Brown Group, Inc. and Subsidiaries v. Commissioner of Internal Revenue, 102 T. C. 616 (1994)

The character of a controlled foreign corporation's distributive share of partnership income is determined at the partnership level, not the partner level, for subpart F income purposes.

Summary

Brown Group, Inc. contested a tax deficiency claim by the IRS, arguing that its subsidiary's share of income from a foreign partnership was not subpart F income. The Tax Court ruled in favor of Brown Group, holding that the character of partnership income for subpart F purposes must be determined at the partnership level, not the partner level. This decision rejected the IRS's position in Revenue Ruling 89-72, emphasizing the entity theory of partnership taxation and its implications for subpart F income calculations.

Facts

Brown Group, Inc. , a U. S. corporation, was the parent of an affiliated group that filed a consolidated Federal income tax return. Brown Cayman Ltd. , a wholly owned subsidiary of Brown Group, held a 98% interest in Brinco, a Cayman Islands partnership. Brinco acted as a purchasing agent for Brazilian footwear, which was primarily sold in the U. S. The IRS determined that Brown Cayman's distributive share of Brinco's income was foreign base company sales income under subpart F, subject to U. S. taxation. Brown Group contested this, arguing that Brinco's income was not subpart F income to Brown Cayman.

Procedural History

The IRS determined a tax deficiency against Brown Group for the taxable year ended November 1, 1986, asserting that Brown Cayman's share of Brinco's income was subpart F income. Brown Group petitioned the U. S. Tax Court for a redetermination of the deficiency. The Tax Court issued its opinion on April 12, 1994, holding that Brown Cayman's distributive share of Brinco's income was not subpart F income.

Issue(s)

1. Whether the character of a controlled foreign corporation's distributive share of partnership income is determined at the partnership level or the partner level for subpart F income purposes?
2. Whether Revenue Ruling 89-72 correctly applied the aggregate theory of partnership taxation to characterize partnership income as subpart F income at the partner level?

Holding

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1. Yes, because the character of partnership income for subpart F purposes is determined at the partnership level, not the partner level, as required by Section 702(b) and related regulations.
2. No, because Revenue Ruling 89-72 incorrectly applied the aggregate theory of partnership taxation, and the court declined to follow it, favoring the entity theory instead.

Court's Reasoning

The Tax Court reasoned that under Section 702(b) and the related regulations, the character of partnership income must be determined as if the income were realized directly by the partnership. The court emphasized that the entity theory of partnership taxation is the general rule for subpart F income purposes, as supported by numerous court decisions and IRS rulings that consistently apply partnership-level characterization. The court found no statutory or doctrinal basis to support the IRS's use of the aggregate theory in Revenue Ruling 89-72. The court also noted that subpart F income definitions apply specifically to controlled foreign corporations, and since Brinco was not a controlled foreign corporation, its income could not be subpart F income to Brown Cayman. The court rejected the IRS's argument, highlighting that the legislative history and judicial interpretations consistently favor the entity approach for partnership income characterization.

Practical Implications

This decision clarifies that for subpart F income purposes, the character of a controlled foreign corporation's distributive share of partnership income must be determined at the partnership level. This ruling impacts how multinational corporations structure their foreign partnerships and report income, as it may reduce the U. S. tax liability on certain foreign income. Practitioners must now ensure that partnership agreements and tax planning strategies align with the entity theory of partnership taxation. The decision also invalidates Revenue Ruling 89-72, requiring the IRS to adjust its administrative practices regarding the characterization of partnership income for subpart F purposes. This case may influence future court decisions and IRS guidance on similar issues, reinforcing the importance of the partnership level in determining the character of income under subpart F.

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