Erich O. and Gabriele H. Grunebaum, Petitioners v. Commissioner of Internal Revenue, Respondent; Kurt H. and Anneliese Grunebaum, Petitioners v. Commissioner of Internal Revenue, Respondent, 50 T. C. 710 (1968)

Deductions that cannot be definitely allocated to either domestic or foreign income must be ratably apportioned when calculating the foreign tax credit limitation.

Summary

The Grunebaums, U. S. residents with income from both domestic and foreign sources, challenged the Commissioner's allocation of certain deductions for calculating their foreign tax credit limitation under IRC § 904(a)(2). The Tax Court upheld the Commissioner's method of apportioning a ratable portion of deductions for charitable contributions, interest, taxes, storm damage, and accounting fees between domestic and foreign income, as these deductions were not definitely allocable to either income source. This ruling ensures that deductions without a clear connection to income source are fairly apportioned, affecting how taxpayers compute their foreign tax credit limitations.

Facts

Erich and Kurt Grunebaum, along with their wives, were U. S. residents who received income from their limited partnership interests in a German bank and from domestic sources. They paid foreign taxes on their German income and sought to credit these against their U. S. tax liability, electing the overall limitation under IRC § 904(a)(2). The Commissioner reduced their foreign taxable income by allocating a portion of their deductions for charitable contributions, interest, taxes, storm damage, and accounting fees to their foreign income, arguing these deductions were not definitely allocable to either domestic or foreign income.

Procedural History

The Commissioner determined deficiencies in the Grunebaums' income taxes for 1961, leading to petitions filed with the U. S. Tax Court. The court addressed the issue of how certain deductions should be allocated for the purpose of calculating the foreign tax credit limitation. The Tax Court's decision upheld the Commissioner's method of allocation.

Issue(s)

1. Whether deductions for charitable contributions, interest, taxes, storm damage, and accounting fees can be definitely allocated to domestic income under IRC § 862(b).
2. Whether the Commissioner's method of allocating a ratable portion of these deductions to foreign income for computing the foreign tax credit limitation under IRC § 904(a)(2) was correct.

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Holding

1. No, because the petitioners failed to prove that these deductions were definitely related to the earning of domestic income.
2. Yes, because the Commissioner's allocation method followed the statutory requirement to apportion a ratable part of deductions that cannot be definitely allocated to any specific income source.

Court's Reasoning

The court applied IRC § 862(b), which requires the deduction of a ratable part of expenses and losses that cannot be definitely allocated to any specific income source when determining taxable income from foreign sources. The Grunebaums did not provide sufficient evidence to show that the disputed deductions were directly related to domestic income. The court noted that deductions like charitable contributions and personal interest payments were not connected to any particular income source, thus requiring apportionment. The court also cited prior cases like *International Standard Electric Corporation* and *South Porto Rico Sugar Co.* to support the Commissioner's allocation method. The burden of proof was on the petitioners to demonstrate a definite connection to domestic income, which they failed to do.

Practical Implications

This decision impacts how taxpayers with both domestic and foreign income must calculate their foreign tax credit limitations. It reinforces that deductions not clearly related to a specific income source must be apportioned ratably, which can reduce the amount of foreign tax credit available. Tax practitioners should carefully document and justify any deductions claimed as definitely allocable to domestic income. The ruling also underscores the importance of understanding the interplay between IRC § 862(b) and § 904(a)(2) when advising clients on foreign tax credit planning. Subsequent cases, such as *Missouri Pacific Railroad Co. v. United States*, have followed this principle, emphasizing its enduring relevance in tax law.

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