

of foreign taxes accrued by A and B with respect to their distributive shares of M's FOGEI is \$11,500 (\$5,750 accrued by A and \$5,750 accrued by B). A and B have no other FOGEI. A's only taxable income for 1984 is his 50% distributive share (\$10,000) of M's FOGEI and A has a preliminary U.S. tax liability of \$1,079. B has \$112,130 of taxable income for 1984 (including his 50% distributive share (\$10,000) of M's FOGEI) and has a preliminary U.S. tax liability of \$44,000. Pursuant to section 907(a), A's FOGEI taxes limitation level for 1984 is \$1,079 $((\$1,079/\$10,000) \times \$10,000)$ and B's FOGEI taxes limitation level for 1984 is \$3,924 $((\$44,000/\$112,130) \times \$10,000)$.

(e) *Effect on other provisions*—(1) *Deduction denied.* If a credit is claimed under section 901, no deduction under section 164(a)(3) is allowed for the amount of the FOGEI taxes that exceed a taxpayer's limitation level for the taxable year. See section 275(a)(4)(A). Thus, FOGEI taxes disallowed under section 907(a) are not added to the cost or inventory amount of oil or gas.

(2) *Reduction inapplicable.* The reduction under section 907(a) does not apply to a taxpayer that deducts foreign taxes and does not claim the benefits of section 901 for a taxable year.

(3) *Section 78 dividend.* The reduction under section 907(a) has no effect on the amount of foreign taxes that are treated as dividends under section 78.

(f) *Section 904 limitation.* FOGEI taxes as reduced under section 907(a) are creditable only to the extent permitted by the general limitation of section 904(d)(1)(I).

[T.D. 8338, 56 FR 11066, Mar. 15, 1991]

§ 1.907(b)-1 Reduction of creditable FORI taxes (for taxable years beginning after December 31, 1982).

If the foreign law imposing a FORI tax (as defined in § 1.907(c)-3) is either structured in a manner, or operates in a manner, so that the amount of tax imposed on FORI is generally materially greater than the tax imposed by the foreign law on income that is neither FORI nor FOGEI ("described manner"), section 907(b) provides a special rule which limits the amount of FORI taxes paid or accrued by a person to a foreign country which will be considered income, war profits, or excess profits taxes. Section 907(b) will apply to a person regardless of whether that

person is a dual capacity taxpayer as defined in § 1.901-2(a)(2)(ii)(A). (In general, a dual capacity taxpayer is a person who pays an amount to a foreign country part of which is attributable to an income tax and the remainder of which is a payment for a specific economic benefit derived from that country.) Foreign law imposing a tax on FORI will be considered either to be structured in or to operate in the described manner only if, under the facts and circumstances, there has been a shifting of tax by the foreign country from a tax on FOGEI to a tax on FORI.

[T.D. 8338, 56 FR 11066, Mar. 15, 1991]

§ 1.907(c)-1 Definitions relating to FOGEI and FORI (for taxable years beginning after December 31, 1982).

(a) *Scope.* This section explains the meaning to be given certain terms and items in section 907(c) (1), (2), and (4). See also §§ 1.907(a)-0(b) and 1.907(c)-2 for further definitions.

(b) *FOGEI*—(1) *General rule.* Under section 907(c)(1), FOGEI means taxable income (or loss) derived from sources outside the United States and its possessions from the extraction (by the taxpayer or any other person) of minerals from oil or gas wells located outside the United States and its possessions or from the sale or exchange of assets used by the taxpayer in the trade or business of extracting those minerals. Extraction of minerals from oil or gas wells will result in gross income from extraction in every case in which that person has an economic interest in the minerals in place. For other circumstances in which gross income from extraction may arise, see paragraph (b)(3) of this section. For determination of the amount of gross income from extraction, see paragraph (b)(2) of this section. For definition of the phrase "assets used by the taxpayer in the trade or business" and for rules relating to that type of FOGEI, see paragraph (e)(1) of this section. The term "minerals" is defined in paragraph (f)(1) of this section. For determination of taxable income, see paragraph (f)(2) of this section. FOGEI includes, in addition, items listed in section 907(c)(3) (relating to dividends, interest, partnership distributions, etc.)

and explained in § 1.907(c)-2. For the reduction of what would otherwise be FOGEI by losses incurred in a prior year, see section 907(c)(4) and paragraph (c) of this section.

