

## ***Garlock Inc. v. Commissioner, 58 T. C. 423 (1972)***

The substance-over-form doctrine applies in determining whether a foreign corporation is controlled by U. S. shareholders, focusing on actual control rather than formal voting power.

### **Summary**

Garlock Inc. attempted to avoid being classified as a controlled foreign corporation by issuing voting preferred stock to foreign investors, reducing its voting power to 50%. The U. S. Tax Court held that the issuance of preferred stock did not effectively transfer voting control because the preferred shareholders did not exercise their voting rights independently of Garlock's common stock. The court emphasized that the substance of control, rather than the form of stock ownership, determines whether a foreign corporation is controlled under section 957(a). The court also upheld the constitutionality of taxing U. S. shareholders on the undistributed income of a controlled foreign corporation.

### **Facts**

Garlock Inc. , a U. S. corporation, owned 100% of the stock of Garlock, S. A. , a Panamanian corporation, until December 1962. To avoid classification as a controlled foreign corporation under the Revenue Act of 1962, Garlock Inc. proposed and implemented a plan to issue voting preferred stock to foreign investors, thereby reducing its voting power to 50%. The preferred stock was issued to Canadian Camdex Investments, Ltd. , which resold 900 of the 1,000 shares to other foreign entities. The preferred stock carried voting rights equal to the common stock but was subject to certain restrictions, including transferability only with S. A. 's consent and the right to demand repurchase after one year.

### **Procedural History**

The Commissioner of Internal Revenue determined deficiencies in Garlock Inc. 's federal income tax for the years 1964 and 1965, asserting that Garlock, S. A. remained a controlled foreign corporation despite the issuance of preferred stock. Garlock Inc. petitioned the U. S. Tax Court, which held that the preferred stock issuance did not effectively divest Garlock Inc. of control over S. A. The court entered a decision for the respondent, upholding the tax deficiencies.

### **Issue(s)**

1. Whether Garlock, S. A. was a controlled foreign corporation within the meaning of section 957(a) of the Internal Revenue Code of 1954, as amended.
2. Whether section 951 of the Internal Revenue Code of 1954, as amended, is unconstitutional.

### **Holding**

1. Yes, because the issuance of voting preferred stock did not effectively transfer control to the preferred shareholders, who did not exercise their voting rights independently of the common stock owned by Garlock Inc.
2. No, because the tax imposed on U. S. shareholders of a controlled foreign corporation is constitutional.

### **Court's Reasoning**

The court rejected Garlock Inc. 's argument that a mechanical test of voting power through stock ownership was sufficient under section 957(a). Instead, the court applied the substance-over-form doctrine, focusing on the actual control of the corporation. The court found that the preferred stock issuance was a tax-motivated transaction designed to avoid the controlled foreign corporation provisions. The court noted that the preferred shareholders had no incentive to vote independently, as they could demand repayment of their investment at any time. The court also considered the manipulation of the board of directors, which remained under Garlock Inc. 's control, as evidence of continued control over S. A. The court cited regulations that disregard formal voting arrangements if voting power is retained in substance. The court concluded that Garlock Inc. did not effectively divest itself of control over S. A. , and thus, S. A. remained a controlled foreign corporation. Regarding the constitutionality of section 951, the court held that taxing U. S. shareholders on the undistributed income of a controlled foreign corporation is constitutional, as supported by prior case law.

### **Practical Implications**

This decision emphasizes that the substance of control, rather than the form of stock ownership, is crucial in determining whether a foreign corporation is controlled by U. S. shareholders. Taxpayers cannot avoid controlled foreign corporation status through formalistic arrangements that do not result in a genuine transfer of control. Legal practitioners should carefully analyze the actual control dynamics when structuring transactions involving foreign corporations to ensure compliance with the substance-over-form doctrine. This case may influence how multinational corporations structure their foreign subsidiaries to avoid unintended tax consequences. Subsequent cases, such as those involving similar tax avoidance strategies, have referenced *Garlock Inc. v. Commissioner* to support the application of the substance-over-form doctrine in tax law.