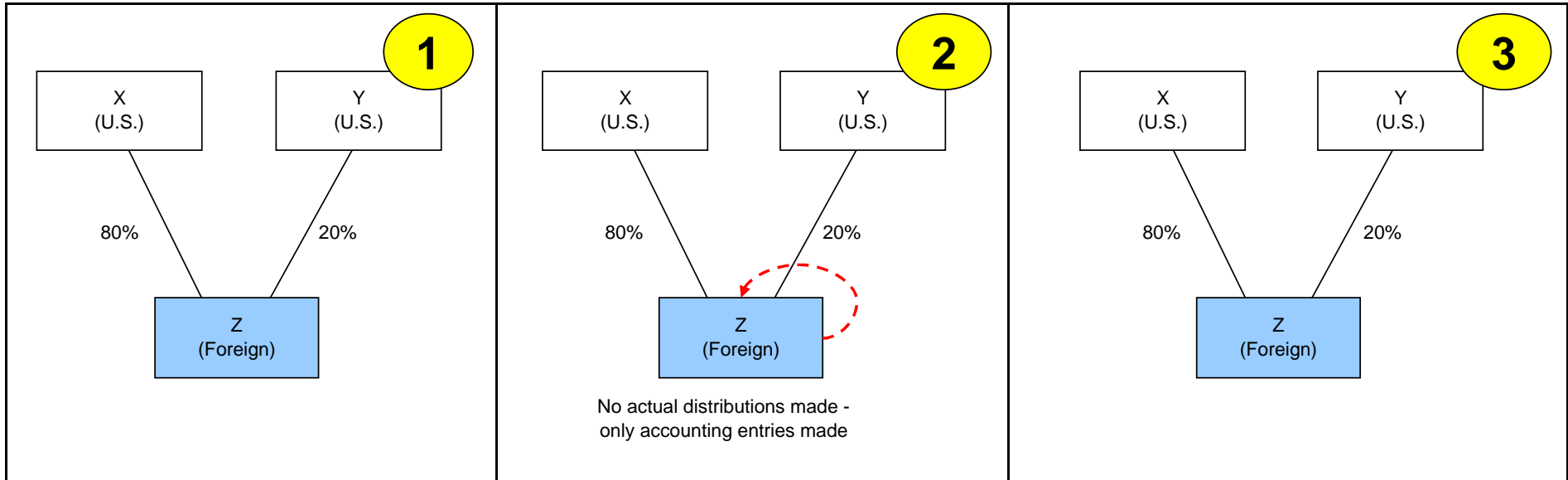


**Foreign Corporation's
Capitalization of Earnings is a
Section 305 Stock Dividend**

Initial Structure

Dividend Declaration & Payment

Ending Point



Under foreign law, Z's profits that are not "capitalized" are taxed to the corporation at a higher rate than capitalized earnings. Earnings are capitalized by declaring and purported paying a dividend. However, rather than actually paying a dividend, accounting entries are made to reflect a decrease in earnings and an increase in capital.

No cash or shares of stock were distributed to the shareholders. The written resolution declaring the dividend stated that the payment would be made in cash. However, the resolution also stated that the dividend would be utilized to cover a new share issue.

The ruling held that although a resolution declaring a cash dividend raises a presumption that a cash dividend is intended, the presumption is rebutted when the resolution ties up the "cash" dividend so effectively that the shareholders (1) never receive it, (2) never exercise any control with respect to it, and (3) the dividend is used to pay for additional stock. The capitalization of profits had the effect of a section 305 stock dividend.