(2) *Amount.* The gross income from extraction is determined by reference to the fair market value of the minerals in the immediate vicinity of the well. Fair market value is determined under paragraph (b)(6) of this section.

(3) *Other circumstances.* Gross income from extraction or the sale or exchange of assets described in section 907(c)(1)(B) includes income from any arrangement, or a combination of arrangements or transactions, to the extent the income is in substance attributable to the extraction of minerals or such a sale or exchange. For instance, a person may have gross income from such a sale or exchange if the person purchased minerals from a foreign government at a discount and the discount reflects an arm's-length amount in consideration for the government's nationalization of assets that person owned and used in the extraction of minerals.

(4) *Income directly related to extraction.* Gross income from extraction includes directly related income under paragraph (g) of this section.

(5) *Income not included.* FOGEI as otherwise determined under this paragraph (b), nevertheless, does not include income to the extent attributable to marketing, distributing, processing or transporting minerals or primary products. Income from the purchase and sale of minerals is not ordinarily FOGEI. If the foreign taxes paid or accrued in connection with income from a purchase and sale are not creditable by reason of section 901(f), that income is not FOGEI. A taxpayer to whom section 901(f) applies is not a producer.

(6) *Fair market value.* For purposes of this paragraph (b), the fair market value of oil or gas in the immediate vicinity of the well depends on all of the facts and circumstances as they exist relative to a party in any particular case. The facts and circumstances that may be taken into account include, but are not limited to, the following—

(i) The facts and circumstances pertaining to an independent market

value (if any) in the immediate vicinity of the well,

(ii) The facts and circumstances pertaining to the relationships between the taxpayer and the foreign government. If an independent fair market value in the immediate vicinity of the well cannot be determined but fair market value at the port, or a similar point, in the foreign country can be determined (port price), an analysis of the arrangement between the taxpayer and the foreign government that retains a share of production could be evidence of the appropriate, arm's-length difference between the port price and the field price, and

(iii) The other facts and circumstances pertaining to any difference in the producing country between the field and port prices.

(7) *Economic interest.* For purposes of this paragraph (b), the term "economic interest" means an economic interest as defined in § 1.611-1(b)(1), whether or not a deduction for depletion is allowable under section 611.

(c) *Carryover of foreign oil extraction losses—(1) In general.* Pursuant to section 907(c)(4), the determination of FOGEI for a particular taxable year takes into account a foreign oil extraction loss incurred in prior taxable years beginning after December 31, 1982. There is no time limitation on this carryover of foreign oil extraction losses. Section 907(c)(4) does not provide for any carryback of these losses. Section 907(c)(4) operates solely for purposes of determining FOGEI and thus operates independently of section 904(f).

(2) *Reduction.* That portion of the income of the taxpayer for the taxable year which but for this paragraph (c) would be treated as FOGEI is reduced (but not below zero) by the excess of—

(i) The aggregate amount of foreign oil extraction losses for preceding taxable years beginning after December 31, 1982, over

(ii) The aggregate amount of reductions under this paragraph (c) for preceding taxable years beginning after December 31, 1982.

(3) *Foreign oil extraction loss defined—(i) In general.* For purposes of this paragraph (c), the term "foreign oil extraction loss" means the amount by which

the gross income for the taxable year that is taken into account in determining FOGEI for that year is exceeded by the sum of the deductions properly allocated and apportioned to that gross income as determined under paragraph (f)(2) of this section). A person can have a foreign oil extraction loss for a taxable year even if the person has not chosen the benefits of section 901 for that year.

