

room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (INTL-0003-95), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

**FOR FURTHER INFORMATION CONTACT:**

Concerning the regulations, Anne Shelburne, (202) 622-3880; concerning submissions and the hearing, Ms. Christina Vasquez, (202) 622-7180 (not toll-free numbers).

**SUPPLEMENTARY INFORMATION:**

**Paperwork Reduction Act**

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget (OMB) for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507).

Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224. Comments on the collection of information should be received by February 9, 1996.

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 collection of information requirements are in proposed §§ 1.863-1(b)(6) and 1.863-3(e)(2). This information is required by the IRS to monitor compliance with the federal tax rules for determining the source of income from the sale of natural resources or other inventory produced in the United States and sold in a foreign country or produced in a foreign country and sold in the United States. The likely respondents are taxpayers who produce natural resources or other inventory in the United States and sell in a foreign country, or who produce natural resources or other inventory in a foreign country and sell in the United States. Responses to this collection of information are required to properly determine the source of a taxpayer's income from such sales.

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.

*Estimated total annual reporting burden:* 1125 hours. The estimated annual burden per respondent varies from 1 hour to 5 hours, depending on individual circumstances, with an estimated average of 2.6 hours.

*Estimated number of respondents:* 425.

*Estimated annual frequency of responses:* One time per year.

**Background**

These proposed regulations contain rules relating to the source of income from the sale of certain natural resources and other inventory. These regulations are proposed to be effective for taxable years beginning 30 days after publication of final regulations. However, taxpayers may elect to apply these regulations for taxable years beginning after July 11, 1995.

**Explanation of Provisions**

**I. Natural Resources**

**A. Current Regulations**

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).

Section 1.863-1 of the existing regulations contains rules for determining the source of income derived from the sale of certain natural resources. Generally, under paragraph (b)(1) of those regulations, income derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber located within the United States and from the sale by the producer of the products within or without the United States ordinarily must be included in gross income from sources within the United States. However, if a taxpayer can show to the satisfaction of the District Director that, due to peculiar conditions of production and sale or for other reasons, not all of the gross income derived therefrom should be allocated to sources within the United States, the source of the income generally is determined under the 50/50 method described in § 1.863-3(b)(2).

*Example 2.* The regulations do not define "peculiar conditions of production and sale." In addition, § 1.863-1(b)(2) permits the Commissioner to make an allocation or

apportionment that more clearly reflects the proper source of a taxpayer's income, if the Commissioner determines that the application of paragraph (b)(1) does not result in the proper allocation or apportionment of income. Similar rules apply in the case of natural resources produced without the United States and sold within the United States. See § 1.863-6. Thus, income from the sale of such products ordinarily will be allocated entirely to foreign sources.

**B. Issues Under Current Regulations**

The IRS and Treasury have reexamined the existing regulations under section 863 regarding natural resources and arrived at several conclusions. First, certain ambiguities in existing § 1.863-1 should be clarified. For example, the regulation does not define the term "peculiar conditions of production and sale," and there is virtually no authoritative guidance as to the scope of that term. To the extent that "peculiar conditions of production and sale" is defined narrowly, the regulation may lead to inappropriate results when determining the source of income from the sale of processed natural resources. For example, if a U.S. corporation harvests timber to manufacture furniture for export, all of its income may be from sources within the United States. However, if another U.S. corporation purchases cut timber to manufacture furniture for export from the United States, one-half of that taxpayer's income may be from sources without the United States under the 50/50 method.

Second, the interaction of the existing regulations and the recently-issued consolidated return regulations may cause inappropriate sourcing results. On July 11, 1995, the IRS and Treasury issued final regulations under § 1.1502-13 [TD 8597 (60 FR 36671)], treating members of a U.S. consolidated group as a single entity for purposes of determining the source of a taxpayer's income. The IRS and Treasury understand that inappropriate results may occur when the current section 863 regulations are applied to certain consolidated groups on a single entity basis. For example, a U.S. corporation that is a member of a consolidated group may extract oil abroad. The oil is then transported to the United States where it is refined by another member of the consolidated group. It is sold in the United States through other members of the consolidated group. Under § 1.1502-13 of the consolidated return rules, the consolidated group is treated as a single entity, and the source of income from the sale of oil must be determined under