

section 636 of the Code applies to production payments carved out during the taxable year which includes August 7, 1969, as provided in paragraph (a) of this section, only to the extent that the aggregate amount of such production payments exceeds the lesser of:

(i) The excess of:

(a) The aggregate amount of production payments carved out and sold by the taxpayer during the 12-month period immediately preceding his taxable year which includes August 7, 1969, over

(b) The aggregate amount of production payments carved out and sold before August 7, 1969, by the taxpayer during his taxable year which includes such date, or

(ii) The amount necessary to increase the amount of the taxpayer's gross income within the meaning of chapter 1 of subtitle A of the Code, for his taxable year which includes August 7, 1969, to an amount equal to the amount of his deductions (other than any deduction under section 172) allowable for such year under such chapter.

In applying the preceding sentence, production payments carved out for exploration or development are to be taken into account only to the extent, if any, that *gross income from the property* (for purposes of section 613) would have been realized by the taxpayer creating such production payment under the law existing at the time of the creation of such production payment, in the absence of section 636(a).

(2) Subparagraph (1) of this paragraph shall not apply for any taxable year for purposes of determining the amount of any deduction for cost or percentage depletion allowable under section 611 or the limitation on any foreign tax credit under section 904.

(3) The application of this paragraph may be illustrated by the following examples:

Example 1. (a) A, a calendar-year taxpayer who does not make the election provided in section 503(c)(2) of the Tax Reform Act of 1969, carves out and sells on December 31, 1968, a \$500,000 production payment. Further, A carves out and sells on March 4, 1969, a \$300,000 production payment, and on November 14, 1969, a \$150,000 production payment. None of the production payments are carved out for exploration or development. During 1969, A has gross income of \$600,000 (deter-

mined initially for this purpose by treating the \$150,000 production payment carved out on November 14, 1969, as a loan) and allowable deductions of \$700,000.

(b) The provisions of section 636 do not apply to a portion of the November 14, 1969, production payment for purposes other than section 611 and section 904 of the Code, determined as follows:

(1) Amount of production payment carved out in 1969 on or after August 7, 1969	\$150,000
(2) Amount of production payment carved out during 1968	500,000
(3) Amount of production payment carved out during 1969 taxable year before August 7, 1969	300,000
(4) Item (2) minus item (3)	200,000
(5) Excess of allowable deductions over gross income for 1969	100,000
(6) Amount of production payment carved out in 1969 on or after August 7, 1969, to which section 636 does not apply (lesser of items (1), (4), and (5))	100,000

Thus, A will not treat \$100,000 of the consideration received for the production payment carved out on November 14, 1969, as a loan and as a result his gross income for 1969 will be \$700,000. However, in computing percentage depletion, A will not include the \$100,000 in *gross income from property* and in computing cost depletion A will not include the mineral units attributable thereto. Nor, will A include the \$100,000 in determining the limitation on foreign tax credit under section 904.

Example 2. Assume the same facts as in example 1 except that for taxable year 1969 A's gross income (determined initially for this purpose by treating the November 14, 1969, production payment as a loan) exceeds the amount of his allowable deductions under chapter 1 of subtitle A of the Code. The entire amount of the November 14, 1969, production payment is treated as a mortgage loan under section 636(a).

[T.D. 7261, 38 FR 5465, Mar. 1, 1973, as amended by T.D. 8435, 57 FR 43896, Sept. 23, 1992]

CONTINENTAL SHELF AREAS

§ 1.638-1 Continental Shelf areas.

(a) *General rule.* For purposes of applying any provision of chapter 1, 2, 3, or 24 (including section 861(a)(3), 862(a)(3), 1441, 3402, or other provisions dealing with the performance of personal services), with respect to mines, oil and gas wells, and other natural deposits:

(1) *United States and possession of the United States.* The terms *United States* and *possession of the United States* when used in a geographical sense include

the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the United States or such possession and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration for, and exploitation of, natural resources. The terms *Continental Shelf of the United States* and *Continental Shelf of a possession of the United States*, as used in this section, refer to the seabed and subsoil included, respectively, in the terms *United States* and *possession of the United States*, as provided in the preceding sentence.

(2) *Foreign country.* The term *foreign country* when used in a geographical sense includes the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the foreign country and over which such foreign country has exclusive rights, in accordance with international law, with respect to the exploration for, and exploitation of, natural resources, but this sentence applies only if such foreign country exercises, directly or indirectly, taxing jurisdiction with respect to such exploration or exploitation. The term *foreign continental shelf*, as used in this section, refers to the seabed and subsoil described in the preceding sentence. A foreign country is not to be treated as a country contiguous to the United States by reason of the application of section 638 and this section.

