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Careful Planning May Avoid Reduction in Foreign-Source Income Under Section 863(b) Prop. Regs.

BY JOHN P. KENNEDY AND STEPHEN C. FOX

Proposed Regulations for mixed-sourcing of income from goods produced in the U.S. and sold overseas, or vice versa, would significantly change the existing rules. The independent factory price method will be elective and not conditioned on the existence of a foreign sales branch or division. While the Service has said that, in finalizing the proposal, it would consider recent Tax Court decisions requiring mixed sourcing, the proposed rules seem to result in solely U.S.-source income from the exporting of natural resources absent any additional production activities beyond the basics.

JOHN P. KENNEDY, CPA, is a partner and STEPHEN C. FOX, CPA, is a senior manager in the Tri-State International Tax Group of Deloitte & Touche LLP, and are located in the Parsippany, New Jersey, office. *The authors gratefully acknowledge the considerable assistance of Bruce Reynolds of the firm's Washington, D.C., office.*

Proposed Regulations under Section 863(b) (INTL-3-95, 12/7/95) provide new rules for sourcing gross income from inventory property (1) produced in and sold outside, or (2) produced outside and sold in, the U.S. ("Section 863 sales" or "cross-border sales"). Under the proposal, gross income from Section 863 sales is sourced under a 50/50 rule unless the taxpayer elects to use the independent factory price (IFP) method. The proposed changes, in part, reflect the Service's consideration of three Tax Court rulings in favor of taxpayers, recently affirmed on appeal (discussed below). Also, significant guidance relates to new methods of calculating taxable income on Section 863 sales.

In addition, the Proposed Regulations provide new rules for sourcing gross income from the sale of natural resources and farm products, including oil, timber, and crops, based on the location and extent of additional production activity undertaken by the taxpayer following extraction or other production. The income is sourced to the place of production based on the FMV of the product at the export terminal or immediately prior to any additional production activity.

The Proposed Regulations are an intriguing response to the Service's defeats in the Tax Court. While they frequently clarify or perhaps even improve the result that can be obtained under current law, they also contain provisions that would eviscerate the results achieved by the taxpayers in these cases. The new rules may be helpful to some taxpayers, but they clearly will have an adverse U.S.-tax effect on companies with fact patterns similar to those of the taxpayers that successfully challenged the Service's interpretation and application of the current rules.

Existing Mixed-Source Rules

U.S. taxpayers are taxed on worldwide income and may claim a credit for foreign taxes paid or accrued, limited to the portion of their U.S. tax liability attributable to foreign-source income. Income from the sale of taxpayer-produced goods is sourced partly where the goods are produced and partly where they are sold. This determination is made under rules that have remained substantially unchanged since 1922.[1] Under the Regulations, "produced" includes "created, fabricated, manufactured, extracted, processed, cured, or aged." The Regulations offer two sourcing methods—the IFP approach and the 50/50 rule—by way of example rather than in a statement of the rules.[2]

IFP. Reg. 1.863-3(b)(2), Example (1), applies where "an independent factory or production price" is established (either by regular sales to "independent distributors" or otherwise by the taxpayer), and the "selling or distributing branch or department of the business is located" in a country other than where the goods are pro-

duced.[3] For the purpose of determining the source of income, the goods are deemed sold by the taxpayer's production unit to its sales unit at the IFP, with the resulting sales income sourced to the place of production. The sales unit is deemed to generate income sourced to the place where title passes, using the IFP as its cost of goods sold. The Regulation requires that "the basis of the accounting ... be fully explained in a statement attached to the return."

50/50 method. Absent a fairly established IFP, Temp. Reg. 1.863-3T(b)(2), Example (2), requires use of the 50/50 method.[4] The application of this method is substantially the same as under Example (2) in effect before the temporary rules were issued in 1988. Half of the income is apportioned based on where the taxpayer's sales occur. The other half is sourced by apportioning the income in accordance with the location of assets used to generate the income. The prior rules did not describe the assets to be considered other than by referring generally to "property held or used to produce income which is derived from such sales," and specifically to the situs of accounts receivable. It was widely believed that all relevant assets, including production assets as well as receivables and sales assets, were to be used in the calculation. The practical effect of this interpretation of the 50/50 rule was that more than half the income was sourced to the place of sale (which, for a U.S. exporter, for example, was foreign-source).

Natural resources. Under Reg. 1.863-1(b), income from "the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber" in the U.S. is U.S.-source. If, however, a taxpayer shows that this determination is inappropriate, it may apportion income under the sourcing rules described above. Similarly, IRS may correct an improper apportionment or allocation of income from a U.S. farm or natural resource using any method that will more clearly reflect the source.

