraph (b)(3)(i) of this section does not apply. In the case of a nonresident alien with a tax home within the United States, as defined in section 911(d)(3), the amount of income from the sale of goods or merchandise that is properly allocable to the individual’s U.S. office is determined under § 1.865–3(d).

(3) *Examples.* The application of this paragraph (c) may be illustrated by the following examples—

(i) *Example 1.* Nonresident alien individual A, who has a tax home in the United States, manufactures machinery in a foreign country and sells the machinery outside the United States through A’s sales office in the United States for use in foreign countries. Title to the property sold is transferred to the foreign purchaser outside the United States, but no office or other fixed place of business of A in a foreign country participates materially in the sale made through its U.S. office. By reason of its sales activities in the United States, A is engaged in business in the United States during the taxable year. During the taxable year, A derives a total income of \$250,000x from these sales. Under section 865(b)(2), all of A’s income from these sales is foreign source as production occurs outside the United States. Under paragraph (c)(2) of this section, the amount of income that is allocable to A’s U.S. office is determined under § 1.865–3(d)(2). The taxpayer does not allocate income from the sale under the books and records method described in § 1.865–3(d)(2)(ii). Thus, 50 percent of A’s foreign source income, plus any additional income allocable based on the location of production activities under §§ 1.863–3(b) and 1.865–3(d)(2)(i) (in this case, \$0x), is effectively connected for the taxable year with the conduct of A’s U.S. trade or business, or \$125,000x.

(ii) *Example 2.* Nonresident alien individual B, who has a tax home in the United States, has an office in a foreign country that purchases merchandise and sells it through B’s sales office in the United States for use in various foreign countries, with title to the property passing outside the United States. No other office of B participates materially in these sales made through its U.S. office. By reason of its sales activities in the United States, B is engaged in business in the United States during the taxable year. During the taxable year, B derives income of \$300,000x from these sales made through its U.S. sales office. Under section 865(b), all of B’s income from these sales is foreign source as title to the merchandise passes outside the United States. The amount of income properly allocable to B’s US office determined under § 1.865–3(d)(3) is \$300,000x.

(iii) *Example 3.* The facts are the same as in paragraph (c)(3)(ii) of this section (*Example 2*), except that B has an office in a foreign country which participates materially in the sales which are made through its U.S. office. The income which is allocable to B’s U.S. sales

office is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation.

(4) *Applicability date.* Paragraphs (c)(2) and (3) of this section, to the extent they apply to sales of inventory described in section 864(c)(4)(B)(iii), apply to sales occurring in taxable years ending on or after December 23, 2019. However, taxpayers may apply this section in its entirety for taxable years beginning after December 31, 2017, and ending before December 23, 2019, provided that the taxpayer and persons that are related (within the meaning of section 267 or 707) to the taxpayer apply this section in its entirety.

■ **Par. 7.** Section 1.865-3 is added to read as follows:

**§ 1.865-3 Source of income from sales of personal property (including inventory property) by a nonresident attributable to an office or other fixed place of business in the United States.**

(a) *In general.* Notwithstanding any other provisions of sections 861 through 865 or the regulations in this part except paragraph (b) of this section, if a nonresident, as defined in section 865(g)(1)(B), maintains an office or other fixed place of business in the United States, income from any sale of personal property (including inventory property) attributable to such office or other fixed place of business (as determined under paragraph (c) of this section) is sourced in the United States in an amount described in paragraph (d) of this section. See section 865(i)(1) for the definition of inventory property.

(b) *Exceptions for inventory property.* Paragraph (a) of this section does not apply with respect to the income derived by a nonresident from any sale of inventory property that is sold for use, disposition, or consumption outside the United States if an office or other fixed place of business of the nonresident in a foreign country materially participated in the sale. See § 1.864-6(b)(3) to determine whether a foreign office materially participated in the sale and whether the property was destined for foreign use.

(c) *Attribution of a sale to a United States office.* In determining whether a sale of personal property by a nonresident is attributable to an office or other fixed place of business in the United States, the principles of section 864(c)(5)(B) as prescribed in § 1.864-6(b) and (c) apply. The rule in this paragraph (c) applies without regard to whether the property is described in § 1.864-5(b)(3)(iii). In determining whether a nonresident maintains an office or other fixed place of business in

the United States, the principles of section 864(c)(5)(A) as prescribed in § 1.864-7 apply, including the rules of paragraph (d) of that section regarding the office or fixed place of business of a dependent agent of the nonresident.