(b) *Exercise of taxing jurisdiction.* For purposes of paragraph (a)(2) of this section, the exercise, directly or indirectly, of taxing jurisdiction with respect to the exploration for, or exploitation of, natural resources is deemed to include (but is not limited to) those cases in which a foreign country:

(1) Imposes a tax upon assets, equipment, or other property connected with or income derived from such exploration or exploitation, or

(2) Requires natural resources referred to in paragraph (a)(2) of this section to be transported to points within its landward boundaries and then levies a tax upon such natural resources or upon the income derived from the sale thereof.

A foreign country which, for purposes of paragraph (a)(2) of this section, exer-

cises taxing jurisdiction by the imposition of tax upon any person, property, or activity engaged in or related to the exploration for, or exploitation of, natural resources in the seabed or subsoil referred to in paragraph (a)(2) of this section, or the income therefrom of any taxpayer, is deemed to exercise taxing jurisdiction over all such persons, property, and activities and over all income therefrom of all such taxpayers; thus, for example, a foreign country which imposes tax upon a person engaged in exploitation of oil and gas wells in its seabed and subsoil referred to in paragraph (a)(2) of this section is deemed to exercise taxing jurisdiction over property related to exploration for other natural deposits in such seabed and subsoil. A foreign country is deemed to be imposing tax upon a person, property, activity, or income described in the preceding sentence if such foreign country exempts such person, property, activity, or income from tax for a period not in excess of 10 years from the commencement of such exploration or exploitation. Except in the case of a foreign country which is deemed under the preceding sentence to impose tax by virtue of an exemption for a period not in excess of 10 years, a foreign country which exempts all persons, property, and activities engaged in or related to the exploration for, or exploitation of, natural resources in the seabed or subsoil referred to in paragraph (a)(2) of this section and the income therefrom, from taxation is deemed not to be exercising, directly or indirectly, taxing jurisdiction for purposes of paragraph (a)(2) of this section. For purposes of paragraph (a)(2) of this section, the exercise of taxing jurisdiction with respect to any type of tax constitutes the exercise of taxing jurisdiction with respect to all types of taxes. However, a royalty or other charge (whether payable in a lump sum or over a period of time or in amounts dependent upon the volume of production of natural resources) for the right to explore for or exploit natural resources does not constitute a tax.

(c) *Scope.* (1) For purposes of applying this section, persons, property, or activities which are engaged in or related to the exploration for, or exploitation

of, mines, oil and gas wells, or other natural deposits need not be physically upon, connected, or attached to the seabed or subsoil referred to in subparagraph (1) or (2) of paragraph (a) of this section to be deemed to be within the United States, a possession of the United States, or a foreign country, as the case may be, to the extent provided in subparagraph (2) or (3) and subparagraph (4) of this paragraph.

(2) Persons, property, or activities which are not in a foreign country (determined without regard to section 638 or this section), and which are engaged in or related to the exploration for, or exploitation of, mines, oil and gas wells, or other natural deposits of the seabed or subsoil referred to in paragraph (a)(1) of this section, are generally within the United States or a possession of the United States, as the case may be, unless such persons, property, or activities are solely involved in or constitute transportation to (or from) the site of exploration or exploitation from (or to) a foreign country, other than transportation on a regular basis from (or to) a base of operations.

(3) Persons, property, or activities which are not in the United States or in a third country (determined in each case without regard to section 638 or this section), and which are engaged in or related to the exploration for, or exploitation of, mines, oil and gas wells, or other natural deposits of the seabed or subsoil of a foreign country referred to in paragraph (a)(2) of this section, are generally within such foreign country, unless such persons, property, or activities are solely involved in or constitute transportation to (or from) the site of exploration or exploitation from (or to) the United States or a possession of the United States or a third country, as the case may be, other than transportation on a regular basis from (or to) a base of operations.

(4) Persons, property, or activities are within the United States, a possession of the United States, or a foreign country, as the case may be, pursuant to this paragraph, only to the extent such persons, property, or activities are engaged in or related to the exploration for or exploitation of, mines, oil and gas wells, or other natural deposits.

(d) *Natural deposits and natural resources.* For purposes of this section, the terms *natural deposits* and *natural resources* mean nonliving resources to which section 611(a) applies. Such terms do not include sedentary species (organisms which, at the harvestable stage, either are immovable on or under the seabed or are unable to move except in constant physical contact with the seabed or subsoil), fish or other animal or plant life.

(e) *Rights under international law.* Nothing in this section shall prejudice or affect the freedoms of the high seas and other rights under international law, or the exercise of such freedoms and rights by the United States or foreign countries.

