

income under section 959(a)(1) (\$100). The rule of paragraph (d)(6)(ii) of this section does not apply since X does not include any amount in its gross income under section 951(a) with respect to Y. If Y paid taxes to S, this paragraph (d) would apply to characterize those taxes as FOGEI taxes or other taxes. See § 1.907(c)-3(a)(8) and Example 2 (iii) under § 1.907(c)-3(e).

(iii) The distribution from Y to X is a dividend to the extent of \$300, *i.e.*, the amount of the distribution (\$400) minus the amount excluded from X's gross income under section 959(a)(1) (\$100). Under paragraphs (d) (1)(i) and (6)(i) of this section, \$112.50 of the dividend is FOGEI, *i.e.*, the amount of the dividend (\$300) multiplied by a fraction. The numerator of the fraction is \$112.50, *i.e.*, the FOGEI accumulated profits of Y in excess of FOGEI taxes paid (\$150) minus the FOGEI accumulated profits of Y in excess of FOGEI taxes paid excluded from X's gross income under section 959(a)(1) (\$37.50). The denominator of the fraction is \$300, *i.e.*, the total accumulated profits of Y in excess of taxes paid (\$400) minus the amount excluded from X's gross income under section 959(a)(1) (\$100).

Example 4. Assume the same facts as in Example 1 with the following modifications: In 1983, Z's only earnings and profits are FORI earnings and profits which are included in X's gross income under section 951(a). Z distributes its entire earnings and profits to Y. In 1983, Y has total earnings and profits of \$100 without regard to the dividend from Z, \$60 of which are FORI earnings and profits. Y also has \$40 which is included in X's gross income under section 951(a). Under paragraph (d)(6)(ii) of this section, the dividend from Z is disregarded for purposes of applying paragraph (d)(4)(i) of this section to the \$40 included in X's gross income under section 951(a) with respect to Y. Accordingly, \$24 of the amount described in section 951(a) is FORI ($\$40 \times \$60 / \$100$). Had these circumstances existed in 1988, and if the \$40 included in X's gross income under section 951(a) was directly attributable to FORI activity, all of that income would be FORI to X.

(e) *Dividends, interest, and other amounts from sources within a possession.* FORI includes the items listed in (A) and (C) to the extent attributable to FORI of a corporation that is created or organized in or under the laws of a possession of the United States.

(f) *Income from partnerships, trusts, etc.* FORI and FOGEI include a person's distributive share (determined under the principles of section 704) of the income of any partnership and amounts included in income under subchapter J of chapter 1 of the Code (relating to the taxation of trusts, estates, and bene-

ficiaries) to the extent the income and amounts are attributable to FORI and FOGEI. For taxable years beginning after 1986, the principles of § 1.904-5 (h) and (i) shall be applied to determine whether (and to what extent) a person's distributive share is FORI and FOGEI. Thus, for example, a less-than-10 percent corporate partner's share of income of the partnership would generally be treated as passive income to the partner, and not as FORI or FOGEI, unless an exception under § 1.904-5 (h) and (i) applies.

[T.D. 8338, 56 FR 11071, Mar. 15, 1991]

§ 1.907(c)-3 FOGEI and FORI taxes (for taxable years beginning after December 31, 1982).

(a) *Tax characterization, allocation and apportionment—(1) Scope.* Paragraphs (a) (2) through (6) of this section provides rules for the characterization, allocation, and apportionment of the income taxes (other than withholding taxes) paid or accrued to a foreign country among FOGEI, FORI, and other income relevant for purposes of sections 907 and 904. Some of the rules in this section are expressed in terms of FOGEI taxes but they apply to FORI taxes by substituting "FORI taxes" for "FOGEI taxes" whenever appropriate. For the treatment of withholding taxes, see paragraph (a)(8) of this section. FOGEI taxes are determined without any reduction under section 907(a). In addition, determination of FOGEI taxes will not be affected by re-characterization of FOGEI by section 907(c)(4). See § 1.907(c)-1(c)(5). Foreign taxes will not be characterized as creditable FORI taxes if section 907(b) and § 1.907(b)-1 apply.

