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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Anne O'Connell Devereaux
Assistant to the Branch Chief CC:INTL:BR3

SUBJECT:

This Field Service Advice responds to your memorandum dated March 7, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND

Taxpayer =

USSub =
business a =

ISSUE

Whether for tax year 1997 foreign oil and gas extraction income ("FOGEI") for purposes of the limitation of section 907(a) of the Internal Revenue Code includes income from extraction of oil and gas from wells located within the United States.

CONCLUSION

Under the export terminal rule of Treas. Reg. §1.863-1(b)(1), Taxpayer's income relating to extraction activities is U.S. source. Accordingly, since a prerequisite of FOGEI under section 907 of the Code is that the relevant income must be foreign source, none of the U.S. income can be FOGEI. In addition, because Treas. Reg. §1.907(c)-1 (b)(1) requires that FOGEI relate to extraction from foreign rather than domestic wells, the extraction income is not properly classified as FOGEI under section 907(c).

FACTS

In 1997, Taxpayer conducted through USSub business a which involved in part extraction of oil and gas from wells within the United States. Taxpayer asserted, in part, in a disclosure statement attached to its 1997 Federal income tax return that "[p]ursuant to Treas. Reg. §1.863-1 (b), a portion of [USSub's oil and gas] was sourced as derived from sources outside the United States. A portion of the income derived from sources outside the United States was characterized as foreign oil and gas extraction income..." In addition, Taxpayer asserted in that disclosure statement that "[t]he regulation is contrary to the statute insofar as §907(c)(1) defines FOGEI as 'taxable income derived from sources without the United States' and makes no reference as to the location of the [oil and gas] well. Treas. Reg. §1.907(c)-1(b)(1) has also had its validity questioned in Phillips (sic) v. Commissioner, 97 T.C. 30 (1991) wherein the regulation was found to have had a dubious statutory basis." Exam has challenged Taxpayer's characterization of extraction income as FOGEI.

LAW AND ANALYSIS

Section 907(a) of the Code imposes an annual limit on the amount of foreign taxes paid on FOGEI that can be credited under section 901 against the U.S. tax liability of U.S. taxpayers. The limitation is a certain percentage of FOGEI. The percentage limitation for corporate taxpayers for 1997 was the highest U.S. corporate tax rate for the year. Foreign taxes paid on FOGEI in excess of the section 907(a) limitation are not deductible as taxes or as royalties but may be carried back for two years or forward for five years subject to the section 907(a) limitation in the year to which the taxes are carried.

For 1997, FOGEI is defined in section 907(c)(1) of the Code as:

> taxable income derived from sources without the United States and its possessions from-
> (A) the extraction (by the taxpayer or any other person) of minerals from oil and gas wells, or

(B) the sale or exchange of assets used by the taxpayer in the trade or business described in subparagraph (A).

Taxpayer's assertion on its 1997 return that a portion of its income relating to the oil and gas extracted from the U.S. well was FOGEI is contrary to the export terminal rule of Treas. Reg. §1.863-1(b)(1), which determines the source of gross receipts relating to natural resources.[1] Under that rule applicable to 1997, Taxpayer's income equal to the fair market value at the export terminal is sourced in the U.S., the location of the natural resources. Accordingly, even assuming contrary to the regulatory requirement that FOGEI may include income from U.S. wells, none of Taxpayer's extraction income would be FOGEI since it would not be foreign source income. This analysis is consistent with the definition of gross income at Treas. Reg. §1.907(c)-1(b)(2) that provides that the "gross income from extraction is determined by reference to the fair market value of the minerals in the immediate vicinity of the well."

