supplemented with a direct source of good lighting at an intensity deemed appropriate. Inspection aids such as mirror, magnifying lenses, etc., may be necessary. Surface cleaning and elaborate procedures may be required.''

(i) If no crack is found during the detailed inspection required by paragraph (i)(2) of this AD, prior to further flight, install a rivet in the open hole in accordance with the service bulletin.

(ii) If any crack is found during the inspection required by paragraph (i)(2) of this AD, prior to further flight, repair the crack in accordance with a method approved by the Manager, International Branch, ANM–116, or the DGAC (or its delegated agent).

Inspection and/or Replacement of Entry Door Structure

(j) For Model ATR42–300 series airplanes having serial numbers listed in ATR Service Bulletin ATR42–52–0052, Revision 1, dated March 2, 1993: Except as provided by paragraph (f) of this AD, prior to the accumulation of 10,000 total flight cycles, or within 90 days after April 26, 2000, whichever occurs later, accomplish the requirements of paragraphs (j)(1) and (j)(2) of this AD.

(1) Perform an eddy current inspection of the forward entry door stop holes to detect cracking, in accordance with the service bulletin. If any cracking is detected, prior to further flight, replace any cracked forward entry door stop fitting with a new fitting, in accordance with the service bulletin.

(2) Perform a detailed inspection of the forward entry door friction plates for wear, in accordance with the service bulletin. If wear is found on any friction plate, and the wear has a depth equal to or greater than 0.8mm (0.0315 in.), prior to further flight, replace the friction plate with a new or serviceable part in accordance with the service bulletin.

(k) For Model ATR42–300 series airplanes listed in ATR Service Bulletin ATR42–52–0052, Revision 1, dated March 2, 1993, accomplishment of the requirements of paragraph (l) of this AD at the time specified in paragraph (j) of this AD constitutes terminating action for the requirements of paragraph (j) of this AD.

(l) For Model ATR42–300 series airplanes listed in ATR Service Bulletin ATR42–52–0059, dated February 16, 1995: Prior to the accumulation of 18,000 total flight cycles, or within 180 days after April 26, 2000, whichever occurs later, accomplish the requirements of paragraphs (l)(1), (l)(2), and (l)(3) of this AD in accordance with the service bulletin.

(1) Replace the forward entry door friction plates with improved friction plates.

(2) Replace the upper corners of the forward entry door surround structure with improved door surround corners.

(3) Replace the forward entry door stop fittings and bolts with improved fittings and bolts.

New Requirements of This AD

Replacing Hinges on the Cargo Compartment Door and Fuselage

(m) For airplanes identified as having main serial numbers (MSNs) 317, 319, 321, 323, 325, 327, 329 through 335 inclusive, 360, and 368 that are equipped with a cargo compartment door on which Aerospatiale Modification 3191 has not been accomplished: Prior to the accumulation of 27,000 total flight hours, or within 180 days after the effective date of this AD, whichever occurs later, replace the hinges on the cargo compartment door and fuselage (including inspections for fastener type and tolerances, hole diameters, or cracking, and repair; as applicable) with new improved hinges, in accordance with the Accomplishment Instructions of Avions de Transport Regional (ATR) Service Bulletin ATR42–52–0058, Revision 2, dated June 22, 2000.

(n) Where the instructions in ATR Service Bulletin ATR42–52–0058, Revision 2, dated June 22, 2000, specify that ATR is to be contacted for a repair, prior to further flight, repair in accordance with a method approved by the Manager, International Branch, ANM–116, FAA; or the DGAC (or its delegated agent).

Alternative Methods of Compliance (AMOCs)

(o) The Manager, International Branch, ANM–116, has the authority to approve AMOCs for this AD, if requested in accordance with the procedures found in 14 CFR 39.19.

Related Information

(p) French airworthiness directive 2000–337–079(B), dated July 26, 2000, also addresses the subject of this AD.

Issued in Renton, Washington, on September 9, 2005.

Ali Bahrami,

Manager, Transport Airplane Directorate, Aircraft Certification Service.

[FR Doc. 05–18528 Filed 9–16–05; 8:45 am]

BILLING CODE 4910–13–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–106030–98]

RIN 1545–AW50

Source of Income From Certain Space and Ocean Activities; Source of Communications Income

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Withdrawal of notice of proposed rulemaking; notice of proposed rulemaking; and notice of public hearing.

SUMMARY: This document contains proposed regulations under section 863(d) governing the source of income from certain space and ocean activities. It also contains proposed regulations under section 863(a), (d), and (e) governing the source of income from certain communications activities. This document also contains proposed regulations under section 863(a) and (b), amending the regulations in § 1.863–3 to conform those regulations to these proposed regulations. This document affects persons who derive income from activities conducted in space, or on or under water not within the jurisdiction of a foreign country, possession of the United States, or the United States (in international water). This document also affects persons who derive income from transmission of communications. In addition, this document provides notice of a public hearing on these proposed regulations and withdraws the notice of proposed rulemaking (66 FR 3903) published in the **Federal Register** on January 17, 2001.

DATES: Written or electronic comments must be received by November 23, 2005. Outlines of topics to be discussed at the public hearing scheduled for December 15, 2005, at 10 a.m., must be received by November 23, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–106030–98), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG–106030–98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically, via either the IRS Internet site at *http://www.irs.gov/regs* or the Federal eRulemaking Portal at *http://www.regulations.gov* (IRS–REG–106030–98). The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Edward R. Barret, (202) 622–3880; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Cynthia Grigsby, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been reviewed and approved by the Office of Management and Budget (OMB) in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–1718.

The collection of information in these proposed regulations is in §§ 1.863–8(g) and 1.863–9(g). This information is required by the IRS to monitor

compliance with the Federal tax rules for determining the source of income from space or ocean activities, or from transmission of communications.

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 assigned by the Office of Management and Budget.

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

Congress enacted section 863(d) and (e) as part of the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2085) (the 1986 Act). Section 863(d) governs the source of income derived from certain space and ocean activities. Section 863(e) governs the source of income derived from international communications activity.

On January 17, 2001, the Treasury Department and the IRS published a notice of proposed rulemaking (REG–106030–98) in the **Federal Register** (66 FR 3903) under section 863(a), (b), (d), and (e) (the 2001 proposed regulations). The 2001 proposed regulations provide two sets of rules, one in § 1.863–8 for determining the source of income from space and ocean activities (space and ocean income), the other in § 1.863–9 for determining the source of income from communications activity (communications income).

The IRS received numerous written comments on the 2001 proposed regulations and held a public hearing on May 23, 2001. Since that time, the aerospace, telecommunications, and related industries have experienced substantial technological evolution and significant business change and consolidation. In addition, the American Jobs Creation Act of 2004, Public Law 108–357, (AJCA) enacted a number of materially relevant statutory changes that affect the treatment of space and ocean income for purposes of the foreign tax credit and subpart F. In light of the extensive written comments, industry evolution, and AJCA changes, the Treasury Department and the IRS believe it is appropriate to repropose these regulations to provide a further opportunity for comment. Accordingly, this document withdraws the 2001 proposed regulations and provides new proposed regulations, which are referred to herein as the reproposed regulations.

Explanation of Provisions

A. Space and Ocean Activity Under Section 863(d)

1. Space and Ocean Income

Section 863(d)(2)(A)(i) defines space activity to include any activity conducted in space. Section 863(d)(2)(A)(ii) defines ocean activity to include any activity conducted on or under water not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States. Section 863(d)(2)(B) excludes three specific types of activities from the definition of space or ocean activity. Section 863(d)(1) generally provides that, except as provided in regulations, any income derived from a space or ocean activity (space and ocean income) is U.S. source income if derived by a U.S. person and foreign source income if derived by a foreign person.

Pursuant to the statute's grant of regulatory authority, the reproposed regulations provide that a U.S. person's space and ocean income will be sourced outside the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries. This approach to allocation of space and ocean income between U.S. and foreign sources is pursuant to broad regulatory authority in section 863(d). The reproposed regulations also contain certain exceptions to the general foreign source rule for space and ocean income of foreign persons.

2. Space and Ocean Income of U.S.-Owned Foreign Corporation

Section 1.863–8(b)(2) of the 2001 proposed regulations provides that if U.S. persons own 50 percent or more of a foreign corporation by vote or value (directly, indirectly, or constructively) and such corporation is not a controlled foreign corporation within the meaning of section 957 (CFC), all space and ocean income derived by the corporation (hereinafter a U.S.-owned foreign corporation) is U.S. source income.

Several commentators requested that § 1.863–8(b)(2) of the 2001 proposed regulations be withdrawn. Commentators stated that the rule expanded the scope of U.S. taxing jurisdiction beyond the apparent intent of Congress by subjecting income not covered by subpart F to immediate U.S. taxation. Several commentators also stated that under the rule space and ocean income could in some cases be subject to multiple levels of taxation. In this regard, some commentators noted that the space and ocean income of a U.S.-owned foreign corporation could be subject to potential double taxation at the corporate level (by the United States and by the U.S.-owned foreign corporation's country of residence or the countries where such corporation does business) because § 1.863–8(b)(2) of the 2001 proposed regulations makes such space and ocean income U.S. source. When the U.S.-owned foreign corporation's space and ocean income is distributed as a dividend, that income could be subject to an additional level of tax in the hands of its shareholders. Consequently, some commentators suggested that, if the rule were retained, the space and ocean income of U.S.-owned foreign corporations should be considered U.S. source solely for purposes of the U.S. shareholder's foreign tax credit limitation under section 904(a). Some commentators noted that although section 245 may partially ameliorate this situation by providing a dividends received deduction (DRD) to shareholders of foreign corporations in certain circumstances, the DRD would be limited to 80 percent of qualifying dividends.

Some commentators also noted potential withholding tax issues with the source rules for U.S.-owned foreign corporations. In such cases, U.S. source fixed or determinable annual or periodic income (FDAP) of a U.S.-owned foreign corporation would (in the absence of an applicable treaty) likely be subject to the 30-percent gross income tax imposed by section 881, which is typically collected through withholding by the payors of such income. Commentators stated that enforcement and administration of the 30-percent tax and withholding requirements could present multiple challenges (and potential multiple withholding tax obligations) for payments between foreign persons.

Several commentators addressed the stock ownership test applicable to U.S.-owned foreign corporations. They stated that determining whether a foreign corporation is 50-percent U.S.-owned, especially without regard to the size of an owner's holding, presents potential difficulties (for example, when the foreign corporation is widely-held). Some commentators stated that the indirect and constructive ownership rules are complex and would make it difficult for payors of space and ocean income to determine withholding tax obligations. Some commentators suggested that if the rule were retained, the determination whether a foreign corporation is 50-percent U.S.-owned

should be similar to the determination of CFC status, that is, only U.S. persons who own or are considered to own 10 percent or more of the total combined voting power of all classes of stock entitled to vote should be counted. Some commentators stated that the rule should not apply to publicly-traded foreign corporations.

In light of the potential complexity in determining whether a foreign corporation is a U.S.-owned foreign corporation and the belief of the Treasury Department and the IRS that space and ocean income earned by foreign corporations should be sourced in accord with the rules for foreign persons, with the limited exception for certain CFCs discussed below, the reproposed regulations do not include a special source rule for space and ocean income earned by a U.S.-owned foreign corporation. Instead, the space and ocean income of foreign corporations (other than CFCs) is sourced under the applicable provisions of reproposed § 1.863–8(b)(2)(i) or (iii). Under these provisions, space and ocean income of a foreign person is generally foreign source income. Space and ocean income of a foreign person (other than a CFC) that is engaged in trade or business within the United States is U.S. source income to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed within the United States.

3. Space and Ocean Income of CFCs

In enacting section 863(d), Congress ultimately did not adopt a provision included in early versions of the legislation that would have treated a CFC as a U.S. person for purposes of determining the source of a CFC's space and ocean income. The legislative history to the 1986 Act indicates that Congress at that time viewed the provision as unnecessary because ''[t]he application of the separate foreign tax credit limitation for shipping income to any space or ocean income derived by a [CFC] provides adequate assurance, in the conferee's view, that high foreign taxes on unrelated income will not inappropriately offset U.S. taxes on this generally low-taxed income.'' H.R. Conf. Rep. No. 99–841, 99th Cong., 2d Sess., Vol. II, at II–600 (Sept. 18, 1986); see also Staff of Joint Comm. on Taxation, *General Explanation of the Tax Reform Act of 1986,* JCS–10–87, at 934 (May 4, 1987). Consequently, the 2001 proposed regulations also did not contain such a rule and only treated a U.S.-owned foreign corporation as a U.S. person for purposes of determining the source of space and ocean income.

In 2004, AJCA enacted a number of significant statutory changes to subpart F and the foreign tax credit regimes as applicable to space and ocean income. These statutory changes have been taken into account in issuing the reproposed regulations.

Section 415 of AJCA eliminated foreign base company shipping income from the definition of foreign base company income. This change is effective for taxable years of foreign corporations beginning after December 31, 2004, and for taxable years with or within which such taxable years of foreign corporations end. Prior to AJCA, foreign base company shipping income was defined by section 954(f) to include any income derived from a space or ocean activity as defined in section 863(d)(2).