(d) *Amount of income or loss on sale of personal property attributable to a U.S. office—(1) In general.* Subject to the special rules described in paragraphs (d)(2), (3), and (4) of this section, the amount of income, gain, or loss from the sale of personal property attributable to an office or other fixed place of business in the United States is determined under § 1.864-6(c)(1).

(2) *Produced inventory property—(i) In general.* With respect to income from the sale of inventory property subject to paragraph (a) of this section that is produced by a nonresident, 50 percent of the gross income from such sale is properly allocable to the office or fixed place of business in the United States. The remaining 50 percent of the gross income is allocable to production activities and is sourced in accordance with § 1.863-3 (the “50/50 method”). However, in lieu of the 50/50 method, a taxpayer may elect to allocate income from the sale of inventory property that is produced by a nonresident under the books and records method described in paragraph (d)(2)(ii) of this section, provided it satisfies all of the requirements described in that paragraph to the satisfaction of the Commissioner. For purposes of this paragraph (d)(2)(i), the term “produced” includes created, fabricated, manufactured, extracted, processed, cured, and aged. See section 864(a) and § 1.864-1.

(ii) *Books and records method—(A) Method.* A taxpayer may elect to determine the amount of its gross income from the sale of inventory property subject to paragraph (a) of this section and produced by a nonresident that is allocable to production and sales activities for the taxable year based upon its books of account. The taxpayer must establish that the taxpayer, in good faith and unaffected by considerations of tax liability, regularly employs in its books of account a detailed allocation of receipts and expenditures that clearly reflects the amount of the taxpayer’s gross income from its inventory sales that is attributable to its sales activities, and gross income from sales that is attributable to its production activities under the principles of section 482. For purposes of this paragraph (d)(2)(ii)(A), section 482 principles will apply as if the office or fixed place of business in the United States were a separate taxpayer from the nonresident (whether or not payments are made between the

United States office or other fixed place of business and the nonresident taxpayer’s other offices). The gross income allocable to sales activity under this method is treated as properly allocable to the office or other fixed place of business in the United States.

The gross income allocable to production activities is sourced in accordance with § 1.863-3.

(B) *Election and reporting rules—(1) In general.* A taxpayer making an allocation of gross income under the books and records method in paragraph (d)(2)(ii)(A) of this section must satisfy the requirements of paragraphs (d)(2)(ii)(B)(2) and (3) of this section. Failure to satisfy the requirements in paragraphs (d)(2)(ii)(B)(2) and (3) in full and to the satisfaction of the Commissioner will result in application of the 50/50 method specified in paragraph (d)(2)(i) of this section.

(2) *Required records.* A taxpayer electing the books and records method under paragraph (d)(2)(ii)(A) of this section must prepare and maintain records that are in existence when its return is filed regarding the allocation of gross income between sales and production activities in its books of account. The taxpayer must also prepare an explanation of how such allocation clearly reflects the taxpayer’s income from production and sales activities under the principles of section 482. The taxpayer must make available such explanation and records for both the U.S. sales office and the entity or entities that perform the production activities upon request of the Commissioner, generally within 30 days or some other time period as agreed between the Commissioner and the taxpayer.

(3) *Disclosure on a tax return.* A taxpayer who chooses to apply the books and records method under paragraph (d)(2)(ii)(A) of this section must indicate in a statement attached to a timely filed return (including extensions) that it elects to apply such method and has prepared the records described in paragraph (d)(2)(ii)(B)(2) of this section.

(3) *Purchased inventory property.* With respect to income from the sale of inventory property subject to paragraph (a) of this section that is purchased by the nonresident, the entire income from such sale is properly allocable to the office or other fixed place of business in the United States.

(4) *Depreciable personal property.* With respect to income from the sale of depreciable personal property subject to paragraph (a) of this section—

(i) The gain not in excess of the depreciation adjustments is allocable to

an office or other fixed place of business in the United States to the same extent that the gain would be allocated to sources within the United States under the rules of section 865(c)(1). The remaining gain not in excess of the depreciation adjustments is allocated to sources without the United States in accordance with section 865(c)(1). However, notwithstanding the preceding sentences, if the property was predominantly used in the United States, within the meaning of section 865(c)(3)(B)(i), for a specific year, all of the gain not in excess of depreciation for that year is allocated to sources within the United States.

(ii) The gain in excess of the depreciation adjustments is treated as if such property were inventory and is sourced under paragraph (d)(2) or (3) of this section as applicable.

(e) *Determination of source of taxable income.* For rules allocating and apportioning expenses to income effectively connected with the conduct of a trade or business in the United States, see §§ 1.882–4 and 1.882–5.

