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NOTE

STAPLED STOCK AND I.R.C. SECTION 269B: ILL-CONCEIVED CHANGE IN THE RULES OF INTERNATIONAL TAX JURISDICTION

Domestic corporations with significant overseas business employ stapled stock arrangements[1] to escape United States taxation of income earned abroad. The domestic corporation avoids this tax liability by incorporating its foreign operations in a foreign tax haven[2] and then widely dispersing ownership of the new foreign corporation among its own shareholders through a stock-on-stock dividend. Foreign corporations with widely held stock fall outside the United States's tax jurisdiction. To retain a close beneficial relationship with the new foreign corporation, the domestic corporation "staples" or "pairs" its own stock with the newly issued stock of the foreign corporation. The pairing arrangement restricts subsequent stock transfers to ensure that ownership in the foreign corporation passes only with a fixed ratio of ownership in the domestic corporation. Consequently, the same shareholders own both corporations, and presumably will continue to operate the companies in a mutually beneficial manner.

As part of the Tax Reform Act of 1984,[3] Congress added section 269B[4] to the Internal Revenue Code in an effort to increase revenue collection by ending the abusive use of stapled stock. Section 269B extends United States tax jurisdiction to include otherwise nontaxable foreign corporations that are paired with domestic entities and unilaterally overrides all United States tax treaty provisions that might shield foreign corporations from direct United States tax jurisdiction. The shortsighted solution offered by section 269B represents an unprecedented expansion of United States tax jurisdiction and fails to conform with international standards of tax

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1 Stapled stock arrangements exist where one independent corporation "staples" or "pairs" its stock to that of a second independent corporation. Hence, any future transfer of an interest in one corporation triggers a simultaneous transfer of an interest in the second corporation.

2 For the purpose of this Note, a tax haven is a jurisdiction that taxes types and levels of income at a lower rate than that of the United States. For a description of other characteristics typically associated with tax havens and a list of such jurisdictions, see generally B. SPITZ, TAX HAVENS ENCYCLOPAEDIA (1975).

3 The Tax Reform Act of 1984 is contained in the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 494.

4 I.R.C. § 269B (Supp. II 1984).

jurisdiction. Moreover, the treaty override provisions jeopardize the future viability and cooperative enforcement of United States tax treaties. Instead, Congress should close the stapled stock loophole by treating stapled foreign corporations as fully owned subsidiaries of their domestic counterparts and ignore the distribution of stapled foreign corporations' ownership among many individual shareholders.

I
BACKGROUND

A. United States Tax Jurisdiction

The United States employs three independent bases for asserting tax jurisdiction: citizenship, residency, and geographic location. The interaction of these three bases of jurisdiction often creates double taxation through the overlap of the United States and foreign tax jurisdictions. Bilateral tax treaties partially mitigate double taxation's harmful effects. Except for the due process clause, which proscribes arbitrary taxation,[5] no constitutional provision[6] or international law[7] restricts the scope of United States tax jurisdiction. Instead jurisdictional limits within the Internal Revenue Code are the product of compromise, convenience, and politics.[8]

The current bases for exerting United States jurisdiction parallel in personam and in rem jurisdiction.[9] Jurisdiction over the person for tax purposes stems from United States residence or citizenship,[10] and jurisdiction over a transaction or property arises from existence of the res within the United States's geographic lim-

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5 Brushaher v. Union Pac. R.R., 240 U.S. 1, 24 (1915) (for tax to violate fifth amendment due process clause, government must have acted in fashion "so arbitrary . . . that it was not the exertion of taxation but a confiscation of property").

6 The scope of "power to lay and collect taxes" delegated to Congress by art. I, § 8 of the Constitution covers "every conceivable power of taxation." 240 U.S. at 12. The sixteenth amendment did not augment Congress's power to tax, but instead eliminated the requirement that direct taxes be apportioned among the states. *Id.* at 17-18. *See* 1 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 4.01 (rev. ed. 1981); 1 R. RHOADES & M. LANGER, INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS § 1.11 (1985).

7 Buruet v. Brooks, 288 U.S. 378, 396 (1933) (United States could exercise sovereign power to tax "without violating any established principle of international law"); 1 R. RHOADES & M. LANGER, *supra* note 6, § 1.11, at 1-3 (no rule of international law limits United States power to tax); Norr, *Jurisdiction to Tax and International Income,* 17 TAX. L. REV. 431, 431 (1962) ("[n]o rules of international law exist to limit the extent of any country's tax jurisdiction").

8 1 R. RHOADES & M. LANGER, *supra* note 6, § 1.11 (Code limitations stem solely from congressional policy decisions).

9 J. BISCHEL & R. FEINSCHREIBER, FUNDAMENTALS OF INTERNATIONAL TAXATION 4 (2d ed. 1985).

10 I.R.C. §§ 11, 61 & 63 (1982 & Supp. II 1984). Citizenship of corporations is based on the jurisdiction of incorporation. I.R.C. § 7701(a)(4)-(5) (1982).

its.[11] By utilizing both residency and citizenship to assert United States jurisdiction over a taxpayer's worldwide income[12] *and* geographic location of income sources or wealth to tax foreign entities on United States source income, the United States tax code reaches more taxpayers and conduct than the codes of most other jurisdictions.[13]

The long reach of United States jurisdiction and the lack of international law regnlating a sovereign's power to tax combine to create double taxation problems. Double taxation occurs when two sovereigns, each acting within its self-created jurisdictional boundaries, impose a full rate of tax on a single income.[14] The specter of double taxation discourages profitable international commerce by threatening business entities with effective tax rates in excess of one hundred percent of taxable income.[15] A government may act unilaterally to spare its constituents the burden of double taxation,[16] but using bilateral tax treaties provides a more equitable and refined solution.[17]

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11 I.R.C. §§ 871, 881 (1982 & Supp. II 1984).

12 For example, few other countries impose tax jurisdiction based on citizenship as well as residency. J. BISCHEL & R. FEINSCHREIBER, *supra* note 9, at 5; Norr, *supra* note 7, at 436-37.

13 Some jurisdictions, particularly Mediterranean and Latin American countries, ignore citizenship or residency and impose income tax only on transactions or sources of wealth geographically located within their borders. Norr, *supra* note 7, at 434-36; Note, *United States International Taxation: Jurisdiction to Tax and Accommodation Among Competing Tax Systems,* 1 N.Y.L. SCH. J. INT'L & COMP. L. 36 (1979).

14 J. BISCHEL & R. FEINSCHREIBER, *supra* note 9, at 5. Double taxation may arise in three ways:

> 1. Two countries assert tax jurisdiction over the parties . . . .
> 2. Two countries assert tax jurisdiction over the transaction . . . .
> 3. One country asserts tax jurisdiction over the parties and the other asserts tax jurisdiction over the transaction . . . .