The export terminal rule splits income from sales of natural resources at the export terminal, and allocates gross receipts from cross-border natural resource sales between sources within and without the United States based on the fair market value of the goods at the export terminal. Treas. Reg. §1.863-1(b)(1). Thus, income attributable to the value of U.S.-produced natural resources, or income attributable to functions performed prior to goods leaving the U.S. export terminal, will produce U.S. source income. Under this rule, even income attributable to sales activity occurring before goods leave the export terminal would be sourced under the export terminal rule to the location of the natural resources, not under the title passage rule. Gross receipts in excess of the fair market value at the export terminal ("excess gross receipts") are sourced to the country of sale. Treas. Reg. §1.863-1(b)(1)(ii). Although not applicable based on the facts of this case, special sourcing rules apply when there is either prior production before the goods leave

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[1]Treas. Reg. §1.863-1(b)(1) provides, in part, as follows:

(b) *Natural resources*-(1) *In general*. Notwithstanding any other provision, except to the extent provided in paragraph (b)(2) of the section, gross receipts from the sale outside the United States of products derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber within the United States, must be allocated between sources within and without the United States based on the fair market value of the product at the export terminal (as defined in paragraph (b)(3)(iii) of this section). ... The source of gross receipts equal to the fair market value of the product at the export terminal will be from sources where the farm, mine, well, deposit, or uncut timber is located.

the export terminal or further production when goods reach a third country, outside the country of sale. Treas. Reg. §1.863-1(b)(1)(i) and (2).

Accordingly, none of the extraction income is foreign source, and therefore, none is FOGEI. Furthermore, even if the operation of the sourcing rules treated some portion of Taxpayer's income as foreign source, such income would nonetheless not be included in FOGEI under the policies underlying section 907 of the Code, as reflected in the regulations under that section. Prior to the enactment of section 907 as part of the Tax Reduction Act of 1975, 89 Stat. 26, 54-58, U.S. oil companies operating in foreign countries were accumulating large amounts of unused foreign tax credits attributable to foreign oil and gas extraction activities. In 1974, the Treasury Department estimated that the excess credits generated in that year might exceed $16 billion. H.R. Rept. No. 93-1502, 93d Cong., 2d Sess. 62 (1974)[2]. These excess credits were attributable to at least three factors. First, some of the oil producing countries had stated tax rates in excess of the U.S. tax rates. Second, some foreign countries increased effective tax rates by limiting deductions and by overstating gross income by basing the tax on artificially high posted prices rather than on market prices. H.R. Rept. No. 93-1502, 93d Cong., 2d Sess. 62 (1974).

Finally, foreign countries imposing the taxes generally retained the rights to the oil in the ground. Foreign countries could generate revenue from their oil and gas resources by demanding a royalty payment, imposing an income tax, or collecting a combination of royalties and taxes. In many instances, when a U.S. corporation began its oil and gas operations in a foreign country, it paid the foreign country only a royalty because the country did not have a generally imposed income tax. When the foreign country later sought to increase its revenue, it often instituted an income tax system rather than increased royalties. Over time, the foreign income taxes grew while the royalty payments remained relatively constant. This change to income taxes from royalties benefitted U.S. oil companies' after-tax positions since income taxes are creditable against U.S. taxes while the royalties are only deductible in arriving at the U.S. tax base. Since foreign governments acted as sovereigns in imposing taxes and as proprietors in collecting royalties, what producers claimed as creditable income taxes may have been in fact deductible royalties. Congress bypassed the difficult issue of determining what is a deductible royalty and what is a creditable tax by imposing the section 907(a) limitation on

[2]That report is the basic source of legislative intent since it marks the first time the House Ways and Means committee proposed the section 907(a) limitation in 1974; the section 907 limitation was not added to the Code until the subsequent year, at which time it was accompanied by only a brief conference report.

creditability of FOGEI taxes. H.R. Rept. No. 93-1502, 93d Cong., 2d Sess. 61 and 63 (1974).

In furtherance of this Congressional intent, Treas. Reg. §1.907(c)-1(b)(1) defines FOGEI to include taxable income (or loss) from sources outside of the United States and possessions but only with regard to income from the extraction of oil and gas from "wells located outside the United States." It is clear from the legislative history that Congress did not intend to include income related to extraction activities within the U.S. in the FOGEI limitation calculation. To do so would in fact undermine that limitation since it would include income that would not be subject to tax by a foreign country and, thereby, improperly inflate the FOGEI limitation.