Application of the rules. For many years, the IRS generally left unchallenged the widely held beliefs that taxpayers could choose between the IFP and 50/50 methods and that the statutory framework required that some portion of income be allocated to each source, foreign and domestic. In audits during the late 1970s, however, the Service attempted to compel taxpayers to use an IFP if one existed. The question then became one of proof, with taxpayers often in control of the facts. Further, the IRS determined that application of the IFP method could result in an allocation of all income to the U.S. These new ideas advanced by the Service predictably led to litigation, since U.S. exporters in particular did not wish to lose the significant foreign tax credit benefits they derived under the traditional interpretations.

The Controversy

In three significant cases, two taxpayers challenged the Service's views on apportioning mixed-source income.

The *Phillips* cases. Phillips Petroleum Co. extracted natural gas from U.S. wells, liquified it at a facility in Alaska, and shipped it to Japan where it was sold to, among others, Tokyo Electric and Tokyo Gas. Tokyo Electric burned the liquified natural gas (LNG) to generate electricity for sale to its customers. Tokyo Gas regasified the LNG, added other gas to change the BTU content, transported it through its pipelines, and sold the gas to its customers. IRS challenged Phillips's application of the mixed-source rules for 1975-1978 on several fronts.

Mixed-source and IFP mandatory. The IRS contended that, under the Regulations, 100% of Phillips's income from the sale of the LNG—a U.S. natural resource—was U.S.-source. In *Phillips Petroleum Co.*, 97 TC 30 (1991) (*Phillips I*), the Tax Court held that the Regulations were invalid to the extent they resulted in income from Section 863 sales having a single source, whether domestic or foreign. In so ruling, the court relied on the plain language of Section 863(b)(2). In addition, the Tax Court held that the use of an IFP was mandatory if all the factual requirements in Reg. 1.863-3(b)(2), Example (1), were present.

Did IFP apply? In *Phillips Petroleum Co.*, 101 TC 78 (1993) (*Phillips II*), the parties returned to litigate the Service's other contention. The IRS argued that an IFP existed and thus Example (1) of the Regulations provided the applicable guidance for determining the source of Phillips's income. According to IRS, the Japanese utility companies that purchased the LNG were "distributors." Further, the Service said, it was unnecessary for a taxpayer to have a branch in a foreign country for Example (1) to apply. The Service used Phillips's LNG sales to the utilities to formulate the IFP, resulting in the taxpayer's having no foreign-source taxable income.

The Tax Court held that Tokyo Gas was not a distributor, because it substantially changed the energy content of the regasified LNG by blending it with other gas before selling the product to its customers. Moreover, Tokyo Electric itself consumed the LNG. Thus, it clearly was not a distributor, despite IRS arguments that electricity and gas were really the same thing.

The court noted that the theory behind the IFP was that, in the Service's words, "'[s]ince the independent distributor performs the marketing or

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[1] The only significant development was the addition in 1957 of the rule regarding passage of title in related Reg. 1.861-7(c), which provides in part that "a sale of personal property is consummated at the time when, and the place where, the rights, title, and interest of the seller in the property are transferred to the buyer." For another aspect of the effect of this Regulation, see Erdahl, "Source of Losses Incurred on Stock in Foreign Affiliates," 84 JTAX 174 (March 1996).

[2] Under Reg. 1.863-3(b)(2), Example (3), a taxpayer may request permission to source income based on its books and records. Although this method is rarely, if ever, used, it remains available under the Proposed Regulations. The Preamble to INTL-3-95, 12/7/95, requests comments as to its utility.

[3] In Phillips Petroleum Co., 97 TC 30 (1991) (Phillips I), *aff'd in an unpub. opn.* 70 F.3d 1282 (CA-10, 1995) (discussed in the text below), the Tax Court rejected the taxpayer's contention that the use of an IFP was elective.

[4] Related rules and definitions are in Reg. 1.863-3(b)(2), Example (2)(iii), (iv), and (v).

selling activities, the price paid by the distributor to the manufacturer or producer is treated as fairly establishing'" the income attributable to manufacturing or production. The court pointed out that the Japanese utilities "did not sell to their customers the same product they received from Phillips. They regasified the LNG and then modified or burned the resulting natural gas." The court found that for purposes of Reg. 1.863-3(b)(2), Example (1), "distributor" was not "meant to include an entity that transformed the product ... to this degree." Thus, the court concluded that there was no IFP and Example (1) did not apply.

The *Intel* case. Intel Corp. designed and manufactured semiconductor components and computer systems in the U.S. that it sold with title and risk of loss passing to buyers outside the U.S. The company had no sales or distribution branch or department in any other country. In determining the source of its taxable income from those sales, Intel used the 50/50 rule in Reg. 1.863-3(b)(2), Example (2), which produced significant foreign-source income, affording the taxpayer the benefit of foreign tax credits..On examination, the IRS contended that Intel had an IFP, the use of which would result in reduction or elimination of the foreign-source income. Further, the Service asserted (as it later did in *Phillips II*) that no foreign branch was required for the application of Example (1).