Id.

15 *Id.* at 6. For example, if two competing jurisdictions each impose a tax rate of 50%, a taxpayer must pay 100% of his income to satisfy both jurisdictions' tax bill.

16 For example, a government may eliminate double taxation by offering a tax credit for income taxes paid to a foreign government. *See infra* notes 31-32 and accompanying text.

17 Unlike unilateral solutions to double taxation, bilateral tax treaties require both parties to forego opportunities for tax income. Kingson, *The Coherence of International Taxation,* 81 COLUM. L. REV. 1151, 1157 (1981). Moreover, bilateral solutions focus on areas that unilateral solutions leave unaddressed. For example, bilateral treaties may establish uniform rnles for the concepts of taxable income, allowances and timing of deductions, and conflicts in sourcing and allocating international income. Bischel, *Basic Treaty Structures and Provisions* in TAX TREATIES IN INTERNATIONAL PLANNING 9 (Practising Law Inst. 1975). The United States recognizes bilateral income tax treaties in force with 35 countries and has approved but not yet put in force treaties with three countries. 10 FED. TAXES (P-H) 42,001, at 42,007-42,009 (1985). Only one treaty, the 1933 U.S.S.R. treaty, fails to address double taxation. 3 R. RHOADES & M. LANGER, *supra* note 6, § 14.03[4].

Although each treaty's details may vary,[18] bilateral tax treaties generally ease the burden of double taxation in two ways. First, where a jurisdictional conflict arises over a transaction, the treaties typically favor the income-earning party's country of residence over the government with geographic jurisdiction over the income source.[19] Second, the treaties reconcile and define common principles of taxation between the jurisdictions to facilitate the use of reciprocal tax credits.[20] These treaties also establish an administrative framework for the efficient exchange of information needed to police the treaty and prevent fraud or fiscal evasion by taxpayers.[21]

The supremacy clause[22] of the Constitution bestows the authority of congressional acts upon validly enacted treaties. The Internal Revenue Code specifically provides that income exempt from taxation by virtue of a treaty obligation remains exempt under the Code.[23] Where treaty provisions directly collide with statutes, the more recent rule prevails.[24] However, for a statute to override an

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18 Variation among the treaties reflects the differences in negotiating postures between the United States and its individual treaty partners. *See* Kingson, *supra* note 17, at 1163-93. In 1977, the IRS unveiled a model treaty intended to provide a more consistent framework for all future treaties. For the text of the treaty, see 3 R. RHOADES & M. LANGER, *supra* note 6, § 15.02.

19 For example the Model Treaty provides that "[t]he business profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein." United States Model Income Tax Treaty, art. VII, *reprinted in* 3 R. RHOADES & M. LANGER, *supra* note 6, § 15.02[7]. *See also* P. MCDANIEL & H. AULT, INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION 167-68 (1981) (describing treaty objectives and techniques). The Model Treaty defines a permanent establishment as "a fixed place of business through which the business of an enterprise is wholly or partly carried on." United States Model Income Tax Treaty, art. V, *reprinted in* 3 R. RHOADES & M. LANGER, *supra* note 6, § 15.02[5](1). One major exception to the rule giving tax priority to the country of residence lies in the "Savings Clause" found explicitly or implicitly in all United States treaties. Under the "Savings Clause," the United States retains authority to tax its citizens as if the treaty were not in force. *See, e.g.*, Convention with Respect to Taxes on Income and on Capital, Sept. 26, 1980, United States-Canada, art. XXIX, *reprinted in* 3 R. RHOADES & M. LANGER, *supra* note 6, § 25.29. Thus, for United States taxpayers the treaties only reduce foreign tax liability, not domestic liability. J. BISCHEL & R. FEINSCHREIBER, *supra* note 9, at 280.

20 *See, e.g.*, United States Model Income Tax Treaty, art. III (General Definitions), *reprinted in* 3 R. RHOADES & M. LANGER, *supra* note 6, § 15.02[3].

21 *See, e.g.*, United States Model Income Tax Treaty, art. XXVI (Exchange of Information and Administrative Assistance), *reprinted in* 3 R. RHOADES & M. LANGER, *supra* note 6, § 15.02[26].

22 "This Constitution and the laws of the United States which shall be made in pursuance thereof; and all treaties made, or which shall be made, under the authority of the United States, shall be the supreme law of the land." U.S. CONST. art. VI, cl. 2.

23 I.R.C. § 894(a) (1982); *see also id.* § 7852(d) (preserving treaty benefits that existed prior to 1954 Code's adoption).

24 *See* Reid v. Covert, 354 U.S. 1, 18 (1957) ("[A]n Act of Congress, which must comply with the Constitution, is on a full parity with a treaty, and . . . when a statute which is subsequent in time is inconsistent with a treaty, the statute to the extent of conflict renders the treaty null.") (footnote omitted); Whitney v. Robertson, 124 U.S.

existing treaty provision, Congress must clearly intend to abrogate that provision.[25]

B. Subpart F and Foreign Corporations

By adding subpart F[26] to the Internal Revenue Code in 1962, Congress indirectly broadened the scope of United States tax jurisdiction to cover foreign corporations controlled by a small number of United States shareholders. If more than fifty percent of a foreign corporation's voting stock resides in the hands of United States shareholders,[27] then subpart F treats the corporation as a Controlled Foreign Corporation subject to United States taxation on the earnings and profits it generates for United States shareholders.[28]

Despite this assertion of United States authority, a jurisdictional problem remains because the subsidiary qualifies as a nonresident, foreign citizen and earns income outside the territorial jurisdiction of the United States.[29] Congress avoided this jurisdictional obstacle by taxing the United States shareholders of the foreign corporation

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190, 194 (1888) ("When the [treaty and an act of legislation] relate to the same subject, the courts will always endeavor to construe them so as to give effect to both, if that can be done without violating the language of either; but if the two are inconsistent, the one last in date will control the other . . . ."); Watson v. Hoey, 59 F. Supp. 197, 200 (S.D.N.Y. 1943) (" 'If there were any legislative violation of the treaties by the enactment of the statute, that enactment being subsequent to the treaties would prevail over them in establishing the law for the courts of this country.' ") (quoting George E. Warren Corp. v. United States, 94 F.2d 597, 599 (2d Cir. 1938)).

25 *See* Cook v. United States, 288 U.S. 102, 120 (1933) ("A treaty will not be deemed to have been abrogated or modified by a later statute unless such purpose on the part of Congress has been clearly expressed.").