(ii) *Items not taken into account.* For purposes of paragraph (c)(3)(i) of this section, the following items are not taken into account—

(A) The net operating loss deduction allowable for the taxable year under section 172(a),

(B) Any foreign expropriation loss (as defined in section 172(h)) for the taxable year, and

(C) Any loss for the taxable year which arises from fire, storm, shipwreck, or other casualty, or from theft. A loss mentioned in paragraph (c)(3)(ii) (B) or (C) of this section is taken into account, however, to the extent compensation (for instance by insurance) for the loss is included in gross income.

(4) *Affiliated groups.* The foreign oil extraction loss of an affiliated group of corporations (within the meaning of section 1504(a)) that files a consolidated return is determined on a group basis. If the group does not have a foreign oil extraction loss, the foreign oil extraction loss of a member of that group will not reduce on a separate basis that member's FOGEI for a later taxable year. For special rules affecting the foreign oil extraction loss in the case of certain related domestic corporations that are not members of the same affiliated group, see section 904(i).

(5) *FOGEI taxes.* If FOGEI is reduced pursuant to this paragraph (c) (and thereby recharacterized as non-FOGEI income), any foreign taxes imposed on the FOGEI that is recharacterized as other income retain their character as FOGEI taxes. See section 907(c)(5).

(6) *Examples.* The provisions of this paragraph (c) may be illustrated by the following examples.

Example 1 —(i) *Facts.* X, a U.S. corporation using the accrual method of accounting and the calendar year as its taxable year, is engaged in extraction activities in three for-

ign countries. X has only the following combined foreign tax items for the three countries (prior to the application of this paragraph (c)) for 1983, 1984, and 1985:

	1983	1984	1985
FOGEI	\$(700)	\$100	\$450
FOGEI taxes	10	60	200
Net operating loss deduction	(200)	0	0
Foreign oil extraction loss allowable after adjustment for paragraph (c)(3)(ii) amounts	(500)	0	0
General limitation taxes other than FOGEI taxes	30	90	230

(ii) *1983.* Because X's FOGEI for 1983 is a loss of \$(700), X's section 907(a) limitation for 1983 is \$0 (.46×\$0). Thus, none of the FOGEI taxes paid or accrued in 1983 (\$10) can be credited in 1983. They can, however, be carried back to 1981 or 1982 pursuant to the provisions of section 907(e)(2) and §1.907(e)-1 and carried forward pursuant to the provisions of section 907(f) and §1.907(f)-1.

(iii) *1984.* X's FOGEI for 1984, prior to the application of this paragraph (c), is \$100. X has a foreign oil extraction loss for 1983 of \$(500). This loss must be applied against X's preliminary FOGEI of \$100 for 1984. Thus, X's FOGEI for 1984 is \$0 and X has \$(400) (\$500 - \$100) of foreign oil extraction loss from 1983 to be carried to 1985. Since X's FOGEI for 1984 is \$0, its section 907(a) limitation is \$0 (.46×\$0). Therefore, none of the FOGEI taxes paid or accrued in 1984 (\$60) can be credited in 1984. They can, however, be carried back pursuant to the provisions of section 907(e)(2) and §1.907(e)-1 and carried forward pursuant to the provisions of section 907(f) and §1.907(f)-1.

(iv) *1985.* X's FOGEI for 1985, prior to the application of this paragraph (c), is \$450. X's remaining foreign oil extraction loss carry-over from 1983 is \$(400) and this must be applied against X's preliminary FOGEI of \$450 for 1985. Thus, X's FOGEI for 1984 is \$50 (\$450 - \$400). X's section 907 (a) limitation is \$23 (.46×\$50). Therefore, \$23 of the FOGEI taxes paid or accrued in 1985, together with the other \$230 of general limitation taxes, can be credited in 1985, subject to the general limitation of section 904(d)(1)(E) (as in effect prior to 1987). The excess of FOGEI taxes, \$177 (\$200 - \$23), can be carried back pursuant to the provisions of section 907(e)(2) and §1.907(e)-1 and carried forward pursuant to the provisions of section 907(f) and §1.907(f)-1.