(2) *Three classes of income.* There are three classes of income: FOGEI, FORI, and other income.

(3) *More than one class in a foreign tax base.* If more than one class of income is taxed under one tax base under the law of a foreign country, the amount of pre-credit foreign tax for each base must be determined. This amount is the foreign taxes paid or accrued to that country for the base as increased by the tax credits (if any) which reduced those taxes and were allowed in the country for that tax. More than one class of income is taxed under the

same base, if, under a foreign country's law, deductions from one class of income may reduce the income of any other class and the classes are subject to foreign tax at the same rates.

(4) *Allocation of tax within a base.* If more than one class of income is taxed under the same base under a foreign country's law, the pre-credit foreign tax for the base is apportioned to each class of income in proportion to the income of each class. Tax credits are then allocated (under paragraph (a)(6) of this section) to the apportioned pre-credit tax. Income of a class over the deductions allowed under foreign law for, and which are attributable to, that class.

(5) *Modified gross income.* Modified gross income is not necessarily the same as gross income as defined for purposes of chapter 1 of the Internal Revenue Code. Modified gross income is determined with reference to the foreign tax base for gross income (or its equivalent). However, the characterization of the base as a particular class of income is governed by general principles of U.S. tax law. Thus, for example—

(i) Gross income from extraction is the fair market value of oil or gas in the immediate vicinity of the well (as determined under § 1.907(c)-1(b)(6) (without any deductions)).

(ii) Whether cost of goods sold (or any other deduction) is a deduction from modified gross income and the amount of such a deduction is determined under foreign law.

(iii) Modified gross income includes items that are part of the foreign tax base even though they are not gross income under U.S. law so long as the foreign taxes paid on the base constitute creditable taxes under section 901 (including taxes described in section 903). For example, if a foreign country imposes a tax (creditable under section 901) on a tax base that includes in small part a percentage of the value of a company's oil reserves in place, modified gross income from extraction includes such a percentage of value solely for purposes of making the tax allocation in paragraph (a)(4) of this section.

(iv) Modified gross income from extraction is increased for purposes of

this paragraph (a)(5) by the entire excess of the posted price over fair market value if the foreign country uses a posted price system or other pricing arrangement described in section 907(d) in imposing its income tax.

(v) Modified gross income from FORI is that income attributable to the activities in sections 907(c)(2) (A) through (C) and (E).

(vi) Modified gross income for any class may not include gross income that is not subject to taxation by the foreign country.

(6) *Allocation of tax credits.* The foreign taxes paid or accrued on a particular class of income equals the precredit tax on the class reduced (but not below zero) by the credits allowed under foreign law against the foreign tax on the particular class. Any tax credit attributable to a class that is not allocated to that class is allocated to the other class in the base or, if there are three classes in the base, is apportioned ratably among the taxes paid or accrued on the other two classes (as reduced in accordance with the preceding sentence).

(7) *Withholding taxes.* Paragraph (a) (2) through (6) of this section does not apply to withholding taxes imposed by a foreign country. FOGEI taxes may include withholding taxes imposed with respect to a distribution from a corporation. The portion of the total withholding taxes on a distribution that constitutes FOGEI taxes is determined by the portion of the distribution that is FOGEI. In addition, FOGEI taxes may include taxes imposed on a distribution described in section 959(a)(1) or on amounts described in section 959(b). The portion of the total withholding taxes imposed on a distribution described in section 959(a)(1) or on amounts described in section 959(b) is determined by reference to the portion of the amount included in gross income under section 951(a) that was FOGEI.

(b) *Dividends—In general—*(i) FOGEI taxes deemed paid with respect to a dividend equal the total taxes deemed paid with respect to the dividend multiplied by the fraction:

FOGEI taxes paid or accrued by the payor/Total foreign taxes paid or accrued by the payor.

