Dougherty v. Commissioner, 60 T. C. 917 (1973)

Pre-1963 earnings of a controlled foreign corporation can be considered as invested in U. S. property for tax purposes under subpart F.

Summary

Albert L. Dougherty, the sole shareholder of Dougherty Overseas, Inc. (Liberia), a controlled foreign corporation, challenged the IRS's inclusion of pre-1963 earnings in his gross income under section 951(a)(1)(B) due to Liberia's investment in U. S. property. The court ruled that pre-1963 earnings could be taxed when invested in U. S. property, rejecting Dougherty's arguments on statutory interpretation and constitutionality. The court also determined that Liberia used a calendar year accounting period and upheld Dougherty's late election to be taxed at corporate rates under section 962.

Facts

Albert L. Dougherty was the sole shareholder of Dougherty Overseas, Inc. (Liberia), a Liberian corporation established in 1956 for construction projects abroad. By 1963, Liberia had no current earnings but had accumulated earnings and profits of $1,887,272. 75 from prior years. During 1963, Liberia loaned money to related U. S. entities: $17,151. 16 to A. L. Dougherty Overseas, Inc. (Indiana), and $37,167. 07 to A. L. Dougherty Co. (Company), a sole proprietorship. These loans were not repaid within one year. The IRS determined these loans constituted an increase in earnings invested in U. S. property under section 956, leading to a tax deficiency of $412,241. 87 for Dougherty.

Procedural History

The IRS issued a statutory notice of deficiency to Dougherty for 1963, asserting that the increase in Liberia's earnings invested in U. S. property should be included in Dougherty's gross income. Dougherty petitioned the U. S. Tax Court, challenging the inclusion of pre-1963 earnings, the constitutionality of the tax, Liberia's taxable year, and the calculation of the increase. The court addressed these issues in its decision.

Issue(s)

1. Whether pre-1963 earnings and profits of a controlled foreign corporation are to be considered in determining its increase in earnings invested in U. S. property under section 951(a)(1)(B).
2. Whether the application of section 951(a)(1)(B) to pre-1963 earnings is constitutional.
3. Whether Liberia's taxable year for subpart F purposes was a fiscal year ending August 31 or a calendar year.
4. What was the proper measure of Liberia's increase in earnings invested in U. S.

property for 1963?
5. Whether Dougherty made an effective election under section 962 to be taxed at corporate rates.

Holding

1. Yes, because the statute's language and legislative history support including pre-1963 earnings when invested in U. S. property.
2. Yes, because Congress has the power to tax income generated by pre-1963 earnings when reinvested in U. S. property.
3. No, because the evidence showed Liberia used a calendar year as its accounting period.
4. The court determined Liberia's increase in earnings invested in U. S. property for 1963 was $51,201. 92, based on loans to Indiana and Company not repaid within one year.
5. Yes, because Dougherty's late election was timely and not inconsistent with his earlier actions.

Court's Reasoning

The court interpreted section 956(a)(1) to include pre-1963 earnings when invested in U. S. property, rejecting Dougherty's argument that only post-1962 earnings should be considered. The court found no constitutional barrier to taxing pre-1963 earnings when reinvested, distinguishing this from direct taxation of capital. Evidence showed Liberia used a calendar year, not a fiscal year ending August 31, for accounting purposes. Loans to Indiana and Company were considered U. S. property under section 956(b)(1)(C), while loans to Illinois Basin Oil Association, Inc. (IBOA) were excluded due to IBOA's inability to repay within one year. The court upheld Dougherty's late election under section 962, finding it timely and consistent with his position throughout the tax proceedings.

Practical Implications

This decision clarifies that pre-1963 earnings of a controlled foreign corporation can be taxed when invested in U. S. property, affecting how similar cases are analyzed. It emphasizes the importance of the timing and nature of investments in U. S. property by foreign corporations. Tax practitioners must consider the potential tax consequences of such investments, even if the earnings were accumulated before the effective date of subpart F. The ruling also highlights the need for clear documentation of a foreign corporation's accounting period, as this can impact the application of subpart F. Later cases, such as *Clayton E. Greenfield*, have applied or distinguished this ruling based on the specifics of the investments involved. This case also demonstrates the flexibility courts may apply in accepting late elections under section 962, provided they are consistent and timely under the circumstances.