In *Intel Corp.*, 100 TC 616 (1993), *aff'd* 67 F.3d 1445 (CA-9, 1995), the Tax Court agreed that the taxpayer's sales came under Section 863(b)(2) and, citing *Phillips I*, found that Congress intended that at least part of the income from such sales be apportioned to foreign sources. In addition, the court noted that the plain language of the Regulations specified that for Example (1) to apply, the sales in question must have been transacted through a branch or department in a foreign country. Accordingly, the court upheld Intel's use of the 50/50 rule of Example (2).

IRS pronouncements. During the course of the *Phillips* litigation, IRS attempted to rewrite the rules administratively. In *Rev. Rul.* 88-73, 1988-2 CB 173 (issued after the taxpayer filed its petition in *Phillips I*), the IRS held that Example (1) must be used when an IFP can be fairly established, whether or not the taxpayer had a foreign branch. This Ruling was a complete reversal of 66 years of administrative practice.

Rather than merely relying on thin examples, the Proposed Regulations offer explanations of the methods to be used.

The following year, IRS issued three Notices concerning IFPs. *Notice* 89-10, 1989-1 CB 631, elaborated considerably on the meaning of the terms used in Example (1). The IRS defined "wholly independent distributors" and "manufacturer or producer," and clarified the extent and character of sales required to establish an IFP. Sales involving "significant non-production, income-generating activities," the Service said, would not qualify. It also discussed the impact of differing geographic markets on an IFP.

Notice 89-11, 1989-1 CB 632, stated that Regulations to be issued would provide that sales involving a foreign sales corporation (FSC)[5] would not be subject to either an IRS-mandated or a taxpayer-elected IFP. This rule was modified in *Notice* 89-87, 1989-2 CB 405, which stated that a FSC that used arm's-length pricing rather than the administrative pricing rules[6] must use any existing IFP.

In July 1995, the IRS finalized new deferred intercompany transaction rules under the consolidated return Regulations.[7] One aspect of the new rules is to treat a consolidated group as a single entity in determining the source of income.[8] Before these Regulations foreclosed the technique, some taxpayers had attempted to circumvent the potential limitations of the 50/50 and IFP rules by using a resale subsidiary. The producer would sell its foreign-destined output to the resale subsidiary, shifting most of its profit there. Under the passage of title rule, all the subsidiary's income would be foreign-source. This technique for increasing foreign-source income was always subject to IRS reallocation under Section 482.

Proposed Rules for Inventory

Against this backdrop, the Proposed Regulations provide changes in the rules for sourcing income from cross-border sales of personal property and natural resources. Rather than merely relying on thin examples, the proposal offers explanations of the methods to be used. As with the existing scheme, the proposed rules bifurcate Section 863 sales into income from manufacturing and income from sales. The income attributable to each operation is then sourced separately based on where the activity occurs. The 50/50 rule is modified to provide an even split between the two activities (Prop. Reg. 1.863-3(b)(1)). The IFP is no longer mandatory where the requisite circumstances exist, but taxpayers may elect to use it in those instances. Moreover, IRS will consent to a change of method as long as the source of income is not substantially distorted (Prop. Regs. 1.863-3(b)(2) and (e)(1)).

Under Prop. Reg. 1.863-3(b)(2)(i) (as under the current rules), an IFP may be "fairly established" only if "the taxpayer regularly sells part of its output to wholly independent distributors or other selling concerns in such a way as to reasonably reflect the income earned from production activity." The IFP must be applied to all Section 863 sales of similar inventory sold at a sim-

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5 See Sections 921-927.

6 Sections 925(a)(1) and (2).

7 TD 8597, 7/12/95. See Casinelli, Hennessey, and Yates, "Final Intercompany Transaction Regs. Focus on Broad Concepts Rather Than Mechanics," 83 JTAX 325 (December 1995).

8 Reg. 1.1502-13(c)(7), Example (14), illustrates the potential recharacterization of income for one or both members involved in intercompany sales using the IFP and the 50/50 rule under existing Regulations. There is no effect on combined foreign-source income under the IFP approach, but sourcing under the 50/50 method can change dramatically.

ilar level of distribution as the goods sold in the transaction establishing the IFP. Nevertheless, the IFP applies only to sales that are reasonably contemporaneous with, and in geographic markets that are not substantially different from, the sales and markets used to establish the IFP.[9] If elected, the IFP method must be applied to all sales for which an IFP may be fairly established. For Section 863 sales for which an IFP cannot be established or applied, taxpayers must use either the 50/50 method or, with IRS consent, the books and records method.[10]

The Proposed Regulations go further than the existing rules in defining terms and specifying when the IFP will apply, but they do not cover all terms and circumstances. Thus, for now, *Notice* 89-10 continues to be authoritative guidance, including definitions of "independent distributor," "regular sales," and "significant non-production, income-generating activity." (The Preamble to INTL-3-95 states that final Regulations will supersede the Notice.)