In addition, section 404 of AJCA reduced the number of foreign tax credit limitation categories from nine to two (i.e., passive category income and general category income) in order to address Congressional concerns regarding the complexity of the foreign tax credit calculation. See H.R. Rep. No 108–548, 108th Cong., 2d Sess., at 190 (June 16, 2004). This change is effective for taxable years beginning after December 31, 2006. Prior to AJCA, section 904(d) treated shipping income, defined as income ''which would be foreign base company shipping income (as defined in section 954(f)),'' as a separate category of income for foreign tax credit limitation purposes. For taxable years beginning after December 31, 2006, space and ocean income will generally fall into the general limitation category. See H.R. Conf. Rep. No. 108–755, 108th Cong., 2d Sess., at 383 (Oct. 7, 2004).

The Treasury Department and the IRS believe that the changes made by AJCA with respect to the foreign tax credit reflect a decision to reduce the complexity in the foreign tax credit calculation caused by having nine foreign tax credit categories of income as well as a willingness to allow additional cross-crediting in order to minimize such complexity. However, the Treasury Department and the IRS also believe that for taxable years beginning after December 31, 2006, Congress's concern expressed in the 1986 Act that high foreign taxes on unrelated income may inappropriately offset U.S. taxes on space and ocean income, which is generally subject to low foreign taxes, is no longer addressed by the foreign tax credit rules because space and ocean income likely will be general limitation category income. In addition, Congress provided a broad grant of regulatory authority to the Treasury Department and the IRS in section 863(d) to issue guidance with respect to the source of space and ocean income.

In light of AJCA, the reproposed regulations provide that if a foreign corporation is a CFC, its space and ocean income, like that of a U.S. person, is income from sources within the United States. However, a CFC's space and ocean income is sourced outside the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries. This allocation approach is pursuant to broad regulatory authority under section 863(d).

As noted above, several commentators stated that under the rule for U.S.-owned foreign corporations in the 2001 proposed regulations, space and ocean income could in some cases be subject to multiple levels of taxation. The Treasury Department and the IRS believe that the reproposed regulations mitigate such a possibility for CFCs because the reproposed regulations provide for foreign sourcing when a CFC's space and ocean income is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries. The rule for CFCs in the reproposed regulations is thus a rule of limited application that, consistent with the legislative history of the 1986 Act, provides U.S. source treatment only with respect to space and ocean income attributable to activities in space or international water that are not likely to be subject to tax in any foreign country. The rule for CFCs will permit a United States shareholder to establish as foreign source the amount of income attributable to the CFC's operations in a foreign country or countries.

Several commentators submitted comments on potential withholding tax issues posed by the 2001 proposed regulations. The Treasury Department and the IRS recognize that certain provisions of the reproposed regulations (such as the source rule for the space and ocean income of CFCs in reproposed § 1.863–8(b)(2)(ii)) may raise similar withholding tax issues. The Treasury Department and the IRS accordingly seek comments on these issues, in particular with regard to the following: (1) The extent to which Form W–8ECI, ''Certificate of Foreign Person's Claim for Exemption From Withholding on Income Effectively Connected With the Conduct of a Trade or Business in the United States'', may practically address these issues; (2) the nature of

situations in which withholding tax issues will arise (for example, how particular businesses involving space, ocean, or communications activities are conducted, whether payors of income potentially subject to withholding under the reproposed regulations are typically related or unrelated parties, etc.); and (3) suggestions to address these issues in the cases in which they arise.

4. Space and Ocean Income of a Foreign Person Engaged in a Trade or Business Within the United States

Section 1.863–3(b)(3) of the 2001 proposed regulations provides that if a foreign person is engaged in a trade or business within the United States, the foreign person's income derived from a space or ocean activity is presumed to be U.S. source income. The rule reflects the general view of the Treasury Department and the IRS that Congress intended that a foreign person engaged in a substantial business within the United States be subject to U.S. tax on related space or ocean income. However, the Treasury Department and the IRS recognize that the presumption may be over-inclusive in certain cases. Therefore, the 2001 proposed regulations provide that if the foreign person can allocate gross space or ocean income between income from sources within the United States, space, or international water, and sources without the United States, space, and international water, to the satisfaction of the Commissioner, based on all the facts and circumstances, income allocated to sources without the United States, space, and international water will be treated as foreign source income.

Several commentators stated that the presumption is overbroad, given that it applies to all space and ocean income regardless of any nexus with the foreign corporation's U.S. trade or business. Several commentators suggested that if the presumption were retained, objective standards consistent with existing rules for effectively connected income should be included to ensure that the space and ocean income has a meaningful connection with the foreign corporation's U.S. trade or business. In the absence of objective standards, commentators stated that taxpayers should be permitted to apply a reasonable allocation method on a consistent basis to all of their space and ocean income. In addition, as with § 1.863–8(b)(2) of the 2001 proposed regulations, several commentators stated that under § 1.863–8(b)(3) of the 2001 proposed regulations space and ocean income could in some cases be subject to multiple levels of taxation.

In response to these comments, the reproposed regulations provide that if a foreign person, other than a CFC, is engaged in a trade or business within the United States, its space or ocean income is from sources within the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed within the United States.

The Treasury Department and the IRS believe that the revision in reproposed § 1.863–8(b)(2)(iii) providing that space or ocean income will be U.S. source income to the extent the space or ocean income is attributable to functions performed, resources employed, or risks assumed in the United States should mitigate commentators' concerns about potential multiple levels of taxation.

Examples 12 and *13* in § 1.863–8(f) of the 2001 proposed regulations illustrate the application of § 1.863–8(b)(3) of those regulations to foreign persons that conduct certain activities in the United States. One commentator noted that these examples appear to state that engaging in certain activities would constitute the conduct of a trade or business in the United States. In response to this comment, *Examples 12* and *13* have been clarified in the reproposed regulations to state that they assume, on the facts of the example, that the activities constitute the conduct of a trade or business within the United States within the meaning of section 864(b). The Treasury Department and the IRS intend that the determination whether a foreign person is engaged in a trade or business in the United States continue to be made under general section 864(b) principles.

5. Source Rules for Sales of Property in Space or International Water

The 2001 proposed regulations provide generally that taxpayers must apply the rules of section 863(d) and the 2001 proposed regulations to determine the source of income from sales of property purchased or produced by the taxpayer, either when production occurs in whole or in part in space or international water, or when the sale occurs in space or international water. Under the 2001 proposed regulations, income from sales of inventory property (within the meaning of section 1221(a)(1)) on international water is sourced under § 1.863–3(c)(2). Section 1.863–3(c)(2), as amended by the 2001 proposed regulations, provides that the place of sale will be presumed to be the United States when property is produced in the United States and the property is sold to a U.S. resident for use in space or international water; in such cases, the property will be treated as sold for use, consumption, or disposition in the United States.

Section 1.863–8(d)(1)(i) of the 2001 proposed regulations defines space activity to include the sale of property in space. Section 1.863–8(d)(1)(ii) of the 2001 proposed regulations defines ocean activity to include the sale of property in international water, but not the sale of inventory property on international water. Under § 1.863–8(d)(2)(iii) of the 2001 proposed regulations, a sale occurs in space or international water if the property is located in space or international water at the time the rights, title, and interest of the seller in the property are transferred to the purchaser, or if the property is sold for use in space or international water.

For sales in space or international water of property produced by the taxpayer, § 1.863–8(b)(4)(ii)(A) of the 2001 proposed regulations generally provides that the source of income attributable to sales activity is determined under § 1.863–8(b)(1), (2), or (3) of the 2001 proposed regulations. If, however, the taxpayer sells such property outside space and international water, the source of income attributable to sales activity is determined under § 1.863–3(c)(2).

Commentators stated that the inclusion of sales of inventory property in space or international water in the definitions of space and ocean activity is inconsistent with the legislative history of the 1986 Act, which indicates that the Senate Committee on Finance did not intend sales of inventory property on the high seas to be considered space or ocean activity. See S. Rep. No. 99–313, at 359.

In response to comments, the reproposed regulations provide that sales of inventory property in space or international water will be considered space or ocean activity only if the inventory property is sold for use, consumption, or disposition in space or international water. In such cases, the source of income will be determined under the source rules provided for space and ocean income by the reproposed regulations. The source of income from sales in space or international water of inventory property when the inventory property is sold for use, consumption, or disposition outside space and international water will be determined under §§ 1.861–7(c) and 1.863–3(c)(2). The Treasury Department and the IRS believe that sales of property in space or international water—with the exception of sales of inventory property in space

or international water for use, consumption, or disposition outside space or international water—should be considered space or ocean activity, and that the source of income from such sales should be determined under section 863(d). The Treasury Department and the IRS believe that this result is consistent with both the statute and the legislative history. The statute provides that space or ocean activity includes any activity in space or international water. However, the Senate Report states that the Senate Committee on Finance did not intend to override the general source rule in § 1.861–7(c) for sales of property on the high seas. See S. Rep. No. 99–313, at 359. Thus, sales of inventory property in transit between the United States and a foreign country will continue to be sourced under sections 861 through 865, and not section 863(d).

The reproposed regulations do not contain the presumption in § 1.863–3(c)(2) of the 2001 proposed regulations regarding sales of property produced by the taxpayer in the United States to U.S. residents for use in space or international water. Under the reproposed regulations, if such sales occur in space or international water, the source of income attributable to sales activity will be determined under reproposed § 1.863–8(b)(3)(ii)(D).

6. Special Rule for Determining the Source of Income From Services

Section 1.863–8(b)(5) of the 2001 proposed regulations provides that income derived from the performance of services in space or international water is sourced under § 1.863–8(b)(1), (2), or (3) of the 2001 proposed regulations, as applicable. Section 1.863–8(d)(2)(ii)(A) of the 2001 proposed regulations contains a general rule providing that the performance of a service is a space or ocean activity in its entirety when a part of the service, even if *de minimis*, is performed in space or international water.

The Treasury Department and the IRS recognized that this rule could be over-inclusive in certain cases. Therefore, § 1.863–8(d)(2)(ii)(A) of the 2001 proposed regulations provides a facilitation exception, under which a service will not be treated as either space or ocean activity if the taxpayer's only activity in space or international water is to facilitate the taxpayer's own communications as part of the provision or delivery of a service provided by the taxpayer, and the service would not otherwise be a space or ocean activity. Section 1.863–8(b)(5) of the 2001 proposed regulations also provides that if the taxpayer can allocate, to the satisfaction of the Commissioner, gross income from the services transaction between performance occurring outside space and international water, and performance occurring in space or international water, the source of income allocated to performance occurring outside space and international water will be determined under sections 861, 862, 863, and 865.

Several commentators commented unfavorably on a rule that characterizes an entire services transaction as space or ocean activity when only *de minimis* performance occurs in space or international water. Several commentators noted that even though § 1.863–8(b)(5) of the 2001 proposed regulations permits a taxpayer to source services income to sources outside space or international water, the entire transaction continues to be characterized as space or ocean activity, and all income derived from the services transaction is thus included in the separate subpart F and foreign tax credit limitation category for shipping income. Some commentators stated that under the 2001 proposed regulations significant consequences result from characterization as a services transaction, even though the characterization rules are themselves unclear. Some commentators also stated that the facilitation exception to space or ocean activity characterization is confusing, and that the example intended to illustrate the application of the facilitation exception (*Example 4* in § 1.863–8(f) of the 2001 proposed regulations) is itself unclear.

As noted above, subsequent to the publication of the 2001 proposed regulations, AJCA amended the subpart F rules relating to space and ocean income by eliminating shipping income as a category of subpart F income and reduced the number of foreign tax credit limitation categories from nine to two (with space and ocean income generally falling into the general limitation category) for taxable years beginning after December 31, 2006. The Treasury Department and the IRS believe that these statutory changes should allay commentators' concerns regarding the characterization of a services transaction as space or ocean activity. In addition, as discussed below, the reproposed regulations provide that if the taxpayer can demonstrate the value of the service attributable to performance in space or international water and the value of the service attributable to performance outside space and international water, then the service will be treated as a space or ocean activity only to the extent of the activity performed in space or international water. The value of the service is attributable to performance occurring in space or international water to the extent the performance of services, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in space or international water.

Based on the comments, the reproposed regulations eliminate the facilitation exception. Under reproposed § 1.863–8(d)(2)(ii), to the extent, based on all the facts and circumstances, the value of the service attributable to functions performed, resources employed, or risks assumed in space or international water is *de minimis*, such service is not treated as space or ocean activity. The adoption of the *de minimis* rule is intended to address taxpayer concerns about potential confusion in qualifying for the facilitation exception. *Example 4* of reproposed § 1.863–8(f) has been revised accordingly.

The rule for determining the source of income from performance of services that occur in part in space or international water and in part outside space and international water has been adapted to conform to the changes made to reproposed § 1.863–8(d)(2)(ii). To the extent a service is characterized as space or ocean activity under reproposed § 1.863–8(d)(2)(ii), the source of gross income derived from such transaction is determined under reproposed § 1.863–8(b)(1) or (2), as applicable, as provided by reproposed § 1.863–8(b)(4). Accordingly, to the extent the value of the service, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed outside space and international water, the service will not constitute space or ocean activity, and, to that extent, the source of income from the service will be determined under section 861, 862, or 863, as applicable.

7. Definition of Space and Ocean Activity

a. Foreign Communications Activity as Space or Ocean Activity

Section 1.863–8(b)(6) of the 2001 proposed regulations provides that space and ocean activity include communications activity (but not international communications activity) occurring in space or international water. Foreign communications activity is thus characterized under the 2001 proposed regulations as space or ocean activity when, for example, part of the transmission is via satellite or via underwater cable located in international water.

