Greenfield v. Commissioner, 60 T. C. 425 (1973)

A controlled foreign corporation's increase in earnings invested in U. S. property is taxable to U. S. shareholders, even if transactions involve related parties.

Summary

In Greenfield v. Commissioner, the U. S. Tax Court ruled that U. S. shareholders of a controlled foreign corporation must include in their gross income the corporation's increase in earnings invested in U. S. property. The case involved two transactions: a $100,000 transfer to a U. S. corporation and the subordination of a $100,000 debt. The court found the transfer to be a taxable investment in U. S. property under I. R. C. § 951(a) and § 956, while only the increase in the debt ($29,958) was taxable. The decision clarifies the taxation of controlled foreign corporation investments and the application of exceptions under § 956(b)(2)(C).

Facts

Clayton E. Greenfield and Fred S. Bugg, U. S. shareholders of Carline Ltd. (a Bahamian controlled foreign corporation), were involved in two transactions. First, Carline Ltd. transferred $100,000 to Carline Electric Corp. (a U. S. corporation), which was used to issue preferred stock to Greenfield and Bugg. The funds were then redeposited into Carline Electric's account. Second, Carline Ltd. subordinated a $100,000 debt from Carline Electric to obtain a performance bond. The open account between the corporations showed a consistent balance in favor of Carline Ltd. , indicating that the debt exceeded amounts necessary for normal business operations.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioners' 1964 tax returns, asserting that the $200,000 from both transactions constituted taxable income. The case was reassigned from Judge Austin Hoyt to Judge Theodore Tannenwald, Jr. in December 1972. The Tax Court heard the case and issued its decision on June 13, 1973.

Issue(s)

1. Whether the $100,000 transfer from Carline Ltd. to Carline Electric Corp. constituted an increase in earnings invested in U. S. property under I. R. C. § 951(a) and § 956.
2. Whether the subordination of the $100,000 debt from Carline Electric to Carline Ltd. constituted an increase in earnings invested in U. S. property under the same sections.
3. Whether the transactions constituted constructive dividends to the petitioners.

Holding

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1. Yes, because the $100,000 transfer was not excluded under § 956(b)(2)(C) and was taxable to the petitioners under § 951(a).
2. Yes, because the increase in the debt from $64,056 to $94,014 ($29,958) was taxable under § 951(a) and § 956, as it was not excluded under § 956(b)(2)(C).
3. No, because the transactions did not result in personal benefit to the petitioners sufficient to constitute constructive dividends.

Court's Reasoning

The court applied § 951(a) and § 956 to determine that the $100,000 transfer was an investment in U. S. property because it did not fall under the exception in § 956(b)(2)(C), which excludes obligations arising from ordinary and necessary business transactions. The court found no evidence that the transfer was a loan with a one-year maturity or that it was collected within a year. Regarding the subordinated debt, the court held that only the increase in the debt ($29,958) was taxable, as the balance in favor of Carline Ltd. before December 31, 1962, was not subject to § 956. The court rejected the constructive dividend argument, noting that the funds remained in corporate solution and were not for the personal benefit of the petitioners.

Practical Implications

This decision impacts how controlled foreign corporations and their U. S. shareholders must account for investments in U. S. property. It clarifies that transfers between related parties can be taxable under § 951(a) and § 956, even if they are structured as loans or capital contributions. The case also limits the application of the § 956(b)(2)(C) exception, requiring that obligations not exceed amounts necessary for ordinary and necessary business transactions. Practitioners should carefully review transactions between related entities to ensure compliance with these rules. Subsequent cases, such as David F. Bolger (59 T. C. 760 (1973)), have applied similar reasoning to determine the tax treatment of related-party transactions involving controlled foreign corporations.

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