26 I.R.C. §§ 951-970 (1982 & Supp. II 1984). Congress enacted subpart F to prevent domestic corporations from manipulating jurisdictional rules to shield their foreign subsidiaries from American taxation. *See, e.g.*, Special Message to the Congress on Taxation, 1961 PUB. PAPERS 290, 295 (speech by President John F. Kennedy deploring unjustified use of tax havens by American firms to defer United States income tax and urging adoption of tax reform).

Before 1962, foreign corporations owned by domestic parents and receiving revenues solely from non-United States sources fell outside United States jurisdiction. Under these rules, a domestic corporation could reap considerable tax advantages by funneling all profitable foreign business through a foreign corporation located in a tax haven: the subsidiary pays a lower tax on its income to the host government, and the domestic corporation defers paying the difference between the United States tax rate and the haven's rate until the parent repatriates the earnings as a dividend or liquidation distribution. It is possible for a foreign subsidiary to pay no tax to the host government by incorporating in a country that asserts jurisdiction only on the basis of residency, acquiring residency in a country that asserts jurisdiction only on the basis of geographic source, and conducting business in a variety of countries that assert jurisdiction only on the basis of residency.

27 A "United States shareholder" is any United States individual or corporation owning more than 10% of the combined voting stock of a foreign corporation. I.R.C. §§ 951(b) (1982), 951(d) (1982 & Supp. II 1984), 7701(a)(30) (1982).

28 I.R.C. § 957(a) (1982).

29 *See supra* notes 9-13 and accompanying text.

as if they recognized an allocable portion of the foreign corporation's profits in the form of a dividend.[30] To prevent excessive or double taxation, subpart F recognizes the subsidiary's duty to pay taxes to its host government by allowing shareholders either a credit[31] or a deduction[32] for a pro rata share of all income taxes paid by a foreign subsidiary to a foreign government. Hence, the subsidiary pays tax at the host country's corporate tax rate and the United States shareholders pay only the difference between the United States corporate tax rate and the haven's tax rate.

Domestic corporations with foreign subsidiaries seek to avoid application of subpart F because it destroys the advantages otherwise available to foreign entities owned by United States shareholders but incorporated in a tax haven. First, because subpart F treats domestic corporations with foreign subsidiaries as United States shareholders, the domestic parent must eventually and sometimes immediately recognize the foreign entity's earnings.[33] Hence, the domestic parent, as the principal or even sole shareholder, pays tax

30 I.R.C. § 951(a) (1982). Even if a shareholder never receives his allocable portion of the earnings and profits, subpart F requires that he report his share in gross income. *Id.* A shareholder may exclude from gross income actual distributions of earnings and profits already taxed under subpart F. *Id.* § 959(a). Under I.R.C. § 961(a) (1982), a shareholder increases his basis in the foreign corporation's stock by the amount of undistributed profits included in his gross income and decreases his basis when the profits are actually distributed.

31 I.R.C. § 960(a) (1982) allows taxpayers who are subject to United States corporate tax rates a full credit for foreign income taxes paid.

32 I.R.C. § 162 (1982 & Supp. II 1984).

33 I.R.C. § 952 (1982). Immediately taxed income includes subpart F income and previously excluded subpart F income. Subpart F income consists of income derived from the insurance of United States risks, increases in earnings that are invested in United States property for the year, foreign base company income, earnings and profits attributable to participation in or cooperation with an international boycott, and payments unlawful under the Foreign Corrupt Practices Act of 1977. *Id.* § 952(a). Foreign Base Company Income, defined in detail in I.R.C. § 954 (1982 & Supp. II 1984), refers to earnings and profits garnered from goods or services purchased from or sold to related parties as defined by I.R.C. § 954(a)(3) (1982), for use outside the foreign corporation's country of incorporation, passive investment income, shipping income, and oil related income earned outside the country of incorporation. *See* P. McDaniel & H. Ault, *supra* note 19, at 120-25 (listing income taxable to United States shareholders, including subpart F income due to increase in earnings invested in United States property).

Subpart F excludes income earned within the foreign country of incorporation from the list of immediately taxable earnings and profits. I.R.C. § 952(b) (1982). Consequently, such earnings and profits fall beyond the limits of United States tax jurisdiction until the United States parent repatriates them. This exception for in-country income aids subsidiaries that legitimately incorporated in a foreign country to compete against local corporations whose cost structures reflect only the host country's lower income tax rate. That is, under subpart F, a foreign subsidiary pays the same low rate of tax as its competitors to the host government. The domestic parent pays the difference between the foreign host's tax rate and the United States rate only when the parent repatriates the earnings. *See* P. McDaniel & H. Ault, *supra* note 19, at 127-28.

at the United States corporate rate on certain types of subsidiary income. Second, Congress structured the taxing power of subpart F to regulate foreign subsidiaries' adherence to the Foreigu Corrupt Practices Act[34] and Anti-Boycott restrictions.[35] Domestic corporations can no longer use foreign subsidiaries to circumvent the application of these laws.

The emphasis on actual control of the foreign corporation—substance over form—given by judicial and IRS interpretations of subpart F, however, seriously hampers the ability of United States shareholders to retain control over a foreign corporation while avoiding application of subpart F. Treasury Regulation section 1.957[36] converts the mechanical test of stock ownership[37] into one of substance. For example, if shareholders seeking to decontrol a foreign corporation distribute fifty percent or more of the foreign corporation's combined voting power, yet retain the privileges normally associated with control (such as the right to elect more than half of the foreign corporation's board of directors or break deadlocks on the board), then the foreign corporation remains a controlled foreign corporation subject to subpart F.[38] Consequently,

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34 Pub. L. No. 95-213, 91 Stat. 1494 (1977) (codified at 15 U.S.C. §§ 78a note, 78m, 78dd-1, 78dd-2, 78ff (1982)). The Foreign Corrupt Practices Act employs criminal sanctions to discourage corporations from paying bribes to secure business or favorable treatment from foreign government officials. Supplementing the Act's criminal sanctions, subpart F taxes domestic parents on income a foreign subsidiary uses for bribes, kickbacks, or other illegal payments, and specifically disallows a deduction for the cost of those illegal payments. I.R.C. § 952(a)(4) (1982). Illegal payments, bribes, and kickbacks are defined in *id.* § 162(c).

35 *Id.* § 952(a)(3). The anti-boycott provisions of subpart F penalize a domestic parent when its subsidiary participates in an international boycott, defined in *id.* § 999(b)(3), by denying a deferral for earnings and profits generated by business attributed to the illegal participation, and denying tax benefits, such as tax credits, claimed in relation to those earnings and profits. *Id.* § 952(a)(3).

36 Treas. Reg. § 1.957 (1963).

37 *See supra* notes 27-28 and accompanying text.