Commentators requested that the regulations characterize income from foreign-to-foreign communications as international communications income, which is specifically excluded from the definition of space and ocean activity by section 863(d)(2)(B) and § 1.863–8(d)(3) of the 2001 proposed regulations, but retain the 100 percent foreign source rule otherwise provided for foreign communications income by § 1.863–9(b)(4) of the 2001 proposed regulations. International communications income is defined by section 863(e)(2) as income derived from the transmission of communications between the United States and a foreign country (or possession of the United States) and is discussed in greater detail below.

Commentators noted that this rule puts telecommunications companies using satellite or underwater cable methods of transmission at a competitive disadvantage vis-á-vis competitors in foreign marketplaces that use solely land-based facilities. For example, if a CFC were paid to transmit a telephone call between two foreign countries and used a land line connecting the two countries to transmit the call, the CFC's income from the transmission would be included in the general limitation category for foreign tax credit purposes. If the communication were transmitted using fiber optic cable located in international water or a satellite, the CFC's income from the transmission would be foreign source space or ocean income included in the separate subpart F and foreign tax credit limitation category for shipping income.

The reproposed regulations do not characterize income from foreign-to-foreign communications as international communications income as suggested by commentators. Section 863(d)(2)(A) broadly defines space and ocean activity as *any activity* conducted in space or international water. The statutory exception to space and ocean activity in section 863(d)(2)(B) removes only activities giving rise to international communications income from the scope of space and ocean activity. In addition, if foreign-to-foreign communications income were characterized as international communications income, U.S. persons with such income would be subject to the statutory source rule in section 863(e)(1)(A), which provides for the split-sourcing of a U.S. person's international communications income. The Treasury Department and the IRS thus consider the language of the statute to preclude the approach suggested by commentators with respect to the characterization and sourcing of income from foreign-to-foreign communications. The legislative history of the 1986 Act also indicates that Congress intended income from foreign-to-foreign communications to be foreign source income. See S. Rep. No. 99–313, at 359, ''Finally, if the communication is between two foreign locations, the committee intends income attributable thereto to be foreign source.''. This would not be the result, however, if foreign-to-foreign communications income were included in the definition of international communications income and thus subject to the statute's 50/50 source rule for U.S. persons.

In addition, as noted above, AJCA made significant changes to subpart F and the foreign tax credit regime as applicable to space and ocean income. The Treasury Department and the IRS believe that these statutory changes should allay commentators' concerns regarding the characterization of foreign-to-foreign communications as space or ocean activity.

The Treasury Department and the IRS believe that the modifications in the reproposed regulations with respect to the characterization of services involving space or ocean activities address some of the commentators' concerns regarding the characterization of foreign-to-foreign communications activities involving services performed both in space or international water and in foreign countries. Reproposed § 1.863–8(d)(2)(ii) provides that a transaction characterized as the performance of a service will be treated as a space or ocean activity only to the extent the value of the service, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in space or international water.

b. Definition of Space

Section 1.863–8(d)(1)(i) of the 2001 proposed regulations defines space as any area not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States, and not in international water. Under the 2001 proposed regulations, space comprises the entire area outside the jurisdiction of any country or U.S. possession, extending from just above the surface of international water (and Antarctica) through, and beyond, the earth's atmosphere. Space thus includes international airspace.

Several commentators stated that the definition of space should be limited to the area beyond the earth's atmosphere. One commentator proposed a definition of space that conforms to a definition used for non-tax purposes (for example, beyond the maximum altitude at which powered flight by aircraft equipped with air-breathing engines is possible). Another commentator stated that the definition of space could be read to include cyberspace, the electronic medium in which online communication takes place, and suggested that cyberspace be specifically excluded from the definition of space. One commentator noted language in the legislative history stating that space activities had not been very prevalent at the time of the 1986 Act (see, for example, S. Rep. No. 99–313, at 358) and argued that Congress did not intend to include international airspace in space.

No changes were made to the reproposed regulations in response to these comments. The Treasury Department and the IRS believe a broad definition of space that includes international airspace is consistent with legislative intent to assert primary tax jurisdiction over income earned by U.S. residents that is not within any foreign country's taxing jurisdiction. See, *e.g.*, S. Rep. No. 99–313, at 357. The Treasury Department and the IRS also believe that providing guidance with respect to the place of performance of activities involving online communications is beyond the scope of the present regulations, and that taxpayers should rely on generally applicable principles to determine where functions are performed, resources are employed, or risks are assumed in a specific online transaction.

c. Transportation Income

Certain activities occurring in space or international water are not considered either space or ocean activity. Section 1.863–8(d)(3)(i) of the 2001 proposed regulations, consistent with section 863(d), provides that space or ocean activity does not include any activity that gives rise to transportation income as defined in section 863(c).

One commentator stated that a portion of a bareboat charter—the return of an empty vessel that has unloaded its cargo (backhaul)—may potentially be considered ocean activity under the 2001 proposed regulations. Another commentator stated that income from container leasing by a party other than the ship operator could constitute space or ocean income, and could be subject to withholding tax. One commentator also suggested that the regulations should state that they do not apply to the income of foreign corporations derived from the international operation of ships, or to container leasing.

The reproposed regulations do not adopt changes to reflect these

comments. The reproposed regulations reflect the broad statutory definition of ocean activity in section 863(d)(2) as ''any activity conducted on or under water not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States.'' The Treasury Department and the IRS do not consider it appropriate to construe the definition of section 863(c) transportation income in the context of these regulations. The Treasury Department and the IRS will consider addressing the definition of section 863(c) transportation income in separate guidance.

8. Treatment of Partnerships

Section 1.863–8(e) of the 2001 proposed regulations generally provides that section 863(d) and the regulations thereunder will be applied to domestic partnerships at the partnership level and to foreign partnerships at the partner level. Commentators suggested that the source rules of § 1.863–8 of the 2001 proposed regulations be applied to all partnerships either at the entity level or at the partner level.

The Treasury Department and the IRS believe that section 863(d) should be applied to domestic and foreign partnerships in the same manner. Accordingly, the reproposed regulations do not provide a different rule for foreign partnerships and domestic partnerships. Section 1.863–8(e) of the reproposed regulations provides that section 863(d) and the regulations thereunder will be applied to domestic partnerships at the partner level. In order to conform the treatment of domestic and foreign partnerships, no change was made with respect to the rule in the 2001 proposed regulations that section 863(d) and the regulations thereunder will be applied to foreign partnerships at the partner level.

9. Allocations

When a taxpayer must allocate gross income to the satisfaction of the Commissioner, based on all the facts and circumstances, under the provisions of the 2001 proposed regulations, the Treasury Department and the IRS believe such allocations generally should be based on section 482 principles.

Several commentators stated that allocation of gross income based on section 482 principles will be burdensome and expensive and will create uncertainty. Commentators also noted that the 2001 proposed regulations provide no guidance on allocating income other than a facts and circumstances approach.

The Treasury Department and the IRS consider the allocation of gross income based on the general guidance of section 482 to be an approach that is well-suited to application in the wide variety of factual contexts within the scope of the reproposed regulations. The Treasury Department and the IRS solicit comments on alternative methods of allocation for particular industries and criteria that could be used to evaluate the reasonableness of such methods.

10. Reporting and Documentation Requirements

In order to satisfy the Commissioner with respect to a taxpayer's allocation of gross income under § 1.863–8(b)(3), (b)(4)(ii)(C), or (b)(5) of the 2001 proposed regulations, the taxpayer must make the allocation on a timely filed original return (including extensions). An amended return does not qualify for this purpose, and section 9100 relief will not be available. In all cases, a taxpayer must also maintain contemporaneous documentation regarding the allocation of gross income, allocation and apportionment of expenses, losses, and other deductions, the methodologies used, and the circumstances justifying use of those methodologies. The taxpayer must produce such documentation within 30 days upon request.

Commentators stated that neither the statute nor the legislative history provides a basis for the reporting, recordkeeping, and contemporaneous documentation requirements in the 2001 proposed regulations. Commentators also noted that the Code and regulations do not contain similar requirements with respect to certain other expense allocation provisions.

The reproposed regulations generally retain the recordkeeping and documentation requirements. The Treasury Department and the IRS believe that it is appropriate to require taxpayers to keep proper records, and additionally note the potentially considerable difficulties the IRS would face in performing the allocations required by the reproposed regulations without appropriate taxpayer records.

The Treasury Department and the IRS recognize, however, that taxpayers may not have all the information necessary to make allocations at the time a return is originally filed. The reproposed regulations therefore provide that a taxpayer may make changes to allocations made on the taxpayer's original return with respect to any taxable year for which the statute of limitations has not closed, subject to certain conditions. Nonetheless, changes to such allocations that are not made until an audit of the taxable year to which the allocations relate has commenced, or a taxpayer's failure timely to provide documentation and other information supporting the allocations, create administrative difficulties for the IRS. Accordingly, reproposed § 1.863–8(g)(4) sets forth the actions required of taxpayers and the procedures the IRS will follow in the case of taxpayers that change their allocations.

The reproposed regulations also require taxpayers, upon request, to provide access to the software programs and other systems used by the taxpayer to make allocations under these regulations. For this purpose, software has the meaning provided in section 7612(d). The Treasury Department and the IRS believe that the IRS could face significant administrative and other difficulties in the examination of allocations made under these regulations without access to such software.

11. Examples

Certain examples in § 1.863–8(f) of the 2001 proposed regulations contain statements regarding the characterization of certain activities (as, for example, the lease of equipment or the performance of services). One commentator suggested that the examples clarify that the character of the transactions at issue is only assumed for purposes of the specific example. In response to this comment, the examples in reproposed § 1.863–8(f) have been revised to make clear that the characterization of certain transactions is assumed based on the facts of the specific example. The Treasury Department and the IRS did not consider it necessary to modify certain other examples (for example, *Example 1* of reproposed § 1.863–8(f)) in which the character of the transaction at issue should be clear under the facts presented.

In addition, *Examples 2, 3, 4,* and *7* of reproposed § 1.863–8(f), have been revised to reflect substantive changes made to reproposed § 1.863–8(b)(4) and (d)(2)(ii) with respect to services that involve activities performed in space or international water.

B. Communications Activity Under Section 863(a), (d), and (e)

1. International Communications Income

International communications income is defined by section 863(e)(2) as income derived from the transmission of communications between the United States and a foreign country (or

possession of the United States). Section 863(e)(1)(A) provides that in the case of any U.S. person, 50 percent of any international communications income will be sourced in the United States and 50 percent of such income will be sourced outside the United States. Section 863(e)(1)(B)(i) provides that any international communications income of a foreign person will be foreign source income except as provided in regulations or in section 863(e)(1)(B)(ii). Section 1.863–9(b)(2)(ii)(A) of the 2001 proposed regulations states the general rule that international communications income of a foreign person is foreign source income. However, the 2001 proposed regulations contain certain exceptions to the general rule.

2. International Communications Income of 50-Percent or More U.S.-Owned Foreign Corporations

The first exception, in § 1.863–9(b)(2)(ii)(B) of the 2001 proposed regulations, provides that if U.S. persons own 50 percent or more of a foreign corporation by vote or value (directly, indirectly, or constructively), including a CFC within the meaning of section 957, international communications income derived by that corporation is entirely U.S. source income.

As with the similar rule provided for the space and ocean income of U.S.-owned foreign corporations in § 1.863–8(b)(2) of the 2001 proposed regulations, several commentators requested that the rule be withdrawn because it expands the scope of U.S. taxing jurisdiction beyond the apparent intent of Congress. Commentators stated that the rule is punitive in nature because it is less favorable than the 50/50 source rule applied to international communications income earned directly by U.S. persons. As with § 1.863–8(b)(2) and (3) of the 2001 proposed regulations, commentators also stated that under the rule the international communications income of certain foreign corporations may be subject to multiple levels of taxation.

Commentators noted that in certain circumstances international communications income could be subject to the 30-percent gross income tax imposed by section 881, which is typically collected through withholding by the payors of such income. Commentators stated that although most tax treaties should prevent the imposition of the 30-percent tax (international communications income would likely be characterized as business profits under most treaties and would accordingly be exempt from U.S. taxation unless attributable to a permanent establishment in the United States), the rule in the 2001 proposed regulations would result in disparate treatment for corporations from treaty countries vis-à-vis corporations from non-treaty countries. The requirement to withhold the 30-percent tax could also create numerous administrative and enforcement difficulties. In addition, given the extent of resale of capacity between telecommunications providers, commentators noted that payments relating to the same transmission could be subject to multiple withholding. Finally, as with the similar rule provided for the space and ocean income of U.S.-owned foreign corporations in § 1.863–8(b)(2) of the 2001 proposed regulations, commentators raised the issue of potential difficulties in determining whether a foreign corporation is 50-percent or more U.S.-owned.

As noted above, several commentators addressed the stock ownership test applicable to U.S.-owned foreign corporations. They stated that determining whether a foreign corporation is 50-percent U.S. owned, especially without regard to the size of an owner's holding, presents potential difficulties (for example, when the foreign corporation is widely-held).

In light of the potential complexity in determining whether a foreign corporation is a U.S.-owned foreign corporation and the belief of the Treasury Department and the IRS that international communications income earned by foreign corporations should be sourced in accord with the rules for foreign persons, with the limited exception for CFCs discussed below, the reproposed regulations do not include a special source rule for international communications income earned by a 50 percent or more U.S.-owned foreign corporation. Instead, the international communications income of foreign corporations (other than CFCs) is sourced under the applicable provisions of reproposed § 1.863–9(b)(2)(i), (iii), and (iv).

