Kraus v. Commissioner, 59 T. C. 681 (1973)

The substance of control, rather than the form of stock ownership, determines whether a foreign corporation is a controlled foreign corporation under section 957(a).

Summary

Kraus v. Commissioner involved the petitioners' attempt to avoid the controlled foreign corporation (CFC) status of Kraus Reprint, Ltd. (KRL) by issuing preferred stock with voting rights to non-U. S. shareholders. The U. S. Tax Court held that despite the formal reduction of voting power below 50%, the petitioners retained control through restrictive provisions on the preferred stock, which could be redeemed at the corporation's discretion. This ruling emphasized the principle that substance over form governs the determination of control for tax purposes, resulting in KRL being classified as a CFC. Consequently, the gains from the petitioners' sale of KRL stock were treated as dividends under section 1248.

Facts

The petitioners, U. S. shareholders, owned 100% of KRL, a Liechtenstein corporation. In December 1962, KRL issued preferred stock with voting power to non-U. S. shareholders, reducing U. S. shareholders' voting power to below 50%. The preferred stock was subject to restrictions, including board approval for transfer and redemption at par value on three months' notice. In 1965, the petitioners sold 51% of their common stock to Thomson International Corp. , Ltd. , and the preferred shareholders sold their stock to Bank Und Finanz, which later sold it to Thomson and the petitioners.

Procedural History

The Commissioner determined deficiencies in the petitioners' 1965 Federal income tax, treating the gains from the sale of KRL stock as dividends under section 1248. The case proceeded to the U. S. Tax Court, where the petitioners argued that KRL was not a CFC due to the issuance of preferred stock to non-U. S. shareholders.

Issue(s)

1. Whether Kraus Reprint, Ltd. was a controlled foreign corporation within the meaning of section 957(a) after the issuance of preferred stock to non-U. S. shareholders.

Holding

1. Yes, because despite the formal reduction of voting power below 50%, the petitioners retained effective control through the restrictive provisions on the preferred stock, which allowed for its redemption at the corporation's discretion.

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Court’s Reasoning

The court applied the substance-over-form doctrine, emphasizing that the petitioners’ control over KRL was not meaningfully altered by the issuance of preferred stock. The court noted the restrictions on the preferred stock, including the requirement of board approval for transfer and the ability to redeem it at par value, which effectively nullified the voting power of the preferred shareholders. The court also considered the lack of participation by preferred shareholders in corporate governance and the coordinated sale of preferred stock prior to the petitioners’ sale of common stock to Thomson. The court cited section 1. 957-1(b)(2) of the Income Tax Regulations, which states that arrangements to shift formal voting power away from U. S. shareholders will not be recognized if voting power is retained in reality. The court concluded that the petitioners never intended to relinquish control, and the preferred shareholders did not intend to exercise their voting rights, thus maintaining KRL’s status as a CFC.

Practical Implications

This decision reinforces the importance of substance over form in determining control for tax purposes. Attorneys and tax professionals must carefully structure transactions to ensure that any changes in control are substantive and not merely formal. The ruling impacts how similar cases involving the manipulation of voting power to avoid CFC status should be analyzed, emphasizing the need to examine the economic realities and control mechanisms behind stock issuances. Businesses must be cautious when attempting to alter their tax status through stock restructuring, as the IRS and courts will scrutinize such arrangements. Subsequent cases, such as Garlock Inc. , have further clarified the application of the substance-over-form doctrine in the context of CFCs.

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