Example 2 —(i) *Facts.* The facts are the same as in *Example 1* except that X's paragraph (c)(3)(ii) items for 1983 allocable to FOGEI are \$(800) instead of \$(200). FOGEI remains a loss of \$(700). Thus, X does not have a foreign oil extraction loss for 1983 because it has \$100 of FOGEI when its paragraph (c)(3)(ii) items are not taken into account (\$ (700)+\$800).

§ 1.907(c)-1

(ii) 1983. The results are the same as in Example 1.

(iii) 1984. Although X had FOGEI loss of \$(700) in 1983, there is not a loss that can be carried forward after adjustment for paragraph (c)(3)(ii) items. Thus, X's FOGEI for 1984 is not reduced by the 1983 loss. X's section 907(a) limitation for 1984 is \$46 (.46x\$100). Therefore, \$46 of the FOGEI taxes paid or accrued in 1984, together with the other \$90 of general limitation taxes, can be credited in 1984, subject to the general limitation of section 904(d)(1)(E) (as in effect prior to 1987). The excess of \$14 (\$60-\$46) can be carried back to 1982 pursuant to the provisions of section 907(e)(2) and § 1.907(e)-1 and carried forward pursuant to the provisions of section 907(f) and § 1.907(f)-1.

(iv) 1985. Since there is no foreign oil extraction loss for either 1983 or 1984 to be applied in 1985, X's FOGEI for 1985 is \$450. Thus, its section 907(a) limitation for 1985 is \$207 (.46x\$450) and all of its FOGEI taxes paid or accrued in 1985 (\$200), together with the other \$230 of general limitation taxes, can be credited in 1985, subject to the general limitation of section 904(d)(1)(E) (as in effect prior to 1987). FOGEI taxes in the amount of \$10 from 1983 and \$14 from 1984 may be carried forward to 1985 if they have not been used in carryback years. However, because the excess section 907(a) limitation for 1985 is only \$7, that is the maximum potential FOGEI taxes from 1983 or 1984 that may be used in 1985.

Example 3—(i) *Facts*. Y, a U.S. corporation using the accrual method of accounting and the calendar year as its taxable year, is engaged in extraction activities in three foreign countries. Y's only foreign taxable income is income subject to the general limitation of section 904(d)(1)(E) (as in effect prior to 1987). Y has no paragraph (c)(3)(ii) items. Y has the following foreign tax items for 1983 and 1984:

	1983	1984
FOGEI	\$(400)	\$300
Other foreign taxable income	250	200
U.S. taxable income	1,000	1,100
Worldwide taxable income	850	1,600
FOGEI taxes	10	180
Other general limitation taxes	50	40
Foreign oil extraction loss	(400)	0

(ii) 1983—(A) *Section 907(a) limitation*. Because Y's FOGEI for 1983 is a loss of \$(400), Y's section 907(a) limitation for 1983 is \$0. Thus, none of the FOGEI taxes paid or accrued in 1983 (\$10) can be credited in 1983. They can, however, be carried back to 1981 or 1982 pursuant to the provisions of section 907(e)(2) and § 1.907(e)-1 and carried forward pursuant to the provisions of section 907(f) and § 1.907(f)-1.

(B) *Section 904(d) fraction*. Y has a foreign loss of \$(150) (\$400 + \$250) for 1983. Thus, its

fraction for purposes of determining its general limitation of section 904(d)(1)(E) is \$0/\$850.

(iii) 1984—(A) *Section 907(a) limitation*. Y's foreign oil extraction loss for 1983 is \$(400). Applying this loss to its preliminary FOGEI for 1984 (\$300) eliminates all of Y's FOGEI for 1984. Because Y's FOGEI for 1984 is \$0, its section 907(a) limitation is also \$0. Thus, none of the FOGEI taxes paid or accrued in 1984 (\$180) can be credited in 1984. They can, however, be carried back to 1982 pursuant to the provisions of section 907(e)(2) and § 1.907(e)-1 and carried forward pursuant to the provisions of section 907(f) and § 1.907(f)-1. Y has a remaining foreign oil extraction loss of \$(100) from 1983 to be carried to 1985.

