

for the private financial benefit of a specific person or persons or organization.

(4) *Effective dates.* The following are the effective dates concerning this paragraph (d):

(i) *Scholarships and fellowship grants.* This paragraph (d) is effective for scholarship and fellowship grant payments made after December 31, 1986. However, for scholarship and fellowship grant payments made after May 14, 1989, and before June 16, 1993, the residence of the payor rule of paragraph (d)(2) (i) and (ii) of this section may be applied without applying paragraph (d)(2)(iii) of this section.

(ii) *Grants, prizes and awards.* This paragraph (d) is effective for payments made for grants, prizes and awards, targeted grants, and achievement awards after September 25, 1995. However, the taxpayer may elect to apply the provisions of this paragraph (d) to payments made for grants, prizes and awards, targeted grants, and achievement awards after December 31, 1986, and before September 26, 1995.

(e) *Effective dates.* The rules of paragraphs (a), (b) and (c) of this section will apply to taxable years beginning after December 30, 1996. However, taxpayers may apply the rules of this section for taxable years beginning after July 11, 1995, and on or before December 30, 1996. For years beginning before December 30, 1996, see § 1.863-1 (as contained in 26 CFR part 1 revised as of April 1, 1996).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 8615, 60 FR 44275, Aug. 25, 1995; T.D. 8687, 61 FR 60545, Nov. 29, 1996; 61 FR 65323, Dec. 12, 1996]

§ 1.863-2 Allocation and apportionment of taxable income.

(a) *Determination of taxable income.* Section 863(b) provides an alternate method for determining taxable income from sources within the United States in the case of gross income derived from sources partly within and partly without the United States. Under this method, taxable income is determined by deducting from such gross income the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deduc-

tions that cannot definitely be allocated to some item or class of gross income. The income to which this section applies (and that is treated as derived partly from sources within and partly from sources without the United States) will consist of gains, profits, and income

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

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

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

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

(c) *Effective dates.* This section will apply to taxable years beginning after

December 30, 1996. However, taxpayers may apply the rules of this section for taxable years beginning after July 11, 1995, and on or before December 30, 1996. For years beginning before December 30, 1996, see §1.863-2 (as contained in 26 CFR part 1 revised as of April 1, 1996).

[T.D. 8687, 61 FR 60546, Nov. 29, 1996; 61 FR 65323, Dec. 12, 1996]

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

(a) *In general*—(1) *Scope*. Paragraphs (a) through (e) of this section apply to determine the source of income derived from the sale of inventory property (inventory), which a taxpayer produces (in whole or in part) within the United States and sells outside the United States, or which a taxpayer produces (in whole or in part) outside the United States and sells within the United States (Section 863 Sales). A taxpayer must divide gross income from Section 863 Sales between production activity and sales activity using one of the methods described in paragraph (b) of this section. The source of gross income from production activity and from sales activity must then be determined under paragraph (c) of this section. Taxable income from Section 863 Sales is determined under paragraph (d) of this section. Paragraph (e) of this section describes the rules for electing the methods described in paragraph (b) of this section and the information that a taxpayer must disclose on a tax return. Paragraph (f) of this section applies to determine the source of certain income derived from a possession of the United States. Paragraph (g) of this section provides special rules for partnerships for all sales subject to §§1.863-1 through 1.863-3. Paragraph (h) of this section provides effective dates for the rules in this section.

(2) *Rules of application for Section 863 Sales*. Once a taxpayer has elected a method described in paragraph (b) of this section, the taxpayer must separately apply that method to Section 863 Sales in the United States and to Section 863 Sales outside the United States. In addition, the taxpayer must apply the rules of paragraphs (c) and (d) of this section by aggregating all

Section 863 Sales to which a method described in paragraph (b) of this section applies, after separately applying that method to Section 863 Sales in the United States and to Section 863 Sales outside the United States. See section 865(i)(1) for the definition of inventory property. See also section 865(e)(2). See §1.861-7(c) and paragraph (c)(2) of this section for the time and place of sale.

(b) *Methods to determine income attributable to production activity and sales activity*—(1) *50/50 method*—(i) *Determination of gross income*. Generally, gross income from Section 863 Sales will be apportioned between production activity and sales activity under the 50/50 method as described in this paragraph (b)(1). Under the 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 (c)(1) of this section. The remaining one-half of such gross income will be considered income attributable to sales activity and the source of that income will be determined under the rules of paragraph (c)(2) of this section. In lieu of the 50/50 method, the taxpayer may elect to determine the source of income from Section 863 Sales under the IFP method described in paragraph (b)(2) of this section or, with the consent of the District Director, the books and records method described in paragraph (b)(3) of this section.

(ii) *Example*. The following example illustrates the rules of this paragraph (b)(1):

Example. 50/50 method. (i) P, a U.S. corporation, produces widgets in the United States. P sells the widgets for \$100 to D, an unrelated foreign distributor, in another country. P's cost of goods sold is \$40. Thus, P's gross income is \$60.

(ii) Pursuant to the 50/50 method, one-half of P's gross income, or \$30, is considered income attributable to production activity, and one-half of P's gross income, or \$30, is considered income attributable to sales activity.

(2) *IFP method*—(i) *Establishing an IFP*. A taxpayer may elect to allocate gross income earned from production activity and sales activity using the independent factory price (IFP) method described in this paragraph (b)(2) if