Brewster v. Commissioner, 67 T. C. 352 (1976)

A U. S. citizen residing abroad must exclude a portion of gross farm income as earned income and allocate a corresponding portion of farm expenses as non-deductible, even if the foreign farming business operates at a loss.

Summary

Anne Moen Bullitt Biddle Brewster, a U. S. citizen residing in Ireland, operated a farming business at a loss. The IRS determined that 30% of her gross farm income should be excluded as earned income under IRC §911, and a corresponding percentage of her farm expenses should be non-deductible. The Tax Court upheld this determination, ruling that even though the business operated at a loss, a portion of gross income must be excluded as earned income, and expenses must be proportionally allocated. The decision was based on the court's prior ruling and the need to prevent a double tax benefit. This case clarifies how earned income exclusions and deduction allocations are applied to foreign business losses.

Facts

Anne Moen Bullitt Biddle Brewster, a U. S. citizen, resided in Ireland and operated Palmerstown Stud, a 700-acre farm focused on thoroughbred horse breeding and racing. She employed 45-50 individuals and had both personal services and capital as material income-producing factors in the business. From 1962 to 1969, her farming operation consistently operated at a loss, with gross farm income ranging from $38,238 to $123,502 and expenses from $224,868 to $299,391 annually. Brewster reported all her gross farm income and deducted all farming expenses on her U. S. tax returns, offsetting her U. S. source income with the foreign losses.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Brewster's federal income tax for the years 1962-1969, asserting that 30% of her gross farm income should be excluded as earned income under IRC §911 and a corresponding portion of her farm expenses should be non-deductible. Brewster petitioned the U. S. Tax Court, which had previously ruled in her favor on the issue of earned income exclusions for foreign losses in a related case (55 T. C. 251, 1970), affirmed by the D. C. Circuit (473 F. 2d 160, 1972). In the current case, the Tax Court upheld the Commissioner's determination regarding the exclusion and expense allocation, following its prior ruling and the Golsen rule.

Issue(s)

1. Whether a portion of Brewster's gross farm income was excludable as earned income under IRC §911 when her foreign farming proprietorship operated at a loss?
2. If a portion was excludable, what was the amount thereof?
3. What was the amount of Brewster's farming expenses "allocable to or chargeable

against" the excludable income?

Holding

1. Yes, because the Tax Court's prior decision and the Golsen rule required the court to follow its earlier ruling that a portion of gross income must be excluded as earned income even when the business operates at a loss.
2. The amount excludable was 30% of gross farm income, as determined by the Commissioner, because Brewster failed to prove that this amount did not represent a reasonable allowance for her personal services.
3. The amount of farming expenses allocable to the excludable income was 30% of gross farm expenses, as determined by the Commissioner, because this allocation was necessary to prevent a double tax benefit and Brewster failed to prove otherwise.

Court's Reasoning

The Tax Court followed its prior decision in Brewster v. Commissioner (55 T. C. 251, 1970), which held that even when a foreign service-capital business operates at a loss, a portion of gross income must be excluded as earned income under IRC §911. This ruling was affirmed by the D. C. Circuit (473 F. 2d 160, 1972). The court applied the Golsen rule, which requires it to follow prior decisions of the circuit court to which an appeal would lie. The court rejected Brewster's arguments that no earned income could be excluded from a loss operation and that the 30% figure should not apply to gross income. The court found that 30% of gross farm income was a reasonable allowance for Brewster's personal services, as she failed to provide evidence to the contrary. Similarly, the court upheld the Commissioner's determination that 30% of farm expenses should be allocated to the excludable income to prevent a double tax benefit. The court noted the difficulty in determining a reasonable allowance for personal services in a loss situation but found no basis to overturn the Commissioner's determinations. A dissenting opinion argued that the 30% limitation should apply to net profits only, resulting in no exclusion when there were net losses.

Practical Implications

This decision has significant implications for U. S. citizens operating foreign businesses at a loss who seek to offset U. S. source income with foreign losses. It clarifies that a portion of gross income must be excluded as earned income under IRC §911, even in loss situations, and a corresponding portion of expenses must be allocated as non-deductible. This ruling may affect how similar cases are analyzed, as it requires a careful calculation of earned income and expense allocations based on gross income figures. Tax practitioners advising clients with foreign operations should be aware of this decision when planning and reporting income and deductions. The ruling may encourage taxpayers to challenge the percentage used for exclusion and allocation, though the burden of proof remains high. Subsequent cases have applied this principle, while some have criticized the incongruities it creates in the taxation of foreign income and losses.