3. International Communications Income of CFCs

In light of the comments with respect to CFCs described above, the reproposed regulations provide that in the case of a CFC, 50 percent of any international communications income will be sourced in the United States and 50 percent of such income will be sourced outside the United States. The 100-percent U.S. source rule is eliminated. Consequently, the source rule for international communications income in the hands of a CFC is the same rule that applies to U.S. persons. In both cases, the source rules take into account that international communications activities must have both a U.S. and a foreign connection (i.e., one endpoint in the United States and the other in a foreign country or possession of the United States). The Treasury Department and the IRS believe that the revision of the source rule for CFCs deriving international communications income should mitigate commentators' concerns about potential multiple levels of taxation because 50 percent of this income is foreign source.

The Treasury Department and the IRS recognize that this and other provisions of reproposed § 1.863–9 may raise withholding tax issues similar to those discussed above in connection with the source rule for the space and ocean income of CFCs (in reproposed § 1.863–8(b)(2)(ii)). As noted above, the Treasury Department and the IRS seek comments on these issues and practical suggestions to address them in the specific factual contexts in which they may arise.

4. International Communications Income Derived by a Foreign Person With an Office or Fixed Place of Business in the United States

Section 863(e)(1)(B)(ii) and § 1.863–9(b)(2)(ii)(C) of the 2001 proposed regulations provide that international communications income derived by a foreign person that is attributable to an office or other fixed place of business in the United States is from sources within the United States. Section 864 and the regulations thereunder provide guidance in determining ''income * * * attributable to an office or other fixed place of business'' in specific contexts. However, the Treasury Department and the IRS believe that, for purposes of section 863(e), international communications income should be attributed to an office or fixed place on business based on functions performed, resources employed, and risks assumed. Therefore, pursuant to the regulatory authority in section 863(e)(1)(B)(i), the reproposed regulations provide that, for purposes of this section, income is attributable to an office or other fixed place of business in the United States to the extent of functions performed, resources employed, or risks assumed by the office or other fixed place of business.

5. International Communications Income of a Foreign Person Engaged in a Trade or Business Within the United States

The second exception to § 1.863–9(b)(2)(ii)(A) of the 2001 proposed regulations is contained in § 1.863–

9(b)(2)(ii)(D), which provides that if a foreign person (other than a 50 percent or more U.S.-owned foreign corporation described in § 1.863–9(b)(2)(ii)(B) of the 2001 proposed regulations) is engaged in a trade or business within the United States, the foreign person's international communications income is presumed to be U.S. source income. However, if the foreign person can allocate its international communications income between sources within the United States, space, and international water and sources outside the United States, space, and international water to the satisfaction of the Commissioner, based on all the facts and circumstances, which may include functions performed, resources employed, or risks assumed, then the income allocated to sources outside the United States, space, and international water will be foreign source income.

Several commentators stated that the presumption is overbroad because it applies to all international communications income regardless of any nexus with the foreign corporation's U.S. trade or business. These commentators claimed that the presumption is inconsistent with U.S. tax policy and international norms that require a connection between the income and the foreign person's activities in the United States before U.S. taxing jurisdiction is exercised.

In response to comments, the reproposed regulations provide that if a foreign person, other than a CFC, is engaged in a trade or business within the United States, gross income derived by that person from international communications activity is from sources within the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed within the United States. This rule is similar to the rule in the reproposed regulations under section 863(d) for foreign persons engaged in a trade or business within the United States. There is no longer a presumption of U.S. source income.

The Treasury Department and the IRS believe that the provision in the reproposed regulations that such a foreign person's international communications income is U.S. source only to the extent attributable to functions performed, resources employed, or risks assumed in the United States addresses taxpayers' concerns regarding a nexus between the foreign person's international communications income and its business activities in the United States.

Several commentators objected to the rule that international communications income could be foreign source income only to the extent that the foreign person could allocate international communications income to activity occurring in a foreign country. Because the reproposed regulations provide for U.S. sourcing only to the extent that the foreign person's international communications income is attributable to functions performed, resources employed, or risks assumed in the United States, this concern should be mitigated.

Several commentators stated that section 863(e) makes international communications income that is attributable to a U.S. office U.S. source income, and that the regulations should not adopt a broader U.S. trade or business rule. Section 863(e)(1)(B)(ii) provides that if a foreign person has a fixed place of business in the United States, international communications income attributable to such fixed place of business is U.S. source income. The Treasury Department and the IRS have not made changes to the reproposed regulations in response to these comments. Section 863(e)(1)(B)(i) by its terms gives the Secretary broad authority to source international communications income of a foreign person as U.S. source income. The Treasury Department and the IRS believe that it is appropriate to exercise that authority in this case. The trade or business rule reflects the concern of the Treasury Department and the IRS that a foreign person could avoid a U.S. fixed place of business under section 863(e)(1)(B)(ii), yet engage in significant communications activity in the United States. The Treasury Department and the IRS believe that Congress intended that a foreign person engaged in substantial business in the United States be subject to U.S. tax on that communications activity.

6. Income Derived From Communications Activity—The Paid-To-Do Rule

Income derived from communications activity is defined in § 1.863–9(d)(2) of the 2001 proposed regulations as income derived from the transmission of communications, including income derived from the provision of capacity to transmit communications. There is no requirement that the recipient of communications income perform the transmission function itself. This rule reflects the understanding of the Treasury Department and the IRS that providers of communications services often use capacity owned or operated by others. However, income is derived from communications activity only if the taxpayer is paid to transmit, and bears the risk of transmitting, the communications.

Section 1.863–9(d)(3) of the 2001 proposed regulations provides rules for characterizing income derived from a communications activity for purposes of sourcing the income derived from such activity. The character of income derived from communications activity is determined by establishing the two points between which the taxpayer is paid to transmit, and bears the risk of transmitting, the communication (the paid-to-do rule). Under the paid-to-do rule, the path the communication takes between the two points is not relevant in determining the character of the transmission. If a taxpayer is paid to take a communication from one point to another point, income derived from the transmission is characterized based on the transmission between those two points, even if the taxpayer contracts out part of the transmission to another party. This rule reflects the recognition by the Treasury Department and the IRS, as noted above, that providers of communications services often use capacity owned or operated by others.

When the taxpayer cannot establish the two points between which the taxpayer is paid to transmit the communication, § 1.863–9(b)(6) of the 2001 proposed regulations provides a default source rule, under which all income from the communications activity, whether derived by a U.S. person or a foreign person, is deemed to be from sources within the United States. Thus, for example, when a provider of communications services provides both local and international long distance services in one-price bundles for a set amount each month and tracing each transmission is not possible or practical, the income derived from the communications activity is U.S. source income. The Treasury Department and the IRS understand that many taxpayers in the communications industry may consider it impractical or impossible to prove the endpoints of the communications they transmit. The Treasury Department and the IRS accordingly solicited comments as to proposals for those situations when taxpayers cannot establish the points between which the taxpayer is paid to transmit the communication.

One commentator stated that the phrase ''bears the risk of transmitting,'' contained in § 1.863–9(d)(2) and (d)(3)(i) of the 2001 proposed regulations, is ambiguous and does not meaningfully improve the determination of when income is derived from communications activity. This commentator noted that the nature of the risk a taxpayer must bear to be treated as deriving

communications income was unclear, and that the determination of risk would pose administrative difficulties given the complexity of business models and structures. No change was made to the reproposed regulations in response to this comment. The Treasury Department and the IRS believe that, in determining whether a taxpayer derives communications income, risk is more important than the mere fact of payment. The Treasury Department and the IRS thus believe that a taxpayer should not be considered to derive communications income unless the taxpayer bears the economic risk of nonpayment with respect to the transmission of communications or the provision of capacity to transmit communications.

Commentators stated that the paid-to-do rule is overbroad because it asserts primary U.S. taxing jurisdiction over certain communications income regardless of any nexus between the income and the United States. Commentators also noted that when certain taxpayers cannot establish the two points between which they are paid to transmit a communication, the income from such communications activity may be subject to potential double taxation at the corporate level (for example, a foreign corporation could be subject to tax on such communications income in both the United States and in the foreign corporation's country of residence or incorporation or countries where it does business).

Commentators stated that the paid-to-do rule places undue burdens on taxpayers who want to obtain the benefit of foreign source income characterization. Commentators noted that, in many cases, it may be impractical or technologically impossible to track the origination and termination points of an individual transmission, and that development of the required technology, software, and other systems would require significant capital investments. Maintenance of the records needed to substantiate proper income sourcing could also be onerous for those taxpayers who perform extremely large numbers of transmissions. Commentators thus requested that the regulations provide assurance that reasonable methods of proof, consistent with industry practice and consistently applied, would be accepted in establishing the points of origin and/or destination of a communication.

Commentators submitted suggested modifications to the paid-to-do rule. One commentator suggested that the paid-to-do rule be modified to characterize all income from a communication based on the two endpoints between which the transmission is made. Under this commentator's suggested rule, whether a particular taxpayer itself carried out all, or only a portion, of the transmission would be irrelevant, and the characterization of the communication would be the same for all taxpayers involved in the transmission. One commentator suggested that the paid-to-do rule be applied on a single entity basis for United States corporations that join in the filing of a consolidated U.S. income tax return.

Commentators also suggested reasonable method approaches to determine the endpoints between which a taxpayer is paid to transmit communications (for example, based on technical characteristics of the communication or contractual terms, or on a per transaction, per customer, or aggregate basis). One commentator suggested factors that could be taken into account in determining whether a particular method is reasonable, including the reliability of the method chosen, the degree to which the method is in line with generally accepted industry practices and norms, and the extent to which the method takes into account all the information available to the taxpayer.

Commentators suggested that the U.S. source default rule for income from communications for which the endpoints of transmission cannot be identified should only apply to foreign taxpayers that directly own or operate communications facilities, or otherwise directly hold rights to communications capacity, in the United States; when a foreign taxpayer does not own or otherwise have rights to telecommunications capacity in the United States, income from such communications would thus be foreign source. Other commentators suggested that income from communications for which the endpoints of transmission cannot be identified be treated in the same manner as international communications income, with a 100-percent U.S. source exception provided for telecommunications service providers who are paid to transmit communications that are substantially all between multiple points located within the United States.

The Treasury Department and the IRS continue to believe that communications activity is most appropriately characterized based on the two points between which the taxpayer is paid to transmit, and bears the risk of transmitting, the communication. The Treasury Department and the IRS consider the endpoint-based source rule in the reproposed regulations to be an approach that best matches the source of communications income to the location where functions are performed, resources are employed, or risks are assumed in a taxpayer's communications transaction. Moreover, although commentators noted potential difficulties in identifying the endpoints of a communication, the industry-specific comments received in response to the 2001 proposed regulations generally focused on recordkeeping burdens. Taxpayers have much better access to the relevant information regarding the facts and circumstances of their communications transactions than the IRS. The Treasury Department and the IRS accordingly solicit comments on the challenges to identifying the endpoints of communications in specific industries or situations, as well as suggestions for rules that are responsive to these particular challenges. The Treasury Department and the IRS also again solicit comments on methods to identify the endpoints of a communication that may be reasonable for particular industries, as well as criteria that may be appropriate to evaluate the reasonableness of such methods.

7. Treatment of a Content Provider's Communications Activity

Section 1.863–9(d)(1)(ii) of the 2001 proposed regulations provides that, to the extent a taxpayer's transaction consists in part of non-*de minimis* communications activities and in part of non-*de minimis* non-communications activities, such parts of the transaction must be treated as separate transactions. Section 1.863–9(d)(1)(ii) of the 2001 proposed regulations then provides that gross income derived from the activities must be allocated to each separate transaction, to the satisfaction of the Commissioner, based on all the facts and circumstances, which may include functions performed, resources employed, or risks assumed in the respective transactions.

One commentator suggested that the regulations be clarified to provide that a *content* company (for example, the creator of a television or radio program) that does not possess or operate communications equipment or itself perform any communications function is not engaged in communications activities. This commentator did not believe that communication activities should be attributed to a content provider and stated that delivery of a content provider's programming by a

third party should not change the character of the content provider's income to communications income.

No changes were made to the reproposed regulations in response to this comment. The Treasury Department and the IRS believe that the transmission of any communications, including content, is appropriately considered a communications activity. The Treasury Department and the IRS also believe that when a content provider is paid to transmit, and bears the risk of transmitting, content to a customer, the content provider should be considered to derive communications income. Under reproposed § 1.863–9(h)(1)(ii), as under the 2001 proposed regulations, the content provider will derive communications income only to the extent of the gross income allocated to the separate transaction involving the communications activity. The Treasury Department and the IRS believe that it is appropriate for a content provider to derive communications income when communications activities make more than a de minimis contribution to the value of the content provider's overall transaction with its customer.

8. Treatment of Partnerships

Section 1.863–9(e)(1) of the 2001 proposed regulations generally provides that section 863(e) and the regulations thereunder will be applied to domestic partnerships at the partnership level. Section 1.863–9(e)(1) of the 2001 proposed regulations also provides that section 863(e) and the regulations thereunder will be applied at the partner level to foreign partnerships. Section 1.863–9(e)(2) of the 2001 proposed regulations similarly provides that section 863(e) and the regulations thereunder will be applied at the partner level to domestic partnerships in which 50 percent or more of the partnership interests are owned by foreign persons.

