[4830-01-u]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 8786]

RIN 1545-AU79

Source of Income From Sales of Inventory Partly From Sources Within a Possession of the United States; Also, Source of Income Derived From Certain Purchases From a Corporation Electing Section 936

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under section 863 governing the source of income from sales of inventory produced in the United States and sold in a possession of the United States or produced in a possession of the United States and sold in the United States; final regulations under section 863 governing the source of income from sales of inventory purchased in a possession of the United States and sold in the United States; and final regulations under section 936 governing the source of income of a taxpayer from the sale in the United States of property purchased from a corporation that has an election under section 936 in effect. This document affects persons who produce (in whole or in part) inventory in the United States and sell in a possession, or produce (in whole or in part) inventory in a possession and sell in the United States, as well as persons who purchase inventory in a possession and sell in the

United States, and also persons who sell in the United States property purchased from a corporation that has a section 936 election in effect.

DATES: Effective Date. These regulations are effective November 13, 1998.

Applicability Date. These regulations apply to taxable years beginning on or after November 13, 1998.

FOR FURTHER INFORMATION CONTACT: Anne Shelburne, (202) 874-1305 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this final regulation has been reviewed and approved by the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-1556. Responses to this collection of information are mandatory.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The estimated average annual burden per respondent is approximately 2.5 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224, and the **Office of Management and**

Budget, Attn: Desk Officer for the Department of Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains final regulations under section 863 of the Internal Revenue Code (Code), providing rules to source income from cross-border sales of certain property, where the property is manufactured in a possession of the United States and sold in the United States, or vice versa, or purchased in a possession and sold in the United States. These regulations also contain rules under section 936 to source income of a taxpayer from the sale in the United States of property purchased from a corporation that has an election under section 936 in effect.

On October 10, 1997, proposed regulations [REG-251985-96] were published in the **Federal Register** (62 FR 52953). Having considered the comments, the IRS and the Treasury Department adopt the proposed regulations without significant change in this Treasury decision.

Explanation of Provisions

I. <u>Income Partly From Sources Within a Possession</u>

Section 863 authorizes the Secretary to promulgate regulations allocating or apportioning, to sources within or without the United States, all items of gross income, expenses, losses, and deductions other than those items specified in sections 861(a) and 862(a).

Guidance in these regulations to determine the source of possession income under section 863 concerns two types of transactions: transactions described in section 863(b)(2) for property produced in the United States and sold in a possession (or vice versa), and transactions described in section 863(b)(3) for property purchased in a possession and sold in the United States (collectively, Section 863 Possession Sales).

1. Methods for allocating or apportioning gross income from Section 863 Possession Sales

a. Property produced and sold

Under the final regulations, income from sales of inventory produced in the United States and sold in a possession of the United States or produced in a possession and sold in the United States (collectively, Possession Production Sales), is allocated or apportioned according to one of three methods.

Paragraph (f)(2)(i)(A) of the regulations makes the 50/50 method the general rule to allocate gross income from Possession Production Sales between production activity and business sales activity, so that the income from each type of activity can then be apportioned between U.S. and foreign sources. The taxpayer, however, may elect to apply the independent factory price (IFP) method (described in paragraph (f)(2)(i)(B)), or, with the consent of the District Director, the books and records method (described in paragraph (f)(2)(i)(C)).

Under the possession 50/50 method, the final regulations allocate half of the taxpayer’s gross income from Possession Production Sales to production activity and half to business sales activity. The income is then apportioned between U.S. and possession sources based on a property fraction and a business sales activity fraction.

The final regulations apply the property fraction in §1.863-3(c) to apportion the half of a taxpayer's income allocated to production activity. Thus, income is apportioned to the United States or to a possession or to other foreign sources based on the location of the taxpayer's production assets. Consistent with the changes made to the regulations under §1.863-3(c), production assets are defined as tangible and intangible assets owned directly by the taxpayer that are directly used by the taxpayer to produce inventory sold in Possession Production Sales. Production assets are included in the fraction at their adjusted tax basis, consistent with the changes made to the regulations under §1.863-3(c).