New 50/50 rule. The 50% of gross income that is deemed from sales activity under the proposed 50/50 method is sourced in accordance with the passage of title (Prop. Reg. 1.863-3(c)(2)).[11] Gross income from production is sourced based on the location of all production assets, i.e., tangible and intangible assets owned by the taxpayer that are *directly* used to produce Section 863 sales inventory. Intangible assets are located where the related tangible assets are physically situated. Under Prop. Reg. 1.863-3(c)(1), partners are deemed to own a proportionate share of the partnership's production assets—a useful clarification, given the proliferation of joint ventures conducted in partnership form. Production assets do not include cash and other liquid assets (including working capital), accounts receivable, prepaid expenses, transportation assets, warehouses, and the inventory itself, including raw materials and work-in-process. IRS seems to be trying to restrict "production assets" to factories and equipment, perhaps believing that including additional assets may allow taxpayers to inappropriately manipulate foreign-source income. Marketing intangibles, such as trademarks and customer lists, also are excluded from production assets.

Income is sourced in accordance with the portion of the production assets located in and outside the U.S., using the beginning- and end-of-year average adjusted bases of the assets. If this computation does not fairly represent the average for the year, "a more appropriate" average must be used. For mixed-use assets, the applicable adjusted bases may be determined using any method that reasonably reflects the portion of the assets that produced Section 863 sales inventory, e.g., apportionment of the asset based on the share of gross receipts from sales of such inventory.

Title passage. For the Section 863(b) rules to apply, the rights, title, and interest of the seller must pass to the buyer outside the U.S. for property produced in the U.S., or vice versa. The Preamble to INTL-3-95 states the IRS view that under the existing and Proposed Regulations, the sourcing rules for income attributable to sales activities of U.S.-produced goods apply only to sales that take place in a foreign country. This requirement is troubling, since title passage within a foreign country may expose the U.S. exporter to tax in that country in the absence of treaty protection. The Service may believe that the possibility of taxation by the foreign country is a prerequisite to foreign-source treatment of the income.[12] The IRS requests comments regarding application of the rules to sales occurring in international waters or in space. Nevertheless, where title passes in international waters, most IRS agents treat sales of U.S.-produced goods as foreign-source.

Some commentators have suggested that title passage itself may be sufficient to control sourcing. Although under Reg. 1.861-7(c), a sales transaction that was arranged for the primary purpose of tax avoidance may be treated by IRS as "having been consummated at the place where the substance of the sale occurred," the courts have looked favorably on title passage as the sole factor to determine place of sale.[13]

Taxpayers must be sensitive to the law governing title passage for particular sales. The sales contract (invoice, etc.) should contain explicit language regarding the passage of title. Otherwise, it may be difficult and time consuming to determine where title and risk of loss really passed. For U.S. sales, the Uniform Commercial Code will apply in most states.

The Service will consent to a change of methods as long as it does not substantially distort the source of income.

For sales outside the U.S., one of several other sets of rules may apply. In an international sale, the mere specification of, e.g., "FOB factory" may not necessarily be sufficient by itself to fix title passage in a particular place without an analysis of the intent of the parties. The United Nations Convention on Contracts for the International Sale of Goods applies where both parties are residents of contracting states. This agreement has specific rules for passage of risk of loss in various circumstances, depending primarily on transportation arrangements. Alternatively, the parties may specify that standard terms developed by the International Chamber of Commerce ("Incoterms") will apply. For example, under Incoterms, "FOB" is properly used only in shipments by water. The approximate Incoterms equivalent of FOB factory is EXW (exworks) factory. Finally, numerous bilateral conventions may alter definitions.

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9 The Proposed Regulations seem to allow broader latitude in grouping than is contemplated in the Section 482 Regulations for purposes of the comparable uncontrolled price method.

10 Prop. Reg. 1.863-3(b)(3). See note 2, *supra*.

11 The proposed rules incorporate by reference the provisions of Reg. 1.861-7(c) (sale occurs generally when and where title passes).

12 See, for example, Section 865(e)(1)(B), which treats certain sales of personal property as foreign-source only if a foreign income tax of at least 10% is paid with respect to the income.

13 See, e.g., A.P. Green Export Co., 284 F.2d 383 (Ct. Cl., 1960), citing numerous other cases.

To secure foreign-source treatment of a sale, explicit language regarding title passage and risk of loss is therefore generally advised.

