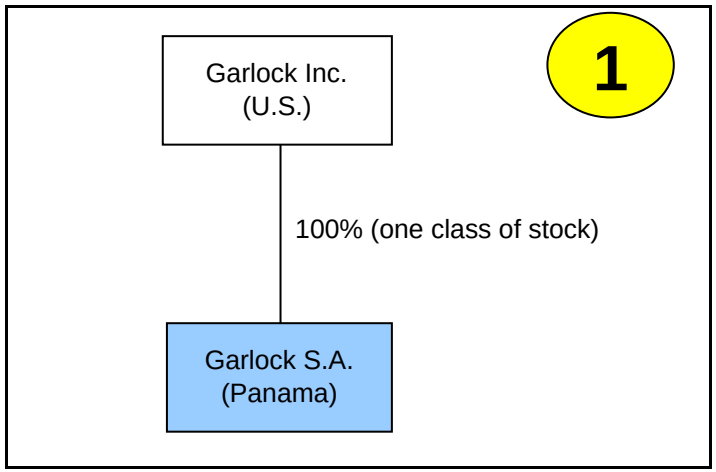
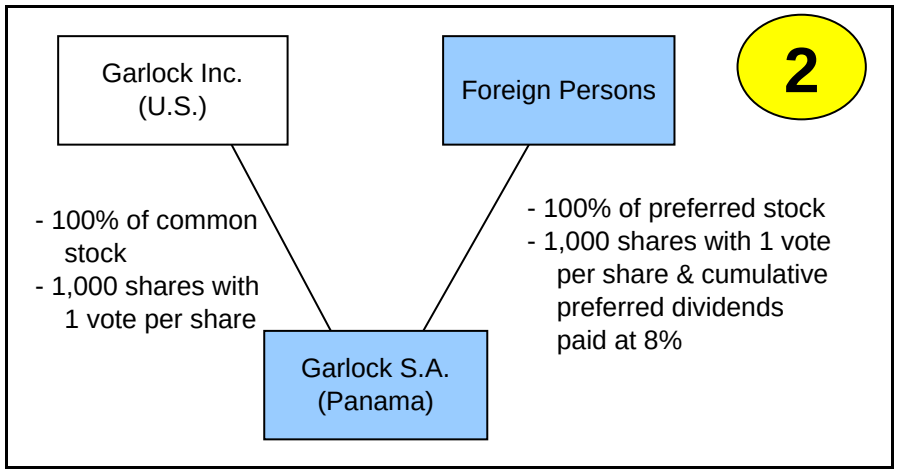
Garlock Inc. v. Commissioner
489 F.2d 197 (2d Cir. 1973)

Shift of Formal Voting Power to Avoid CFC Status

Initial Structure (1962)



After Recapitalization (1963)



Through December, 1962, Garlock S.A. had one class of common stock issued and outstanding, all of which was owned by Garlock, Inc. On December 4, 1962, the president of Garlock submitted a written report to his board of directors proposing a recapitalization of Garlock, S.A. That report, referenced provisions in the Revenue Act of 1962 which tax earnings of CFC's after January 1, 1963, (subpart F income) whether or not those earnings were repatriated as dividends. The report stated: "to avoid this tax result it will be necessary to change the capital stock structure and voting rights in such a way that Garlock, S. A., will no longer be a controlled foreign corporation as defined in the Revenue Act." The report went on to propose that Garlock S.A. would "place this stock [the preferred] with foreign investors who understand our motives and are willing to vote their stock with us in return for an ample dividend rate--probably 8%"

Treas. Reg. §1.957-1(b)(2) provides, inter alia, that any arrangement to shift formal voting power away from United States shareholders "will not be given effect if in reality voting power is retained." It provides further that "The mere ownership of stock entitled to vote does not by itself mean that the shareholder owning such stock has the voting power of such stock for purposes of section 957." In floor debate on the bill Senator Kerr specifically referred to the fact that, if the bill were passed, "It will no longer be possible to flout our tax laws by simply setting up an address company, say in Panama, to sell goods in Europe which did not originate in Panama, which never in fact were in Panama, and which had nothing to do with Panama." The Second Circuit agreed with the Tax Court that the preferred shareholders' voting power here was "illusory" and that Garlock SA was a CFC.