

§ 1.863-9 Source of income derived from communications activity
under section 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 United States person.* Income derived from international communications activity (international communications income) by a United States 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 United States 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.* The source of 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. A taxpayer may satisfy the requirement that the taxpayer establish the two points between which the taxpayer is paid to transmit, and bears the risk of transmitting, the communication by using any consistently applied reasonable method to establish one or both endpoints. In evaluating the reasonableness of such method, consideration will be given to all the facts and circumstances, including whether the endpoints would otherwise be identifiable absent this reasonable method provision and the reliability of the data. Depending on the facts and circumstances, methods based on, for example, records of port or transport charges, customer billing records, a satellite footprint, or records of termination fees made pursuant to an international settlement agreement may be reasonable. In addition, practices used by taxpayers to classify or categorize certain communications activity in connection with preparation of statements and analyses for the use of management, creditors, minority shareholders, joint ventures, or other parties or

governmental agencies in interest may be reliable indicators of the reasonableness of the method chosen, but need not be accorded conclusive weight by the Commissioner. In all cases, the method chosen to establish the two points between which the taxpayer is paid to transmit, and bears the risk of transmitting, the communication must be supported by sufficient documentation to permit verification by the Commissioner.

(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—

(A) Between a point in the United States and a point in a foreign country (or a possession of the United States); or

(B) Foreign-originating communications (communications with a beginning point in a foreign country or a possession of the United States) from a point in space or international water to a point in 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, except as provided in paragraph (h)(3)(ii)(B) of this section.

(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 United States 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 United States 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 United States 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. The paid-to-do rule—foreign-originating communications—

(i) *Facts.* Under an international settlement agreement, G, a Country X international carrier, pays T to receive all calls originating in Country X that are bound for the United States and to terminate such calls in the United States. Due to Country X legal restrictions, the international settlement agreement specifies

that G carries the transmission to a point outside the territory of Country X and that T carries the foreign-originating transmission from such point to the destined point in the United States. T, in turn, contracts out with another communications company, S, to transmit the U.S. portion of the communications. Tracing and identifying the endpoints of each transmission is not possible or practical. T does, however, keep records of termination fees received from G for terminating the foreign-originating calls.

(ii) *Analysis.* T derives communications income as defined in paragraph (h)(2) of this section. Based on all the facts and circumstances, T can establish that T is paid to transmit, and bears the risk of transmitting, foreign-originating calls from a point in space or international water to a point in the United States using a reasonable method to establish the endpoints, assuming that this method is consistently applied. In this case, T can reasonably establish that T is paid to receive foreign-originating calls and terminate such calls in the United States based on the records of termination fees pursuant to an international settlement agreement. Under paragraph (h)(3)(ii)(B) of this section, a taxpayer derives income from international communications activity when the taxpayer is paid to transmit foreign-originating communications from space or international water to the United States. Thus, under paragraph (h)(3)(ii)(B) of this section, T derives income from international communications. If, based on all the facts and circumstances, T could reasonably trace and identify the endpoints, then T would have to directly establish that each call originated in a foreign country. Assuming T is able to do so, the rest of the analysis in this *Example 7* remains the same. Under paragraph (h)(3)(iii) of this section, S derives income from U.S. communications activity because S is paid to transmit the communications between two U.S. points.

Example 8. 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, even under the reasonable method rule of paragraph (h)(3) of this section.

(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 9. Reasonable methods—minutes of use data on long distance calling plans—

(i) *Facts.* B provides both domestic and international long distance services in a calling plan for a limited number of minutes for a set amount each month. Tracing and identifying the endpoints of each transmission is not possible or practical. B is, however, able to establish that the calling plan generated \$10,000 of revenue for 25,000 minutes based on reports derived from customer billing records. Based on minutes of use data in these reports, B is able to establish that of the total 25,000 minutes, 60 percent or 15,000 minutes were for U.S. long distance calls and 40 percent or 10,000 minutes were for international calls.

(ii) *Analysis.* B derives communications income as defined in paragraph (h)(2) of this section. Based on all the facts and circumstances, B can establish the two points between which B is paid to transmit, and bears the risk of transmitting, the communications using a reasonable method to establish the endpoints, assuming that this method is consistently applied. In this case, B can

reasonably establish that 60 percent of the income derived from the long distance calling plan is U.S. communications income and 40 percent is international communications income based on the minutes of use data derived from customer billing records to establish the endpoints of the communications. If, based on all the facts and circumstances, B could reasonably trace and identify the endpoints, then B would have to directly identify the endpoints between which B is paid to transmit the communications.

Example 10. Reasonable methods—system design—

(i) *Facts.* D operates satellites which are designed to transmit signals through two separate ranges of signal frequencies (bands). Due to technological limitations, requirements, and practicalities, one band is designed to only transmit signals within the United States. The other band is designed to transmit signals between foreign countries and the United States. D cannot trace and identify the endpoints of each individual transmission. D does, however, track the total transmission through each band and the total income derived from transmitting signals through each band.

(ii) *Analysis.* D derives communications income as defined in paragraph (h)(2) of this section. Based on all the facts and circumstances, D can establish the two points between which D is paid to transmit, and bears the risk of transmitting, the communications using a reasonable method to establish endpoints, assuming that this method is consistently applied. In this case, D can reasonably establish that income derived from transmissions through the first band is U.S. communications income and income derived from transmissions through the second band is international communications income based on the design of the bands to establish the endpoints of the communications.

Example 11. Reasonable methods—port locations—

(i) *Facts.* X provides its customer, C, with a virtual private network (VPN) so that C's U.S. headquarter office can connect and communicate with offices in the United States, Country X, Country Y, and Country Z. Assume that the VPN is only for communications with the U.S. headquarter office. X cannot trace and identify the endpoints of each transmission. C pays X a set amount each month for the entire service, regardless of the magnitude of the usage or the geographic points between which C uses the service.

(ii) *Analysis.* X derives communications income as defined in paragraph (h)(2) of this section. Based on the facts and circumstances, X can establish the two points between which X is paid to transmit, and bears the risk of transmitting, the communications using a reasonable method to establish endpoints, assuming that this method is consistently applied. In this case, X can reasonably establish that one-fourth of the income derived from the VPN service is U.S. communications income and three-fourths is international communications income based on the location of the VPN ports to establish the endpoints of the communications.

Example 12. 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 13. De minimis non-communications activity—

(i) *Facts.* The same facts as in Example 12. 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 14. 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 15. 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 16. Income derived from foreign communications activity—

(i) *Facts.* STS 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), (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)(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 December 27, 2006.

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