Significance of the proposal. The Proposed Regulations present potentially significant changes from current practice. Although the proposed IFP rule drops the requirement for a foreign sales branch, which was fatal to the IRS position in *Intel*,[14] it makes the IFP method elective, an obvious benefit to U.S. producers. The use of an IFP, however, is limited to similar products, similar circumstances, and comparable geographic markets. Also, the sourcing of production income based on the adjusted bases of production assets effectively eliminates self-developed intangibles from the equation, since such assets typically are expensed and thus have zero basis.[15]

The bifurcation of income between sales and production activities may have other significant effects as well. Taxpayers electing to use the IFP method must allocate and apportion expenses under the Section 861 Regulations. In these circumstances, production and sales assets apparently will no longer produce mixed-source income. This may have a substantial effect on the apportionment of interest expense, as the assets will no longer be multiple-category assets. Also, all marketing expenses will be allocated to the sales activity, which arguably should be the practical effect under existing IFP rules. Taxpayers using the 50/50 method must apportion expenses pro rata based on the relative U.S.- and foreign-source gross incomes. In most instances, this requirement should not substantially alter the results of the existing 50/50 method.[16]

Overreaching? The substantial changes in the personal property sourcing rules raise an additional concern. These Regulations are authorized by the Code, and thus are legislative rather than interpretive. The proposed rules remove the long-standing requirement that a taxpayer have a foreign sales branch or division for the IFP to apply. Congress had relied on the rules through many other changes in the law. Does IRS have the authority to alter its rules without congressional authorization?

Natural Resources

Under an "all or nothing" general rule in Reg. 1.863-1(b), income from natural resources is allocated to the location of the mine, well, tract, or farm. Thus, for example, income from the ownership or operation of a farm, coal mine, or oil well in the U.S. normally is U.S.-source, regardless of where the products are sold. The inventory property rules of Section 863(b) and related Regulations apply, however, if the taxpayer shows that "due to the peculiar conditions of production and sale" not all the income should be allocated to U.S. sources. There has been a notable lack of further guidance on this issue. The Tax Court invalidated this Regulation in *Phillips I*, because it failed to achieve the congressional mandate for mixed-source income. The Proposed Regulations appear to be an attempt to administratively overturn the effect of *Phillips I* by minimizing natural resource income allocated to the place of sale, in some instances reducing it to zero. Unless the taxpayer engages in "additional production activity" (discussed below), the Proposed Regulations require the single-source result held invalid by the court.[17]

Export terminal rule. Under Prop. Reg. 1.863-1(b)(1), the source of the gross receipts from the sale of natural resources and farm products generally is the location of the mine, well, or farm, to the extent of the FMV of the product at the "export terminal." This is the last point within the U.S. from which natural resources or farm products are shipped to a foreign country, or the last point in a foreign country (not necessarily the production country) from which such products are shipped to the U.S.[18] Absent any "additional production activities" beyond basic production—which, under Prop. Reg. 1.863-1(b)(3)(i), includes creating, fabricating, manufacturing, extracting, processing, curing, or aging inventory—any excess gross receipts also are sourced to the location of the mine, farm, etc. This position (illustrated in Prop. Reg. 1.863-1(b)(7), Example (1)), seems directly at odds with the court's view in *Phillips I* that Congress required mixed-source results from the Service's Regulations. Thus, it is not clear whether the new rule will survive judicial scrutiny.

IRS seems to be trying to restrict 'production assets' to factories and equipment, perhaps to avoid taxpayers' manipulating income sourcing.

Additional production activities are those performed by the taxpayer in addition to activities from the ownership or operation of the mine, etc., (1) that substantially transform the product, (2) that are generally considered manufacturing, or (3) in which the corporation incurs costs of at least 20% of the total cost of goods sold for the product. Activities that merely prepare the goods for export, however, are not additional production.[19]

If the taxpayer engages in additional production activities, sourcing depends on whether the activities occur (1) before shipment from the export

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14 The IRS has filed a motion for rehearing in Intel Corp., 67 F.3d 1445 (CA-9, 1995), *aff'g* 100 TC 616 (1993), even though the Proposed Regulations seem to acknowledge that the current rules reflect the Tax Court's position.

15 See, e.g., Section 174 (R&E expenses).

16 Prop. Reg. 1.863-3(d). It is hoped that final Regulations will provide greater clarity.

17 The Preamble to INTL-3-95, however, states that IRS and Treasury will "consider the implications" of Phillips I, *supra* note 3, when finalizing the Proposed Regulations.

18 Prop. Reg. 1.863-1(b)(3)(iii). The proposal leaves unresolved the location of the export terminal in two common oil industry arrangements. In these days of deep-draft supertankers, many oil terminals are far offshore and may not be "in" a foreign country. In addition, for pipelines between the U.S. and Canada or Mexico, oil or gas commonly enters the pipeline in one country to be delivered nonstop to customers in the other. Is the value at the "terminal" (which may be merely a particular point along the pipeline) the same as it is at either end or at some measuring or compression station? In the case of gas, how is the gas to be measured at some intermediate point?

