Chevron Corporation and Affiliated Companies v. Commissioner of Internal Revenue, 104 T. C. 719 (1995)

State income taxes must be allocated based on the income subject to state taxation, even if that includes foreign source income, for the purpose of calculating the foreign tax credit limitation.

Summary

Chevron Corporation challenged the IRS's method of allocating state income taxes between domestic and foreign source income for calculating the foreign tax credit under Section 904. The Tax Court held that Chevron's methods (gross income and factor operations) were contrary to the regulations under Section 1. 861-8(e)(6)(i), which require allocation based on state taxable income. The court upheld the validity of these regulations and allowed Chevron to rely on examples in the regulations for allocation and apportionment. The decision emphasizes the need to consider state law principles in determining the allocation of state taxes for federal tax purposes, affecting how multinational corporations calculate their foreign tax credits.

Facts

Chevron Corporation and its affiliated companies paid state income and franchise taxes, including California's unitary tax. Chevron filed consolidated federal income tax returns and claimed foreign tax credits. The IRS adjusted Chevron's foreign tax credit limitation by increasing the amount of state taxes allocated to foreign source income. Chevron contested these adjustments, arguing that their methods of allocation based on gross income or apportionment factors were more appropriate than the IRS's methods, which considered state taxable income and combined reporting.

Procedural History

Chevron filed a petition with the U. S. Tax Court challenging the IRS's deficiency notice for the tax years 1977 and 1978. The court limited the issues for trial to the allocation and apportionment of state taxes, focusing on California's franchise tax. Chevron argued for the validity of their allocation methods, while the IRS defended their statutory notice and pro rata methods.

Issue(s)

1. Whether Chevron's gross income and factor operations methods of allocating and apportioning state income taxes comply with Section 1. 861-8(e)(6)(i).
2. Whether the application of Section 1. 861-8(e)(6)(i) to Chevron's tax years constitutes an impermissible retroactive application.
3. Whether Section 1. 861-8(e)(6)(i) is a valid regulation under the Internal Revenue Code.

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4. Whether Chevron may rely on examples in Section 1. 861-8(g) to allocate and apportion state taxes.

Holding

1. No, because Chevron's methods do not allocate state taxes based on state taxable income as required by the regulation.
2. No, because the regulation's principles were implicit in prior versions and its application was not impermissibly retroactive.
3. Yes, because the regulation reasonably implements the statutory requirement to allocate state taxes based on their factual relationship to income.
4. Yes, Chevron may rely on examples in the regulations, as they have the option to apply these methods to earlier tax years.

Court's Reasoning

The court reasoned that Section 1. 861-8(e)(6)(i) mandates the allocation of state taxes based on state taxable income, which may include foreign source income under combined reporting systems like California's. Chevron's methods, focusing on gross income or apportionment factors, did not comply with this requirement. The court found that the regulation's approach was consistent with the statute's purpose of accurately determining foreign source taxable income for foreign tax credit calculations. The court also noted that the regulation's principles were implicit in earlier versions, thus not constituting an impermissible retroactive application. The examples in the regulation were deemed illustrative of acceptable allocation methods, allowing Chevron to use them if their factual situation was similar.

Practical Implications

This decision impacts how multinational corporations allocate state income taxes for foreign tax credit purposes, requiring them to consider state law principles in determining taxable income. It reinforces the use of state taxable income, including foreign source income under combined reporting, for federal tax purposes. The ruling may lead to increased foreign tax credit limitations for corporations operating in states with combined reporting systems. Future cases may need to carefully analyze state tax laws to ensure compliance with federal regulations. The decision also highlights the importance of regulatory examples in guiding tax allocation practices.

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