38 Treas. Reg. § 1.957-1(b)(1)-(2) (1963). The Tax Court has upheld the regulation on several occasions. *See, e.g.*, Garlock, Inc. v. Commissioner, 58 T.C. 423 (1972) (literal avoidance of ownership requirements under § 957 insufficient to decontrol where foreign shareholders had no interest in independently exercising their right to control foreign corporation), *aff'd*, 489 F.2d 197 (2d Cir. 1973), *cert. denied*, 417 U.S. 911 (1974); *see also* Koehring Co. v. United States, 433 F. Supp. 929, *aff'd*, 583 F.2d 313 (7th Cir. 1978) (implied agreement between foreign shareholder majority and United States shareholder minority restricting power of majority to control corporation without approval of minority entitled IRS to ignore majority's formal ownership in calculating 50% ownership under § 957). *But see* CCA, Inc. v. Commissioner, 64 T.C. 137 (1975) (fact that non-United States shareholder majority had limited interest in exercising independent voting control over foreign corporation did not dilute significance of majority's unrestricted right to act independently under corporate charter). Commentators question the vitality of *CCA, Inc.*, because it preceded *Koehring*, which recognized that implied agreements could modify express provisions in a corporate charter, and was never appealed by the IRS. *See* Corry, *Stapled Stock—Time for a New Look*, 36 TAX L. REV. 167, 186 (1981).

for a domestic corporation successfully to remove a wholly owned subsidiary from the scope of subpart F, it must make an unrestricted distribution of more than fifty percent of the foreign corporation's stock to shareholders who do not qualify as United States shareholders under section 957.[39] Such a distribution sacrifices the domestic parent's unimpaired control over the subsidiary and threatens the continued beneficial, servient working relationship the parent enjoyed with its former subsidiary.[40]

C. Stapled Stock

An alternative method of avoiding subpart F calls for restructuring the parent's ownership of a foreign subsidiary by distributing all of the subsidiary's stock directly to the domestic corporation's shareholders. This method shields the foreign subsidiary from United States taxation under subpart F by widely dispersing the subsidiary's ownership among many shareholders who do not qualify as "United States shareholders." Moreover, the common pool of ownership shared by the two corporations ensures that both companies will continue to operate in a mutually beneficial manner. To perpetuate the common pool of ownership, the shares of both corporations undergo "stapling" or "pairing" which ties a unit of ownership in one corporation to a unit of ownership in the other.

As a consequence of stapling, the distributing corporation—the former parent—must recognize ordinary taxable gain because the distribution of the foreign corporation's stock will cause the distributing corporation to recapture previously deferred earnings of the foreign corporation. Stapling requires the newly paired corporations to orchestrate changes in capital strncture to maintain the pairing ratio. Taxpayers must recognize a taxable dividend upon receipt of the distributed stock.

1. *The Mechanics*

The process of decontrol and pairing encompasses three stages.[41] In the first stage, the domestic corporation with significant

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39 *See supra* notes 27-28 and accompanying text.

40 As a minority shareholder, the former parent could no longer exercise unfettered control over the foreign corporation.

41 As an alternative, though no longer as popular, approach, the domestic corporation may create a trust that decontrols the subsidiary and ensures that the domestic and foreign corporations share an identity of ownership. Schuldenfrei, *Stock-Pairing to Decontrol a CFC,* 6 INT'L TAX. J. 424, 425 (1980). The domestic corporation either distributes the subsidiary's shares to a trustee with beneficial ownership residing in its shareholders or issues a cash dividend to its shareholders who acquire a pro rata interest in a prearranged trust by contributing the cash dividend to that trust. In the latter arrangement, the trust uses the contributed cash dividend to purchase the subsidiary's stock from the domestic corporation. In lieu of pairing the two stock issues, the shareholders' pro rata

foreign business creates a corporate shell outside the United States. The domestic corporation selects a host country with more favorable corporation regulations and a tax rate below the United States corporate rate. The success of the stapled stock scheme rests primarily on the potential savings offered by the new jurisdiction's lower tax rate[42] and less onerous restrictions on corporate conduct.[43] At this stage, the domestic corporation retains complete ownership of the foreign shell; thus, the foreign shell qualifies as a controlled foreign corporation and remains subject to subpart F.[44] The domestic and foreign corporations remain liable for the equivalent of the United States corporate tax rate on foreign earnings.[45]

In the second stage, the domestic corporation converts the foreign entity from a shell to a working corporation by transferring working assets from the domestic corporation to the foreign shell. The domestic corporation suffers no adverse tax consequences when the transfer involves cash or other property with a basis equal to its value. When the transfer involves appreciated property, however, the corporation must recognize as gain the difference between basis and value.[46] Hence, the form[47] of the transfer and its con-

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interests in the trust accompany any transfer of stock in the domestic corporation. If the trust acts as an agent for all shareholders of the domestic corporation and avoids classification as a grantor trust or an independent entity, the Internal Revenue Service will recognize decontrol because beneficial ownership of the foreign corporation will reside in the hands of the shareholders. Rev. Rul. 54-140, 1954-1 C.B. 116. A grantor trust exists where the grantor retains such control over the trust's corpus or income that the Service treats the grantor as owner of the trust property for tax purposes. I.R.C. §§ 671-677 (1982). If the trust constitutes an independent entity, and possesses more than 50% of the foreign corporation's stock, the trust qualifies as a United States shareholder under I.R.C. § 957 (1982), and the foreign corporation becomes a controlled foreign corporation. *See supra* notes 27-28 and accompanying text.

42 *See supra* note 33 and accompanying text.

43 *See supra* notes 34-35 and accompanying text.

44 *See supra* notes 26-40 and accompanying text.

45 *See supra* notes 31-32 and accompanying text.

46 Recognition of gain is required to prevent domestic corporations from transferring appreciated property abroad and thereby avoiding United States tax on the gain from the property's sale. P. McDaniel & H. Ault, *supra* note 19, at 130-31.

47 A corporation seeking to transfer assets from an existing controlled foreign corporation to a new controlled foreign corporation incorporated in a more favorable tax haven must also gnard against an "in-bound out-bound" format if it wishes to avoid recognizing gain on the final transfer. An "in-bound out-bound" transfer occurs when the domestic corporation acquires assets below market rates from the first controlled foreign corporation and subsequently transfers the assets to the new controlled foreign corporation. In the out-bound exchange, the domestic corporation faces liability under § 367 for the difference between the market value of the assets and their bases. If the domestic corporation transfers cash or unappreciated property to the new subsidiary and allows the two subsidiaries to make the final exchange, the assets may successfully pass from one controlled foreign corporation to the other at below market rates without adverse United States tax results. I.R.C. § 367 (1982 & Supp. II 1984).

tent[48] turn on the desired tax consequences of the transfer.