19 Prop. Reg. 1.863-1(b)(3)(ii), citing Reg. 1.954-3(a)(4) (the Subpart F rules regarding manufacturing).

terminal or (2) if after shipment, in or outside the country of sale. If such activities take place after shipment and outside the country of sale, any excess gross receipts are sourced in accordance with the rules for inventory (Prop. Reg. 1.863-1(b)(1)(ii)). For purposes of the 50/50 rule, only production assets used in the additional production activity are taken into account. If post-shipment production activity occurs within the country of sale, as determined under the passage of title rules, the excess gross receipts are sourced to that country (Prop. Reg. 1.863-1(b)(1)(iii)).

Additional production prior to export. If the taxpayer engages in additional production activities before the goods are shipped from the export terminal, gross receipts are allocated to the location of the mine, etc., to the extent of the FMV of the product immediately before the additional activities.[20] Gross receipts in excess of that value are sourced in accordance with the rules for inventory. As with post-shipment additional production activities (noted above), only production assets used in the additional activity are taken into account under the 50/50 rule.

Exporting LNG. In Prop. Reg. 1.863-1(b)(7), Example (2), which is based on the facts stipulated in *Phillips,* IRS states that "[l]iquefaction of natural gas is not an additional production activity because liquefaction prepares the natural gas for transportation...." Accordingly, 100% of the LNG producer's income is U.S.-source. This was the result the IRS had sought in *Phillips.* If the liquefaction process were deemed additional production, however, any receipts in excess of the value of the LNG before liquefaction would be sourced under the 50/50 or IFP rules. The Service's position is particularly disturbing in that it seems to be trying to administratively change facts and chemistry to achieve 100% U.S.-sourcing, as well as overturn case law.

Liquefaction changes both the physical and chemical properties of a gas. Liquid gas has an additional component that has value—the cryogenic property, or coldness that can be used separately from the gas. It seems difficult to reconcile this example with the proposed definition of additional production, which, under the incorporated-by-reference Reg. 1.954-3(a)(4), includes "substantially transformed" as one criterion. The IRS agreed in *Phillips II* that liquefaction of the gas was manufacturing. Further, it is hard to justify the position that a multibillion dollar liquefaction plant is merely some sort of packing facility, as the Proposed Regulations imply.

The Service may believe that the possibility of taxation by the foreign country is a prerequisite to foreign-source treatment of the income.

Finally, the example seems inconsistent with the Service's position on "pipeline drip" under the former windfall profit tax. The IRS had held that "[n]atural gas liquids that are recovered ... by ... extraneous refrigeration processes are not subject to [the] tax." To be exempt, the liquid must not have been "produced" by extraction from the ground. This implies that extraneous refrigeration processes (such as liquefaction) are manufacturing and not merely preparation for shipping (e.g., through a pipeline).[21]

FMV. Another difficulty arises in connection with the export terminal value. Prop. Reg. 1.863-1(b)(4) requires that for related-party transactions subject to Section 482, FMV must be consistent with the arm's-length price determined under that section. This poses no problem for frequently quoted commodities at major ports or where there is an actual sale. For many products, however, determining the FMV at the export terminal may require sophisticated economic analyses or access to data not available to many taxpayers. Further, for many commodities that are not frequently quoted, the market price often fluctuates considerably over short periods. Requiring a value determination *for each shipment* thus poses an onerous burden.

Reporting, Effective Date

Prop. Regs. 1.863-1(b)(6) and -3(e)(2) require that the method used to compute the source of income for Section 863 sales, as well as the justification for the method, be disclosed on the tax return. This requirement may be moot, however. No disallowance or other penalty is specified, and the IRS is given no additional powers on a taxpayer's failure to properly disclose. It would be hard to argue that the omission of information would prevent the IRS, in most instances, from having enough data to determine the correct tax, or that the selected methods were lacking substantial authority.

The new rules are proposed to be effective for tax years beginning at least 30 days after final Regulations are published. Taxpayers may elect to apply the new rules to any tax year beginning before that date but after 7/11/95.

Conclusion

The Proposed Regulations may significantly reduce controversies over sourcing by allowing taxpayers more flexibility and providing certainty of methods. Taxpayers may now choose between an IFP (if one exists) and the 50/50 rule with little risk of an IRS challenge. Producers of natural resources and farm products will find most of their income sourced to the place of production. Those taxpayer-producers whose foreign-source income is thus decreased may be inclined to test the single-source rule in court.

Given the changes in the manner of apportioning taxable income as U.S.- and foreign-source under the new 50/50 method, including the new rules for production assets and the pro rata allocation of deductions, U.S. exporters will have to study the results to determine whether the modifications are beneficial. Additional tax return disclosures also are required. ■

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20 Prop. Reg. 1.863-1(b)(2). This raises the same concerns discussed in connection with the definition of export terminal, *supra* note 18.

