

Code

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

(a) In general.

Items of gross income other than those specified in section 861(a) and section 862(a) will generally be separately allocated to sources within or without the United States. See section 1.863-2 for alternate methods to determine the income from sources within or without the United States in the case of items specified in section 1.863-2(a). See also sections 865(b) and (e)(2). In the case of sales of property involving partners and partnerships, the rules of section 1.863-3(g) apply.

(b) Natural resources --

(1) In general

Notwithstanding any other provision, except to the extent provided in paragraph (b)(2) of this section, gross receipts from the sale outside the United States of products derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber within the United States, 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). Notwithstanding any other provision, except to the extent provided in paragraph (b)(2) of this section, 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 must be allocated between sources within and without the United States based on the fair market value of the product at the export terminal. For place of sale, see sections 1.861-7(c) and 1.863-3(c)(2). The source of gross receipts equal to the fair market value of the product at the export terminal will be from sources where the farm, mine, well, deposit, or uncut timber is located. The source of gross receipts from the sale of the product in excess of its fair market value at the export terminal (excess gross receipts) will be determined as follows --

(i) If the taxpayer engages in additional production activities subsequent to shipment from the export terminal and outside the country of sale, the source of excess gross receipts must be determined under section 1.863-3. For purposes of applying section 1.863-3, only production assets used in additional production activity subsequent to the export terminal are taken into account.

(ii) In all other cases, excess gross receipts will be from sources within the country of sale. This paragraph (b)(1)(ii) applies to a taxpayer that engages in additional production activities in the country of sale, as well as to a taxpayer that does not engage in additional production activities at all.

(2) Additional production prior to export terminal.

Notwithstanding any other provision of this section, gross receipts from the sale of products derived by a taxpayer who performs additional production activities as defined in paragraph (b)(3)(ii) of this section before the relevant product is shipped from the export terminal are allocated between sources within and without the United States based on the fair market value of the product immediately prior to the additional production activities. The source of gross receipts equal to the fair market value of the product immediately prior to the additional production activities will be from sources where the farm, mine, well, deposit, or uncut timber is located. The source of gross receipts from the sale of the product in excess of the fair market value immediately prior to the additional production activities must be determined under section 1.863-3. For purposes of applying section 1.863-3, only production assets used in the additional production activities are taken into account.

(3) Definitions --

(i) Production activity.

For purposes of this section, production activity means an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages inventory. See section 1.864-1. Except as otherwise provided in sections 1.1502-13 or 1.863-3(g)(2), only production activities conducted directly by the taxpayer are taken into account.

(ii) Additional production activities.

For purposes of this section, additional production activities are substantial production activities performed directly by the taxpayer in addition to activities from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber. Whether a taxpayer's activities constitute additional production activities will be determined under the principles of section 1.954-3(a)(4). However, in no case will activities that prepare the natural resource itself for export, including those that are designed to facilitate the transportation of the natural resource to or from the export terminal, be considered additional production activities for purposes of this section.

(iii) Export terminal.

Where the farm, mine, well, deposit, or uncut timber is located without the United States, the export terminal will be the final point in a foreign country from which goods are shipped to the United States. If there is no such final point in a foreign country (e.g., the property is extracted and produced on the high seas), the export terminal will be the place of production. Where the farm, mine, well, deposit, or uncut timber is located within the United States, the export terminal will be the final point in the United States from which goods are shipped from the United States to a foreign country. The location of the export terminal is determined without regard to any contractual terms agreed to by the taxpayer and without regard to whether there is an actual sale of the products at the export terminal.

(4) Determination of fair market value.

For purposes of this section, fair market value depends on all of the facts and circumstances as they exist relative to a party in any particular case. Where the products are sold to a related party in a transaction subject to section 482, the determination of fair market value under this section must be consistent with the arm's length price determined under section 482.

(5) Determination of gross income.

To determine the amount of a taxpayer's gross income from sources within or without the United States, the taxpayer's gross receipts from sources within or without the United States determined under this paragraph (b) must be reduced by the cost of goods sold properly attributable to gross receipts from sources within or without the United States.

(6) Tax return disclosure.

A taxpayer that determines the source of its income under this paragraph (b) shall attach a statement to its return explaining the methodology used to determine fair market value under paragraph (b)(4) of this section, and explaining any additional production activities (as defined in paragraph (b)(3)(ii) of this section) performed by the taxpayer. In addition, the taxpayer must provide such other information as is required by section 1.863- 3.

(7) Examples.

The following examples illustrate the rules of this paragraph (b):

Example 1. No additional production.

U.S. Mines, a U.S. 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 title to the property is passed in the United States and, under the facts and circumstances, none of U.S. Mine's activities constitutes additional production prior to the export terminal within the meaning of paragraph (b)(3)(ii) of this section, under paragraph (b)(1) and (b)(1)(ii) of this section, gross receipts equal to the fair market value of the concentrate at the export terminal will be from sources without the United States, and excess gross receipts will be from sources within the United States.

Example 2. No additional production.

US Gas, a U.S. corporation, extracts natural gas within the United States, and transports the natural gas to a U.S. port where it is liquified in preparation for shipment. The liquified 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 from the export terminal. Therefore, under paragraph (b)(1) and (b)(1)(ii) of this section, gross receipts equal to the fair market value of the liquefied natural gas at the export terminal will be from sources within the United States, and excess gross receipts will be

from sources without the United States.

