Sunoco, Inc. v. Comm'r, 118 T. C. 181 (U. S. Tax Ct. 2002)

In Sunoco, Inc. v. Comm'r, the U. S. Tax Court ruled that the IRS regulations do not permit the netting of interest income against interest expense when calculating foreign tax credits. This decision, which overruled a prior court opinion, impacts multinational corporations by limiting the ability to offset interest costs against foreign income for tax credit purposes, potentially reducing available tax credits.

Parties

Sunoco, Inc. , and its subsidiaries (collectively, Sunoco) were the petitioners throughout the litigation. The Commissioner of Internal Revenue was the respondent at all stages.

Facts

Sunoco, Inc. , the parent company of an affiliated group of corporations, engaged in the acquisition, development, refining, marketing, and transportation of oil, gas, and other energy products both domestically and internationally. For the tax years 1982, 1983, 1984, and 1986, Sunoco claimed foreign tax credits under section 901(a) of the Internal Revenue Code. In computing these credits, Sunoco allocated and apportioned interest expenses among its subsidiaries to determine foreign-source income. Sunoco sought to change its method of computing the overall limitation on these credits by offsetting interest income against interest expenses before allocation, a practice known as 'netting'. This netting approach was not reflected in the original tax filings for these years.

Procedural History

The case originated with the Commissioner of Internal Revenue determining deficiencies in Sunoco's federal income taxes for the years 1979, 1981, and 1983, which Sunoco disputed. Sunoco filed a petition with the U. S. Tax Court challenging these deficiencies and seeking to have overpaid taxes refunded. The specific issue of interest netting was addressed by the court after both parties stipulated the relevant facts. The Tax Court's decision was based on de novo review of the legal interpretation of the applicable regulations.

Issue(s)

Whether section 1. 861-8(e)(2) of the Income Tax Regulations permits Sunoco to offset its interest income against interest expenses before allocating and apportioning net interest expenses to foreign-source income for the purpose of computing the overall limitation on foreign tax credits under section 904(a) of the Internal Revenue Code?

Rule(s) of Law

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The controlling legal principle is found in section 1. 861-8(e)(2) of the Income Tax Regulations, which states that the aggregate of deductions for interest shall be considered related to all income-producing activities and properties of the taxpayer and thus allocable to all the gross income the taxpayer generates. This regulation is based on the fungibility of money and the flexibility of management in using funds.

Holding

The U. S. Tax Court held that section 1. 861-8(e)(2) of the Income Tax Regulations does not permit Sunoco to offset its interest income against interest expenses before allocating and apportioning the net interest expenses to foreign-source income. The court overruled its prior decision in *Bowater, Inc. & Subs. v. Commissioner* which had allowed for such netting.

Reasoning

The court's reasoning included the following points:

– The plain language of the regulation requires that the 'aggregate of deductions for interest' be allocated to 'all the gross income' of the taxpayer, indicating that gross interest expense, not net interest expense, should be used for allocation purposes.

– The court rejected Sunoco's argument that the term 'interest' in the context of the regulation could be interpreted to mean net interest expense. The court found no ambiguity in the regulation's language that would support such an interpretation.

– The court considered that netting would subvert the operation of the source rules, which assign gross income to different sources based on specific standards. Netting would disregard the source of interest income, potentially leading to incongruous and erroneous results.

– The court noted that allowing netting would require an adjustment to gross income, a step not contemplated by the regulations. The court also highlighted that netting would have a different impact on the foreign tax credit depending on the source of the interest income being offset.

– The court took into account the subsequent reversal of its *Bowater* decision by the U. S. Court of Appeals for the Second Circuit and a similar ruling by the Fifth Circuit in *Dresser Indus. , Inc. v. United States*, which both found that interest netting was not permitted under the regulations.

Disposition

The U. S. Tax Court granted the Commissioner's motion in limine, thereby rejecting Sunoco's method of interest netting for the computation of foreign tax credits.

Significance/Impact

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The decision in *Sunoco, Inc. v. Comm'r* is significant for multinational corporations as it clarifies that the IRS regulations do not permit the netting of interest income against interest expenses when computing foreign tax credits. This ruling overruled a prior Tax Court decision, aligning the Tax Court's position with that of two Circuit Courts. The practical implication is that corporations may face a higher tax liability due to the inability to offset domestic interest income against foreign interest expenses. Subsequent legislative changes and temporary regulations have explicitly addressed interest netting, but for the years in question, this decision sets a precedent that has been followed in subsequent cases and IRS guidance.

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