One commentator stated that § 1.863–9(e)(2) of the 2001 proposed regulations conflicts with sections 863(e)(1)(A) (which provides that the international communications income of any United States person shall be 50-percent U.S. source and 50-percent foreign source) and 7701(a)(3) (which defines United States person to include a domestic partnership). According to this commentator, the rule potentially discriminates against foreign partners in a domestic partnership owned 50 percent or more by foreign partners vis-á-vis the U.S. partners in such a partnership. For example, the international communications income of a foreign partner could be 100-percent U.S. source under § 1.863–9(b)(2)(ii)(B) or (C) of the 2001 proposed regulations, whereas the international communications income of a U.S. partner would be 50-percent U.S. source and 50-percent foreign source, creating the potential for double taxation of the foreign partner. Another commentator stated that § 1.863–9(e)(1) of the 2001 proposed regulations could result in the double taxation of the U.S. partners of foreign partnerships. This commentator noted that the international communications income of a foreign partnership could be subject to tax in the country in which the foreign partnership is organized. Under § 1.863–9(e) of the 2001 proposed regulations, a U.S. partner's share of such international communications income would be subject to the 50/50 source rule in § 1.863–9(b)(2)(i) of the 2001 proposed regulations. As a result, the U.S. partner may be unable to credit its proportionate share of tax paid in the foreign country. Commentators suggested that the source rules of § 1.863–9 of the 2001 proposed regulations be applied to all partnerships at the entity level.

As is the case for reproposed § 1.863–8(e) with respect to section 863(d), the Treasury Department and the IRS believe that section 863(e) should be applied to domestic and foreign partnerships in the same manner. Accordingly, the reproposed regulations do not provide a different rule for foreign partnerships and domestic partnerships. Section 1.863–9(i) of the reproposed regulations provides that the regulations will be applied at the partner level for all partnerships.

9. Allocations

When a taxpayer must allocate gross income to the satisfaction of the Commissioner, based on all the facts and circumstances, under § 1.863–9(b)(2)(ii)(D) or (d)(1)(ii) of the 2001 proposed regulations, the Treasury Department and the IRS believe that such allocations should be based generally on section 482 principles. As with § 1.863–8 of the 2001 proposed regulations, commentators stated that allocation of income based on section 482 principles would be burdensome and expensive and would create uncertainty.

The Treasury Department and the IRS consider the allocation of gross income based on the general guidance of section 482 to be an approach that is well-suited to application in the wide variety of factual contexts within the scope of the reproposed regulations. The Treasury Department and the IRS solicit comments on alternative methods of allocation for particular industries and criteria that could be used to evaluate the reasonableness of such methods.

10. Issues With Uplink Functions

Examples 5, 10, and *12* of § 1.863–9(f) of the 2001 proposed regulations involve communications activities that include the performance of satellite uplink and downlink functions. One commentator stated that these examples do not provide clear guidance as to whether the satellite operator must itself perform the uplink function in order for its income to qualify as international communications income, and could be read to treat a satellite operator that contracts with another party to transmit signals as not engaged in international communications activity because the uplink function is performed by that other party.

No changes were made to the reproposed regulations in response to this comment. Reproposed § 1.863–9(h)(2) provides that income may be considered derived from a communications activity even if the taxpayer does not perform the transmission function, but, in all cases, a taxpayer derives communications income only if the taxpayer is paid to transmit, and bears the risk of transmitting, the communications. The Treasury Department and the IRS believe that whether a satellite operator should be considered to derive international telecommunications income from a transaction is appropriately determined by applying reproposed § 1.863–9(h)(2), as well as the other substantive provisions of the reproposed regulations, to the specific facts of the taxpayer's transaction.

11. Characterization of Income

One commentator stated that the regulations should be clarified to provide that they do not purport to establish general rules for the characterization of income and that the characterization of income items for purposes of the application of section 863(d) and (e) is to be made under general principles of tax law. This commentator stated that some examples in the 2001 proposed regulations could suggest conflicting characterizations of income from what appear to be the same activities. In response to this comment, the examples in the reproposed regulations have been clarified to state that the characterization of the transactions at issue is assumed for purposes of the specific example. In addition, certain examples have been reconciled to the extent they could suggest different characterizations of the same activities.

12. Reporting and Documentation Requirements

In order to satisfy the Commissioner with respect to a taxpayer's allocation of gross income under § 1.863–9(b)(2)(ii)(D) or (d)(1)(ii) of the 2001 proposed regulations, the taxpayer must make the allocation on a timely filed original return (including extensions). An amended return does not qualify for this purpose, and section 9100 relief will not be available. In all cases, a taxpayer must also maintain contemporaneous documentation regarding the allocation of gross income, allocation and apportionment of expenses, losses and other deductions, the methodologies used, and the circumstances justifying use of those methodologies. The taxpayer must produce such documentation within 30 days upon request.

As with the similar requirements under § 1.863–8 of the 2001 proposed regulations, commentators stated that there is no basis in the statute or the legislative history for the reporting, recordkeeping, and contemporaneous documentation requirements in the 2001 proposed regulations. Commentators also noted that the Code and regulations do not contain similar requirements with respect to other expense allocation provisions.

The reproposed regulations generally retain the recordkeeping and documentation requirements. The Treasury Department and the IRS believe that it is appropriate to require taxpayers to keep proper records, and additionally note the potentially considerable difficulties the IRS would face in performing the allocations required by the reproposed regulations without appropriate taxpayer records.

The Treasury Department and the IRS recognize, however, that taxpayers may not have all the information necessary to make allocations at the time a return is originally filed. The reproposed regulations therefore provide that a taxpayer may make changes to allocations made on the taxpayer's original return with respect to any taxable year for which the statute of limitations has not closed, subject to certain conditions. Nonetheless, changes to such allocations that are not made until an audit of the taxable year to which the allocations relate has commenced, or a taxpayer's failure timely to provide documentation and other information supporting the allocations, create administrative difficulties for the IRS. Accordingly, reproposed § 1.863–9(k)(4) sets forth the actions required of taxpayers and the procedures the IRS will follow in the case of taxpayers changing their allocations.

The reproposed regulations also require taxpayers, upon request, to provide access to the software programs and other systems used by the taxpayer to make allocations under these regulations. For this purpose, *software* has the meaning provided in section 7612(d). The Treasury Department and the IRS believe that the IRS could face significant administrative and other difficulties in the examination of income allocations made under these regulations without access to such software.

Proposed Effective Date

These regulations are proposed to apply for taxable years beginning on or after the date of publication of final regulations in the **Federal Register.**

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment pursuant to that Order is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that the collection of information in 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 provided in these regulations principally affect large multinational corporations that pay foreign taxes on income derived from substantial foreign operations and that use these and any other applicable source rules in determining their foreign tax credit. Accordingly, a Regulatory Flexibility Act assessment is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The Treasury Department and the IRS specifically request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for December 15, 2005, at 10 a.m., in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information on having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by November 23, 2005. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

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

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Withdrawal of Previous Notice of Proposed Rulemaking

Accordingly, under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking (REG–106030–98) that was published in the **Federal Register** on January 17, 2001 (66 FR 3903), is withdrawn as of September 19, 2005.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read, in part, as follows:

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

Section 1.863–8 also issued under 26 U.S.C. 863(a), (b) and (d). * * *

Section 1.863–9 also issued under 26 U.S.C. 863(a), (d) and (e). * * *

Par. 2. Section 1.863–3 is amended by:

1. Adding a sentence after the first sentence in paragraph (a)(1).

2. Adding a sentence at the end of paragraph (c)(1)(i)(A).

3. Adding a sentence after the first sentence in paragraph (c)(2).

The additions read as follows:

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

(a) * * * (1) * * * To determine the source of income from sales of property produced by the taxpayer, when the property is either produced in whole or in part in space or on or under water not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States (in international water), or is sold in space or international water, the rules of § 1.863–8 apply, and the rules of this section do not apply except to the extent provided in § 1.863–8. * * *

* * * * *

(c) * * * (1) * * * (i) * * * (A) * * * For rules regarding the source of income when production takes place, in whole or in part, in space or international water, the rules of § 1.863–8 apply, and the rules of this section do not apply except to the extent provided in § 1.863–8.

* * * * *

(2) * * * Notwithstanding any other provision, for rules regarding the source of income when a sale takes place in space or international water, the rules of § 1.863–8 apply, and the rules of this section do not apply except to the extent provided in § 1.863–8. * * *

* * * * *

Par. 3. Sections 1.863–8 and 1.863–9 are added to read as follows:

§ 1.863–8 Source of income from space and ocean activity under section 863(d).

(a) *In general.* Income of a United States or a foreign person derived from space and ocean activity (space and ocean income) is sourced under the rules of this section, notwithstanding any other provision, including sections 861, 862, 863, and 865. A taxpayer will not be considered to derive income from space or ocean activity, as defined in paragraph (d) of this section, if such activity is performed by another person, subject to the rules for the treatment of consolidated groups in § 1.1502–13.

(b) *Source of gross income from space and ocean activity*—(1) *Space and ocean income derived by a U.S. person.* Space and ocean income derived by a U.S. person is income from sources within the United States. However, space and ocean income derived by a U.S. person is income from sources without the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries.

(2) *Space and ocean income derived by a foreign person*—(i) *In general.* Space and ocean income derived by a person other than a U.S. person is income from sources without the United States, except as otherwise provided in this paragraph (b)(2).

(ii) *Space and ocean income derived by a controlled foreign corporation.* Space and ocean income derived by a controlled foreign corporation within the meaning of section 957 (CFC) is income from sources within the United States. However, space and ocean income derived by a CFC is income from sources without the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries.

(iii) *Space and ocean income derived by foreign persons engaged in a trade or business within the United States.* Space and ocean income derived by a foreign person (other than a CFC) engaged in a trade or business within the United States is income from sources within the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed within the United States.

(3) *Source rules for income from certain sales of property*—(i) *Sales of purchased property.* When a taxpayer sells purchased property in space or international water, the source of gross income from the sale generally will be determined under paragraph (b)(1) or (2) of this section, as applicable. However, if such property is inventory property within the meaning of section 1221(a)(1) (inventory property) and is not sold for use, consumption, or disposition in space or international water, the source of income from the sale will be determined under § 1.861–7(c).

(ii) *Sales of property produced by the taxpayer*—(A) *General.* If the taxpayer both produces property and sells such property, the taxpayer must allocate gross income from such sales between production activity and sales activity under the 50/50 method. Under the 50/50 method, one-half of the taxpayer's gross income will be considered income allocable to production activity, and the source of that income will be determined under paragraph (b)(3)(ii)(B) or (C) of this section. The remaining one-half of such gross income will be considered income allocable to sales activity, and the source of that income will be determined under paragraph (b)(3)(ii)(D) of this section.

(B) *Production only in space or international water, or only outside space and international water.* When production occurs only in space or international water, income allocable to production activity is sourced under paragraph (b)(1) or (2) of this section, as applicable. When production occurs only outside space and international water, income allocable to production activity is sourced under § 1.863–3(c)(1).

(C) *Production both in space or international water and outside space and international water.* When property is produced both in space or international water and outside space and international water, gross income allocable to production activity must be allocated to production occurring in space or international water and production occurring outside space and international water. Such gross income is allocated to production activity occurring in space or international water to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in space or international water. The balance of such gross income is allocated to production activity occurring outside space and international water. The source of gross income allocable to production activity in space or international water is determined under paragraph (b)(1) or (2) of this section, as applicable. The source of gross income allocated to production activity occurring outside space and international water is determined under § 1.863–3(c)(1).

(D) *Source of income allocable to sales activity.* When property produced by the taxpayer is sold outside space and international water, the source of gross income allocable to sales activity will be determined under §§ 1.861–7(c) and 1.863–3(c)(2). When property produced by the taxpayer is sold in space or international water, the source of gross income allocable to sales activity generally will be determined under paragraph (b)(1) or (2) of this section, as applicable. However, if such property is inventory property within the meaning of section 1221(a)(1) and is sold in space or international water for use, consumption, or disposition outside space, international water, or

the United States, the source of gross income allocable to sales activity will be determined under §§ 1.861–7(c) and 1.863–3(c)(2).

(4) *Special rule for determining the source of gross income from services.* To the extent a transaction characterized as the performance of a service constitutes a space or ocean activity, as determined under paragraph (d)(2)(ii) of this section, the source of gross income derived from such transaction is determined under paragraph (b)(1) or (2) of this section.

(5) *Special rule for determining source of income from communications activity (other than income from international communications activity).* Space and ocean activity, as defined in paragraph (d) of this section, includes activity that occurs in space or international water that is characterized as a communications activity as defined in § 1.863–9(h)(1) (other than international communications activity). The source of space and ocean income that is also communications income as defined in § 1.863–9(h)(2) (but not space/ocean communications income as defined in § 1.863–9(h)(3)(v)) is determined under the rules of § 1.863–9(c), (d), and (f), as applicable, rather than under paragraph (b) of this section. The source of space and ocean income that is also space/ocean communications income as defined in § 1.863–9(h)(3)(v) is determined under the rules of paragraph (b) of this section. See § 1.863–9(e).