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(ii) With regard to dividends received in taxable years beginning after December 31, 1986, FOGEI taxes deemed paid with respect to a dividend equal

the total taxes deemed paid with respect to the portion of the dividend within a separate category multiplied by the fraction:

$$\frac{\text{Post-1986 FOGEI taxes as determined under the principles of section 902(c)(2) that are allocable to that separate category}}{\text{Post-1986 foreign income taxes as determined under the principles of section 902(c)(2) that are allocable to that separate category.}}$$

(iii) This paragraph (b) applies to a dividend described in section 907(c)(3)(A) (including a section 1248 dividend) with reference to the particular taxable year or years of those accumulated profits out of which a dividend is paid. Determination of FOGEI taxes under this paragraph (b) must be made separately.

(A) For FOGEI taxes paid on FOGEI accumulated profits and total taxes paid on accumulated profits that arose in taxable years beginning before January 1, 1987, to which paragraph (b)(1)(i) of this section applies, and

(B) For FOGEI taxes paid on FOGEI accumulated profits and total taxes paid on accumulated profits that arose in taxable years beginning after December 31, 1986, to which paragraph (b)(1)(ii) of this section applies.

For purposes of these determinations, dividends are deemed to be paid first out of FOGEI and total accumulated profits that arose in taxable years beginning after December 31, 1986. See § 1.907(c)-2(d)(1)(i). See section 960(a)(3) and § 1.960-2 relating to distributions that are treated as dividends for purposes of section 902.

(2) *Section 78 dividend.* There are no FOGEI taxes with respect to section 78 dividends.

(c) *Includable amounts under section 951(a).* (1) FOGEI taxes deemed paid with respect to an amount includable in gross income under section 951(a) equal the total taxes deemed paid with respect to that amount multiplied by the fraction:

$$\frac{\text{FOGEI taxes paid or accrued by the foreign corporation}}{\text{Total foreign taxes paid or accrued by the foreign corporation.}}$$

(2) With regard to an amount includable in gross income under section 951(a) in taxable years beginning after December 31, 1986, FOGEI taxes deemed

paid with respect to that amount equal the total taxes deemed paid with respect to that amount within a separate category multiplied by the fraction:

$$\frac{\text{Post-1986 FOGEI taxes as determined under the principles of section 902(c)(2) that are allocable to that separate category}}{\text{Post-1986 foreign income taxes as determined under the principles of section 902(c)(2) that are allocable to that separate category.}}$$

Taxes in the fraction in this paragraph (c)(2) include only those foreign taxes that may be deemed paid under section

960(a) by reason of such inclusion. See §§ 1.960-1(c)(3) and 1.960-2(c).

(d) *Partnerships.* A partner's distributive share of the partnership's FOGEI taxes is determined under the principles of section 704.

(e) *Illustrations.* The application of this section may be illustrated by the following examples.

Example 1. X, a domestic corporation, owns all of the stock of Y, a foreign corporation organized in country S. Y owns all of the stock of Z, a foreign corporation organized in country T. Each corporation used the calendar year as its taxable year. In 1983, X includes in its gross income an amount described in section 951(a) with respect to Z. Assume that the taxes deemed paid under section 902(a) by X by reason of such an inclusion is \$70. Assume further that Z paid total taxes of \$120, \$80 of which is FOGEI tax. Under paragraph (c) of this section, the FOGEI tax deemed paid is \$46.67 (*i.e.*, \$70 × \$80/\$120). This \$46.67 is also FOGEI under §1.907(c)-2(d)(5) because it must be included in X's gross income under section 78.

Example 2 —(i) Assume the same facts as in Example 1. Assume further that in 1983, Z distributes its entire earnings and profits to Y. Y has no earnings and profits during 1983 other than this dividend. Y paid a tax of \$50 to S. Assume that Y is deemed under section 902(b)(1) to pay \$50 of the tax paid by Z which was not deemed paid by X under section 960(a)(1) in 1983. In 1983, Y distributes its entire earnings and profits to X. Assume that X is deemed under section 902(a) to pay \$100 of the taxes actually paid, and deemed paid, by Y.

