Determination of Whether Income of a Controlled Foreign Corporation Earned Through a Partnership Is Subpart F Income

Notice 96–39

This Notice sets forth the Service's position on the Eighth Circuit's recent decision in *Brown Group, Inc. v. Commissioner*, 77 F.3d 217 (8th Cir. 1996), *vacating and remanding* 104 T.C. 105 (1995). This Notice also announces that the Service intends to issue regulations under Subpart F of the Internal Revenue Code describing how the aggregate approach to partnerships applies to determine the treatment of a controlled foreign corporation's (''CFC's'') distributive share of partnership income for purposes of subpart F.

BACKGROUND

In *Brown Group* a CFC incorporated in the Cayman Islands was a partner in a Cayman Islands partnership. The partnership was not a sham. It acted as a purchasing agent for the CFC's U.S. parent with respect to footwear manufactured in Brazil and received commission income from the U.S. parent as compensation for its efforts. The footwear imported by the U.S. parent was sold primarily in the United States. For its fiscal year ended November 1, 1986, the U.S. parent did not include as subpart F income the CFC's distributive share of the partnership's commission income.

At issue in *Brown Group* was whether the CFC partner's distributive share of the income of the Cayman Islands partnership was foreign base company sales income. If so, this income would be currently includible in the gross income of the CFC's U.S. shareholder as subpart F income. *See* sections 951(a)(1) and (b), 952(a), 954(d) and 957(a) of the Internal Revenue Code. Foreign base company sales income is defined under section 954(d) to include commission income from the purchase of personal property on behalf of a related person where the property that is purchased is both manufactured and sold for use outside the CFC's country of incorporation.

In *Brown Group* the parties agreed that the commission income was earned from purchasing personal property that was both manufactured and sold for use outside the CFC's country of incorporation. The narrow issue in dispute was whether the footwear was purchased on behalf of a related person, as defined in section 954(d)(3) of the Code. It was undisputed that the U.S. parent, on whose behalf the purchases were made, was a related person with respect to the CFC. The Service argued that an aggregate theory of partnerships should apply, under which the CFC's distributive share of the partnership's commission income would be tested at the CFC level to determine whether it was foreign base company sales income. Accordingly, the related person determination would be made at the partner level, as if the purchases had been made directly by the CFC. The taxpayer argued that an entity theory of partnerships should apply, under which the CFC's distributive share of partnership income would be tested at the partnership level. The taxpayer maintained that, at the partnership level, the purchases were not made on behalf of a related person.

The Tax Court, after withdrawing an earlier opinion favorable to the taxpayer, held in a reviewed opinion that the CFC partner's distributive share of the partnership's commission income was foreign base company sales income. The Tax Court reached its conclusion based upon an analysis of the provisions and purposes of subpart F and subchapter K, as well as the case law discussing the application of the entity and aggregate theories of partnership taxation. The Tax Court's holding is consistent with the Service's published position in Rev. Rul. 89– 72, 1989–1 C.B. 257.

On appeal by the taxpayer, the Eighth Circuit vacated and remanded the decision of the Tax Court. The court concluded, based upon its application of the definition of related person in section 954(d)(3) of the Code, that the commission income was not foreign base company sales income at the partnership level and that the CFC partner's distributive share of this partnership income therefore was not subpart F income.

THE SERVICE'S POSITION

The Service disagrees with the opinion of the Eighth Circuit in *Brown Group*. To permit a CFC to avoid subpart F by earning income through a partnership under circumstances in which the income would be subpart F income if earned directly by the CFC would be contrary to the purposes of subpart F. *See* S. Rep. No. 1881, 87th Cong., 2d Sess. 78–79 (1962).

The legislative history of subchapter K indicates that, although a partnership is to be considered an entity in the treatment of transactions between a partner and a partnership, it need not be considered a separate entity for purposes of applying other provisions of the Code ''if the concept of the partnership as a collection of individuals is more appropriate for such provisions.'' H.R. Conf. Rep. No. 2543, 83d Cong. 2d. Sess. 59 (1954). The courts have recognized that the aggregate approach may be applied in appropriate circumstances. *See Casel v. Commissioner*, 79 T.C. 424, 433 (1982); *Unger v. Commissioner*, T.C. Memo. 1990–15, *aff'd* 936 F.2d 1316 (D.C. Cir. 1991). Section 1.701–2(e) and (f) of the Income Tax Regulations confirmed the Commissioner's authority to treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purposes of any provision of the Code or regulations thereunder.

The Service intends to issue regulations under subpart F to confirm its position that whether a CFC partner's distributive share of partnership income is subpart F income generally is determined at the CFC partner level. Prior to the effective date of those regulations, the Service will rely on principles and authorities under subpart F and subchapter K to apply the aggregate approach, including section 1.701–2(e) and (f) of the regulations for periods for which it is effective.

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