(f) *Export trade corporations.* This section is not applicable for purposes of defining an export trade corporation under section 971.

(g) *Applicability date.* This section applies to sales occurring in taxable years ending on or after December 23, 2019. However, taxpayers may apply this section in its entirety for taxable years beginning after December 31, 2017, and ending before December 23, 2019, provided that the taxpayer and persons that are related (within the meaning of section 267 or 707) to the taxpayer apply this section in its entirety.

#### § 1.937–2 [Amended]

■ Par. 8. Section 1.937–2 is amended by removing “§ 1.863–3(f)” from paragraph (d) and adding in its place “§ 1.863–3(e)”.

#### § 1.937–3 [Amended]

■ Par. 9. Section 1.937–3 is amended by removing “§ 1.863–3(f)” from paragraph (d) and adding in its place “§ 1.863–3(e)”.

■ Par. 10. Section 1.1502–13, as proposed to be amended at 83 FR 67490 (December 28, 2018), is further amended by revising paragraph (c)(7)(ii)(N) to read as follows:

#### § 1.1502–13 Intercompany transactions.

\* \* \* \* \*

(c) \* \* \*

(7) \* \* \*

(ii) \* \* \*

(N) *Example (14): Source of income under section 863—(1) Intercompany sale—(i) Facts.* S manufactures inventory property solely in the United States, and recognizes \$75x of income on sales to B in Year 1. B conducts further production activity on the inventory property solely in Country Y and then sells the inventory property to X in Country Y and recognizes \$25x of income on the sale to X, also in Year 1. Title passes from S to B, and from B to X, in Country Y. Assume that applying § 1.863–3 on a single entity basis, including the formula for apportionment of multi-country production activities by reference to the basis of production assets, \$10x is treated as foreign source income and \$90x is treated as U.S. source income (that is, 10 percent of the production occurred outside the United States and 90 percent occurred within the United States, as measured by the basis of assets used in production activities with respect to the property). Assume further that, on a separate entity basis, S would have \$0 of foreign source income and \$75x of U.S. source income and all of B’s \$25x of income would be foreign source income.

(ii) *Analysis.* Under the matching rule, both S’s \$75x intercompany income and B’s \$25x corresponding income are taken into account in Year 1. In determining the source of S and B’s income from the inventory property sales, the attributes of S’s intercompany item and B’s corresponding item are redetermined to the extent necessary to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation. See paragraph (c)(1)(i) of this section. On a separate entity basis, S would have \$75x of U.S. source income because the product would be treated as produced wholly in the United States and sold outside the United States, and B would have \$25x of foreign source income because the product would be treated as produced wholly outside the United States and sold outside the United States. On a single entity basis, S and B are treated as divisions of a single corporation, and section 863 applies as if \$100x of income were recognized from producing partly in the United States and partly in Country Y and selling in Country Y. This results in \$10x of foreign source income and \$90x of U.S. source income. Accordingly, under single entity

treatment, \$15x of B’s sales income that would be treated as foreign source income on a separate entity basis is redetermined to be U.S. source income. Under paragraph (c)(1)(i) of this section, attributes are redetermined only to the extent of the \$15x necessary to achieve the same effect as if S and B were divisions of a single corporation. Under paragraph (c)(4)(ii) of this section, the redetermined attribute must be allocated between S and B using a reasonable method. In this case, only B would have foreign source income on a separate entity basis, and thus \$15x of B’s foreign source income must be recharacterized as U.S. source income.

(2) *Sale of property reflecting intercompany services or intangibles—(i) Facts.* S earns \$10x of income performing services in the United States for B. B capitalizes S’s fees into the basis of inventory property that it manufactures in the United States and sells to an unrelated person in Year 1 at a \$90x profit, with title passing in Country Y. Assume that on a single entity basis, \$100x is treated as U.S. source income and \$0 is treated as foreign source income. Further assume that on a separate entity basis, S would have \$10x of U.S. source income, and B would have \$90x of U.S. source income, with neither having any foreign source income.

(ii) *Analysis.* Under the matching rule, S’s \$10x income and B’s \$90x income are taken into account in Year 1. In determining the source of S and B’s income, the attributes of S’s intercompany item and B’s corresponding item are redetermined to the extent necessary to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation, such that section 863 applies as if \$100x were earned from manufacturing in the United States and selling in Country Y. Because the results are the same on a single entity basis and a separate entity basis (\$100x of U.S. source income and \$0x of foreign source income), the attributes are not redetermined under paragraph (c)(1)(i) of this section.

\* \* \* \* \*

**Sunita Lough,**

*Deputy Commissioner for Services and Enforcement.*

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