(B) *Section 904(d) fraction*. Y's preliminary foreign taxable income for purposes of determining its general limitation of section 904(d)(1)(E) is \$500 (\$300 + \$200). However, Y has an overall foreign loss from 1983 of \$(150) (\$(400) + \$250) and thus, pursuant to section 904(f), Y must recharacterize \$150 (lesser of \$150 or 50% of \$500) of its 1984 foreign taxable income as U.S. taxable income. Thus, Y's fraction for purposes of determining its general limitation of section 904(d)(1)(E) for 1984 is \$350/\$1,600.

Example 4—(i) *Facts*. Assume the same facts as in *Example 3* except that Y has the following foreign tax items:

	1983	1984	1985
FOGEI		\$(100)	\$225
Other foreign source taxable income subject to the general limitation of section 904(d)(1)(E)	\$(50)		
U.S. source taxable income	50		
Worldwide taxable income		(100)	225
FOGEI taxes		10	125
Foreign oil extraction loss		(100)	

(ii) 1983. For 1983, Y has a section 904(d)(1)(E) overall foreign loss account of \$50; see section 904(f) and § 1.904(f)-1(b).

(iii) 1984. Because Y's FOGEI for 1984 is a loss of \$(100), Y's section 907(a) limitation for 1984 is \$0. Thus, none of the FOGEI taxes paid or accrued in 1984 (\$10) can be credited in 1984. They can, however, be carried back under the provisions of section 907(e)(2) and § 1.907(e)-1 and carried forward under the provisions of section 907(f) and § 1.907(f)-1.

(iv) 1985. Y's FOGEI loss of \$(100) for 1984 is carried forward to 1985 and offsets FOGEI income in that amount in 1985. The entire section 904(d)(1)(E) overall foreign loss account of \$50 is recaptured in 1985; therefore, Y has \$75 of foreign source income and \$50 of U.S. source income. However, Y has \$125 of FOGEI since, for purposes of section 907(a), the \$50 resourced by section 904(f) will be treated as income from sources outside the United States; see § 1.907(a)-1(c)(4)(iii). Accordingly, Y's section 907(a) limitation is \$57.50 (.46 x

\$125). Y's section 904(d)(1)(E) limitation is, however, only \$34.50 (.46 × \$75). Thus, Y may claim a foreign tax credit of \$34.50 in 1985. Y may carry back or carry forward \$23 (\$57.50-\$34.50) and that amount is not subject to the section 907(a) limitation in the carry to year. In addition, \$67.50 (\$125-\$57.50) may be carried back pursuant to the provisions of section 907(e)(2) and § 1.907(e)-1 and carried forward pursuant to the provisions of section 907(f) and § 1.907(f)-1. This amount is subject to the section 907(a) limitation in the carry to year.

(d) *FORI*—(1) *In general*. Section 907(c)(2) defines FORI to include taxable income from the processing of oil and gas into their primary products, from the transportation or distribution and sale of oil and gas and their primary products, from the disposition of assets used in these activities and from the performance of any other related service. FORI may also include, under section 907(c)(3), certain dividends, interest, or amounts described in section 951(a). This paragraph (d) defines certain terms and items applicable to FORI.

(2) *Transportation*. Gross income from transportation of minerals or primary products ("gross transportation income") is gross income arising from carrying minerals or primary products between two places (including time or voyage charter hires) by any means of transportation, such as a vessel, pipeline, truck, railroad, or aircraft. Except for directly related income under paragraphs (d)(7) and (g) of this section, gross transportation income does not include gross income received by a lessor from a bareboat charter hire of a means of transportation, certain other rental income, or income from the performance of certain services.

(3) *Distribution or sale*. The term "distribution or sale" means the sale or exchange of minerals or primary products to processors, users who purchase, store, or use in bulk quantities, other persons for further distribution, retailers, or consumers. Gross income from distribution or sale includes interest income attributable to the distribution of minerals or primary products on credit.

(4) *Processing*. The term "processing" means the destructive distillation, or a process similar in effect to destructive distillation, of crude oil and the proc-

essing of natural gas into their primary products including processes used to remove pollutants from crude oil or natural gas.