In the third stage of the pairing process, the domestic corporation spins off the controlled foreign corporation by distributing the foreign corporation's stock as a pro rata, in-kind dividend to its shareholders. At the time of the distribution, both corporations revise their bylaws. The amended bylaws prohibit conveying shares in one corporation without a coincidental transfer of a specified number of shares in the paired entity.[49] Although no single factor dictates the pairing ratio, ordinarily one share of the domestic corporation is stapled to one share of the foreign corporation.[50] To warn subsequent purchasers of the transfer restrictions, the corporations may set forth the terms governing the pairing arrangement on each stock certificate and in the corporate registers, or print each set of paired stock certificates on one paper.[51]

2. *The Effects*

For the domestic corporation, the immediate tax consequence of the distribution of the foreign subsidiary's stock springs from section 1248's[52] treatment of the distribution as a taxable sale or exchange of a controlled foreign corporation. Subpart F compels the qualifying United States shareholders of a controlled foreign corporation to recognize only certain types of the subsidiary's income for United States tax purposes.[53] Through section 1248, the Code seeks to recapture the earnings unrecognized under subpart F by treating the domestic corporation's gain on the distribution as a taxable dividend up to the amount of the foreign corporation's accumulated untaxed earnings and profits.[54] For domestic corporations distributing the stock of newly incorporated foreign companies, untaxed earnings and profits have not yet accumulated, and section 1248 has no impact.[55]

Following distribution and pairing, paired domestic corpora-

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48 For example, in a service industry where contracts constitute the principal asset of a business, a corporation may elect to retain existing foreign branch operations under the domestic corporation and employ the new foreign corporation to handle subsequent, newly created foreign business opportunities. Such an arrangement only requires the transfer of cash as a contribution to the foreign corporation's capital, and avoids the adverse tax consequence of transferring appreciated assets from a domestic corporation's foreign branch to the new foreign corporation. *See supra* note 46 and accompanying text.

49 *See* Schuldenfrei, *supra* note 41, at 425.

50 *Id.*

51 *Id.*

52 I.R.C. § 1248 (1982 & Supp. II 1984).

53 *See supra* note 33 and accompanying text.

54 I.R.C. § 1248(f) (1982).

55 *See* Schuldenfrei, *supra* note 41, at 427.

tions must accommodate the closely related sister corporation in all stock-related activities. For example, a paired corporation may no longer take advantage of section 361 to acquire another company in a tax-free exchange of stock.[56] Moreover, for a paired entity raising capital in the equity markets, stapling requires that any alterations in one corporation's equity structure match comparable modifications in the sister corporation's equity structure.[57] Consequently, notwithstanding differences in capital requirements, a corporation must couple authorized increases in its own outstanding stock with a corresponding issue of the paired sister corporation's stock.

For the shareholder receiving the foreign corporation's stock, the distribution qualifies as a dividend subject to taxation as ordinary income.[58] The market value of the distributed stock determines the value of the dividend for tax purposes.[59] An in-kind distribution tailored to satisfy the requirements of section 355 allows the taxpayer to defer recognition of the distribution.[60]

D. The Internal Revenue Service's Response

Since the emergence of pairing in the 1920s, the Internal Revenue Service has claimed both that distribution and pairing create two independent corporations and do not create two independent corporations. Although never explicitly resolving the contradiction

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56 To qualify for tax free status under I.R.C. § 361 (1982), shareholders must sell their company solely in exchange for stock of equal value in the acquiring company. However, a paired corporation cannot qualify because the matching paired shares in its sister corporation must accompany a transfer of its own stock. Section 361(b) treats the matching shares given to the target company's shareholders as stock of a corporation not a party to the reorganization and, consequently, boot taxable to the acquired corporation's shareholders. *See* I.R.C. §§ 361 (1982), 368 (1982 & Supp. II 1984); RALPH M. PARSONS CO., NOTICE OF ANNUAL MEETING OF SHAREHOLDERS 27 (Sept. 19, 1978); Corry, *supra* note 38, at 189-90.

57 *See* Corry, *supra* note 38, at 190.

58 Rev. Rul. 54-140, 1954-1 C.B. 116.

59 *Id. See also* I.R.C. § 301(d) (1982) (calculation of basis in property received by shareholder as corporate distribution). I.R.C. § 355 (1982) allows a taxpayer to defer immediate recognition of the distribution if certain requirements are met. *See infra* note 60 and accompanying text.

Because the pairing restrictions on trading make it difficult to determine the independent value of a newly issued stock, the IRS employs valuation guidelines published in Revenue Ruling 80-213, 1980-2 C.B. 102. The guidelines treat the favorable advantages of stock pairing as additions to value, while ignoring some of the aspects which may lower value. For example, in determining market value, the IRS acknowledges that investors will value the foreign corporation more highly because it operates beyond the reach of the United States regulations and taxes. *Id.* § 4.02. However, the IRS overlooks reductions in market value caused by the stapling restrictions. *Id.* § 4.08.

60 I.R.C. § 355(a)(1) (1982). To satisfy § 355, the distributing corporation must issue all or a controlling block of the controlled foreign corporation's stock, and both the parent and controlled foreign corporation must have actively engaged in a trade or business during the five-year period ending on the date of distribution.

among court decisions and revenue rulings, the IRS has implicitly adopted a position that distribution and pairing result in the successful decontrol of controlled foreign corporations.

The peculiar history of stapled stock explains its current success as the linchpin of tax avoidance schemes involving foreign earnings. Regnlations in the 1920s compelling banks to terminate nonbanking related lines of business[61] spurred the first creative use of stapled stock. Not wishing to relinquish the benefits of a profitable business, many banks chose to spin off the prohibited activities into newly formed domestic corporations, conveying ownership of these new corporations to their shareholders.[62] The banks employed trust funds and restrictions on stock transfers to pair the two corporations. The arrangement satisfied the banking requirements and preserved the former subsidiary's servient, mutually beneficial relationship with the bank.[63] Most important, profits earned by the new corporation continued to benefit the bank's original shareholders.[64]

The initial court decisions discussing stapled stock appeared in two contexts: dividend tax treatment for shareholders receiving an interest in the paired entity, and the allocation of basis between the stapled interests for subsequent purchasers of the stapled shares. Examining dividend tax treatment, the courts focused on whether a shareholder receiving the distribution of a paired entity must report the distribution as an immediately taxable dividend or delay recognition until the shareholders disposed of the interest in a taxable sale or exchange. In *John G. Lonsdale*[65] a bank issued a cash distribution to its shareholders; most distributees then transferred the cash to a trust authorized to purchase the bank's subsidiary. The shareholders argued that because the pairing arrangement created common ownership and essentially common management, they received an unseverable unit of ownership, consisting of the bank and its former subsidiary, no different from what they possessed prior to the distribution.[66] Accordingly, the shareholders argued they recognized no taxable dividend. The Internal Revenue Service disagreed, asserting that a valid and effective distribution of the subsidiary's ownership had occurred.[67] The court agreed with the IRS and

61 *See, e.g.*, National Banking Act, 12 U.S.C. §§ 21-200 (1926) (prohibiting national banks from engaging in certain business activities relating to real estate).

