Framatome Connectors USA, Inc. v. Commissioner, 118 T. C. 32 (2002)

In Framatome Connectors USA, Inc. v. Commissioner, the U. S. Tax Court ruled that Burndy-Japan was not a controlled foreign corporation (CFC) in 1992 due to Burndy-US's inability to control it, affecting foreign tax credits. Additionally, the court found that Burndy-US's 1993 transfers to FCI were constructive dividends subject to withholding tax under section 1442, despite claims of arm's-length transactions. This decision clarifies the criteria for CFC status and the treatment of constructive dividends in international tax law.

Parties

Framatome Connectors USA, Inc. , and Burndy Corporation (collectively referred to as Petitioners) challenged the determinations of the Commissioner of Internal Revenue (Respondent) in the United States Tax Court. Framatome Connectors USA, Inc. , was the successor to Burndy Corporation, which was involved in the transactions at issue. The Commissioner of Internal Revenue represented the interests of the United States government in the enforcement of tax laws.

Facts

In 1961, Burndy-US, Furukawa Electric Co. , and Sumitomo Electrical Industries, Ltd. , formed Burndy-Japan to manufacture and sell Burndy-US products in Japan. Initially, each owned a one-third interest, but in 1973, Burndy-US increased its ownership to 50%, with Furukawa and Sumitomo each holding 25%. The 1973 agreement granted veto powers to Furukawa and Sumitomo over certain decisions of Burndy-Japan. In 1993, Burndy-US acquired an additional 40% of Burndy-Japan from Furukawa and Sumitomo through its parent, FCI, resulting in a 90% ownership. This transaction involved the transfer of European subsidiaries and cash to FCI, which was more valuable than the Burndy-Japan stock received by Burndy-US. Additionally, in 1992, Burndy-US acquired assets and a noncompetition agreement from TRW, Inc. , and transferred European subsidiaries to FCI in exchange.

Procedural History

The Commissioner issued notices of deficiency for income tax, penalties, and withholding tax against the Petitioners for the years 1991, 1992, and 1993. The Petitioners filed petitions with the U. S. Tax Court contesting these determinations. The court's review involved analyzing whether Burndy-Japan was a CFC in 1992 and whether the 1993 transfers from Burndy-US to FCI constituted constructive dividends subject to withholding tax. The standard of review applied was de novo, meaning the court independently assessed the facts and law.

Issue(s)

Whether Burndy-Japan was a controlled foreign corporation of Burndy-US in 1992 under section 957(a)?

Whether the transfers from Burndy-US to FCI in 1993 of assets worth more than the assets received from FCI were constructive dividends subject to withholding tax under section 1442?

Rule(s) of Law

A foreign corporation is considered a CFC if U. S. shareholders own more than 50% of the total combined voting power of all classes of its stock or more than 50% of the total value of its stock, as per section 957(a). Constructive dividends are distributions of corporate earnings and profits to shareholders, which are taxable under section 316(a). Withholding tax applies to dividends paid to foreign entities under section 1442. The U. S. -France Tax Treaty, in effect during the years in issue, defines dividends to include income treated as a distribution by the taxation laws of the contracting state of the distributing company.

Holding

The court held that Burndy-Japan was not a CFC of Burndy-US in 1992 because Burndy-US did not own more than 50% of the voting power or more than 50% of the value of Burndy-Japan's stock. The court also held that the transfers from Burndy-US to FCI in 1993, where the value transferred exceeded the value received, were constructive dividends subject to withholding tax under section 1442.

Reasoning

The court's reasoning for the CFC determination included an analysis of the veto powers held by Furukawa and Sumitomo, which reduced Burndy-US's voting power below the 50% threshold required by section 957(a)(1). The court also considered the value of Burndy-Japan's stock, concluding that the veto powers and the inability to extract private benefits meant that Burndy-US did not own more than 50% of the stock's value under section 957(a)(2). For the withholding tax issue, the court found that the excess value transferred to FCI in 1993 constituted constructive dividends because the transactions were not at arm's length, and the excess value was distributed to FCI. The court rejected the Petitioners' argument that the U. S. -France Tax Treaty excluded constructive dividends from withholding tax, interpreting the treaty to include income treated as a distribution under U. S. tax law. The court also noted that the Petitioners were bound by the form of their transactions and could not recast them to gain tax advantages.

Disposition

The court ruled that decisions would be entered under Rule 155, indicating that the court would calculate the precise amount of tax due based on its findings.

Significance/Impact

This case is significant for its interpretation of the criteria for CFC status and the treatment of constructive dividends under withholding tax. It clarifies that veto powers can significantly impact the determination of voting power and stock value for CFC purposes. The decision also emphasizes that constructive dividends, even in the context of international transactions, are subject to withholding tax under section 1442, and that the U. S. -France Tax Treaty does not provide an exemption for such dividends. This ruling has implications for multinational corporations engaging in transactions with foreign affiliates, particularly in assessing the tax treatment of such transactions and the applicability of international tax treaties.

