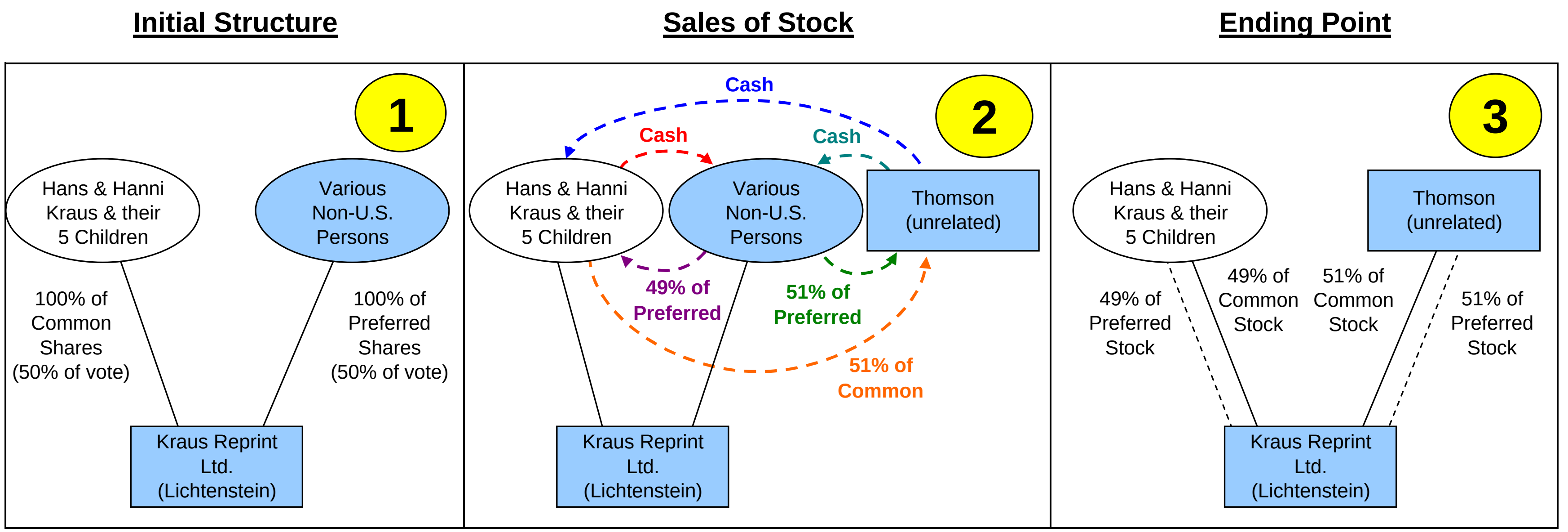
Kraus v. Commissioner
490 F.2d 898 (2d Cir. 1974)

Corporation Treated as CFC and Gain on Sale Treated as Dividend Income



On July 30, 1965 each of the taxpayers sold part of the common shares which he held in Kraus Reprint, Ltd. (KRL), a Liechtenstein corporation, realizing a substantial gain. Section 1248(a) provides that a gain realized by U.S. shareholders on the sale of foreign stock shall be treated as a dividend (rather than as a capital gain) "to the extent of the earnings and profits of the foreign corporation attributable . . . to such stock which were accumulated in taxable years of such foreign corporation beginning after December 31, 1962 and during the period or periods the stock sold . . . was held by such person[s] while such foreign corporation was a controlled foreign corporation." The taxpayers reported the entire gain on the sale of their stock as a long-term capital gain. The Internal Revenue Service found, however, that KRL had been a "controlled foreign corporation," and therefore, determined that the proportion of the gain equal to all the earnings and profits accumulated by KRL and attributable to the stock during the relevant period should be treated as a dividend.

Any arrangement to shift formal voting power away from United States shareholders of a foreign corporation will not be given effect if in reality voting power is retained. 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. The court held that "[i]t defies credulity that the taxpayers who owned 100% of KRL, a corporation which at the end of the fiscal year 1962 had a net worth in excess of $250,000, and was then making annual profits in excess of $225,000, would surrender 50% of the control of their corporation to new shareholders who were making a capital contribution of SFr. 100,000, less than $25,000."

The new preferred stockholders were carefully selected, moreover, so that no rocking of the corporate boat could be anticipated. Although the common stock was in bearer form and freely transferable, the preferred stock was registered and transfer was permitted only with the approval of the board of directors. Transfer could be prohibited for "important reasons" and there was no definition or suggestion as to what such reasons might be. Even shares passing by operation of law could be denied registration if the corporation itself desired to purchase the shares. The board of directors had the right to redeem the preferred shares at par value, plus past due and current dividends, on three months' notice. While no single factor set forth might in itself be sufficient to establish that KRL was a "controlled foreign corporation" the sum total establishes that was.