62 *See, e.g.*, John G. Lonsdale, 11 B.T.A. 658, 660 (1928), *aff'd*, 32 F.2d 537 (8th Cir), *cert. denied*, 280 U.S. 575 (1929).

63 *Id.* at 663-66.

64 *Id.*

65 11 B.T.A. 659 (1928), *aff'd*, 32 F.2d 537 (8th Cir.), *cert. denied*, 280 U.S. 575 (1929).

66 32 F.2d at 538.

67 *Id.*

deemed the pairing arrangement irrelevant in determining the nature of the distribution. The court noted that following the distribution there existed two " 'distinct legal organizations, operating under separate charters, derived from different sources, and possessing independent powers and privileges.' "[68] Consequently, the shareholders received a distinct, individual, and therefore taxable gain.

A decade later, on the issue of basis allocation for purchasers of paired entities, the Internal Revenue Service adopted a contradictory position. In *Andre deCoppet*[69] a taxpayer sought to allocate his purchase price among paired stocks in order to recognize a loss on the worthlessness of one of the stocks.[70] The IRS disallowed the allocation on the grounds that pairing created a single indivisible investment. The Tax Court[71] and the Second Circuit[72] agreed. According to Judge Learned Hand, the pairing cancelled an effective distribution of beneficial ownership because it did not alter the status quo: the owners of the bank continued to own the subsidiary by virtue of their ownership of the bank.[73] Consequently, Judge Hand agreed with the IRS, concluding that the paired entity's bankruptcy created "no more a 'realized' loss, than if [it] had been [that] of a corporate subsidiary."[74]

In 1954, the IRS attempted to reconcile this apparent contradiction by issuing Revenue Ruling 54-140.[75] The ruling addressed the tax treatment of a bank's distribution of a subsidiary's stock to a trust created on behalf of the bank's shareholders. Citing the economic effects of pairing[76] and ignoring *Andre deCoppet,* the IRS found that the transfer effectively distributed beneficial ownership and required the shareholders to recognize the distribution as a taxable dividend.[77] The IRS litigated 54-140 in *Earl R. Wilkinson*[78] and, de-

68 *Id.* at 539 (quoting Oriscana Nat'l Bank v. Johnson, 251 U.S. 68, 88 (1918)). Originally, courts read the decision in *Lonsdale* to turn on the nature of the distribution as a cash dividend. Subsequent cases, however, dispelled this notion by emphasizing the separateness of the two entities. *See, e.g.*, Mrs. Frank Andrews, 26 B.T.A. 642, 653-54 (1932) (that taxpayer enjoyed no option to receive dividend as cash irrelevant in light of broad principles articulated in *Lonsdale*).

69 38 B.T.A. 1381 (1938), *aff'd,* 108 F.2d 787 (2d Cir. 1940).

70 *Id.* at 1388, 1392.

71 *Id.* at 1393.

72 108 F.2d at 789.

73 *Id.* at 788-89.

74 *Id.* at 787, 789.

75 1954-1 C.B. 116.

76 The shift of the subsidiary's ownership from the bank to the shareholders put the subsidiary beyond the reach of third parties such as the bank's creditors or depositors. *Id.* at 116-17.

77 *Id.* at 117.

78 29 T.C. 421 (1957), *nonacq.* 1960-1 C.B. 7.

spite losing, continues to maintain that distribution and pairing create two separate and identifiable corporations. The service issued a nonacquiescence in *Wilkinson*[79] and reasserted in Revenue Ruling 69-155[80] the basic premise of *Lonsdale* and Revenue Ruling 54-140: a distribution and pairing create two independent entities; the receiving shareholders must recognize the distribution as a taxable dividend.

When stock pairing between a domestic and a foreign corporation first emerged as a means of avoiding United States tax liability on foreign income, the IRS faced a curious dilemma. The IRS could have disallowed pairing as a means of converting a domestic corporation with a foreign subsidiary into paired brother-sister entities, but could have continued to tax the distribution.[81] Alternatively, the Service could have tolerated pairing as a tax avoidance scheme, and relied on a uniform recognition of a distribution's effect on ownership. Although never formally ruling on the matter, the IRS implicitly chose to accept stock pairing as a legitimate means of avoiding United States tax liability. In a pair of private letter rulings,[82] the Service found that a corporation's distribution of stock in a paired entity constituted a dividend taxable to the corporation under section 1248 for accumulated, untaxed earnings and profits.[83] Although the Service failed in the second ruling to address directly the question of tax treatment for shareholders receiving the distribution, the stipulated facts underlying this ruling implicitly assumed that the distribution would occur in the form of a declared dividend subject to immediate recognition by shareholders.[84]

Because the IRS recognizes a valid and effective distribution of ownership, a domestic corporation that distributes a former subsidiary's stock among a large number of shareholders removes the foreign corporation from the reach of subpart F. Even the attribution of control tests found in Treasury Regulation section 1.957[85] should not change this result. Whatever control a particular pairing vests

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79 1960-1 C.B. 7.

80 1969-1 C.B. 93.

81 The IRS would tax the distribution on the theory that it created brother-sister entities. *See supra* notes 75-80 and accompanying text.

82 Letter Ruling 7839012, IRS LETTER RULINGS book 6, fiche 5 (CCH 1978) (microfiche); Letter Ruling 7842104, IRS LETTER RULINGS book 7, fiche 2 (CCH) (microfiche), *amended by* Letter Ruling 7852101, IRS LETTER RULINGS book 8, fiche 3 (CCH 1978) (microfiche).

83 *See* Letter Ruling 7839012, IRS LETTER RULINGS book 6, fiche 5 (CCH 1978) (microfiche). For a discussion of § 1248, see *supra* notes 53-55 and accompanying text.

84 *See* Letter Ruling 7842104, IRS LETTER RULINGS book 7, fiche 2 (CCH) (microfiche), *amended by* Letter Ruling 7852101, IRS LETTER RULINGS book 8, fiche 3 (CCH 1978) (microfiche).

