Compaq Computer Corp. v. Commissioner, 113 T. C. 214, 1999 U. S. Tax Ct. LEXIS 44, 113 T. C. No. 17 (1999)

A transaction lacking economic substance and designed solely for tax avoidance cannot generate a valid foreign tax credit.

Summary

In Compaq Computer Corp. v. Commissioner, the U. S. Tax Court ruled that Compaq's prearranged transaction involving the purchase and immediate resale of American Depository Receipts (ADRs) lacked economic substance and was designed solely to generate a foreign tax credit. Compaq purchased ADRs cum dividend and resold them ex dividend, resulting in a capital loss offset against prior gains and a claimed foreign tax credit. The court disallowed the credit, finding the transaction had no business purpose beyond tax reduction and imposed an accuracy-related penalty for negligence.

Facts

Compaq Computer Corporation engaged in a transaction designed by Twenty-First Securities Corporation to eliminate market risks. On September 16, 1992, Compaq purchased 10 million Royal Dutch Petroleum Company ADRs on the New York Stock Exchange from Arthur J. Gallagher and Company, then immediately resold them back to Gallagher. The purchase was made cum dividend, and the resale ex dividend, allowing Compaq to be the shareholder of record on the dividend date. Compaq received a $22,545,800 dividend, less $3,381,870 in withheld foreign taxes, and reported a $20,652,816 capital loss, which offset previously realized capital gains. The net cash-flow from the transaction was a $1,486,755 loss.

Procedural History

The Commissioner of Internal Revenue challenged Compaq's foreign tax credit claim and imposed an accuracy-related penalty. The case was heard by the U. S. Tax Court, which consolidated the foreign tax credit issue with other issues involving Compaq's 1992 tax year.

Issue(s)

1. Whether Compaq's ADR transaction lacked economic substance and was solely designed for tax avoidance.
2. Whether Compaq is liable for an accuracy-related penalty due to negligence.

Holding

1. Yes, because the transaction was prearranged to yield a specific result, eliminate all market risks, and had no business purpose apart from obtaining a foreign tax credit.

© 2025 SCOTUSreports.com. All rights reserved.

2. Yes, because Compaq's failure to investigate the economic substance of the transaction constituted negligence.

Court's Reasoning

The court applied the economic substance doctrine, determining that the transaction lacked both economic substance and a business purpose. The court noted that Compaq's transaction was a prearranged, risk-free scheme designed solely to generate a foreign tax credit. The court cited Frank Lyon Co. v. United States for the principle that transactions must have genuine economic substance to be respected for tax purposes. The court also referenced cases like ACM Partnership v. Commissioner and Friendship Dairies, Inc. v. Commissioner, which disallowed tax benefits from transactions lacking economic substance. The court emphasized that Compaq's failure to conduct a thorough investigation before entering the transaction indicated negligence, justifying the accuracy-related penalty under section 6662(a).

Practical Implications

This decision reinforces the application of the economic substance doctrine to foreign tax credits, warning taxpayers against engaging in transactions designed solely for tax avoidance. Practitioners must carefully evaluate the economic substance and business purpose of transactions, especially those involving foreign tax credits. The ruling may deter similar tax avoidance schemes and encourage more rigorous due diligence before entering into complex financial transactions. Subsequent cases like IES Industries, Inc. v. United States have cited Compaq in applying the economic substance doctrine to deny tax benefits from artificial transactions.

© 2025 SCOTUSreports.com. All rights reserved.