(f) *Examples.* The application of the provisions of section 638 and this section may be illustrated by the following examples:

Example 1. A, a citizen of the United States employed as an engineer, is engaged in the exploitation of oil and is physically present on an offshore oil drilling platform operated by employees of L Corporation. Such platform is affixed to the foreign continental shelf of foreign country X. Assuming that foreign country X exercises taxing jurisdiction as provided in paragraph (b) of this section, A is to be treated as being employed in foreign country X with respect to compensation for his employment for purposes of chapters 1 and 24.

Example 2. The facts are the same as in example 1 except that B, a citizen of the United States engaged in the private practice of law, is physically present on such platform for the sole purpose of interviewing his client, A, whom he represents in a domestic relations matter. Since B is not engaged in activities related to the exploration for, or exploitation of, natural deposits, he is not to be treated as being in foreign country X for purposes of chapters 1 and 2.

Example 3. The facts are the same as in example 1 except that C, a citizen of the United States engaged in the private practice of medicine, is physically present on such platform for the purpose of making routine physical examinations of L Corporation's employees who are engaged in the exploitation of oil on the platform. C is paid by L Corporation to give such examinations on the platform at regular intervals in order to determine whether the state of any employee's health is such that he should not continue work on the platform. The balance of C's medical practice is conducted at his office on the U.S. mainland. Since C is engaged in activities related to the exploitation of oil, he

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is treated as being in foreign country X under section 638 and this section while making physical examinations on L Corporation's platform, provided that foreign country X exercise taxing jurisdiction as provided in paragraph (b) of this section. For purposes of chapters 1 and 2, amounts paid by L Corporation to C are treated as derived from sources within foreign country X.

Example 4. C, a nonresident alien individual employed as an engineer in a foreign country, designs equipment for use on oil drilling platforms affixed to the continental shelf of the United States and engaged in the exploitation of oil. Although C's activities in this respect are related to the exploitation of oil, C is not treated as being in the United States under section 638 and this section by reason of such activities.

Example 5. M Corporation, a domestic corporation, chartered a ship from N Corporation, also a domestic corporation, under a time charter under which N Corporation's personnel continued to navigate and manage the ship. M Corporation equipped the ship with special oil exploration equipment and furnished its personnel to operate the equipment. The ship then commenced to explore for oil in the foreign Continental Shelf of foreign country Y. Foreign country Y exercises taxing jurisdiction as provided in paragraph (b) of this section. The ship is treated as being within foreign country Y under section 638 and this section for the period it was engaged in the exploration for oil in such foreign Continental Shelf. Thus, the entire income derived during such period by N Corporation from the charter is income derived from sources within foreign country Y, since N Corporation had property and employees engaged in the exploration for oil in such foreign Continental Shelf.

Example 6. The facts are the same as in example 5 except that C, a citizen of the United States, was employed by N Corporation as a cook and was physically present on the ship. C's sole duties consisted of cooking meals for personnel aboard such ship. In such case, as C's activities are related to the exploration for oil, C is to be treated as being in foreign country Y under section 638 and this section for the period he was aboard such ship while it was engaged in activities relating to the exploration for oil in the foreign Continental Shelf referred to in example 5. For purposes

of chapters 1 and 24, C's compensation as a cook for such period is treated as derived from sources without the United States.

Example 7. Z Corporation, a foreign corporation, entered into a contract with Y Corporation, a United States corporation, to engage in exploratory oil drilling activities on a leasehold held by Y Corporation. Such leasehold was located in the Continental Shelf of the United States. Since Z Corporation is engaged in and has property and activities which are engaged in the exploration for oil, such property and activities are to be treated as being in the United States under section 638 and this section for the period such property and activities were engaged in or related to the exploration for oil in the Continental Shelf of the United States and were not in a foreign country. For purposes of chapters 1 and 3, amounts paid to Z Corporation pursuant to the contract are treated as derived from sources within the United States.

Example 8. M Corporation is a controlled foreign corporation (within the meaning of section 957(b)) for its entire taxable year beginning in 1972. During such taxable year, M Corporation issues a policy of insurance relating to fire damage to an offshore oil drilling platform, owned by N Corporation (a foreign corporation), which is attached to the Continental Shelf of the United States. The income attributable to the issuing of such policy would be taxed under subchapter L, chapter 1, subtitle A of the Code (as modified, for this purpose, by section 953(b) (1), (2), and (3)) if such income were the income of a domestic insurance corporation. Since N Corporation's oil drilling platform is located within the United States under section 638 and this section, M Corporation's income attributable to the issuing of the insurance in connection with such platform is income derived from the insurance of United States risks, within the meaning of section 953(a)(1)(A).

[T.D. 7277, 38 FR 12740, May 15, 1973]

§ 1.638-2 Effective date.

The specific requirements and limitations of § 1.638-1 apply on and after December 30, 1969.

[T.D. 7277, 38 FR 12742, May 15, 1973]