85 *See supra* notes 36-40 and accompanying text.

in a domestic corporation, the issue of control remains largely irrelevant because the domestic corporation retains no stock on which the IRS could calculate tax liability under subpart F.[86]

Despite the Service's implicit approval of the use of stapled stock, tolerating a means of avoiding United States tax liability on foreign income generated dissent within the IRS.[87] The growing popularity of stapled stock in the late 1970s,[88] despite the Service's refusal to explicitly sanction stapled stock as a means of avoiding tax under subpart F,[89] prompted many commentators to warn interested corporations against tying paired entities too closely together.[90]

II
Legislative Response to Stock Pairing

Congress twice addressed the problem of stapled stock. In its first effort to close this tax loophole, Congress failed to enact legislation that would have treated the foreign paired corporation as a wholly owned subsidiary of the distributing corporation. In its second effort, Congress recognized a broader range of problems posed by stapled stock and adopted section 269B as a palliative. Section 269B permits the United States unilaterally to modify bilateral income tax treaties in order to extend tax jurisdiction directly over paired foreign corporations.

A. Initial Effort

Congress first considered acting to end taxpayers' use of sta-

86 Subpart F may apply through an IRS finding of constructive voting control over a foreign corporation. *See* I.R.C. § 958(b) (1982). Nevertheless, stock ownership forms the basis for calculating the per share tax liability required by I.R.C. § 951(a)(2) (1982). *See* Cliff, *Pairing: A Technique for Avoiding Controlled Foreign Corporation Status and Other Burdens of U.S. Taxation,* 57 Taxes 530, 535 (1979). Thus, § 951 imposes tax liability for the foreign corporation's income only on taxpayers who actually own stock in the foreign corporation.

87 G.C.M. 38244 (Jan. 24, 1980).

88 Many of the prominent stock pairing arrangements appeared in the late 1970s. *See* Ralph M. Parsons Co., *supra* note 56; L.E. Myers Co., Proxy Statement (Nov. 9, 1977). The sudden interest in stock pairing may have grown from the contemporaneous decline in the value of the dollar and reintroduction of human rights concerns as a part of official United States foreign policy. *See* Cliff, *supra* note 86, at 530-31. The lull in stock pairing that has appeared since 1980 may indicate a cautious response by American corporations to Treasury Department efforts to attack stapled stock through post-1980 legislation. *See* Corry, *supra* note 38, at 187-88.

89 *See supra* notes 82-84 and accompanying text.

90 *See* Corry, *supra* note 38, at 183-87 (discussing decontrol of controlled foreign corporations); Fitzgerald, *Does Service's Position on "Stapled Stock" Open a Loophole for Foreign Operations?,* 50 J. Tax'n 354, 357 (1979) (discussing possible IRS responses to close loophole).

pled stock to avoid subpart F in 1980. A report[91] commissioned by the Treasury Department to study taxpayers' use of tax havens called attention to the abusive use of stapled stock[92] and recommended that the IRS reconsider the position embodied in Revenue Ruling 54-140.[93] Rather than attack the problem through administrative action,[94] the Treasury Department supported a bill[95] designed to nullify "the use of [stapled stock] to escape taxation of Subpart F income."[96] This first proposal to regnlate the use of stapled stock died for lack of interest that same year.[97]

Under the proposal, a foreign corporation paired with a domestic corporation would have qualified as a wholly owned subsidiary of the domestic corporation.[98] Because the domestic corporation would have constituted the beneficial owner of the subsidiary, the proposal treated any dividend or other property distributed by the foreign corporation as a distribution first to the domestic corporation and, subsequently, to the shareholders.[99] The original distribution of the foreign corporation's stock by the domestic corporation would not have resulted in a taxable event for the recipient until the shareholders terminated the pairing arrangement.[100] In effect, when a distribution and pairing involved a foreign and domestic corporation, the proposal adopted the Tax Court's position in *Earl R. Wilkinson*:[101] pairing creates a single indivisible investment and therefore cancels an effective distribution of the beneficial ownership of the foreign corporation.[102]

B. Successful Second Effort

Congress's second effort to end the abusive use of stapled stock owes much of its success to congressional concern in 1984 for nar-

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91 Gordon, *Tax Havens and Their Use By United States Taxpayers—An Overview* (1980) (Report to Commissioner of Internal Revenue, Assistant Attorney General (Tax Division), and Assistant Secretary of Treasury (Tax Policy) by Richard Gordon, Special Counsel for International Taxation).

92 *Id.* at 92, 133-34.

93 *Id.* at 133-34.

94 The IRS could have revoked Revenue Ruling 54-140, see *supra* notes 75-80 and accompanying text, and acquiesced to *Wilkinson*, see *supra* notes 78-79 and accompanying text. *See also infra* notes 135-39 and accompanying text (discussing why administrative action might have been less desireable than legislative solution).

95 H.R. 8110, 96th Cong., 2d Sess., 126 CONG. REC. 25,412-13 (1980).

96 126 CONG. REC. 25411 (1980) (statement of Rep. Rostenkowski).

97 *See* Corry, *supra* note 38, at 187.

98 H.R. 8110, 96th Cong., 2d Sess., § 4, 126 CONG. REC. 25,412 (1980).

99 *Id.*

100 *Id.*

101 29 T.C. 421 (1957), *nonacq.* 1960-1 C.B. 7. For a discussion of *Wilkinson*, see *supra* notes 75-80 and accompanying text.

102 *Wilkinson*, 29 T.C. at 426.

rowing the projected budget deficit by closing tax loopholes to enhance revenue collection.[103] The House Report[104] on proposed section 269B states several reasons why Congress targeted stapled stock for reform. First, Congress noted the uncertainty surrounding the tax consequences and treatment under subpart F of a domestic-to-foreign pairing arrangement.[105] Second, Congress expressed concern that by undercharging its foreign counterpart for goods or services, a domestic paired corporation could funnel its own profits abroad through the untaxable foreign counterpart.[106] Although recognizing that "[t]he United States has the right to correct improper transfer prices between related parties,"[107] Congress found that existing provisions could not always adequately cope with such a complicated and difficult issue.[108] Third, Congress observed that stapling enabled paired corporations to avoid anti-boycott rules and other regnlatory measures enforced, in part, by the tax code.[109] Fourth, Congress believed that tolerating the continued "use of such a transparent device [as stapled stock] would have weakened the integrity of the tax system."[110] By closing the loophole, Congress sought to eliminate these four problems and expected to increase budget receipts by approximately five million dollars annually.[111]

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103 Congress passed I.R.C. § 269B (Supp. II 1984) as part of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 494.

104 H.R. REP. No. 432, 98th Cong., 2d Sess. 1543 (1984) [hereinafter cited as HOUSE REPORT], *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 1178.

105 *See id.* at 1543, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 1178-79; *supra* notes 61-90 and accompanying text.

106 *See* HOUSE REPORT, *supra* note 104, at 1544, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 1179. Congress noted that in nonstapled corporations such transactions are policed by the threat of shareholder derivative suits designed to prevent the shareholders' company from transferring profits to an unrelated, foreign corporation. Because the shareholders of the transferee and transferor corporations are identical in exchanges involving paired corporations, shareholders are unlikely to be hurt by such exchanges. Therefore, closing the loophole remains the province of the federal government. *Id.*

107 *Id.* I.R.C. § 482 (1982) allows the IRS to restructure intercompany transfers by allocating gross income, deductions, and credits between the parties as if the transaction occurred between arms-length dealers.

