9 T.C. 1204 (1947)

Foreign income taxes paid by a corporation are deductible from gross income when calculating the 50% net income limitation on percentage depletion for oil and gas properties.

Summary

Kern Oil Company, a British corporation, sought to deduct British income taxes in full without allocating a portion to its U.S. oil-producing properties when calculating its percentage depletion allowance. The Commissioner allocated a portion of the British taxes to the oil properties, reducing the allowable depletion. The Tax Court held that the British income taxes, to the extent they were based on income from the U.S. oil properties, were deductible from the gross income of those properties for purposes of calculating the 50% net income limitation on percentage depletion. The court reasoned that because the British taxes were based on income derived from the oil properties, they were directly related to the income generated by those properties, even if the company had other business activities.

Facts

Kern Oil Company, a British corporation, operated oil-producing properties and gasoline stations in the United States. The company paid British income and excess profits taxes and a national defense contribution, which were based on profits from its global operations, including the U.S. oil properties. The Commissioner of Internal Revenue allowed a deduction for the total amount of British taxes paid but allocated a portion of these taxes as an expense attributable to the U.S. oil-producing properties. This allocation reduced the company's net income from the properties, thereby reducing its percentage depletion allowance.

Procedural History

The Commissioner assessed a deficiency against Kern Oil Co. The company petitioned the Tax Court for a redetermination of the deficiency, arguing that the British income taxes should not have been allocated to the oil-producing properties when calculating the net income limitation on percentage depletion. The Tax Court ruled in favor of the Commissioner, upholding the allocation of taxes.

Issue(s)

Whether British income taxes paid by a British corporation operating oil-producing properties in the U.S. are deductible from the gross income of those properties when calculating the 50% net income limitation on percentage depletion under Section 114(b)(3) of the Internal Revenue Code.

Holding

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Yes, because the British income taxes were based, in part, on the income generated by the U.S. oil properties, they are considered attributable to those properties and must be deducted when calculating the net income limitation on percentage depletion.

Court's Reasoning

The Tax Court relied on Treasury Regulations (Reg. 103, sec. 19.23(m)-1(g)), which define net income from the property as gross income less allowable deductions attributable to the mineral property. The court reasoned that because the British income taxes were based, in part, on the income derived from the U.S. oil properties, they were directly related to the income generated by those properties. The court distinguished the case from *F.H.E. Oil Co., 3 T.C. 13*, which disallowed a deduction for charitable contributions in computing net income from oil properties, because charitable contributions are deductible regardless of their connection to a taxpayer's business, whereas the British taxes were a direct consequence of Kern Oil's business operations and the income generated from the oil properties. The court found support in *Montreal Mining Co., 2 T.C. 688*, where state taxes were held to be deductible in the computation of net income. The court stated,

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