The other half of the taxpayer's gross income, allocated to business sales activity, is apportioned according to a business sales activity fraction. The portion of this income that is possession source income is determined by multiplying the income by a fraction, the numerator being the business sales activity of the taxpayer in the possession, and the denominator being the business sales activity of the taxpayer within the possession and outside the possession. The remaining income is sourced in the United States. Although some of the business sales activity factors not incurred in a possession may be incurred in a foreign country, Treasury and the IRS believe that the business sales activity fraction is only intended to source the business sales activity portion of Possession Production Sales outside the United States to the extent of business sales activity located in a possession.

Under the final regulations, as opposed to the current regulations, business sales activity is measured by the sum of certain expenses, including amounts paid for labor, materials, advertising, and marketing (but excluding any expenses or other amounts that are nondeductible under section 263A, interest, and research and development), plus receipts for the sale of goods. This formula is intended to reflect better the business sales activity producing the income by including more of the factors responsible for producing that income. Also, cost of goods sold is now excluded from the business sales activity fraction apportioning income from Possession Production Sales, because such costs generally reflect production activity. Production activity is already represented in the formula by the one-half of the taxpayer's income apportioned according to the location of production assets.

The final regulations provide explicit guidance for attributing business sales activity between the United States and a possession. In attributing business sales activity between the United States and a possession, expenses are allocated and apportioned between the United States and a possession based on the rules in §§1.861-8 through 1.861-14T. Gross sales are allocated to the United States or a possession based on the place of sale.

The final regulations make the IFP method elective, and thus eliminate any bias against taxpayers choosing to export through independent distributors. The regulations rely upon the regulations under §1.863-3 for rules in applying the IFP method.

The final regulations permit taxpayers to request permission from the District Director to use their books and records to determine the source of their income. The final regulations refer to §1.863-3(b)(3) in applying the method to Possession Production Sales.

b. Property purchased and sold

Paragraph (f)(3)(i)(A) makes the business activity method the general rule to apportion income between the United States and a possession, from sales of property purchased in a possession and sold in the United States (Possession Purchase Sales). The taxpayer may, however, elect to apply, with consent of the District Director, the books and records method.

The final regulations apportion the taxpayer's income from Possession Purchase Sales on the basis of a business activity fraction. The portion of this income that is possession source income is determined by multiplying the income by a fraction, the numerator being the business of the taxpayer in the possession, and the denominator being the business of the taxpayer within the possession and outside the possession. The remaining income is sourced in the United States.

The business activity fraction is similar to the business sales activity fraction discussed previously, used to apportion the taxpayer's income in Possession Production Sales, except that the fraction applies only to expenses, cost of goods sold, and sales attributable to Possession Purchase Sales. In addition, the business activity fraction apportioning Possession Purchase Sales includes amounts paid for cost of goods sold. Such costs are attributed to the possession, however, only to the extent the property purchased is manufactured, produced, grown, or extracted in the possession. Treasury and the Internal Revenue Service anticipate that if a taxpayer acts in the reasonable belief that the products were manufactured in the possession, the taxpayer could act on that basis in preparing its tax return. The business activity fraction reflects the view of Treasury and the IRS that the purchase rule of section 863(b)(3) was intended to apply only to purchase and resale transactions where the goods purchased are created or derived from the possession.

The final regulations permit taxpayers to request permission from the District Director to use their books and records to determine the source of their income. The proposed regulations refer to §1.863-3(b)(3) in applying the method to Possession Purchase Sales.

2. Determination of source of gross income

Under the final regulations, once gross income attributable to production activity, business activity, or sales activity has been determined under one of the prescribed methods, the source of the gross income is determined separately for each type of income. The source of gross income attributable to production activity (when applying the possession 50/50 method) is determined under paragraph (c)(1), based on the location of production assets. The source of gross income attributable to sales activity (when applying the IFP method or the books and records method) is determined under paragraph (c)(2), based generally on the location of the sale. The source of gross income attributable to business sales activity (when applying the possession 50/50 method) is determined under paragraph (f)(2)(ii)(B), based on expenses and gross sales attributable to Possession Production Sales. The source of gross income attributable to business activity (when applying the business activity method) is determined under paragraph (f)(3)(ii), based on expenses, cost of goods sold, and gross sales attributable to Possession Purchase Sales.