(ii) Paragraph (b)(1) of this section applies to characterize the \$50 tax of Z that Y is deemed to pay under section 902(b)(1). Y is deemed to pay \$33.33 of FOGEI tax, *i.e.*, the amount of the tax deemed paid by Y (\$50) multiplied by a fraction. The numerator of the fraction is the amount of Z's FOGEI tax (\$80) and the denominator is the total taxes paid by Z (\$120).

(iii) Under paragraph (a)(8) of this section, a portion of the \$50 tax actually paid by Y on the earnings and profits received from Z is FOGEI tax. The amount of tax actually paid by Y that is FOGEI tax depends on the amount of the distribution from Z that is FOGEI (see §1.907(c)-2(d)(1) (i) and Example 2 (ii) under §1.907(c)-2(d)(8)). This result does not depend upon whether a portion of the distribution from Z is described in section 959(b) and it follows even though a portion of Y's earnings and profits will be excluded from X's gross income under section 959(a)(1) when distributed by Y. Assume that \$12.50 of the \$50 tax actually paid by Y is FOGEI tax.

(iv) Under paragraph (b)(1) of this section, X is deemed to pay \$45.83 of FOGEI tax by reason of the distribution from Y. This amount is determined by multiplying the

total taxes deemed paid by X by reason of such distribution (\$100) by a fraction. The numerator of the fraction is the FOGEI tax paid, and deemed paid, by Y (\$45.83, *i.e.*, \$33.33 under paragraph (ii) of this example plus \$12.50 under paragraph (iii) of this example). The denominator of the fraction is the total taxes paid, and deemed paid, by Y (\$100). This \$45.83 is FOGEI under §1.907(c)-2(d)(5) because it is included in X's gross income as a section 78 dividend.

Example 3 —(i) X, a domestic corporation, has a concession with foreign country Y that gives it the exclusive right to extract and export the crude oil and natural gas owned by Y. The concession agreement and location of the oil and gas wells mandate that X construct a system of pipelines to transport the minerals that are extracted to a port where they are loaded onto tankers for export. X owns the transportation facilities. Y has an income tax system under which income from mineral operations is subject to a 50 percent tax rate. The taxation by Y of the mineral operations is a separate tax base under paragraph (a)(3) of this section. Under this system, Y imposes the tax at the port prior to export and it establishes a posted price of \$12 per barrel. Y also collects royalties of \$1.44 per barrel (*i.e.*, 12 percent of this posted price) which is deductible in computing the petroleum tax. Y also allows X deductible lifting costs of \$.20 per barrel and deductible transporting costs of \$.80 per barrel. Y does not allow any credits against the mineral tax. Assume that X does not have any income in Y other than the mineral income. (In 1983, X extracts, transports, and exports 10,000,000 barrels of crude oil, but for convenience, all computations are in terms of one barrel). X pays foreign taxes of \$4.78 per barrel, computed as follows:

Sales	\$12.00	
Royalties	\$1.44	
Lifting20	
Transporting80	
	2.44	(2.44)
Income base	9.56	
Tax rate (percent)50	
Tax	4.78	

Assume that these taxes are creditable taxes under section 901, that the fair market value of the oil at the port is \$10 per barrel, and that under §1.907(c)-1(b)(6) fair market value in the immediate vicinity of the oil wells is \$9 per barrel. Thus, at the port, the excess of posted price (\$12) over fair market value (\$10) is \$2.

(ii) The \$4.78 foreign tax paid to Y is allocated to FOGEI and FORI in accordance with the rules in paragraph (a) (2) through (5) of this section.

(iii) Under paragraph (a)(3) of this section, FOGEI and FORI are subject to foreign taxation under one tax base. This foreign tax is allocated between FOGEI tax and FORI tax in accordance with paragraph (a) (4) and (5) of this section.