(c) *Taxable income.* When a taxpayer allocates gross income under paragraph (b)(1), (b)(2), (b)(3)(ii)(C), or (b)(4) of this section, the taxpayer must allocate expenses, losses, and other deductions as prescribed in §§ 1.861–8 through 1.861–14T to the class or classes of gross income that include the income so allocated in each case. A taxpayer must then apply the rules of §§ 1.861–8 through 1.861–14T to apportion properly amounts of expenses, losses, and other deductions so allocated to such gross income between gross income from sources within the United States and gross income from sources without the United States.

(d) *Space and ocean activity*—(1) *Definition*—(i) *Space activity.* In general, space activity is any activity conducted in space. For purposes of this section, space means any area not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States, and not in international water. For purposes of determining space activity, the Commissioner may separate parts of a single transaction into separate transactions or combine separate transactions as part of a single transaction. Paragraph (d)(3) of this section lists specific exceptions to the general definition of space activity. Activities that constitute space activity include but are not limited to—

(A) Performance and provision of services in space, as defined in paragraph (d)(2)(ii) of this section;

(B) Leasing of equipment located in space, including spacecraft (for example, satellites) or transponders located in space;

(C) Licensing of technology or other intangibles for use in space;

(D) Production, processing, or creation of property in space, as defined in paragraph (d)(2)(i) of this section;

(E) Activity occurring in space that is characterized as communications activity (other than international communications activity) under § 1.863–9(h)(1);

(F) Underwriting income from the insurance of risks on activities that produce space income; and

(G) Sales of property in space (see § 1.861–7(c)), but not sales of inventory property for use, consumption, or disposition outside space or international water.

(ii) *Ocean activity.* In general, ocean activity is any activity conducted on or under water not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States (collectively, in international water). For purposes of determining ocean activity, the Commissioner may separate parts of a single transaction into separate transactions or combine separate transactions as part of a single transaction. Paragraph (d)(3) of this section lists specific exceptions to the general definition of ocean activity. Activities that constitute ocean activity include but are not limited to—

(A) Performance and provision of services in international water, as defined in paragraph (d)(2)(ii) of this section;

(B) Leasing of equipment located in international water, including underwater cables;

(C) Licensing of technology or other intangibles for use in international water;

(D) Production, processing, or creation of property in international water, as defined in paragraph (d)(2)(i) of this section;

(E) Activity occurring in international water that is characterized as communications activity (other than international communications activity) under § 1.863–9(h)(1);

(F) Underwriting income from the insurance of risks on activities that produce ocean income;

(G) Sales of property in international water (see § 1.861–7(c)), but not sales of inventory property for use, consumption, or disposition outside space or international water;

(H) Any activity performed in Antarctica;

(I) The leasing of a vessel that does not transport cargo or persons for hire between ports-of-call (for example, the leasing of a vessel to engage in research activities in international water); and

(J) The leasing of drilling rigs, extraction of minerals, and performance and provision of services related thereto, except as provided in paragraph (d)(3)(ii) of this section.

(2) *Determining a space or ocean activity*—(i) *Production of property in space or international water.* For purposes of this section, production activity means an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages property within the meaning of section 864(a) and § 1.864–1.

(ii) *Special rule for performance of services*—(A) *General.* Except as provided in paragraph (d)(2)(ii)(B) of this section, if a transaction is characterized as the performance of a service, then such service will be treated as a space or ocean activity in its entirety when any part of the service is performed in space or international water. Services are performed in space or international water if functions are performed, resources are employed, or risks are assumed in space or international water, regardless of whether performed by personnel, equipment, or otherwise.

(B) *Exception to the general rule.* If the taxpayer can demonstrate the value of the service attributable to performance occurring in space or international water, and the value of the service attributable to performance occurring outside space and international water, then such service will be treated as space or ocean activity only to the extent of the activity performed in space or international water. The value of the service is attributable to performance occurring in space or international water to the extent the performance of the service, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in space or international water. In addition, if the taxpayer can demonstrate, based on all the facts and circumstances, that the value of the service attributable to performance in space or international water is de minimis, such service will not be treated as space or ocean activity.

(3) *Exceptions to space or ocean activity.* Space or ocean activity does not include the following types of activities:

(i) Any activity giving rise to transportation income as defined in section 863(c).

(ii) Any activity with respect to mines, oil and gas wells, or other natural deposits, to the extent the mines, wells, or natural deposits are located within the jurisdiction (as recognized by the United States) of any country, including the United States and its possessions.

(iii) Any activity giving rise to international communications income as defined in § 1.863–9(h)(3)(ii).

(e) *Treatment of partnerships.* This section is applied at the partner level.

(f) *Examples.* The following examples illustrate the rules of this section:

Example 1. Space activity—activity occurring on land and in space—(i) *Facts.* S, a U.S. person, owns satellites in orbit. S leases one of its satellites to A. S, as lessor, will not operate the satellite. Part of S's performance as lessor in this transaction occurs on land. Assume that the combination of S's activities is characterized as the lease of equipment.

(ii) *Analysis.* Because the leased equipment is located in space, the transaction is defined as space activity under paragraph (d)(1)(i) of this section. Income derived from the lease will be sourced in its entirety under paragraph (b)(1) of this section. Under paragraph (b)(1) of this section, S's space income is sourced outside the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries.

Example 2. Space activity—(i) *Facts.* X is an Internet service provider. X offers a service that permits a customer (C) to connect to the Internet via a telephone call, initiated by the modem of C's personal computer, to a control center. X transmits information requested by C to C's personal computer, in part using satellite capacity leased by X from S. X charges its customers a flat monthly fee. Assume that neither X nor S derive international communications income within the meaning of § 1.863–9(h)(3)(ii). In addition, assume that X is able to demonstrate, pursuant to paragraph (d)(2)(ii)(B) of this section, the extent to which the value of the service is attributable to functions performed, resources employed, and risks assumed in space.

(ii) *Analysis.* Under paragraph (d)(2)(ii) of this section, the service performed by X constitutes space activity to the extent the value of the service is attributable to functions performed, resources employed, and risks assumed in space. To the extent the service performed by X constitutes space activity, the source of X's income from the service transaction is determined under paragraph (b) of this section. To the extent the service performed by X does not constitute space or ocean activity, the source of X's income from the service is determined under sections 861, 862, and 863, as applicable. To the extent that X derives space and ocean income that is also communications income within the meaning of § 1.863–9(h)(2), the source of X's income is determined under paragraph (b) of this section and § 1.863–9(c), (d), and (f), as applicable, as provided in paragraph (b)(5) of this section. S derives space and ocean income that is also communications income within the meaning of § 1.863–9(h)(2), and the source of S's income is therefore determined under paragraph (b) of this section and § 1.863–9(c), (d), and (f), as applicable, as provided in paragraph (b)(5) of this section.

Example 3. Services as space activity—de minimis value attributable to performance occurring in space—(i) *Facts.* R owns a retail outlet in the United States. R engages S to provide a security system for R's premises. S operates its security system by transmitting images from R's premises directly to a satellite, and from the satellite to a group of S employees located in Country B, who monitor the premises by viewing the transmitted images. O provides S with transponder capacity on O's satellite, which S uses to transmit those images. Assume that S's transaction with R is characterized as the performance of a service. Assume that O's provision of transponder capacity is also viewed as the provision of a service and that the value of O's service transaction attributable to performance in space is not de minimis. In addition, assume that S is able to demonstrate, pursuant to paragraph (d)(2)(ii) of this section, that a de minimis portion of the value of S's service transaction with R is attributable to performance in space. Assume also that S is able to demonstrate, pursuant to § 1.863–9(h)(1), that the value of the transaction with R attributable to communications activities is de minimis.

(ii) *Analysis.* S derives income from providing monitoring services. Because S demonstrates that the value of S's service transaction attributable to performance in space is de minimis, S is not treated as engaged in a space activity, and none of S's income from the service transaction is space income. In addition, because S demonstrates that the value of the transaction with R attributable to communications activities is de minimis, S is not required under § 1.863–9(h)(1)(ii) to treat the transaction as separate communications and non-communications transactions, and none of S's gross income from the transaction is treated as communications income within the meaning of § 1.863–9(h)(2). Because O's provision of transponder capacity is viewed as the provision of a service and the value of O's service transaction attributable to performance in space is not de minimis, O's activity will be considered space activity, pursuant to paragraph (d)(2)(ii) of this section, to the extent the value of the services transaction is attributable to performance in space (unless O's activity in space is international communications activity). To the extent that O derives communications income, the source of such income is determined under paragraph (b) of this section and § 1.863–9(b), (c), (d), and (f), as applicable, as provided in paragraph (b)(5) of this section. R does not derive any income from space activity.

Example 4. Space activity—(i) *Facts.* L, a domestic corporation, offers programming and certain other services to customers located both in the United States and in foreign countries. Assume that L's provision of programming and other services in this Example 4 is characterized as the provision of a service, and that no part of the service transaction occurs in space or international water. Assume that the delivery of the programming constitutes a separate transaction also characterized as the performance of a service. L uses satellite capacity acquired from S to deliver the programming service directly to customers' television sets, so that part of the value of the delivery transaction derives from functions performed and resources employed in space. Assume that these contributions to the value of the delivery transaction occurring in space are not considered de minimis under paragraph (d)(2)(ii)(B) of this section. Customer C pays L to provide and deliver programming to C's residence in the United States. Assume S's provision of satellite capacity in this Example 4 is viewed as the provision of a service, and also that S does not derive international communications income within the meaning of § 1.863–9(h)(3)(ii).

(ii) *Analysis.* S's activity will be considered space activity. To the extent that S derives space and ocean income that is also communications income under § 1.863–9(h)(2), the source of S's income is determined under paragraph (b) of this section and § 1.863–9(c), (d), and (f), as applicable, as provided in paragraph (b)(5) of this section. On these facts, L's activities are treated as two separate service transactions: the provision of programming (and other services), and the delivery of programming. L's income derived from provision of programming and other services is not income derived from space activity. L's delivery of programming and other services is considered space activity, pursuant to paragraph (d)(2)(ii) of this section, to the extent the value of the delivery transaction is attributable to performance in space. To the extent that the delivery of programming is treated as a space activity, the source of L's income derived from the delivery transaction is determined under paragraph (b)(1) of this section, as provided in paragraph (b)(4) of this section. To the extent that L derives space and ocean income that is also communications income within the meaning of § 1.863–9(h)(2), the source of such income is determined under paragraph (b) of this section and § 1.863–9(b), (c), (d), (e), and (f), as applicable, as provided in paragraph (b)(5) of this section.

Example 5. Space activity—treatment of land activity—(i) *Facts.* S, a U.S. person, offers remote imaging products and services to its customers. In year 1, S uses its satellite's remote sensors to gather data on certain geographical terrain. In year 3, C, a construction development company, contracts with S to obtain a satellite image of

an area for site development work. S pulls data from its archives and transfers to C the images gathered in year 1, in a transaction that is characterized as a sale of the data. S's rights, title, and interest in the data pass to C in the United States. Before transferring the images to C, S uses computer software in its land-based office to enhance the images so that the images can be used.

(ii) *Analysis.* The collection of data and creation of images in space is characterized as the creation of property in space. Because S both produces and sells the data, S must allocate gross income from the sale of the data between production activity and sales activity under the 50/50 method of paragraph (b)(3)(ii)(A). The source of S's income allocable to production activity is determined under paragraph (b)(3)(ii)(C) of this section because production activities occur both in space and on land. The source of S's income attributable to sales activity is determined under paragraph (b)(3)(ii)(D) of this section (by reference to § 1.863–3(c)(2)) as U.S. source income because S's rights, title, and interest in the data pass to C in the United States.

Example 6. Use of intangible property in space—(i) *Facts.* X acquires a license to use a particular satellite slot or orbit, which X sublicenses to C. C pays X a royalty.

(ii) *Analysis.* Because the royalty is paid for the right to use intangible property in space, the source of the royalty paid by C to X is determined under paragraph (b) of this section.

Example 7. Performance of services—(i) *Facts.* E, a domestic corporation, operates satellites with sensing equipment that can determine how much heat and light particular plants emit and reflect. Based on the data, E will provide F, a U.S. farmer, a report analyzing the data, which F will use in growing crops. E analyzes the data from offices located in the United States. Assume that E's combined activities are characterized as the performance of services.

(ii) *Analysis.* E's activities will be considered space activities, pursuant to paragraph (d)(2)(ii) of this section, to the extent the value of E's service transaction is attributable to performance in space. To the extent E's service transaction constitutes a space activity, the source of E's income derived from the service transaction will be determined under paragraph (b)(4) of this section, by reference to paragraph (b)(1) of this section. To the extent that E's service transaction does not constitute a space or ocean activity, the source of E's income derived from the service transaction is determined under sections 861, 862, and 863, as applicable.

Example 8. Separate transactions—(i) *Facts.* The same facts as Example 7, except that E provides the raw data to F in a transaction characterized as a sale of a copyrighted article. In addition, E provides an analysis in the form of a report to F. The price F pays E for the raw data is separately stated.

(ii) *Analysis.* To the extent that the provision of raw data and the analysis of the data are each treated as separate transactions, the source of income from the production and sale of data is determined under paragraph (b)(3)(ii) of this section. The provision of services would be analyzed in the same manner as in *Example 7.*

Example 9. Sale of property in international water—(i) *Facts.* T purchased and owns transatlantic cable that lies in international water. T sells the cable to B, with T's rights, title, and interest in the cable passing to B in international water. Assume that the transatlantic cable is not inventory property within the meaning of section 1221(a)(1).

