Phillips Petroleum Co. v. Commissioner, 105 T. C. 486 (1995)

Income from cross-border sales of personal property must be apportioned between domestic and foreign sources using specific regulatory examples when an independent factory price cannot be established.

Summary

Phillips Petroleum Co. sought to apportion income from the sale of liquefied natural gas (LNG) produced in Alaska and sold in Japan as partly foreign-sourced. The IRS determined that all income was domestic-sourced. The Tax Court, in a prior ruling, invalidated the IRS's regulation and mandated apportionment under section 863(b). The key issue was whether the income should be apportioned using an independent factory price (Example 1) or a 50/50 split method (Example 2). The court held that Example 1 was inapplicable due to the absence of sales to independent distributors, and thus applied Example 2, which splits the income equally between production and sales, further apportioning each half based on property and sales location.

Facts

Phillips Petroleum Co. extracted natural gas from the North Cook Inlet in Alaska, liquefied it at a plant in Kenai, Alaska, and sold it to Tokyo Electric Power Co. and Tokyo Gas Co. in Japan under a long-term contract. The sales agreement stipulated delivery and title transfer in Japan. Phillips and Marathon Oil Co. formed a joint venture to fulfill the contract. Phillips engaged in extensive negotiations with Japanese buyers, involving multiple trips to Japan and assistance from its subsidiary, Phillips Petroleum International Corp. The price of LNG was renegotiated several times due to changing market conditions and political pressures.

Procedural History

The IRS issued a notice of deficiency to Phillips, asserting that all income from LNG sales was domestic-sourced. Phillips challenged this in the Tax Court. In a prior opinion (97 T. C. 30 (1991)), the court invalidated the IRS's regulation under section 1. 863-1(b) and held that the income was partly foreign-sourced under section 863(b). The case returned to the court to determine the appropriate method for apportioning the income.

Issue(s)

1. Whether the income from Phillips' sale of LNG to Tokyo Electric and Tokyo Gas should be apportioned under Example 1 of section 1. 863-3(b)(2), Income Tax Regs. , which requires an independent factory price?
2. If Example 1 is inapplicable, whether the income should be apportioned under Example 2 of section 1. 863-3(b)(2), Income Tax Regs. , which uses a 50/50 split method?

Holding

1. No, because the sales were not made to independent distributors or selling concerns as required by Example 1, and thus an independent factory price could not be established.
2. Yes, because Example 1 was inapplicable, the income was apportioned under Example 2, which splits the income equally between production and sales, with each half further apportioned based on the location of property and sales.

Court's Reasoning

The court analyzed the regulatory framework under section 863(b) and the related regulations, focusing on the examples provided for apportioning income from cross-border sales. The court determined that Example 1 required sales to be made to independent distributors or selling concerns to establish an independent factory price, which was not the case with Tokyo Electric and Tokyo Gas, who transformed the LNG before resale. The court rejected the IRS's broad interpretation of "distributor" and found that the buyers did not fit the traditional definition of a distributor. Consequently, the court applied Example 2, which mandates a 50/50 split of taxable income, with one half apportioned based on the location of property and the other half based on the location of sales. The court also addressed disputes over the valuation and location of certain assets used in the apportionment formula, ultimately excluding leased property and inventory in international waters from the property apportionment fraction.

Practical Implications

This decision clarifies the methodology for apportioning income from cross-border sales of personal property when an independent factory price cannot be established. It underscores the importance of the nature of the buyer in determining whether an independent factory price can be used. For companies engaged in similar transactions, this case provides guidance on how to structure sales agreements and manage tax implications. It also highlights the need for careful documentation and valuation of assets used in the production and sale of goods for tax purposes. The decision may influence future tax planning and negotiations in international trade, particularly in industries involving the sale of natural resources or manufactured goods across borders.

