Gray v. Commissioner, 71 T. C. 719 (1979)

The taxable year for including undistributed foreign personal holding company income is the shareholder's tax year in which or with which the company's taxable year ends, with the amount taxable based on a pro rata share of the income up to the last day of U. S. group ownership.

Summary

In Gray v. Commissioner, the U. S. Tax Court clarified the timing and calculation of taxable undistributed foreign personal holding company income under IRC section 551(b). The case involved petitioners who owned a foreign personal holding company (Yarg) that received a dividend from another foreign corporation (Omark 1960). After the dividend, petitioners sold their Yarg stock. The court held that petitioners were taxable in their 1963 tax year on their pro rata share of Yarg's undistributed income for its fiscal year ending June 30, 1963, calculated up to the sale date in 1962. This decision underscores the importance of understanding the interplay between corporate and shareholder tax years when dealing with foreign personal holding companies.

Facts

In 1962, petitioners owned 90. 4% of Omark, a domestic corporation, which fully owned Omark 1960, a Canadian corporation. Yarg, another Canadian corporation fully owned by petitioners, held preferred stock in Omark 1960. On September 25, 1962, Omark 1960 redeemed all its preferred stock from Yarg for $1. 5 million (Canadian). Immediately after, petitioners sold all their Yarg stock to a third party, Frank H. Cameron. Both Yarg and Omark 1960 used a fiscal year ending June 30, while petitioners used a calendar year for tax purposes.

Procedural History

The case initially went to the U. S. Tax Court, where the court found petitioners taxable on the redemption proceeds under a liquidation theory. On appeal, the Ninth Circuit reversed, rejecting the liquidation theory and remanding the case for further proceedings consistent with its opinion. On remand, the Tax Court addressed the timing and calculation of the taxable undistributed foreign personal holding company income.

Issue(s)

1. Whether petitioners are taxable in their 1962 or 1963 tax year on Yarg's undistributed foreign personal holding company income?
2. Whether the amount of taxable income should be all of Yarg's undistributed income as of the sale date or a pro rata share based on the portion of Yarg's fiscal year up to the sale date?

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Holding

1. No, because IRC section 551(b) specifies that the income is taxable in the shareholder's tax year in which or with which the company's taxable year ends, which in this case was 1963.
2. No, because the taxable amount is a pro rata share of Yarg's undistributed income for its fiscal year ending June 30, 1963, calculated up to September 25, 1962, the last day of U. S. group ownership.

Court's Reasoning

The court applied IRC section 551(b), which governs the timing and calculation of taxable undistributed foreign personal holding company income. The court rejected the Commissioner's argument that all of Yarg's income as of the sale date should be taxable to petitioners in 1962, finding this contrary to the statute's clear language and the Ninth Circuit's opinion. The court also dismissed the Commissioner's new theory of a post-sale liquidation of Yarg, as this was inconsistent with the Ninth Circuit's rejection of a similar pre-sale liquidation theory. The court emphasized that the taxable year for the income inclusion was determined by the end of Yarg's fiscal year (June 30, 1963), and the amount taxable was a pro rata share based on the portion of that year up to the sale date, as specified in section 551(b). The court quoted the statute to underscore its application: "Each United States shareholder, who was a shareholder on the day in the taxable year of the company which was the last day on which a United States group. . . existed with respect to the company, shall include in his gross income, as a dividend, for the taxable year in which or with which the taxable year of the company ends. . . "

Practical Implications

This decision clarifies that when dealing with undistributed foreign personal holding company income, the timing of tax inclusion for U. S. shareholders is based on the end of the foreign company's taxable year, not the date of a change in ownership. The amount taxable is a pro rata share based on the portion of the foreign company's year during which the U. S. group existed. This ruling affects how tax professionals should analyze similar cases, particularly in planning the timing of stock sales in foreign personal holding companies. It also underscores the importance of aligning corporate and shareholder tax years to optimize tax outcomes. Subsequent cases, such as Estate of Whitlock v. Commissioner, have applied this principle in determining the timing and calculation of taxable income from foreign personal holding companies.

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