***11 T.C. 704 (1948)***

Payments labeled as royalties from a corporation to its controlling stockholders may be recharacterized as dividends if the arrangement lacks a genuine business purpose and is primarily designed for tax avoidance.

**Summary**

Granberg Equipment sought to deduct royalty payments made to its controlling stockholders for the use of certain patents. The Tax Court disallowed the deduction, finding that the payments were not ordinary and necessary business expenses but were instead disguised dividends. The court emphasized the lack of arm's length dealing between the corporation and its controlling stockholders, the artificiality of the royalty agreement, and the primary tax avoidance motive behind the arrangement. The court also held that the mere crediting of a bonus to the company president's account was not a payment within the meaning of Section 24(c)(1) of the Internal Revenue Code.

**Facts**

A.J. Granberg, the president and principal stockholder of Granberg Equipment, had invented several devices, including meters and pumps. Granberg assigned patent applications to Granberg Equipment. Later, the corporation entered into an agreement to pay royalties to Granberg and other stockholders for the use of these patents. These stockholders consisted primarily of early investors. The royalty payments were made retroactively, and the amount of royalties was a substantial sum. The corporation claimed a deduction for these royalty payments as an ordinary and necessary business expense.

**Procedural History**

The Commissioner of Internal Revenue disallowed the deduction for royalty payments, determining that they were disguised dividends. Granberg Equipment, Inc. petitioned the Tax Court for review.

**Issue(s)**

1. Whether the royalty payments made by Granberg Equipment to its controlling stockholders were deductible as ordinary and necessary business expenses, or whether they should be recharacterized as nondeductible dividends.

2. Whether crediting a bonus to the president's account constitutes payment under Section 24(c)(1) of the Internal Revenue Code.

**Holding**

1. No, because the payments were not the result of arm's length dealing, lacked

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business purpose, and were primarily motivated by tax avoidance.

2. No, the mere crediting of a bonus to the president's account does not meet the requirements for payment under Section 24(c)(1) of the Internal Revenue Code.

**Court's Reasoning**

The court found that the transactions lacked the characteristics of arm's length dealings. The corporation and its controlling stockholders were not operating independently, and the royalty agreement was structured to minimize taxes rather than serve a legitimate business purpose. The court noted that the corporation's early intention was to manufacture devices under each of the inventions. But by 1943, due to lack of priorities, among other reasons, it became impossible to carry out this program and substantial production could not be undertaken. Additionally, the royalty payments were nearly proportional to the stockholders' ownership, further suggesting a dividend distribution. The court emphasized that "in tax matters the realities of a transaction, not artificialities, are given effect."

In regard to the bonus, the court found that crediting the amount to the president's account was not a payment under the code. The court cited *P.G. Lake, Inc.*, noting that it remains valid authority that constructive payment is not actual payment.

**Practical Implications**

This case highlights the importance of establishing a genuine business purpose for transactions between corporations and their controlling stockholders. Courts will scrutinize such arrangements to determine whether they are legitimate business expenses or disguised dividends. Factors such as arm's length negotiations, fair market value, and proportionality to stock ownership are all relevant. The case also serves as a warning against retroactive adjustments designed primarily for tax benefits. Furthermore, this case reinforces that for tax deduction purposes, "constructive payment" may not be considered an actual payment under specific sections of the Internal Revenue Code, requiring careful attention to timing and method of payment. Subsequent cases have cited Granberg for the principle that transactions lacking a bona fide business purpose can be disregarded for tax purposes.

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