Brown Group, Inc. v. Commissioner, 104 T. C. 118 (1995)

A partner's distributive share of partnership income can be considered subpart F income if it is derived in connection with purchases on behalf of a related person.

Summary

In Brown Group, Inc. v. Commissioner, the Tax Court ruled that Brown Cayman, Ltd. 's share of partnership income from Brinco, a Cayman Islands partnership, was subpart F income under section 954(d)(1) of the Internal Revenue Code. The case involved Brown Group, Inc. , and its subsidiaries, which formed Brinco to source Brazilian footwear. The court held that the income derived from Brinco's commissions for purchasing footwear on behalf of Brown Group International, Inc. , a related party, should be treated as foreign base company sales income, thereby subjecting it to immediate taxation under subpart F rules. This decision emphasizes the application of the aggregate theory of partnerships in the context of subpart F, ensuring that income from partnerships involving controlled foreign corporations cannot be deferred.

Facts

Brown Group, Inc. , a New York corporation, formed Brinco, a partnership in the Cayman Islands, to purchase footwear from Brazil. Brinco's partners included Brown Cayman, Ltd. (88%), T. P. Cayman, Ltd. (10%), and Delcio Birck (2%). Brown Cayman was a controlled foreign corporation (CFC) owned by Brown Group International, Inc. (International), a U. S. shareholder. Brinco earned a 10% commission on footwear purchases for International, which were primarily sold in the U. S. The IRS determined that Brown Cayman's share of Brinco's income was subpart F income, subject to immediate taxation.

Procedural History

The IRS issued a notice of deficiency to Brown Group, Inc. , asserting a tax liability based on Brown Cayman's distributive share of Brinco's income being subpart F income. Brown Group filed a petition with the Tax Court challenging this determination. The Tax Court held a trial and ultimately ruled in favor of the Commissioner, affirming the IRS's position.

Issue(s)

1. Whether Brown Cayman, Ltd. 's distributive share of Brinco's income constitutes foreign base company sales income under section 954(d)(1) of the Internal Revenue Code.

Holding

1. Yes, because Brown Cayman's income was derived in connection with the

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purchase of personal property from any person on behalf of a related person, as defined by section 954(d)(1), making it foreign base company sales income and thus subpart F income.

Court’s Reasoning

The court applied the aggregate theory of partnerships, treating Brinco’s income as if earned directly by its partners, including Brown Cayman. This approach was deemed necessary to prevent tax deferral, aligning with the purpose of subpart F, which aims to tax certain foreign income immediately. The court emphasized that subchapter K of the Internal Revenue Code, dealing with partnerships, was applicable in determining subpart F income. The court also interpreted the phrase “in connection with” in section 954(d)(1) broadly, finding a logical relationship between Brinco’s activities and Brown Cayman’s income. The decision was supported by the majority of the court, with no dissenting opinions recorded.

Practical Implications

This decision has significant implications for U. S. companies using foreign partnerships to source goods. It establishes that partnership income can be treated as subpart F income if derived from activities on behalf of related parties, impacting how multinational corporations structure their international operations to avoid immediate taxation. Legal practitioners must consider the aggregate theory when advising clients on partnership arrangements involving CFCs. The ruling may lead businesses to reassess their use of foreign partnerships to ensure compliance with subpart F rules. Subsequent cases, such as those involving similar partnership structures, will likely reference this decision to determine the tax treatment of income derived from foreign partnerships.

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