3. Determination of source of taxable income

Once the source of gross income is determined under paragraph (f)(2) or (3), taxpayers then determine the source of taxable income. Under paragraph (f)(4), taxpayers must allocate and apportion under §§1.861-8 through 1.861-14T the amounts of expenses, losses and other deductions to gross income determined under each of the prescribed methods. In the case of amounts of expenses, losses and other deductions allocated and apportioned to gross income determined under the IFP method or the books and records method, the taxpayer must apply the rules of §§1.861-8 through 1.861-14T to allocate and apportion these amounts between gross income from sources within the United States and within a possession. However, for expenses, losses and other deductions allocated and apportioned to gross income determined under the possessions 50/50 method or gross income from Possession Purchase Sales determined under the business activity method, taxpayers must apportion expenses and other deductions pro rata based on the relative amounts of U.S. and possession source gross income. Nevertheless, the research and experimental (R&E) expense allocation rules in §1.861-17 apply to taxpayers using the 50/50 method, so that the R&E set aside (described in §1.861-17) remains available to such taxpayers.

4. Treatment of gross income derived from certain purchases from a corporation that has an election in effect under section 936

The final regulations clarify that section 863 does not apply to determine the source of a taxpayer's gross income derived from a purchase of inventory from a corporation that has an election in effect under section 936, if the taxpayer's income from sales of that inventory is taken into account to determine benefits under section 936(h)(5)(C) for the section 936 corporation.

5. Treatment of partners and partnerships

The final regulations rely on the rules in §1.863-3(g) for determining the appropriate treatment in transactions involving partnerships. Under those rules, the aggregate approach applies to a partnership’s production and sales activity for two purposes only. First, the aggregate approach applies in determining the character of a partner’s distributive share of partnership income. Second, the aggregate approach applies in sourcing income from sales of inventory property that is transferred in-kind from or to a partnership.

6. Election and reporting rules

Under paragraph (f)(6)(i) of the final regulations, a taxpayer must use the 50/50 method to determine the source of income from Possession Production Sales unless the taxpayer elects to use the IFP method, or elects the books and records method. For Possession Purchase Sales, a taxpayer must use the business activity method, unless the taxpayer elects the books and records method. The taxpayer makes an election by using the method on its timely filed original tax return. That method must be used in later taxable years unless the Commissioner or his delegate consents to a change. Permission to change methods in later years will be granted unless the change would result in a substantial distortion of the source of income.

A taxpayer must fully explain the methodology used in applying either paragraph (f)(2) or (3), and the amount of income allocated or apportioned to U.S. and foreign sources, in a statement attached to its tax return.

II. <u>Income Derived From Certain Purchases From a Corporation</u>

That Has an Election in Effect Under Section 936

These regulations clarify that, where a taxpayer purchases a product from a corporation that has an election in effect under section 936, the source of the taxpayer's gross income derived from sales of that product (in whatever form sold) in the United States is U.S. source, if the taxpayer's income from sales of that product is taken into account to determine benefits under section 936(h)(5)(C)(i) for the section 936 corporation. The taxpayer's income is U.S. source without regard to whether a possession product is a component, end-product form, or integrated product. No inference should be drawn concerning the treatment of transactions involving sales of property purchased from a section 936 corporation entered into before the regulations are applicable.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the rules of this section principally impact large multinationals who pay foreign taxes on substantial foreign operations and therefore the rules will impact very few small entities. Moreover, in those few instances where the rules of this section impact small entities, the economic impact on such entities is not likely to be significant.

Accordingly, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Anne Shelburne, Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by revising the entry for "Section 1.863-3", removing the entry for "Sections 1.936-4 through 1.936-7" and adding entries in numerical order to read as follows:

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

Section 1.863-3 also issued under 26 U.S.C. 863(a) and (b), and 26 U.S.C. 936(h).***

Section 1.936-4 also issued under 26 U.S.C. 936(h).

Section 1.936-5 also issued under 26 U.S.C. 936(h).

