Phillips Petroleum Co. v. Commissioner, 97 T. C. 30 (1991)

Income from the sale of natural resources produced in the U. S. and sold abroad must be sourced partly from the U. S. and partly from foreign sources, invalidating regulations that treat such income as solely U. S. -sourced.

Summary

Phillips Petroleum Co. challenged the IRS's determination that income from its sale of liquefied natural gas (LNG) produced in Alaska and sold in Japan was entirely U. S. -sourced. The Tax Court invalidated the Treasury Regulation that classified such income as U. S. -source, ruling instead that the income should be apportioned between U. S. and foreign sources under IRC § 863(b)(2). The court further clarified that the IRS could require apportionment based on an independent factory price if certain conditions were met, and that the foreign-sourced portion of the income qualified as foreign oil-related income under IRC § 907(c)(2).

Facts

Phillips Petroleum Co. produced LNG from natural gas extracted in Alaska and sold it to Japanese buyers under a 1967 contract. The natural gas was transported by pipeline to a liquefaction facility in Alaska, then shipped to Japan, where the sales occurred. Phillips reported the income as mixed-source, apportioning it between U. S. and foreign sources. The IRS, however, determined that the income was entirely U. S. -sourced, relying on a Treasury Regulation that treated income from U. S. natural resources as U. S. -source income.

Procedural History

The case came before the U. S. Tax Court on cross-motions for partial summary judgment. Phillips challenged the validity of the Treasury Regulation that classified its LNG income as entirely U. S. -sourced. The Tax Court ruled on the validity of the regulation and the proper apportionment of the income, as well as whether the foreign-sourced portion qualified as foreign oil-related income.

Issue(s)

1. Whether IRC § 863(b)(2) requires income from the sale of personal property produced within and sold without the U. S. to be treated as mixed-source income, thereby invalidating the Treasury Regulation that classifies such income as entirely U. S. -sourced?
2. Whether the IRS may require Phillips to apportion its LNG income according to the method stated in Example (1) of Treasury Regulation § 1. 863-3(b)(2), if the factual prerequisites exist?
3. Whether Phillips' foreign source LNG income constitutes "foreign oil related income" under IRC § 907(c)(2)?

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Holding

1. Yes, because IRC § 863(b)(2) clearly states that income from the sale of personal property produced within and sold without the U. S. must be treated as mixed-source income, which conflicts with and thus invalidates the Treasury Regulation's treatment of such income as entirely U. S. -sourced.
2. Yes, because the language of Treasury Regulation § 1. 863-3(b)(2) mandates the use of Example (1)'s apportionment method when the factual prerequisites are met.
3. Yes, because the foreign source portion of Phillips' LNG income falls within the statutory definition of "foreign oil related income" under IRC § 907(c)(2).

Court's Reasoning

The court reasoned that IRC § 863(b)(2) specifically mandates mixed-source treatment for income from the sale of personal property produced within and sold without the U. S. , which directly conflicts with the Treasury Regulation's treatment of such income as solely U. S. -sourced. The court applied the principle that specific statutory provisions override general regulatory authority, finding that the regulation exceeded the scope of the Secretary's authority under IRC § 863(a). The court also interpreted the language of Treasury Regulation § 1. 863-3(b)(2) as mandating the use of Example (1) for apportionment when the necessary factual conditions are met. Lastly, the court determined that the foreign source portion of Phillips' LNG income qualified as foreign oil-related income under IRC § 907(c)(2), rejecting the IRS's argument that the location of the wells should determine the income's character.

Practical Implications

This decision has significant implications for how income from natural resources produced in the U. S. and sold abroad is sourced and apportioned. It establishes that such income must be treated as mixed-source, requiring taxpayers to apportion income between U. S. and foreign sources. This ruling may lead to changes in how the IRS administers sourcing rules for natural resource income, potentially affecting tax planning strategies for companies involved in international sales of natural resources. The decision also clarifies the applicability of foreign oil-related income provisions, impacting the foreign tax credit calculations for such income. Subsequent cases, such as Exxon Corp. v. Commissioner, have applied this ruling, further solidifying its impact on tax law.

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