Example 3. Sale in third country.

US Gold, a U.S. corporation, mines gold in country X, produces gold jewelry in the United States, and sells the jewelry in country Y. Assume that the fair market value of the gold at the export terminal in country X is \$40, and that US Gold ultimately sells the gold jewelry in country Y for \$100. Under section 1.863-1(b), \$40 of US Gold's gross receipts will be allocated to sources without the United States. Under paragraph (b)(1)(i) of this section, the source of the remaining \$60 of gross receipts will be determined under section 1.863-3. If US Gold applies the 50/50 method described in section 1.863-3, \$20 of cost of goods sold is properly attributable to activities subsequent to the export terminal, and all of US Gold's production assets subsequent to the export terminal are located in the United States, then \$20 of gross income will be allocated to sources within the United States and \$20 of gross income will be allocated to sources without the United States.

Example 4. Production in country of sale.

US Oil, a U.S. corporation, extracts oil in country X, transports the oil via pipeline to the export terminal in country Y, refines the oil 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 at the export terminal in country Y is \$80, and that US Oil ultimately sells the refined product for \$100. Under paragraph (b)(1) of this section, \$80 of US Oil's gross receipts will be allocated to sources without the United States, and under paragraph (b)(1)(ii) of this section the remaining \$20 of gross receipts will be allocated to sources within the United States.

Example 5. Additional production prior to export.

The facts are the same as in Example 1, except that U.S. Mines also operates a smelter in country X. The concentrate output from the mill is transported to the smelter where it is transformed into smelted copper. The smelted copper is exported to purchasers in the United States. Under the facts and circumstances, all of the processes applied to make copper concentrate are considered mining. Therefore, under paragraph (b)(2) of this section, gross receipts equal to the fair market value of the concentrate at the smelter will be from sources without the United States. Under the facts and circumstances, the conversion of the concentrate into smelted copper is an additional production activity in a foreign country within the meaning of paragraph (b)(3)(ii) of this section. Therefore, the source of U.S. Mine's excess gross receipts will be determined pursuant to paragraph (b)(2) of this section.

(c) Determination of taxable income.

The taxpayer's taxable income from sources within or without the United States will be determined under the rules of sections 1.861-8 through 1.861-14T for determining taxable income from sources within the United States.

(d) Scholarships, fellowship grants, grants, prizes and awards --

(1) In general.

This paragraph (d) applies to scholarships, fellowship grants, grants, prizes and awards. The provisions of this paragraph (d) do not apply to amounts paid as salary or other compensation for services.

(2) Source of income.

The source of income from scholarships, fellowship grants, grants, prizes and awards is determined as follows:

(i) United states source income.

Except as provided in paragraph (d)(2)(iii) of this section, scholarships, fellowship grants, grants, prizes and awards made by a U.S. citizen or resident, a domestic partnership, a domestic corporation, an estate or trust (other than a foreign estate or trust within the meaning of section 7701(a)(31)), the United States (or an instrumentality or agency thereof), a State (or any political subdivision thereof), or the District of Columbia shall be treated as income from sources within the United States.

(ii) Foreign source income.

Scholarships, fellowship grants, grants, prizes and awards made by a foreign government (or an instrumentality, agency, or any political subdivision thereof), an international organization (as defined in section 7701(a)(18)), or a person other than a U.S. person (as defined in section 7701(a)(30)) shall be treated as income from sources without the United States.

(iii) Certain activities conducted outside the United States.

Scholarships, fellowship grants, targeted grants, and achievement awards received by a person other than a U.S. person (as defined in section 7701(a)(30)) with respect to activities previously conducted (in the case of achievement awards) or to be conducted (in the case of scholarships, fellowships grants, and targeted grants) outside the United States shall be treated as income from sources without the United States.

(3) Definitions.

The following definitions apply for purposes of this paragraph (d):

(i) Scholarships are defined in section 117 and the regulations thereunder.

(ii) Fellowship grants are defined in section 117 and the regulations thereunder.

(iii) Prizes and awards are defined in section 74 and the regulations thereunder.

(iv) Grants are amounts described in subparagraph (3) of section 4945(g) and the regulations thereunder, and are not amounts otherwise described in paragraphs (d)(3)(i), (ii), or (iii) of this section. For purposes of this paragraph (d), the reference to section 4945(g)(3) is applied without regard to the identity of the payor or recipient and without the application of the objective and nondiscriminatory basis test and the requirement of a procedure approved in

advance.

(v) Targeted grants are grants --

(A) Issued by an organization described in section 501(c)(3), the United States (or an instrumentality or agency thereof), a State (or any political subdivision thereof), or the District of Columbia;

(B) For an activity undertaken in the public interest and not primarily for the private financial benefit of a specific person or persons or organization.

(vi) Achievement awards are awards --

(A) Issued by an organization described in section 501(c)(3), the United States (or an instrumentality or agency thereof), a State (or political subdivision thereof), or the District of Columbia; and

(B) For a past activity undertaken in the public interest and not primarily 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 section 1.863-1 (as contained in 26 CFR part 1 revised as of April 1, 1996).

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