Section 1.936-6 also issued under 26 U.S.C. 863(a) and (b), and 26 U.S.C. 936(h).

Section 1.936-7 also issued under 26 U.S.C. 936(h).***

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

1. Paragraph (f) is revised.

2. Paragraph (h) is amended by adding a sentence at the end of the paragraph.

The revision and addition read as follows:

<u>§1.863-3 Allocation and apportionment of income from certain sales of inventory</u>.

* * * * *

(f) <u>Income partly from sources within a possession of the United States</u>--(1) <u>In general</u>. This paragraph (f) relates to gains, profits, and income, which 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 (f) 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 (f) must divide gross income from Section 863 Possession Sales using one of the methods described in either paragraph (f)(2)(i) of this section (in the case of Possession Production Sales) or paragraph (f)(3)(i) of this section (in the case of Possession Purchase Sales). Once a taxpayer has elected a method, the taxpayer must separately apply that method to the applicable category of Section 863 Possession Sales in the United States and to those in a possession. The source of gross income from each type of activity must then be determined under either paragraph (f)(2)(ii) or (3)(ii) of this section, as appropriate. The source of taxable income from Section 863 Possession Sales is determined under paragraph (f)(4) of this section. The taxpayer must apply the rules for computing gross and taxable income by aggregating all Section 863 Possession Sales to which a method in this section applies after separately applying that method to Section 863 Possession Sales in the United States and to Section 863 Possession Sales in a possession. This section does not apply to determine the source of a taxpayer’s gross income derived from a sale of inventory purchased from a corporation that has an election in effect under section 936, if the taxpayer’s income from sales of that inventory is taken into account to determine benefits under section 936 for the section 936 corporation. For rules to be applied to determine the source of such income, see §1.936-6(a)(5) Q&A 7a and 1.936-6(b)(1) Q&A 13.

(2) <u>Allocation or apportionment for Possession Production</u>

Sales--(i) Methods for determining the source of gross income for Possession Production Sales--(A) Possession 50/50 method. Under the possession 50/50 method, gross income from Possession Production Sales is allocated between production activity and business sales activity as described in this paragraph (f)(2)(i)(A). Under the possession 50/50 method, one-half of the taxpayer's gross income will be considered income attributable to production activity and the source of that income will be determined under the rules of paragraph (f)(2)(ii)(A) of this section. The remaining one-half of such gross income will be considered income attributable to business sales activity and the source of that income will be determined under the rules of paragraph (f)(2)(ii)(B) of this section.

(B) IFP method. In lieu of the possession 50/50 method, a taxpayer may elect the independent factory price (IFP) method. Under the IFP method, gross income from Possession Production Sales is allocated to production activity or sales activity using the IFP method, as described in paragraph (b)(2) of this section, if an IFP is fairly established under the rules of paragraph (b)(2) of this section. See paragraphs (f)(2)(ii)(A) and (C) of this section for rules for determining the source of gross income attributable to production activity and sales activity.

(C) Books and records method. A taxpayer may elect to allocate gross income using the books and records method described in paragraph (b)(3) of this section, if it has received in advance the permission of the District Director having audit responsibility over its return. See paragraph (f)(2)(ii) of this section for rules for determining the source of gross income.

(ii) Determination of source of gross income from production, business sales, and sales activity--(A) Gross income attributable to production activity. The source of gross income from production activity is determined under the rules of paragraph (c)(1) of this section, except that the term possession is substituted for foreign country wherever it appears.

(B) Gross income attributable to business sales activity--(1) Source of gross income. Gross income from the taxpayer's business sales activity is sourced in the possession in the same proportion that the amount of the taxpayer's business sales activity for the taxable year within the possession bears to the amount of the taxpayer's business sales activity for the taxable year both within the possession and outside the possession, with respect to Possession Production Sales. The remaining income is sourced in the United States.

(2) Business sales activity. For purposes of this paragraph (f)(2)(ii)(B), the taxpayer's business sales activity is equal to the sum of--

(i) The amounts for the taxable period paid for wages, salaries, and other compensation of employees, and other expenses attributable to Possession Production Sales (other than amounts that are nondeductible under section 263A, interest, and research and development); and

(ii) Possession Production Sales for the taxable period.

