Brunswick International, Ltd. v. Commissioner, 96 T. C. 410 (1991)

Dividends from foreign subsidiaries must be sourced to specific years for foreign tax credit calculations, following the reverse chronological order of accumulated profits.

Summary

In Brunswick International, Ltd. v. Commissioner, the Tax Court addressed how to source foreign taxes paid by a foreign subsidiary for the purpose of calculating the U. S. parent's foreign tax credit under Section 902. The court rejected the taxpayer's 'aggregate' approach, which sought to claim credits for all taxes paid by the subsidiary since its inception. Instead, it upheld the IRS's method of sourcing dividends to specific years of accumulated profits, in reverse chronological order. This decision was grounded in the statutory language and prior case law, emphasizing the importance of year-by-year analysis to prevent credit for taxes paid on income not distributed as dividends. The ruling has significant implications for how multinational corporations structure their operations and claim foreign tax credits.

Facts

Brunswick International, Ltd. (BIL), a wholly owned subsidiary of a U. S. corporation, owned 99. 99% of Sherwood Medical Industries, Ltd. (SMIL), a UK corporation. SMIL operated branches in France and Germany and paid foreign taxes over the years. In 1982, BIL sold SMIL's stock, recognizing a gain treated as a dividend of $5,302,833 under Section 1248. The dispute centered on how to calculate the foreign tax credit for this dividend, with BIL arguing for an aggregate approach to claim credits for all taxes paid by SMIL, while the IRS advocated for sourcing the dividend to specific years of accumulated profits.

Procedural History

The case was submitted fully stipulated to the Tax Court. The court considered the parties' arguments on the sourcing of foreign taxes for the purpose of calculating the foreign tax credit under Section 902. The court's decision was the first instance of this specific issue being adjudicated, relying on statutory interpretation and prior case law to reach its conclusion.

Issue(s)

1. Whether the foreign tax credit for a dividend from a foreign subsidiary should be calculated using an aggregate approach, considering all taxes paid by the subsidiary since its inception?
2. Whether the foreign tax credit should be sourced to specific years of accumulated profits in reverse chronological order?

Holding

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1. No, because the aggregate approach is inconsistent with Section 902(c)(1) and prior case law, which require sourcing dividends to specific years of accumulated profits.
2. Yes, because Section 902(c)(1) mandates sourcing dividends to the most recent accumulated profits first, in reverse chronological order, and the IRS's method aligns with this requirement.

Court's Reasoning

The court's decision was based on the interpretation of Section 902(c)(1), which requires dividends to be sourced to the most recent accumulated profits first. The court cited American Chicle Co. v. United States and H. H. Robertson Co. v. Commissioner, emphasizing the need for a year-by-year analysis to determine which foreign taxes are creditable. The court rejected BIL's aggregate approach, which would have allowed credit for taxes paid on income not distributed as dividends, as contrary to the statute and case law. The court also considered the legislative purpose of avoiding double taxation and achieving equivalence between subsidiaries and branches but found that these goals do not override the statutory requirement for sourcing dividends to specific years. The court noted that Congress's later adoption of an aggregate approach for post-1986 years did not retroactively change the law for earlier years.

Practical Implications

This decision requires multinational corporations to carefully consider the timing of dividend distributions from foreign subsidiaries to maximize foreign tax credits. The year-by-year sourcing method can result in the loss of credits for taxes paid in earlier years if dividends are not distributed promptly. Corporations must plan their operations and dividend policies with this in mind. The ruling also highlights the importance of understanding the interplay between U. S. tax laws and the operations of foreign subsidiaries. Subsequent cases, such as those applying the post-1986 pooling method, have distinguished this ruling, but it remains relevant for pre-1987 transactions. Legal practitioners must advise clients on the potential for permanent loss of foreign tax credits if dividends are not sourced properly under the pre-1987 rules.

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