Further, the regulations provide at Treas. Reg. §1.907(c)-1(b)(2) that the "gross income from extraction is determined by reference to the fair market value of the minerals in the immediate vicinity of the well." For 1997, gross income from transportation of the oil or gas from the immediate vicinity of the well and processing is foreign oil related income (FORI) and not FOGEI. *See* section 907(c)(2)(A) and (B) of the Code. FORI includes "downstream" oil and gas trades or businesses, such as the processing of minerals from oil or gas wells into primary products, marketing and transporting the minerals or primary products, or the sale or exchange of assets used in these trades or businesses. Where a market exists at the load port or at any other point but not in the immediate vicinity of the well, Treas. Reg. §1.907(c)-1(b)(6) provides that the facts and circumstances are to be used to make an allocation of the purchase price between FOGEI and FORI.

In 1991, the U.S. Tax Court issued its decision in *Phillips Petroleum* v. *Commissioner*, 97 T.C. 30 (1991), which involved two issues that are related to the issue presented here. In part, the Tax Court invalidated prior Treas. Reg. §1.863-1 (b)(1)(1958). That regulation provided that income derived from the ownership or operation of any oil or gas well located within the United States, and from the sale by the producer of the products from those wells without the United States, would ordinarily be considered U.S. source income. However, the regulations provided also that an apportionment of the income between U.S. and foreign sources may be made under section 863(b)(2) of the Code if the district director is shown that there are "peculiar conditions of production and sale" or other reasons that support such an allocation. The Tax Court invalidated Treas. Reg. §1.863-1(b)(1)(1958) to the extent it conflicted with the court's reading of the last sentence of section 863(b) of the Code, which in the court's view, requires mixed-source income in all cross-border inventory sales.[3] Under the 100% allocation rule of the invalidated

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[3] For the taxable years at issue in the *Phillips Petroleum*, section 863(b) of the Code provided that:

regulation, irrespective of the regulatory language limiting FOGEI to extraction from foreign wells, Taxpayer's income would not have been FOGEI since the extraction income was from U.S. gas wells and therefore, it would have been U.S. source.

Effective for tax years beginning after 1996, the regulation invalidated by the Tax Court in *Phillips Petroleum* was replaced by the "export terminal rule" regulation which is intended to produce results consistent with the Tax Court's decision in *Phillips Petroleum*, which requires mixed-source income in all cross-border sales.

The Tax Court in *Phillips Petroleum* also rejected the Service's argument that foreign oil related income ("FORI") as defined in section 907(c)(2) of the Code, as applicable for 1975-1978, included covered activities only if the oil or gas was extracted from wells located outside the U.S.[4] For 1975-1978, the years at issue in that case, section 907(c)(2) defined FORI to include taxable income derived from sources outside the United States from FOGEI as well as from the downstream trades or businesses. During those years those downstream activities were referred to as "other FORI" to distinguish them from FOGEI. Although the issue involved in the case was with regard to Phillips Petroleum's income from downstream activities, the Service in its argument to the court did not differentiate between FOGEI and other FORI. Likewise the court in its opinion did not differentiate between the two types of income.

The Tax Court rejected the Service's position since in its view section 907(c)(2) of the Code on its face did not require that the oil and gas be extracted from foreign wells.[5] The court held that it was clear that the phrase "derived from sources outside the United States" in section 907(c)(2) refers to the source of the taxable income, not the location of the oil or gas wells. The Service argued that Congress was concerned with FORI as it related to foreign extracted oil and gas. However,

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> Gains, profits and income . . .
>
> (2) from the sale of personal property produced (in whole or in part) by the taxpayer within and sold without the United States . . .
>
> shall be treated as derived partly from sources within and partly from sources without the United States.

[4]The issue of whether Phillips Petroleum's income was FORI was important for the years in issue because during those years section 907(b) created a separate limitation under section 904 for FORI.

[5]The court did not rule on the validity of Treas. Reg. §1.907(c)-1(b)(1).

the court stated that Congressional intent was not persuasive in light of the clear and unambiguous statutory language. The court cited *Cal-Maine Foods, Inc. v. Commissioner*, 93 T.C. 181, 208-209 (1989), for the position that "[a]bsent a compelling reason to disregard the plain language of the statute, we must assume that Congress meant what it said and that the statutory language should be taken at face value."