(5) *Primary product from oil*. The term "primary product" (in the case of oil) means all products derived from the processing of crude oil, including volatile products, light oils (such as motor fuel and kerosene), distillates (such as naphtha), lubricating oils, greases and waxes, and residues (such as fuel oil).

(6) *Primary product from gas*. The term "primary product" (in the case of gas) means all gas and associated hydrocarbon components from gas wells or oil wells, whether recovered at the lease or upon further processing, including natural gas, condensates, liquefiable petroleum gases (such as ethane, propane, and butane), and liquid products (such as natural gasoline).

(7) *Directly related income*. FORI also includes directly related income under paragraph (g) of this section.

(e) *Assets used in a trade or business*—(1) *In general*. The term "assets used by the taxpayer in the trade or business" in section 907(c) (1)(B) and (2)(D) means property primarily used in one or more of the trades or businesses that are section 907(c) activities. For purposes of this paragraph (e), assets used in a trade or business are assets described in section 1231(b) (applied without regard to any holding period or the character of the asset as being subject to the allowance for depreciation under section 167).

(2) *Section 907(c) activities*. Section 907(c) activities are those described in section 907(c)(1)(A) (for FOGEI) or (c)(2)(A) through (C) (for FORI). If an asset is used primarily in one or more section 907(c) activities, then the entire gain (or loss) will be considered attributable to those activities. For example, if a person uses a service station primarily to distribute primary products from oil, then all of the gain (or loss) on the sale of the station is FORI even though the person uses the station to distribute products that are not primary products (such as tires or batteries). If an asset is not primarily used in one or more section 907(c) activities, then the entire gain or loss will not be FOGEI or FORI.

(3) *Stock.* Stock of any corporation (whether foreign or domestic) will not be treated as an asset used by a person in section 907(c) activities.

(4) *Losses on sale of stock.* If, under § 1.861-8(e)(7), a loss on the sale, exchange, or disposition of stock is considered a deduction which is definitely related and allocable to FOGEI or FORI, then notwithstanding § 1.861-8(e)(7) and paragraph (f)(2) of this section, this loss shall be allocated and apportioned to the same class of income that would have been produced if there were capital gain from the sale, exchange or disposition.

(5) *Character of gain or loss.* Except in the case of stock, gain or loss from the sale, exchange or disposition of assets used in the trade or business may be FORI or FOGEI to the extent taken into account in computing taxable income for the taxable year, whether or not the gain or loss is ordinary income or ordinary loss.

(6) *Allocation of amount realized.* The amount realized from the sale, exchange or disposition of several assets in one transaction is allocated among them in proportion to their respective fair market values. This allocation is made under the principles set forth in § 1.1245-1(a)(5) (relating to allocation between section 1245 property and non-section 1245 property).

(7) *Interest.* Gross income from the sale, exchange or disposition of an asset used in a section 907(c) activity includes interest income from such a sale, exchange or disposition.

(f) *Terms and items common to FORI and FOGEI—(1) Minerals.* The term “minerals” means hydrocarbon minerals extracted from oil and gas wells, including crude oil or natural gas (as defined in section 613A(e)). The term includes incidental impurities from these wells, such as sulphur, nitrogen, or helium. The term does not include hydrocarbon minerals derived from shale oil or tar sands.

(2) *Taxable income.* Deductions to be taken into account in computing taxable income or net operating loss attributable to FOGEI or FORI are determined under the principles of § 1.861-8. For an exception with regard to losses, see paragraph (e)(4) of this section.

(3) *Interest on working capital.* FORI and FOGEI may include interest on bank deposits or on any other temporary investment which is not in excess of funds reasonably necessary to meet the working capital requirements and the specifically anticipated business needs of the person that is engaged in the conduct of the activities described in section 907(c) (1) or (2).

(4) *Exchange gain or loss.* Exchange gain (and loss) may be FORI and FOGEI. For taxable years beginning after 1986, exchange gain or loss from a section 988 transaction may be FORI or FOGEI only if directly related to the business needs (under the principles of section 954(c)(1)(D)) attributable to the conduct of the section 907(c) activity.

