***Island Gas, Inc. v. Commissioner*, 30 T.C. 787 (1958)**

Section 24(c) of the 1939 Internal Revenue Code disallows certain expense and interest deductions when the payor and payee are related parties (specifically, where the payee owns more than 50% of the payor) and the payment is not made within the taxable year or within 2.5 months after the close of the year.

Summary

The case concerns the application of Section 24(c) of the 1939 Internal Revenue Code to Island Gas, Inc., an accrual-basis taxpayer, regarding the deductibility of intangible drilling costs and accrued interest. The IRS disallowed deductions for both, arguing that the conditions of Section 24(c) were met: the payments were not made within the required timeframe, the payee (Kuhn) owned more than 50% of the company, and Kuhn, who was a drilling contractor, was related to the company. The Tax Court found that while Kuhn did own more than 50% of the company stock, Island Gas had, in fact, paid for the intangible drilling costs in the year the work was completed (1950) and should be allowed to deduct these costs, because they were paid using borrowed funds. The Tax Court also agreed with the IRS in its disallowance of the interest deduction for which the conditions of Section 24(c) were met.

Facts

Island Gas, Inc. (petitioner), was formed in 1949 to drill gas wells. Kuhn, a drilling contractor, was brought in to help with the drilling. Kuhn acquired 95% of Island Gas's common stock and was made president. Island Gas entered into a farm-out agreement with Stanolind Oil and Gas Company. Island Gas also entered into a drilling contract with Kuhn to drill nine wells. Kuhn arranged financing, borrowing funds from a bank and gave his personal note and the gas leases as collateral. Island Gas paid Kuhn $175,500 for its share of the drilling costs. The company accrued interest to Kuhn in 1950 and 1951 but did not pay it within the taxable year or 2.5 months thereafter. Island Gas elected to deduct intangible drilling and development costs. The Commissioner disallowed these deductions, claiming that Section 24(c) barred them because Kuhn owned more than 50% of Island Gas's stock.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Island Gas's income tax for 1951, 1952, and 1953 based on the disallowance of deductions for intangible drilling costs and interest. The Tax Court heard the case and issued a decision.

Issue(s)

1. Whether the intangible drilling and development costs are considered expenses under section 23(a) or section 23(m) of the 1939 code.

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2. Whether Section 24(c) of the 1939 Code bars the deduction of intangible drilling and development costs by Island Gas, Inc. in 1950, given that Kuhn owned more than 50% of the company's stock.

3. Whether Section 24(c) of the 1939 Code bars the deduction of accrued but unpaid interest by Island Gas, Inc. in 1950 and 1951, given that Kuhn owned more than 50% of the company's stock.

Holding

1. No, because when Island Gas elected to deduct drilling costs as an expense, this election put the costs under Section 23(a) of the 1939 code.

2. No, because Island Gas paid for its share of the drilling expenses in 1950, when the drilling was completed, by borrowing funds and turning those funds over to the drilling contractor.

3. Yes, because Island Gas did not pay the accrued interest within the taxable year or 2.5 months thereafter, and Kuhn owned more than 50% of the company's stock.

Court's Reasoning

The court first determined that the election to deduct the intangible drilling costs placed the deduction under Section 23(a) as an expense. The court then addressed the applicability of Section 24(c), which disallows deductions for unpaid expenses and interest between related parties. The court held that the condition set in subsection (3) of Section 24(c) was met: Kuhn, as the owner of 95% of the company's stock, was a related party. The court determined that Island Gas paid for the drilling costs by using borrowed funds. The court distinguished the situation from cases where funds were advanced directly by the creditor, holding that it was proper to recognize each step of the process. The court held that since the company had possession of the funds at the time of the expenditure, the company had made a payment in 1950 for purposes of deductibility, and thus Section 24(c) did not apply. The court agreed with the Commissioner that section 24(c) did bar the interest deduction because the accrued interest was unpaid within the time allowed by the law. The court cited *Platt Trailer Co., 23 T. C. 1065, 1068*, holding that all three conditions in Section 24(c) must exist for it to be a bar to deduction.

The court stated: "It is clear that for a deduction to be barred by section 24 (c), 'all three of the conditions set forth therein must exist.'

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