(3) Location of business sales activity. For purposes of determining the location of the taxpayer's business activity within a possession, the following rules apply:

(i) Sales. Receipts from gross sales will be attributed to a possession under the provisions of paragraph (c)(2) of this section.

(ii) Expenses. Expenses will be attributed to a possession under the rules of §§1.861-8 through 1.861-14T.

(C) Gross income attributable to sales activity. The source of the taxpayer's income that is attributable to sales activity, as determined under the IFP method or the books and records method, will be determined under the provisions of paragraph (c)(2) of this section.

(3) Allocation or apportionment for Possession Purchase Sales--(i) Methods for determining the source of gross income for Possession Purchase Sales--(A) Business activity method. Gross income from Possession Purchase Sales is allocated in its entirety to the taxpayer's business activity, and is then apportioned between U.S. and possession sources under paragraph (f)(3)(ii) of this section.

(B) Books and records method. A taxpayer may elect to allocate gross income using the books and records method described in paragraph (b)(3) of this section, subject to the conditions set forth in paragraph (b)(3) of this section. See paragraph (f)(2)(ii) of this section for rules for determining the source of gross income.

(ii) Determination of source of gross income from business activity--(A) Source of gross income. Gross income from the taxpayer's business activity is sourced in the possession in the same proportion that the amount of the taxpayer's business activity for the taxable year within the possession bears to the amount of the taxpayer's business activity for the taxable year both within the possession and outside the possession, with respect to Possession Purchase Sales. The remaining income is sourced in the United States.

(B) Business activity. For purposes of this paragraph (f)(3)(ii), the taxpayer's business activity is equal to the sum of--

(1) The amounts for the taxable period paid for wages, salaries, and other compensation of employees, and other expenses attributable to Possession Purchase Sales (other than amounts that are nondeductible under section 263A, interest, and research and development);

(2) Cost of goods sold attributable to Possession Purchase Sales during the taxable period; and

(3) Possession Purchase Sales for the taxable period.

(C) Location of business activity. For purposes of determining the location of the taxpayer's business activity within a possession, the following rules apply:

(1) Sales. Receipts from gross sales will be attributed to a possession under the provisions of paragraph (c)(2) of this section.

(2) Cost of goods sold. Payments for cost of goods sold will be properly attributable to gross receipts from sources within the possession only to the extent that the property purchased was manufactured, produced, grown, or extracted in the possession (within the meaning of section 954(d)(1)(A)).

(3) Expenses. Expenses will be attributed to a possession under the rules of §§1.861-8 through 1.861-14T.

(iii) Examples. The following examples illustrate the rules of paragraph (f)(3)(ii) of this section relating to the determination of source of gross income from business activity:

Example 1. (i) U.S. Co. purchases in a possession product X for $80 from A. A manufactures X in the possession. Without further production, U.S. Co. sells X in the United States for $100. Assume U.S. Co. has sales and administrative expenses in the possession of $10.

(ii) To determine the source of U.S. Co.'s gross income, the $100 gross income from sales of X is allocated entirely to U.S. Co.'s business activity. Forty-seven dollars of U.S. Co.'s gross income is sourced in the possession. [Possession expenses ($10) plus possession purchases (i.e., cost of goods sold) ($80) plus possessions sales ($0), divided by total expenses ($10) plus total purchases ($80) plus total sales ($100).] The remaining $53 is sourced in the United States.

Example 2. (i) Assume the same facts as in Example 1, except that A manufactures X outside the possession.

(ii) To determine the source of U.S. Co.'s gross income, the $100 gross income is allocated entirely to U.S. Co.'s business activity. Five dollars of U.S. Co.'s gross income is sourced in the possession. [Possession expenses ($10) plus possession purchases ($0) plus possession sales ($0), divided by total expenses ($10) plus total purchases ($80) plus total sales ($100).] The $80 purchase is not included in the numerator used to determine U.S. Co.'s business activity in the possession, since product X was not manufactured in the possession. The remaining $95 is sourced in the United States.