21 TAM 8621002.

NEW DEVELOPMENTS

Final Rules Govern Mixed-Source Income From Sales of Natural Resources and Other Inventory

Final Regulations under Section 863 (TD 8687, 11/27/96) provide rules for sourcing income from the sale of natural resources and farm products (including oil, timber, and crops) and other inventory property (1) produced in and sold outside, or (2) produced outside and sold in, the U.S. The rules are effective for tax years beginning after 12/30/96 and, at the taxpayer's option, may be applied to other tax years that began after 7/11/95. For the most part, the final Regulations conform to the 1995 Proposed Regulations, which were analyzed by John P. Kennedy, CPA, and Stephen C. Fox, CPA (a partner and a senior manager, respectively, in the Tri-State International Tax Group of Deloitte & Touche LLP, located in Parsippany, New Jersey), in "Careful Planning May Avoid Reduction in Foreign-Source Income Under Section 863(b) Prop. Regs.," 84 JTAX 232 (April 1996). Messrs. Kennedy and Fox observe that the final Regulations:

- Clarify certain aspects of the proposed rules.

- Make a cosmetic concession to the holding in *Phillips Petroleum Co.,* 70 F.3d 1282, 76 AFTR2d 95-7978 (CA-10, 1995), *aff'g without pub. opn.* 97 TC 30 (1991) and 101 TC 78 (1993).
- Provide important new rules regarding partnership determinations.
- Allow foreign sourcing for high seas title passage sales (except in certain situations).
- Provide two potentially significant anti-abuse rules.

The authors analyze the impact of these changes from the Proposed Regulations, as follows.

The 1995 proposal. Under the Proposed Regulations, taxpayers could choose one of three methods for determining the source of income from sales of inventory other than natural resources:

- The 50/50 method.
- The independent factory price (IFP) method.
- The books and records method, which required IRS approval.

Under the 50/50 method, half of the income was deemed from production activity and was sourced based on the portions of the production assets in foreign and U.S. locations (Prop. Reg. 1.863-3(c)). For this purpose, partners were treated as owning their share of partnership production assets (Prop. Reg. 1.863-3(c)(1)(i)(B)). The other half of the income was sourced to the place of sale, under title passage rules.

Under the IFP method, all income up to the fairly established IFP was sourced to the place of production. The remainder of the income was sourced to the place of sale. Prop. Reg. 1.863-3(b)(2) provided rules to determine when an IFP was fairly established.[1]

For natural resources (including farm products), the Proposed Regulations provided a 100% allocation rule for sourcing income from production and sale. That is, where the taxpayer did not engage in substantial additional production beyond production of the natural resource, the income would have been sourced entirely to the location of the natural resource (i.e., the mine, well, mineral deposit, or farm).

In *Phillips,* the Tenth Circuit had agreed with the Tax Court's finding that the then-existing rule was invalid to the extent it conflicted with the court's interpretation of Section 863(b)(2), which provides that gains, profits, and income for the sale of inventory produced in and sold outside the U.S. (or vice versa) must be treated as derived from sources partly within and partly outside the U.S. In Kennedy and Fox, *supra,* it was observed that IRS might have a difficult time applying its Proposed Regulation in view of the holding in *Phillips.*

The final Regulations. The most significant changes in the final Regulations may be in the natural resource area. The Service acted in an apparent attempt to deflect a potential attack against the Regulations in the Tax Court, which (as noted above) had invalidated the existing single-source rule to the extent that it was inconsistent with the statute's requirement for a mixed-source result. The final Regulations accede to the ruling in *Phillips,* but in a way that will minimize foreign-source income for U.S. exporters. Had these Regulations been in effect during the years at issue in that case, the IRS might have achieved most, if not all, of the results it unsuccessfully sought in litigating *Phillips.*

Under the final Regulations, income from natural resources is determined separately with respect to (1) gross receipts up to the export terminal value and (2) gross receipts in excess of that value. Receipts up to the FMV at the export terminal (or the value of the products before any additional production activity) are sourced to the place of production. Excess receipts are sourced to the country of sale. If, however, the taxpayer engages in additional production activity subsequent to shipment from the export terminal and outside the country of sale, the excess receipts are sourced under the inventory rules. Only the additional production activity assets are taken into account in determinations under the 50/50 method. Where the taxpayer engages in additional production activity prior to export, the value of the product immediately before that activity is effectively substituted for the export terminal value.

The definitions in Reg. 1.863-1(b) of "export terminal value," "additional production activity," and other terms are unchanged from the Proposed Regulations. Thus, the IRS has not retreated from its exclusion of liquefaction of natural gas from production activities. With regard to additional production activities in connection with mining, new Examples 1 and 5 in Reg. 1.863-1(b)(7) clarify that milling is part of the mining activity but smelting is an additional production activity.