(5) *Allocation.* Interest income and exchange gain (or loss) described, respectively, in paragraph (f) (3) and (4) of this section are allocated among FORI, FOGEI, and any other class of income relevant for purposes of the foreign tax credit limitations under any reasonable method which is consistently applied from year-to-year.

(6) *Facts and circumstances.* Income not described elsewhere in this section may be FOGEI or FORI if, under the facts and circumstances in the particular case, the income is in substance directly attributable to the activities described in section 907(c) (1) or (2). For example, assume that a producer in the North Sea suffers a casualty caused by an explosion, fire, and resulting destruction of a drilling platform. Insurance proceeds received for the platform's destruction in excess of the producer's basis is extraction income if the excess constitutes income from sources outside the United States. In addition, income from an insurance policy for business interruption may be extraction income to the extent the payments under the policy are geared directly to the loss of income from production and are treated as income from sources outside the United States. Also, if an oil company's oil concession or assets used in extraction activities described in section 907(c)(1)(A) and located outside the United States are nationalized or expropriated by a foreign

government, or instrumentality thereof, income derived from that nationalization or expropriation (including interest on the income paid pursuant to the nationalization or expropriation) is FOGEI. Likewise, if a company's assets used in the activities described in section 907(c)(2) (A) through (C) and located outside the United States are nationalized or expropriated by a foreign government, or instrumentality thereof, income (including interest on the income paid pursuant to the nationalization or expropriation) derived from the nationalization or expropriation will be FORI. Nationalization or expropriation is deemed to be a sale or exchange for purposes of section 907(c)(1)(B) and a disposition for purposes of section 907(c)(2)(D). In further example, assume that an oil company has an exclusive right to buy all the oil in country X from Y, an instrumentality of the foreign sovereign which owns all of the oil in X. The oil company does not have an economic interest in any oil in country X. Y has a temporary cash-flow problem and demands that the oil company make advance deposits for the purchase of oil not yet delivered. In return, Y grants the oil company a discount on the price of the oil when delivered. Income represented by the discount on the later disposition of the oil is FORI described in section 907(c)(2)(C). The result would be the same if Y credited the oil company with interest on the advance deposits, which had to be used to purchase oil (the interest income would be FORI).

(g) *Directly related income*—(1) *In general.* Section 907(c)(2)(E) and this paragraph (g) include in FORI, and this paragraph (g) includes in FOGEI, income from the performance of directly related services (as defined in paragraph (g)(2) of this section). This paragraph (g) also includes in FORI and FOGEI income from the lease or license of related property (as defined in paragraph (g)(3) of this section). Section 907(c)(2)(E) with regard to FORI and this paragraph (g) with regard to both FORI and FOGEI do not apply to a person if—

(i) Neither that person nor a related person (as defined in paragraph (g)(4) of this section) has FOGEI described in

paragraph (b) of this section (other than paragraph (b)(4) of this section relating to directly related income) or FORI described in paragraph (d) of this section (other than paragraph (d)(7) of this section relating to directly related income), or

(ii) Less than 50 percent of that person's gross income from sources outside the United States which is related exclusively to the performance of services and from the lease or license of property described in paragraph (g) (2) and (3) of this section, respectively, is attributable to services performed for (or on behalf of), leases to, or licenses with, related persons, but

(iii) Paragraph (g)(1)(ii) of this section will not apply to a person if 50 percent or more of that person's total gross income from sources outside the United States is FOGEI and FORI (as both are described in paragraph (g)(1)(i) of this section).

A person described in paragraph (g)(1) (i) or (ii) of this section will, however, have directly related services income which is FOGEI if the income is so classified by reason of the income based on output test set forth in paragraph (g)(2)(i)(B) of this section.

