

[Code of Federal Regulations]
 [Title 26, Volume 9, Part 1, Sections 1.851 to 1.907]
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 [CITE: 26CFR1.861-1]

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TITLE 26-- INTERNAL REVENUE

(CONTINUED)

Normal Taxes and Surtaxes (Continued)--Table of Contents

Sec. 1.861-1 Income from sources within the United States.

(a) Categories of income. Part I (section 861 and following), subchapter N, chapter 2. of the Code, and the regulations thereunder determine the sources of income for purposes of the income tax. These sections explicitly allocate certain important sources of income to the United States or to areas outside the United States, as the case may be; and, with respect to the remaining income (particularly that derived partly from sources within and partly from sources without the United States), authorize the Secretary or his delegate to determine the income derived from sources within the United States, either by rules of separate allocation or by processes or formulas of general apportionment. The statute provides for the following three categories of income:

(1) Within the United States. The gross income from sources within the United States, consisting of the items of gross income specified in section 861(a) plus the items of gross income allocated or apportioned to such sources in accordance with section 863(a). See Secs. 1.861-2 to 1.861-7, inclusive, and Sec. 1.863-1. The taxable income from sources within the United States, in the case of such income, shall be determined by deducting therefrom, in accordance with sections 861(b) and 863(a), the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely

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be allocated to some item or class of gross income. See Secs. 1.861-8 and 1.863-1.

(2) Without the United States. The gross income from sources without the United States, consisting of the items of gross income specified in section 862(a) plus the items of gross income allocated or apportioned to such sources in accordance with section 863(a). See Secs. 1.862-1 and 1.863-1. The taxable income from sources without the United States, in the case of such income, shall be determined by deducting therefrom, in accordance with sections 862(b) and 863(a), the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income. See Secs. 1.862-1 and 1.863-1.

(3) Partly within and partly without the United States. The gross income derived from sources partly within and partly without the United States, consisting of the items specified in section 863(b) (1), (2), and (3). The taxable income allocated or apportioned to sources within the United States, in the case of such income, shall be determined in

generates primarily sales income from domestic sources in the early years of its operation and then is leased by the taxpayer to a foreign subsidiary in later years, the class of gross income to which the asset gives rise will be considered to be the rental income derived from the lease and will not include sales income from domestic sources.

(ii) Apportionment of losses. Where in the unusual circumstances that an apportionment of a deduction for losses on the sale, exchange, or other disposition of a capital asset or property described in section 1231(b) is necessary, the amount of such deduction shall be apportioned between the statutory grouping (or among the statutory groupings) of gross income (within the class of gross income) and the residual grouping (within the class of gross income) in the same proportion that the amount of gross income within such statutory grouping (or statutory groupings) and such residual grouping bear, respectively, to the total amount of gross income within the class of gross income. Apportionment will be necessary where, for example, the class of gross income to which the deduction is allocated consists of gross income (such as royalties) attributable to an intangible asset used both within and without the United States, or gross income (such as from sales or services) attributable to a tangible asset used both within and without the United States.

(iii) Allocation of loss recognized in taxable years after 1986. See Secs. 1.865-iT, 1.865-2, and 1.865-21 for rules regarding the allocation of certain loss recognized in taxable years beginning after December 31, 1986.

(8) Net operating loss deduction. [Reserved] For guidance, see Sec. 1.861-8T(e)(8).

(9) Deductions which are not definitely related. Deductions which shall generally be considered as not definitely related to any gross income, and therefore are ratably apportioned as provided in paragraph (c)(2) of this section, are--

(i) The deduction allowed by section 163 for interest described in subparagraph (2)(iii) of this paragraph (e);

(ii) The deduction allowed by section 164 for real estate taxes on a personal residence or for sales tax on the purchase of items for personal use;

(iii) The deduction for medical expenses allowed by section 213;

(iv) The deduction for charitable contributions allowed by sections 170, 873(b)(2), and 882(c)(1)(B); and

(v) The deduction for alimony payments allowed by section 215.

(10) Special deductions. The special deductions allowed in the case of a corporation by section 241 (relating to the deductions for partially tax exempt interest, dividends received, etc.), section 922 (relating to Western Hemisphere trade corporations), and section 941 (relating to China Trade Act corporations) shall be allocated and apportioned consistent with the principles of this section.

(11) Personal exemptions. The deductions for the personal exemptions allowed by section 151, 642(b), or 873(b)(3) shall not be taken into account for purpose of allocation and apportionment under this section.

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(f) Miscellaneous matters--(1) Operative sections. The operative sections of the Code which require the determination of taxable income of the taxpayer from specific sources or activities and which give rise to statutory groupings to which this section is applicable include the sections described below.

(i) Overall limitation to the foreign tax credit. Under the overall limitation to the foreign tax credit, as provided in section 904(a)(2) (as in effect before enactment of the Tax Reform Act of 1976, or section

904(a) after such enactment) the amount of the foreign tax credit may not exceed the tentative U.S. tax (i.e., the U.S. tax before application of the foreign tax credit) multiplied by a fraction, the numerator of which is the taxable income from sources without the United States and the denominator of which is the entire taxable income. Accordingly, in this case, the statutory grouping is foreign source income (including, for example, interest received from a domestic corporation which meets the tests of section 861(a)(1)(B), dividends received from a domestic corporation which has an election in effect under section 936, and other types of income specified in section 862). Pursuant to sections 862(b) and 863(a) and Secs. 1.862-1 and 1.863-1, this section provides rules for identifying the deductions to be taken into account in determining taxable income from sources without the United States. See section 904(d) (as in effect after enactment of the Tax Reform Act of 1976) and the regulations thereunder which require separate treatment of certain types of income. See example 3 of paragraph (g) of this section for one example of the application of this section to the overall limitation.