As stated above, Taxpayer asserted in a disclosure statement on its 1997 Federal income tax return that the regulatory requirement in Treas. Reg. §1.907(c)-1(b)(1) that in order for the income to be FOGEI that it must relate to extraction from foreign wells is invalid since that requirement is not in the Code. The regulatory requirement correctly reflects Congressional intent, as discussed above, in enacting the FOGEI limitation of section 907(a) of the Code. It is clear from the legislative history to which we refer to above that Congress did not intend to include income related to extraction activities within the U.S. in the FOGEI limitation calculation.

As stated above, for 1975-1978, the years at issue in *Phillips Petroleum*, FOGEI was one component of FORI. The other component was the downstream income, the other FORI. However, in 1982, Congress redefined FORI to limit its scope to only downstream income by defining FOGEI in a separate paragraph. Congress did not revise the substance of the definition of FOGEI. The decision focused on downstream activities of Phillips Petroleum as opposed to its extraction activities. The 1974 House Report on which the Service relied, and to which the Tax Court referred, in *Phillips Petroleum* indicates that Congress was concerned with only extraction activities in foreign countries and the difficulty in distinguishing between royalty and tax payments to foreign governments with regard to those extraction activities[6]. The regulatory definition of FOGEI at Treas. Reg. §1.907(c)-1(b)(1)

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[6]H. Rept. No. 93-1502 discusses extraction activities of U.S. oil companies in foreign countries but makes no reference to similar activities in the U.S. Among those references the report states that:

> These companies [conducting oil and gas drilling and development operations within a foreign country] have substantial excess credits from oil production activities in part at least because of the difficulty under present law of distinguishing royalty payments from creditable taxes. The difficulty in distinguishing between deductions and credits arises from the fact that in foreign countries the sovereign usually retains the rights to natural resources in the ground. Therefore, if a U.S. corporation drills an oil well in a foreign country, the sovereign can demand a royalty payment from the U.S. corporation, or alternatively can impose a foreign tax.

limiting it to oil and gas extracted from foreign wells is based on that Congressional intent.

Despite the factual distinction between extraction and downstream activities, Taxpayer is apparently asserting that *Phillips Petroleum* should apply here since the phrase "derived from sources outside the United States," which that court held to refer to the source of the taxable income and not the location of the well, is found in both the definition of pre-1983 FORI, which included both FOGEI and other FORI, and in the definition of post-1982 FOGEI on a stand alone basis. However, to allow a taxpayer to increase its FOGEI limitation with extraction income on U.S. wells so undermines the integrity of that limitation so as to present the "compelling reason" as required by *Cal-Maine Foods* to look beyond the clear language of the statute. However, as discussed above, we do not reach the issue of the validity of the regulation because under the export terminal rule all of Taxpayer's extraction income is U.S. source.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

It is possible that, if faced with the issue, the Tax Court could invalidate the regulation definition in Treas. Reg. §1.907(c)-1(b)(1) limiting FOGEI to extraction activities with regard to foreign wells since the phrase "derived from sources outside the United States," which the court in *Phillips Petroleum* held to refer to the source of the taxable income and not the location of the well, is found in both the definition of pre-1983 FORI, which included both FOGEI and other FORI, and in the

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The report provides further that:

> Income from the extraction by the taxpayer or any other person includes the purchase and sale of crude petroleum products by the taxpayer in cases where the taxpayer is not performing the extraction operations. In certain cases foreign countries do not impose a full tax on the person who extracts oil because the tax is paid by another person to whom oil is sold within the country of production. In such situations the tax liability of the producer has been shifted to the purchaser. Accordingly, for purposes of this provision [section 907] the purchaser is treated as having foreign oil and gas extraction income. ... Also, where the taxpayer is performing extraction operations within a country and in addition purchases crude oil from the government of that country (or a corporation owned by the government) the income from that purchase and sale is to be treated as extraction income. There are various forms or arrangements used today whereby U.S. petroleum companies which operate overseas extract their own production of oil and gas and also purchase from the foreign government the foreign government's share of the oil and gas production.

definition of post-1982 FOGEI on a stand alone basis. The court could say the statute is clear on its face and not refer to legislative history which as we state above is overwhelmingly persuasive in support of the regulation. Therefore, it is very important to properly limit Taxpayer's foreign source income from its extraction activities on the U.S. wells pursuant to the export terminal rule of Treas. Reg. §1.863-1(b)(1).

Please call (202) 622-3850 if you have any further questions.

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