New elections. The final Regulations add two new elections. Taxpayers now may separately elect the 50/50 or IFP method with regard to sales in and outside the U.S. (Reg. 1.863-3(a)(2)). This allows taxpayers in consolidated groups that have both inbound and outbound businesses to avoid distortions that otherwise might occur if a single election were required. In addition, for sales of inventory other than natural resources taxpayers may apply the 50/50 method to taxable rather than gross income. In certain instances, this alternative may affect the allocation and apportionment of expenses. It is unclear, however, whether this is an annual election or is linked to the election of the 50/50 method.

Reg. 1.863-3(e)(2) retains the pro-

NOTES

[1] In Intel Corp., 100 TC 616 (1993), *aff'd* 67 F.3d 1445, 76 AFTR2d 95-6825 (CA-9, 1995), the taxpayer had argued that the use of an IFP was elective. IRS asserted that if an IFP existed, its use was mandatory. The court held that it was mandatory only if all conditions specified under the old rules, including the existence of a sales or distribution branch outside the U.S., were satisfied. The Proposed Regulations made the IFP elective even where the requisite circumstances existed.

[2] Taxpayers should consider the implications of Bausch & Lomb Inc., TCM 1996-57, regarding what is manufacturing and what might be additional production activity under the Regulations.

[3] This regulatory change forces (or allows) taxpayers to do what the IRS always had the ability to do under Section 482. Aggressive positions taken by some taxpayers on intercompany pricing, which had artificially altered the sourcing of income, thus no longer have any impact. For more on Reg. 1.1502-13, see generally Casinelli, Hennessey, and Yates, "Final Intercompany Transaction Regs. Focus on Broad Concepts Rather Than Mechanics," 83 JTAX 325 (December 1995).

posed requirement that the method elected, as well as certain additional information, be disclosed on the taxpayer's return. Also as proposed, final Reg. 1.863-3(e)(1) permits a change of method with IRS consent, which generally will not be withheld unless the change distorts income.

Anti-abuse rules. The Regulations provide two new anti-abuse rules. Both the original and the proposed Regulations included under Section 863(b) only those sales that took place in a foreign country, reflecting a concern that taxpayers might abuse the rules to source income as foreign where goods were produced in the U.S., sold outside the U.S., and then returned to the U.S. for use or consumption. Now, any sale outside the U.S. may be foreign-source subject to an anti-abuse rule under final Reg. 1.863-3(c)(2). This rulle presumes a U.S. place of sale (and thus U.S.-source income) for goods manufactured or produced in the U.S. and sold for use or consumption in the U.S. without substantial additional manufacturing, processing, or production.[2] It resolves IRS concerns regarding taxpayers' abusing the 50/50 method by passing title outside the U.S. under Reg. 1.861-7(c) and thus achieving foreign-source treatment for U.S.-produced and destined goods.

The second anti-abuse rule prevents artificial distortions of the asset ratio under the 50/50 method, such as by sale and leaseback of all U.S. production assets. Under Regs. 1.863-3(c)(1)(iii) and -3(c)(1)(iv), Example 3, the Service may make appropriate adjustments, including ignoring sale/leaseback arrangements, in determining the source of income.

Partnerships. As noted above, under the proposed Regulations a partner was deemed to own its proportionate share of the partnership's production assets for purposes of the 50/50 method. This provision has been significantly modified in the final Regulations, which generally do not permit a partner to attribute to itself the sales and production activities conducted by the partnership.

Under final Reg. 1.863-3(g), partners are deemed to own their proportionate share of a partnership's production assets only in determining the source of (1) their distributive share of partnership income and (2) income from the sale of inventory distributed to the partner. Further, a partnership may take into account a partner's production assets to the extent attributable or related to inventory contributed by the partner to the partnership under Section 721. Otherwise, the source of income from sales of property produced by a partnership is determined at the partnership level. Each partner's share of such income is determined under the partnership agreement.

Other provisions. The final Regulations make several minor clarifications to the proposed rules. In addition, conforming adjustments are made to other Regulations promulgated since the release of the Proposed Regulations. For example, under Reg. 1.1502-13 all members of a consolidated group now are treated as one taxpayer.[3] This rule affects the determination of both the total income subject to the 50/50 method and the relative assets considered under that approach, as well as the definition of production activity. Final Regs. 1.863-3(c)(1)(i)(A) and (B) and -1(b)(3)(i) clarify this interaction.

The final Regulations also make clear that Reg. 1.861-17, which governs the apportionment of R&E costs, overrides the pro rata allocation of expenses for taxpayers electing the 50/50 method.

Conclusion. The final Regulations regarding sourcing income from inventory and natural resources contain few surprises. They clarify certain key points and offer taxpayers two new elections. In addition, high-seas sales now may be included in 50/50 income. The Regulations also provide the IRS with tools to combat two potential areas of abuse. The rules provide understandable, administrable methods for determining the source of income under Section 863(b), and also offer several planning opportunities.