(ii) *Analysis.* Because T's rights, title, and interest in the property pass to B in international water, the sale takes place in international water under § 1.861–7(c), and the sale transaction is ocean activity under paragraph (d)(1)(ii) of this section. The source of T's sales income is determined under paragraph (b)(3)(i) of this section, by reference to paragraph (b)(1) or (2) of this section.

Example 10. Sale of property in space—(i) *Facts.* S, a U.S. person, manufactures a satellite in the United States and sells it to a customer who is not a U.S. person. S's rights, title, and interest in the satellite pass to the customer in space.

(ii) *Analysis.* Because S's rights, title, and interest in the satellite pass to the customer in space, the sale takes place in space under § 1.861–7(c), and the sale transaction is space activity under paragraph (d)(1)(i) of this section. The source of income derived from the sale of the satellite in space is determined under paragraph (b)(3)(ii) of this section, with the source of income allocable to production activity determined under paragraphs (b)(3)(ii)(A) and (B) of this section, and the source of income allocable to sales activity determined under paragraphs (b)(3)(ii)(A) and (D) of this section. Under paragraph (b)(1) of this section, S's space income is sourced outside the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries.

Example 11. Sale of property in space—(i) *Facts.* S has a right to operate from a particular position (satellite slot or orbit) in space. S sells the right to operate from that position to P. Assume that the sale of the satellite slot is characterized as a sale of property and that S's rights, title, and interest in the satellite slot pass to P in space.

(ii) *Analysis.* The sale of the satellite slot takes place in space under § 1.861–7(c) because S's rights, title, and interest in the satellite slot pass to P in space. The sale of the satellite slot is space activity under paragraph (d)(1)(i) of this section, and income or gain from the sale is sourced under paragraph (b)(3)(i) of this section, by reference to paragraph (b)(1) or (2) of this section.

Example 12. Source of income of a foreign person—(i) *Facts.* FP, a foreign corporation that is not a CFC, derives income from the operation of satellites. FP operates ground stations in the United States and in foreign country FC. Assume that FP is considered engaged in a trade or business within the United States based on FP's operation of the ground station in the United States.

(ii) *Analysis.* Under paragraph (b)(2)(iii) of this section, FP's space income is sourced in the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed within the United States.

Example 13. Source of income of a foreign person—(i) *Facts.* FP, a foreign corporation that is not a CFC, operates remote sensing satellites in space to collect data and images for its customers. FP uses an independent agent, A, in the United States who provides marketing, order-taking, and other customer service functions. Assume that FP is considered engaged in a trade or business within the United States based on A's activities on FP's behalf in the United States.

(ii) *Analysis.* Under paragraph (b)(2)(iii) of this section, FP's space income is sourced in the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed within the United States.

(g) *Reporting and documentation requirements*—(1) *General.* A taxpayer making an allocation of gross income under paragraph (b)(1), (b)(2), (b)(3)(ii)(C), or (b)(4) of this section must satisfy the requirements in paragraphs (g)(2), (3), and (4) of this section.

(2) *Required documentation.* In all cases, a taxpayer must prepare and maintain documentation in existence when its return is filed regarding the allocation of gross income and allocation and apportionment of expenses, losses, and other deductions, the methodologies used, and the circumstances justifying use of those methodologies. The taxpayer must make available such documentation within 30 days upon request.

(3) *Access to software.* If the taxpayer or any third party used any computer software, within the meaning of section 7612(d), to allocate gross income, or to allocate or apportion expenses, losses, and other deductions, the taxpayer must make available upon request—

(i) Any computer software executable code, within the meaning of section 7612(d), used for such purposes, including an executable copy of the version of the software used in the preparation of the taxpayer's return (including any plug-ins, supplements, etc.) and a copy of all related electronic data files. Thus, if software subsequently is upgraded or supplemented, a separate executable copy of the version used in preparing the taxpayer's return must be retained;

(ii) Any related computer software source code, within the meaning of section 7612(d), acquired or developed by the taxpayer or a related person, or primarily for internal use by the taxpayer or such person rather than for commercial distribution; and

(iii) In the case of any spreadsheet software or similar software, any formulae or links to supporting worksheets.

(4) *Use of allocation methodology.* In general, when a taxpayer allocates gross income under paragraph (b)(1), (b)(2), (b)(3)(ii)(C), or (b)(4) of this section, it does so by making the allocation on a timely filed original return (including extensions). However, a taxpayer will be permitted to make changes to such allocations made on its original return with respect to any taxable year for which the statute of limitations has not closed as follows:

(i) In the case of a taxpayer that has made a change to such allocations prior to the opening conference for the audit of the taxable year to which the allocation relates or who makes such a change within 90 days of such opening conference, if the IRS issues a written information document request asking the taxpayer to provide the documents and such other information described in paragraphs (g)(2) and (3) of this section with respect to the changed allocations and the taxpayer complies with such request within 30 days of the request, then the IRS will complete its examination, if any, with respect to the allocations for that year as part of the current examination cycle. If the taxpayer does not provide the documents and information described in paragraphs (g)(2) and (3) of this section within 30 days of the request, then the procedures described in paragraph (g)(4)(ii) of this section shall apply.

(ii) If the taxpayer changes such allocations more than 90 days after the opening conference for the audit of the taxable year to which the allocations relate or the taxpayer does not provide the documents and information with respect to the changed allocations as requested in accordance with paragraphs (g)(2) and (3) of this section, then the IRS will, in a separate cycle, determine whether an examination of the taxpayer's allocations is warranted and complete any such examination. The separate cycle will be worked as resources are available and may not have the same estimated completion date as the other issues under examination for the taxable year. The IRS may ask the taxpayer to extend the statute of limitations on assessment and collection for the taxable year to permit examination of the taxpayer's method of allocation, including an extension limited, where appropriate, to the taxpayer's method of allocation.

(h) *Effective date.* This section applies to taxable years beginning on or after the date of publication of final regulations in the **Federal Register**.

§ 1.863–9 Source of income derived from communications activity under sections 863(a), (d), and (e).

(a) *In general.* Income of a United States or a foreign person derived from each type of communications activity, as defined in paragraph (h)(3) of this section, is sourced under the rules of this section, notwithstanding any other provision including sections 861, 862, 863, and 865. Notwithstanding that a communications activity would qualify as space or ocean activity under section 863(d) and the regulations thereunder, the source of income derived from such communications activity is determined under this section, and not under section 863(d) and the regulations thereunder, except to the extent provided in § 1.863–8(b)(5).

(b) *Source of international communications income*—(1) *International communications income derived by a U.S. person.* Income derived from international communications activity (international communications income) by a U.S. person is one-half from sources within the United States and one-half from sources without the United States.

(2) *International communications income derived by foreign persons*—(i) *In general.* International communications income derived by a person other than a U.S. person is, except as otherwise provided in this paragraph (b)(2), wholly from sources without the United States.

(ii) *International communications income derived by a controlled foreign corporation.* International communications income derived by a controlled foreign corporation within the meaning of section 957 (CFC) is one-half from sources within the United States and one-half from sources without the United States.

(iii) *International communications income derived by foreign persons with a fixed place of business in the United States.* International communications income derived by a foreign person, other than a CFC, that is attributable to an office or other fixed place of business of the foreign person in the United States is from sources within the United States. The principles of section 864(c)(5) apply in determining whether a foreign person has an office or fixed place of business in the United States. See § 1.864–7. International communications income is attributable to an office or other fixed place of business to the extent of functions performed, resources employed, or risks assumed by the office or other fixed place of business.

(iv) *International communications income derived by foreign persons engaged in a trade or business within the United States.* International communications income derived by a foreign person (other than a CFC) engaged in a trade or business within the United States is income from sources within the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed within the United States.

(c) *Source of U.S. communications income.* Income derived by a United States or foreign person from U.S. communications activity is from sources within the United States.

(d) *Source of foreign communications income.* Income derived by a United States or foreign person from foreign communications activity is from sources without the United States.

(e) *Source of space/ocean communications income.* Income derived by a United States or foreign person from space/ocean communications activity is determined under section 863(d) and the regulations thereunder.

(f) *Source of communications income when taxpayer cannot establish the two points between which the taxpayer is paid to transmit the communication.* Income derived by a United States or foreign person from communications activity, when the taxpayer cannot establish the two points between which the taxpayer is paid to transmit the communication as required in paragraph (h)(3)(i) of this section, is from sources within the United States.

(g) *Taxable income.* When a taxpayer allocates gross income under paragraph (b)(2)(iii), (b)(2)(iv), or (h)(1)(ii) of this section, the taxpayer must allocate expenses, losses, and other deductions as prescribed in §§ 1.861–8 through 1.861–14T to the class or classes of gross income that include the income so allocated in each case. A taxpayer must then apply the rules of §§ 1.861–8 through 1.861–14T properly to apportion amounts of expenses, losses, and other deductions so allocated to such gross income between gross income from sources within the United States and gross income from sources without the United States. For amounts of expenses, losses, and other deductions allocated to gross income derived from international communications activity, when the source of income is determined under the 50/50 method of paragraph (b)(1) or (b)(2)(ii) of this section, taxpayers

generally must apportion expenses, losses, and other deductions between sources within the United States and sources without the United States pro rata based on the relative amounts of gross income from sources within the United States and gross income from sources without the United States. However, the preceding sentence shall not apply to research and experimental expenditures qualifying under § 1.861–17, which are to be allocated and apportioned under the rules of that section.

(h) *Communications activity and income derived from communications activity*—(1) *Communications activity*—(i) *General rule.* For purposes of this part, *communications activity* consists solely of the delivery by transmission of communications or data (communications). Delivery of communications other than by transmission (for example, by delivery of physical packages and letters) is not communications activity within the meaning of this section. Communications activity also includes the provision of capacity to transmit communications. Provision of content or any other additional service provided along with, or in connection with, a non-*de minimis* communications activity must be treated as a separate non-communications activity unless de minimis. Communications activity or non-communications activity will be treated as *de minimis* to the extent, based on the facts and circumstances, the value attributable to such activity is de minimis.

(ii) *Separate transaction.* To the extent that a taxpayer's transaction consists in part of non-*de minimis* communications activity and in part of non-*de minimis* non-communications activity, each such part of the transaction must be treated as a separate transaction. Gross income is allocated to each such communications activity transaction and non-communications activity transaction to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in each such activity.

(2) *Income derived from communications activity. Income derived from communications activity* (communications income) is income derived from the delivery by transmission of communications, including income derived from the provision of capacity to transmit communications. Income may be considered derived from a communications activity even if the taxpayer itself does not perform the transmission function, but in all cases, the taxpayer derives communications income only if the taxpayer is paid to transmit, and bears the risk of transmitting, the communications.

(3) *Determining the type of communications activity*—(i) *In general.* Whether income is derived from international communications activity, U.S. communications activity, foreign communications activity, or space/ocean communications activity is determined by identifying the two points between which the taxpayer is paid to transmit the communication. The taxpayer must establish the two points between which the taxpayer is paid to transmit, and bears the risk of transmitting, the communication. Whether the taxpayer contracts out part or all of the transmission function is not relevant.

(ii) *Income derived from international communications activity. Income derived by a taxpayer from international communications activity* (international communications income) is income derived from communications activity, as defined in paragraph (h)(2) of this section, when the taxpayer is paid to transmit between a point in the United States and a point in a foreign country (or a possession of the United States).

(iii) *Income derived from U.S. communications activity. Income derived by a taxpayer from U.S. communications activity* (U.S. communications income) is income derived from communications activity, as defined in paragraph (h)(2) of this section, when the taxpayer is paid to transmit—

(A) Between two points in the United States; or

(B) Between the United States and a point in space or international water.

(iv) *Income derived from foreign communications activity. Income derived by a taxpayer from foreign communications activity* (foreign communications income) is income derived from communications activity, as defined in paragraph (h)(2) of this section, when the taxpayer is paid to transmit—

(A) Between two points in a foreign country or countries (or a possession or possessions of the United States);

(B) Between a foreign country and a possession of the United States; or

(C) Between a foreign country (or a possession of the United States) and a point in space or international water.

(v) *Income derived from space/ocean communications activity. Income derived by a taxpayer from space/ocean communications activity* (space/ocean communications income) is income derived from communications activity, as defined in paragraph (h)(2) of this section, when the taxpayer is paid to transmit between a point in space or international water and another point in space or international water.

(i) *Treatment of partnerships.* This section is applied at the partner level.

(j) *Examples.* The following examples illustrate the rules of this section:

Example 1. Income derived from non-communications activity—remote data base access—(i) *Facts.* D provides its customers in various foreign countries with access to its data base, which contains information on certain individuals' health care insurance coverage. Customer C obtains access to D's data base by placing a call to D's telephone number. Assume that C's telephone service, used to access D's data base, is provided by a third party, and that D assumes no responsibility for the transmission of the information via telephone.

(ii) *Analysis.* D is not paid to transmit communications and does not derive income from communications activity within the meaning of paragraph (h)(2) of this section. Rather, D derives income from provision of content or provision of services to its customers. Therefore, the rules of this section do not apply to determine the source of D's income.

Example 2. Income derived from U.S. communications activity—U.S. portion of international communication—(i) *Facts.* TC, a local telephone company, receives an access fee from an international carrier for picking up a call from a local telephone customer and delivering the call to a U.S. point of presence (POP) of the international carrier. The international carrier picks up the call from its U.S. POP and delivers the call to a foreign country.