(2) *Directly related services*—(i) *FOGEI.* (A) Income from directly related services will be FOGEI, as that term is defined in paragraph (b) (1) and (3) of this section, if those services are directly related to the active conduct of extraction (including exploration) of minerals from oil and gas wells. Paragraph (b)(1) of this section provides that, in order to have extraction income, a person must have an economic interest in the minerals in place. However, paragraph (b)(3) of this section recognizes that income arising from "other circumstances" is extraction income if that income is in substance attributable to the extraction of minerals.

(B) An example of "other circumstances" under paragraph (b)(3) of this section is the "income based on output test." This income based on output test provides that, if the amount of compensation paid or credited to a person for services is dependent on the amount of minerals discovered or extracted, the income of the person from the performance of the

services will be directly related services income which is FOGEI. This test will apply whether or not the person performing the services has, or had, an economic interest in the minerals discovered or extracted.

(ii) *FORI*. With regard to the determination of directly related services income which is FORI, directly related services are those services directly related to the active conduct of the operations described in section 907(c)(2) (A) through (C). Those services include, for example, services performed in relation to the distribution of minerals or primary products or in connection with the operation of a refinery, or the types of services described in § 1.954-6(d) (other than § 1.954-6(d)(4) which relate to foreign base company shipping income.

(iii) *Recipient of the services*. Directly related services described in paragraph (g)(2) (i) and (ii) of this section may be performed for any person without regard to whether that person is a related person.

(iv) *Excluded services*—(A) *FOGEI*. Directly related services which produce FOGEI do not include insurance, accounting or managerial services.

(B) *FORI*. Directly related services which produce FORI do not, generally, include insurance, accounting or managerial services. These services will, however, produce FORI if they are performed by the person performing the operations described in section 907(c)(2) (A) through (C). For these purposes, insurance income which is FORI means taxable income as defined in section 832(a).

(3) *Leases and licenses*. A lease or license of related property is the lease or license of assets used (or held for use) by the lessor, licensor, or another person (including the lessee or a sublessee) in the active conduct of the activities described in section 907 (c)(1)(A) or (c)(2) (A) through (C). The leases or licenses described in this paragraph (g)(3) include, for example, a lease of a means of transportation under a bareboat charter hire, of drilling equipment used in extraction operations, or the license of a patent, know-how, or similar intangible property used in extracting, transporting, distributing or processing minerals or primary prod-

ucts. This paragraph (g)(3) applies without regard to whether the parties are related persons.

(4) *Related person*. A person will be treated as a related person for purposes of this paragraph (g) if that person would be so treated within the meaning of section 954(d)(3) (as applied by substituting the word “corporation” for the word “controlled foreign corporation”) or that person is a partnership or partner described in section 707(b)(1).

(5) *Gross income*. A foreign corporation shall be treated as a domestic corporation for the purpose of applying the gross-income rules in paragraph (g)(1) (ii) and (iii) of this section.

(h) *Coordination with other provisions*—(1) *Certain adjustments*. The character of income as FOGEI or FORI is determined before making any adjustment under section 482 or section 907(d). For example, assume that X and Y are related parties, Y’s only income is from the sale of oil that Y purchased from X, and FOGEI from X is diverted to Y through an arrangement described in paragraph (b)(3) of this section. Accordingly, Y has FOGEI. If under section 482 the Commissioner reallocates the FOGEI from Y to X, then Y’s remaining income represents only a profit from distributing the oil, and thus is FORI. If the foreign taxes paid by Y on this income are otherwise creditable under section 901, the foreign taxes that are not refunded to Y retain their characterization as FOGEI taxes.

(2) *Section 901(f)*. Section 901(f) (relating to certain payments with respect to oil and gas not considered as taxes) applies before section 907. Taxes disallowed by section 901(f) are added to the cost or inventory amount of oil or gas.

[T.D. 8338, 56 FR 11067, Mar. 15, 1991]

§ 1.907(c)-2 Section 907(c)(3) items (for taxable years beginning after December 31, 1982).

(a) *Scope*. This section provides rules relating to certain items listed in section 907(c)(3). The rules of this section are expressed in terms of FORI but apply for determining FOGEI by substituting “FOGEI” for “FORI” whenever appropriate. FOGEI does not include interest described in section