→ (ii) [Reserved]

→ (iii) DISC and FSC taxable income. Sections 925 and 994 provide rules for determining the taxable income of a FSC and DISC, respectively, with respect to qualified sales and leases of export property and qualified services. The combined taxable income method available for determining a DISC's taxable income provides, without consideration of export promotion expenses, that the taxable income of the DISC shall be 50 percent of the combined taxable income of the DISC and the related supplier derived from sales and leases of export property and from services. In the FSC context, the taxable income of the FSC equals 23 percent of the combined taxable income of the FSC and the related supplier. Pursuant to regulations under section 925 and 994, this section provides rules for determining the deductions to be taken into account in determining combined taxable income, except to the extent modified by the marginal costing rules set forth in the regulations under sections 925(b)(2) and 994(b)(2) if used by the taxpayer. See Examples (22) and (23) of paragraph (g) of this section. In addition, the computation of combined taxable income is necessary to determine the applicability of the section 925(d) limitation and the "no loss" rules of the regulations under sections 925 and 994.

→ (iv) Effectively connected taxable income. Nonresident alien individuals and foreign corporations engaged in trade or business within the United States, under sections 871(b)(1) and 882(a)(1), on taxable income which is effectively connected with the conduct of a trade or business within the United States. Such taxable income is determined in most instances by initially determining, under section 864(c), the amount of gross income which is effectively connected with the conduct of a trade or business within the United States. Pursuant to sections 873 and 882(c), this section is applicable for purposes of determining the deductions from such gross income (other than the deduction for interest expense allowed to foreign corporations (see Sec. 1.882-5)) which are to be taken into account in determining taxable income. See example 21 of paragraph (g) of this section.

→ (v) Foreign base company income. Section 954 defines the term "foreign base company income" with respect to controlled foreign corporations. Section 954(b)(5) provides that in determining foreign base company income the gross income shall be reduced by the deductions of the controlled foreign corporation "properly allocable to such income." This section provides rules for identifying which deductions are properly allocable to foreign base company income.

EXHIBIT 35-D

- (vi) Other operative sections. The rules provided in this section also apply in determining-
- (A) The amount of foreign source items of tax preference under section 58(g) determined for purposes of the minimum tax;
- (B) The amount of foreign mineral income under section 901(e);
- (C) [Reserved]
- (D) The amount of foreign oil and gas extraction income and the amount of foreign oil related income under section 907;
- (E) The tax base for citizens entitled to the benefits of section 931 and the section 936 tax credit of a domestic corporation which has an election in effect under section 936;
- (F) The exclusion for income from Puerto Rico for residents of Puerto Rico under section 933;
- (G) The limitation under section 934 on the maximum reduction in income tax liability incurred to the Virgin Islands;
- (H) The income derived from Guam by an individual who is subject to section 935;
- (I) The special deduction granted to China Trade Act corporations under section 941;
- (J) The amount of certain U.S. source income excluded from the subpart F income of a controlled foreign corporation under section 952(b);
- (K) The amount of income from the insurance of U.S. risks under section 953(b)(5);
- (L) The international boycott factor and the specifically
- (M) The taxable income attributable to the operation of an agreement vessel under section 607 of the Merchant Marine Act of 1936, as amended, and the Capital Construction Fund Regulations thereunder (26 CFR, part (3). See 26 CFR 3.2(b)(3).

(2) Application to more than one operative section. (i) Where more than one operative section applies, it may be necessary for the taxpayer to apply this section separately for each applicable operative section. In such a case, the taxpayer is required to use the same method of allocation and the same principles of apportionment for all operative sections.

(ii) When expenses, losses, and other deductions that have been properly allocated and apportioned between combined gross income of a related supplier and a DISC or former DISC and residual gross income, regardless of which of the administrative pricing methods of section 994 has been applied, such deductions are not also allocated and apportioned to gross income consisting of distributions from the DISC or former DISC attributable to income of the DISC or former DISC as determined under the administrative pricing methods with respect to DISC or former DISC taxable years beginning after December 31, 1986. Accordingly, Example (22) of paragraph (g) of this section does not apply to distributions from a DISC or former DISC with respect to DISC or former DISC taxable years beginning after December 31, 1986. This rule does not apply to the extent that the taxable income of the DISC or former DISC is determined under the section 994(a)(3) transfer pricing method. In addition, for taxable years beginning after December 31, 1986, in the case of expenses, losses, and other deductions that have been properly allocated and apportioned between combined gross income of a related supplier and a FSC and residual gross income, regardless of which of the administrative pricing methods of section 925 has been applied, such deductions are not also allocated and apportioned to gross income consisting of distributions from the FSC or former FSC which are attributable to the foreign trade income of the FSC or former FSC as determined under the administrative pricing methods. This rule does not to the extent that the foreign trade income of the FSC or former

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