(ii) *Analysis.* TC is not paid to carry the transmission between the United States and a foreign country. TC is paid to transmit a communication between two points in the United States. TC derives U.S. communications income as defined in paragraph (h)(3)(iii) of this section, which is sourced under paragraph (c) of this section as U.S. source income.

Example 3. Income derived from international communications activity—underwater cable—(i) *Facts.* TC, a domestic corporation, owns an underwater fiber optic cable. Pursuant to contracts, TC makes available to its customers capacity to transmit communications via the cable. TC's customers then solicit telephone customers and arrange to transmit the telephone customers' calls. The cable runs in part through U.S. waters, in part through international waters, and in part through foreign country waters.

(ii) *Analysis.* TC derives international communications income as defined in paragraph (h)(3)(ii) of this section because TC is paid to make available capacity to transmit communications between the United States and a foreign country. Because TC is a U.S. person, TC's international communications income is sourced under paragraph (b)(1) of this section as one-half from sources within the United States and one-half from sources without the United States.

Example 4. Income derived from international communications activity—satellite—(i) *Facts.* S, a U.S. person, owns satellites in orbit and uplink facilities in Country X, a foreign country. B, a resident of Country X, pays S to deliver B's programming from S's uplink facility, located in Country X, to a downlink facility in the United States owned by C, a customer of B.

(ii) *Analysis.* S derives international communications income under paragraph (h)(3)(ii) of this section because S is paid to transmit the communications between a beginning point in a foreign country and an endpoint in the United States. Because S is a U.S. person, the source of S's international communications income is determined under paragraph (b)(1) of this section as one-half from sources within the United States and one-half from sources without the United States.

Example 5. The paid-to-do rule—foreign communications via domestic route—(i) *Facts.* TC is paid to transmit communications from Toronto, Canada, to Paris, France. TC transmits the communications from Toronto to New York. TC pays another communications company, IC, to transmit the communications from New York to Paris.

(ii) *Analysis.* Under the *paid-to-do* rule of paragraph (h)(3)(i) of this section, TC derives foreign communications income under paragraph (h)(3)(iv) of this section because TC is paid to transmit communications between two points in foreign countries, Toronto and Paris. Under paragraph (h)(3)(i) of this section, the character of TC's communications activity is determined without regard to the fact that TC pays IC to transmit the communications for some portion of the delivery path. IC has international communications income under paragraph (h)(3)(ii) of this section because IC is paid to transmit the communications between a point in the United States and a point in a foreign country.

Example 6. The paid-to-do rule—domestic communication via foreign route—(i) *Facts.* TC is paid to transmit a call between two points in the United States, but routes the call through Canada.

(ii) *Analysis.* Under paragraph (h)(3)(i) of this section, the character of income derived from communications activity is determined by the two points between which the taxpayer is paid to transmit, and bears the risk of transmitting, the communications, without regard to the path of the transmission between those two points. Thus, under paragraph (h)(3)(iii) of this section, TC derives income from U.S. communications activity because it is paid to transmit the communications between two U.S. points.

Example 7. Indeterminate endpoints—prepaid telephone calling cards—(i) *Facts.* S purchases capacity from TC to transmit telephone calls. S sells prepaid telephone calling cards that give customers access to TC's telephone lines for a certain number of minutes. Assume that S cannot establish the endpoints of its customers' telephone calls.

(ii) *Analysis.* S derives communications income as defined in paragraph (h)(2) of this section because S makes capacity to transmit communications available to its customers. In this case, S cannot establish the two points between which the communications are transmitted. Therefore, S's communications income is U.S. source income, as provided by paragraph (f) of this section.

Example 8. Indeterminate endpoints—Internet access—(i) *Facts.* B, a domestic corporation, is an Internet service provider. B charges its customer, C, a monthly lump sum for Internet access. C accesses the Internet via a telephone call, initiated by the modem of C's personal computer, to one of B's control centers, which serves as C's portal to the Internet. B transmits data sent by C from B's control center in France to a recipient in England, over the Internet. B does not maintain records as to the beginning and endpoints of the transmission.

(ii) *Analysis.* B derives communications income as defined in paragraph (h)(2) of this section. The source of B's communications income is determined under paragraph (f) of this section as income from sources within the United States because B cannot establish the two points between which it is paid to transmit the communications.

Example 9. De minimis non-communications activity—(i) *Facts.* The same facts as in *Example 8.* Assume in addition that B replicates frequently requested sites on B's own servers, solely to speed up response time. Assume that B's replication of frequently requested sites would be considered a *de minimis* non-communications activity under this section.

(ii) *Analysis.* On these facts, because B's replication of frequently requested sites would be considered a *de minimis* non-communications activity, B is not required to treat the replication activity as a separate non-communications activity transaction under paragraph (h)(1) of this section. B derives communications income under paragraph (h)(2) of this section. The character and source of B's communications income are determined by demonstrating the points between which B is paid to transmit the communications, under paragraph (h)(3)(i) of this section.

Example 10. Income derived from communications and non-communications activity—bundled services—(i) *Facts.* A, a domestic corporation, offers customers local and long distance phone service, video, and Internet services. Customers pay a flat monthly fee plus 10 cents a minute for all long-distance calls, including international calls.

(ii) *Analysis.* Under paragraph (h)(1)(ii) of this section, to the extent that A's transaction with its customer consists in part of non-*de minimis* communications activity and in part of non-*de minimis* non-communications activity, each such part of the transaction must be treated as a separate transaction. A's gross income from the transaction is allocated to each such communications activity transaction and non-communications activity transaction in accordance with paragraph (h)(1)(ii) of this section. To the extent A can establish that it derives international communications income as defined in paragraph (h)(3)(ii) of this section, A would determine the source of such income under paragraph (b)(1) of this section. If A cannot establish the points between which it is paid to transmit communications, as required by paragraph (h)(3)(i) of this section, A's communications income is from sources within the United States, as provided by paragraph (f) of this section.

Example 11. Income derived from communications and non-communications activity—(i) *Facts.* B, a domestic corporation, is paid by D, a cable system operator in Foreign Country, to provide television programs and to transmit the television programs to Foreign Country. Using its own satellite transponder, B transmits the television programs from the United States to downlink facilities owned by D in Foreign Country. D receives the transmission, unscrambles the signals, and distributes the broadcast to D's customers in Foreign Country. Assume that B's provision of television programs is a non-*de minimis* non-communications activity, and that B's transmission of television programs is a non-*de minimis* communications activity.

(ii) *Analysis.* Under paragraph (h)(1)(ii) of this section, B must treat its communications and non-communications activities as separate transactions. B's gross income is allocated to each such separate communications and non-communications activity transaction in accordance with paragraph (h)(1)(ii) of this section. Income derived by B from the transmission of television programs to D's Foreign Country downlink facility is international communications income as defined in paragraph (h)(3)(ii) of this section because B is paid to transmit communications from the United States to a foreign country.

Example 12. Income derived from foreign communications activity—(i) *Facts.* S provides satellite capacity to B, a broadcaster located in Australia. B beams programming from Australia to the satellite. S's satellite picks the communications up in space and beams the programming over a footprint covering Southeast Asia.

(ii) *Analysis.* S derives communications income as defined in paragraph (h)(2) of this section. S's income is characterized as foreign communications income under paragraph (h)(3)(iv) of this section because S picks up the communication in space, and beams it to a footprint entirely covering a foreign area. Under paragraph (d) of this section, S's foreign communications income is from sources without the United States. If S were beaming the programming over a satellite footprint that covered area both in the United States and outside the United States, S would be required to allocate the income derived from the different types of communications activity.

(k) *Reporting and documentation requirements*—(1) *In general.* A taxpayer making an allocation of gross income under paragraph (b)(2)(iii), (b)(2)(iv), or (h)(1)(ii) of this section must satisfy the requirements in paragraphs (k)(2) and (3) of this section.

(2) *Required documentation.* In all cases, a taxpayer must prepare and

maintain documentation in existence when its return is filed regarding the allocation of gross income, and allocation and apportionment of expenses, losses, and other deductions, the methodologies used, and the circumstances justifying use of those methodologies. The taxpayer must make available such documentation within 30 days upon request.

(3) *Access to software.* If the taxpayer or any third party used any computer software, within the meaning of section 7612(d), to allocate gross income, or to allocate or apportion expenses, losses, and other deductions, the taxpayer must make available upon request—

(i) Any computer software executable code, within the meaning of section 7612(d), used for such purposes, including an executable copy of the version of the software used in the preparation of the taxpayer's return (including any plug-ins, supplements, etc.) and a copy of all related electronic data files. Thus, if software subsequently is upgraded or supplemented, a separate executable copy of the version used in preparing the taxpayer's return must be retained;

(ii) Any related computer software source code, within the meaning of section 7612(d), acquired or developed by the taxpayer or a related person, or primarily for internal use by the taxpayer or such person rather than for commercial distribution; and

(iii) In the case of any spreadsheet software or similar software, any formulae or links to supporting worksheets.

(4) *Use of allocation methodology.* In general, when a taxpayer allocates gross income under paragraph (b)(2)(iii), (b)(2)(iv), or (h)(1)(ii) of this section, it does so by making the allocation on a timely filed original return (including extensions). However, a taxpayer will be permitted to make changes to such allocations made on its original return with respect to any taxable year for which the statute of limitations has not closed as follows:

(i) In the case of a taxpayer that has made a change to such allocations prior to the opening conference for the audit of the taxable year to which the allocation relates or who makes such a change within 90 days of such opening conference, if the IRS issues a written information document request asking the taxpayer to provide the documents and such other information described in paragraphs (k)(2) and (3) of this section with respect to the changed allocations and the taxpayer complies with such request within 30 days of the request, then the IRS will complete its examination, if any, with respect to the allocations for that year as part of the current examination cycle. If the taxpayer does not provide the documents and information described in paragraphs (k)(2) and (3) of this section within 30 days of the request, then the procedures described in paragraph (k)(4)(ii) of this section shall apply.

(ii) If the taxpayer changes such allocations more than 90 days after the opening conference for the audit of the taxable year to which the allocations relate or the taxpayer does not provide the documents and information with respect to the changed allocations as requested in accordance with paragraphs (k)(2) and (3) of this section, then the IRS will, in a separate cycle, determine whether an examination of the taxpayer's allocations is warranted and complete any such examination. The separate cycle will be worked as resources are available and may not have the same estimated completion date as the other issues under examination for the taxable year. The IRS may ask the taxpayer to extend the statute of limitations on assessment and collection for the taxable year to permit examination of the taxpayer's method of allocation, including an extension limited, where appropriate, to the taxpayer's method of allocation.

(l) *Effective date.* This section applies to taxable years beginning on or after the date of publication of final regulations in the **Federal Register**.

Mark E. Matthews,

Deputy Commissioner for Services and Enforcement.

[FR Doc. 05–18265 Filed 9–16–05; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF DEFENSE

GENERAL SERVICES ADMINISTRATION

NATIONAL AERONAUTICS AND SPACE ADMINISTRATION

48 CFR Parts 1, 2, 17, 31, 32, 35, 42, 45, 49, 51, 52, and 53

[FAR Case 2004–025]

RIN: 9000–AK30

Federal Acquisition Regulation; Government Property

AGENCIES: Department of Defense (DoD), General Services Administration (GSA), and National Aeronautics and Space Administration (NASA).

ACTION: Proposed rule.

SUMMARY: The Civilian Agency Acquisition Council and the Defense Acquisition Regulations Council (Councils) are proposing to amend the Federal Acquisition Regulation (FAR) to simplify procedures, clarify language, and eliminate obsolete requirements related to the management and disposition of Government property in the possession of contractors. Various FAR parts are amended to implement a policy that fosters efficiency, flexibility, innovation, and creativity, while continuing to protect the Government's interest in the public's property. The proposed rule specifically impacts contracting officers, property administrators, and contractors responsible for the management of Government property.

DATES: Interested parties should submit written comments to the FAR Secretariat on or before November 18, 2005 to be considered in the formulation of a final rule.

ADDRESSES: Submit comments identified by FAR case 2004–025 by any of the following methods:

- Federal eRulemaking Portal: *http://www.regulations.gov*. Follow the instructions for submitting comments.
- Agency Web Site: *http://www.acqnet.gov/far/ProposedRules/proposed.htm*. Click on the FAR case number to submit comments.
- E-mail: *farcase.2004–025@gsa.gov*. Include FAR case 2004–025 in the subject line of the message.
- Fax: 202–501–4067.
- Mail: General Services Administration, Regulatory Secretariat (VIR), 1800 F Street, NW, Room 4035, ATTN: Laurieann Duarte, Washington, DC 20405.

Instructions: Please submit comments only and cite FAR case 2004–025 in all correspondence related to this case. All comments received will be posted without change to *http://www.acqnet.gov/far/ProposedRules/proposed.htm*, including any personal and/or business confidential information provided.

FOR FURTHER INFORMATION CONTACT The FAR Secretariat at (202) 501–4755 for information pertaining to status or publication schedules. For clarification of content, contact Ms. Jeritta Parnell, Procurement Analyst, at (202) 501–4082. Please cite FAR case 2004–025.

SUPPLEMENTARY INFORMATION:

A. Background

In the late 1990s, the Department of Defense (DoD) initiated a complete rewrite of FAR Part 45 and associated clauses. Beyond attempting to address long-standing property management