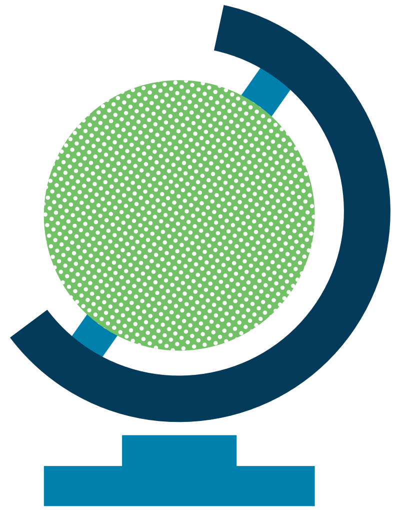

INTERNATIONAL TIDBIT:

BREAKING UP IS HARD TO DO – IF STOCK IS STAPLED

Setting up a multinational business often involves groups of investors based in the U.S. and abroad, including extended families with roots in foreign countries and commercial enterprises to match. For example, the foreign participants may want to minimize exposure to U.S. tax and reporting requirements on income earned by a foreign corporation ("ForCo"), which would arise if ForCo is a "controlled foreign corporation" held by a U.S. corporation ("USCo").

MIRROR STRUCTURE

What looks like a practical solution – parallel structures involving the same shareholders investing in USCo and ForCo as brother-sister entities – can have expensive and unforeseen consequences if IRC section 269B, the so-called stapled stock provision, applies.

In this example, shares of USCo and ForCo are "stapled interests" if, by reason of restrictions on transfer of shares, the transfer of shares of ForCo requires that shares of USCo also be transferred (and vice versa). Interests are considered stapled even if such restrictions are not part of the formal governance documents of USCo and ForCo, such as the by-laws of the entities, but rather are found in an agreement among shareholders or in voting trusts.

STAPLED ENTITIES

Once "stapled interests" exist, USCo and ForCo are considered "stapled entities" if more than 50% in value of the beneficial ownership of each of them consists of "stapled interests," such as the shares subject to the restrictions. Complete identity of owners and percentage ownership is not needed for stapled interests in USCo and ForCo to result in stapled entities impacting all the shareholders.

The consequence of stapling, for purposes of U.S. federal income tax, is that ForCo is treated as a domestic corporation unless it is viewed as "foreign owned" because less than 50% of total combined voting power of all classes of stock entitled to vote and of total value of stock of ForCo is held by U.S. persons. In making this determination, the attribution rules of the Code apply.

As a domestic corporation, ForCo is subject to tax on its worldwide income. However, Treasury Regulations under IRC section 269B provide that ForCo, treated as a domestic corporation, is not eligible to join in a consolidated return with USCo and that the dividends received deduction under IRC section 243 is not available for dividends paid to ForCo's shareholders that are U.S. corporations. The statute and regulations deny recourse to double taxation treaties for relief. The result can be that having stapled entities is worse for their owners than if ForCo had started life as a controlled foreign corporation owned 100% by USCo.

IDENTIFYING THE ISSUE

The first instance when owners of USCo and ForCo learn that their entities are stapled may be in the course of an IRS audit of USCO, meaning that there could be unpaid taxes dating back years. Regulations give the IRS several possible ways to collect tax due as a result of ForCo being treated as a domestic corporation. If ForCo fails to pay the tax due, the IRS can seek to collect it from USCo. If USCo also fails to pay, the IRS can look to shareholders owning at least 10% of ForCo for payment of their proportionate share of ForCo's tax assessed to USCo but remaining unpaid. This is not limited to shareholders of ForCo who are U.S. persons.

UNSTAPLING

Once stapled, there are tax consequences if circumstances change and the stock of ForCo is no longer considered stapled to USCo. Unstapling involves a deemed conversion from a domestic corporation to a foreign one under IRC section 368(a)(1)(F) but implicating the outbound "toll charge" provisions of the regulations under IRC section 367(a). Therefore, if entities are stapled, merely shuffling ownership interests in an attempt to unstaple can have far-reaching tax consequences and should not be undertaken without understanding the U.S., and possibly foreign, tax costs involved.

As the foregoing demonstrates, what sounds like an equitable or even an advantageous idea when setting up a multinational business can have expensive consequences. Breaking up is not only hard to do, but expensive, if stapled stock is involved.