(4) Determination of source of taxable income. Once the source of gross income has been determined under paragraph (f)(2)

or (3) of this section, the taxpayer must properly allocate and apportion separately under §§1.861-8 through 1.861-14T the amounts of its expenses, losses, and other deductions to its respective amounts of gross income from Section 863 Possession Sales determined separately under each method described in paragraph (f)(2) or (3) of this section. In addition, if the taxpayer deducts expenses for research and development under section 174 that may be attributed to its Section 863 Possession Sales under §1.861-17, the taxpayer must separately allocate or apportion expenses, losses, and other deductions to its respective amounts of gross income from each relevant product category that the taxpayer uses in applying the rules of §1.861-17. Thus, in the case of gross income from Section 863 Possession Sales determined under the IFP method or books and records method, a taxpayer must apply the rules of §§1.861-8 through 1.861-14T to properly allocate or apportion amounts of expenses, losses and other deductions, allocated and apportioned to such gross income, between gross income from sources within and without the United States. However, in the case of gross income from Possession Production Sales determined under the possessions 50/50 method or gross income from Possession Purchase Sales computed under the business activity method, the amounts of expenses, losses, and other deductions allocated and apportioned to such gross income must be apportioned between sources within and without the United States pro rata based on the relative amounts of gross income from sources within and without the

United States determined under those methods, except that the rules regarding the allocation and apportionment of research and experimental expenditures in §1.861-17 shall apply to such expenditures of taxpayers using the 50/50 method.

(5) Special rules for partnerships. In applying the rules of this paragraph (f) to transactions involving partners and partnerships, the rules of paragraph (g) of this section apply.

(6) Election and reporting rules--(i) Elections under paragraph (f)(2) or (3) of this section. If a taxpayer does not elect one of the methods specified in paragraph (f)(2) or (3) of this section, the taxpayer must apply the possession 50/50 method in the case of Possession Production Sales or the business activity method in the case of Possession Purchase Sales. The taxpayer may elect to apply a method specified in either paragraph (f)(2) or (3) of this section by using the method on a timely filed original return (including extensions). Once a method has been used, that method must be used in later taxable years unless the Commissioner consents to a change. Permission to change methods from one year to another year will be granted unless the change would result in a substantial distortion of the source of the taxpayer's income.

(ii) Disclosure on tax return. A taxpayer who uses one of the methods described in paragraph (f)(2) or (3) of this section must fully explain in a statement attached to the tax return the methodology used, the circumstances justifying use of that methodology, the extent that sales are aggregated, and the amount of income so allocated.

* * * * *

(h) Effective dates. * * * However, the rules of paragraph (f) of this section apply to taxable years beginning on or after November 13, 1998.

Par. 3. In §1.936-6, paragraph (a)(5) Q&A 7a is added to read as follows:

§1.936-6 Intangible property income when an election out is made: Cost sharing and profit split options; covered intangibles.

* * * * *

(a) * * *

(5) * * *

Q.7a: What is the source of the taxpayer's gross income derived from a sale in the United States of a possession product purchased by the taxpayer (or an affiliate) from a corporation that has an election in effect under section 936, if the income from such sale is taken into account to determine benefits under cost sharing for the section 936 corporation? Is the result different if the taxpayer (or an affiliate) derives gross income from a sale in the United States of an integrated product incorporating a possession product purchased by the taxpayer (or an affiliate) from the section 936 corporation, if the taxpayer (or an affiliate) processes the possession product or an excluded component in the United States?

A.7a: Under either scenario, the income is U.S. source, without regard to whether the possession product is a component, end-product, or integrated product. Section 863 does not apply in determining the source of the taxpayer's income. This Q&A 7a is applicable for taxable years beginning on or after November 13, 1998.

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PART 602--OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 4. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 5. In §602.101, paragraph (c) is amended in the table by revising the entry for 1.863-3 to read as follows:

§602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.863-3	1545-1476 1545-1556
* * * * *	

Michael P. Dolan
Deputy Commissioner of Internal Revenue

Approved: September 18, 1998

Donald C. Lubick
Assistant Secretary of the Treasury for Tax Policy