(iv) The modified gross income for FOGEI is \$11, *i.e.*, fair market value in the immediate vicinity of the well (\$9) plus the excess at the port of posted price over fair market value (\$2). The modified gross income for FORI is \$1, *i.e.*, value added to the oil beyond the well-head which is part of Y's tax base (\$10-\$9).

(v) The royalty deductions are all directly attributable to FOGEI.

(vi) Under paragraph (a)(4) of this section, the income of each class is determined as follows:

	FOGEI	FORI
Modified gross income	\$11.00	\$1.00
Deductions:		
Royalties	1.44	0
Lifting20	0
Transporting	0	.80
Total	1.64	.80
Net Income	9.36	.20

(vii) Under paragraph (a)(4) of this section, the total tax paid to Y is allocated to FOGEI and FORI in proportion to the income in each class. The calculation is as follows:

FOGEI tax=\$4.78×\$9.36/\$9.56=\$4.68
 FORI tax=\$4.78×\$0.20/\$9.56=\$0.10

Thus, for the 10,000,000 barrels, the FOGEI tax is \$46,800,000 and the FORI tax is \$1,000,000.

(viii) The allocation under paragraph (a)(4) of this section, rather than the direct application of stated foreign tax rates to foreign-law taxable income in each class of income (which would produce the same results in the facts of this example), is necessary when a foreign country taxes more than one class of income under a progressive rate structure. See Example 4 in this paragraph (e).

Example 4. Assume the same facts as in Example 3 except that Y's tax is imposed at 40 percent for the first \$20,000,000 of income and at 60 percent for all other income. The foreign taxes are allocated under paragraph (a)(4) of this section between FOGEI and FORI in the same manner as in paragraphs (vi) and (vii) of Example 3, as follows:

(1) Taxable income	\$95,600,000
(2) Tax:	
(a) 40% of \$20,000,000	8,000,000
(b) 60% of \$75,600,000	45,360,000
(c) Total tax	53,360,000
(3) FOGEI tax (line 2(c)×\$9.36/ \$9.56)	52,243,680
(4) FORI tax (line 2(c)×\$0.20/\$9.56)	1,116,320

Example 5. Assume the same facts as in Example 3. Assume further that X refines the crude oil into primary products prior to ex-

port and Y imposes its tax on the basis of crude oil equivalences of \$12 per barrel, rather than the value of the primary products, to establish port prices. Assume that this arrangement is a pricing arrangement described in section 907(d). Thus, Y does not tax the refinery income. The results are the same as in Example 3 even if \$12 per barrel is equal to, more than, or less than, the value of the primary products at the port. See paragraph (a)(5)(vi) of this section.

[T.D. 8338, 56 FR 11073, Mar. 15, 1991]

§ 1.907(d)-1 Disregard of posted prices for purposes of chapter 1 of the Code (for taxable years beginning after December 31, 1982).

(a) *In general*—(1) *Scope.* Section 907(d) applies if a person has FOGEI from the—

(i) Acquisition (other than from a foreign government) or

(ii) Disposition of minerals at a posted price that differs from the fair market value at the time of the transaction. Also, if a seller (other than a foreign government) derives FOGEI upon a disposition described in the preceding sentence, section 907(d) applies to the acquisition by the purchaser whether or not the purchaser has FOGEI. Thus, section 907(d) may apply in determining a person's FORI.

(2) *Initial computation requirement.* If section 907(d) applies to any person, income on the transaction as initially reflected on the person's return shall be computed as if the transaction were effected at fair market value. This requirement applies the first time a person has taxable income derived from either the transaction or an item (such as a dividend described in section 907(c)(3)(A)) determined with reference to that income.

(3) *Burden of proof.* The taxpayer must be able to demonstrate the transaction as it actually occurred and the basis for reporting the transaction under the principles of paragraph (a)(2) of this section.

(4) *Related parties.* Section 907(d) (as a rule of characterization) applies whether or not the parties to the transaction are related. Thus, the excess of the posted price over the fair market value may never be taken into account in determining a person's FOGEI under section 907(a) but may be taken into account in determining a person's FORI.