108 *See* HOUSE REPORT, *supra* note 104, at 1544, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 1179. For a discussion of the difficulties underlying IRS use of § 482 to police intercompany transactions, see REPORT OF THE COMPTROLLER GENERAL OF THE UNITED STATES TO THE HOUSE COMMITTEE ON WAYS AND MEANS, IRS COULD BETTER PROTECT U.S. TAX INTERESTS IN DETERMINING THE INCOME OF MULTINATIONAL CORPORATIONS (Sept. 30, 1981); Note, *Service Discretion and Burden of Proof in International Tax Cases Involving Section 482,* 15 CORNELL INT'L L.J. 203 (1982).

109 *See* HOUSE REPORT, *supra* note 104, at 1544, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 1180; *supra* notes 34-35 and accompanying text.

110 HOUSE REPORT, *supra* note 104, at 1544, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 1180.

111 *See id.* at 1547, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 1183. *But see The*

As enacted by Congress, section 269B subtly alters the jurisdictional rules governing the tax treatment of foreign entities paired with domestic corporations. Prior to section 269B's enactment, direct United States tax jurisdiction extended only to United States citizens, United States residents, or foreign entities earning income from sources located geographically within the United States.[112] Under the general rule of section 269B, however, the Code asserts United States tax jurisdiction over foreign entities stapled to domestic corporations and thus treats the stapled foreign entities as domestic corporations.[113] Consequently, foreign paired entities remain subject to direct taxation of their worldwide income, regardless of its source.[114] Moreover, because distribution and pairing no longer remove a foreign corporation from United States jurisdiction, the paired corporation may engage in tax-free intercompany transfers.[115] Only by terminating the pairing arrangement can a foreign corporation escape United States tax jurisdiction.[116]

Paired entities may avoid application of section 269B if the domestic corporation admits to "owning all interests in the foreign corporation that constitute stapled interests with respect to stock of the U.S. corporation."[117] For paired corporations that exercise this option, the domestic corporation must constitute, under subpart F, a United States shareholder[118] of a controlled foreign corporation, and must consequently recognize certain income, including subpart F income, of the foreign corporation[119] in proportion to its deemed ownership.[120]

Section 269B applies to any group of two or more entities in

IRS Gets a Staple Remover, FORBES, Nov. 7, 1983, at 225 (estimating revenue losses at $20 million over three years).

112 *See supra* notes 9-13 and accompanying text.

113 I.R.C. § 269B(a)(1) (Supp. II 1984).

114 *Id.*; *see also* I.R.C. §§ 11, 61 (1982 & Supp. II 1984) (imposing tax on corporations and defining taxable gross income respectively).

115 I.R.C. § 367 (1982 & Supp. II 1984) does not apply because the paired foreign corporation is now deemed a domestic corporation. *See* HOUSE REPORT, *supra* note 104, at 1545, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 1181; *supra* note 46.

116 On termination of the pairing arrangement, the foreign corporation will no longer constitute a domestic corporation. Hence, § 367 will treat the termination as a transfer of assets to a foreign corporation and require recognition of gain. *See supra* notes 46 & 115.

117 HOUSE REPORT, *supra* note 104, at 1545, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 1181. This election must have occurred within 180 days of § 269B's enactment and is irrevocable without the consent of the Secretary of the Treasury or his delegate. I.R.C. § 269B(c) (Supp. II 1984).

118 *See supra* note 27.

119 *See supra* note 33 and accompanying text.

120 For example, a domestic corporation stapled to 50% of a foreign corporation must recognize 50% of the foreign corporation's earnings and profits subject to indirect United States taxation under subpart F. *See supra* note 30 and accompanying text.

which more than fifty percent of the beneficial ownership of one entity consists of stapled interests.[121] A stapled interest exists where restrictions on transfer or ownership of the stock in one entity require the transfer of tandem interests in the other entity.[122] Section 269B(c)(1) defines an "entity" as "any corporation, partnership, trust, association, estate, or other form of carrying on a business or activity."[123]

The rule enunciated by section 269B conflicts with many of the existing United States bilateral income tax treaties. A typical treaty exempts foreign corporations from paying United States taxes on United States source industrial or commercial profits unless the corporation conducts its business from a permanent United States establishment.[124] Congress recognized this conflict[125] and evinced a clear intent to override the treaties for all pairings consummated after June 30, 1983.[126] For any pairing that existed prior to the cutoff date, Congress authorized an exemption from section 269B until the treaty could be renegotiated to conform with section 269B.[127]

III
ANALYSIS

Tax avoidance through the use of stapled stock posed a complex problem. Congressional action offered the most certain and timely solution. The method embodied by section 269B, however, suffers from drawbacks more serious than the problem it seeks to eliminate. First, the expansion of United States tax jurisdiction over foreign entities paired with domestic corporations fails to conform with either traditional United States or international standards of tax jurisdiction and is overbroad. Second, section 269B's unilateral modification of bilateral tax treaties threatens the continued viability and cooperative enforcement of existing United States tax treaties.

The Treasury Department's 1980 proposal offers a superior alternative to section 269B. By ignoring the distribution of a foreign corporation's stock, and treating the domestic corporation as the beneficial owner of the foreign corporation, the Treasury Depart-

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121 I.R.C. § 269B(c)(2) (Supp. II 1984).
122 *Id.* § 269B(c)(3).
123 *Id.* § 269B(c)(1).
124 *See* HOUSE REPORT, *supra* note 104, at 1546, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 1191 (citing art. III(1) of the United States-Netherlands Income Tax Treaty); *supra* note 17 and accompanying text.
125 *See* HOUSE REPORT, *supra* note 104, at 1546, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 1181.
126 I.R.C. § 269B(d) (Supp. II 1984).
127 *See* HOUSE REPORT, *supra* note 104, at 1545-46, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 1181.

ment's alternative expands the United States jurisdiction in a manner more consistent with traditional United States and international standards of tax jurisdiction and avoids the unilateral modification of bilateral tax treaties.

A. Congress's Timely Action

The problem posed by stapled stock merited Congress's attention. Although Congress estimated that stapled stock cost the government less than $5 million annually,[128] taxpayers were resorting to stapled stock with growing frequency,[129] and literature was increasingly touting the tax avoidance benefits of stapled stock.[130] Moreover, taxpayers recently employing stapled stock arrangements often cited tax avoidance as their primary motive.[131] In fact, even where taxpayers resorted to stapled stock for legitimate reasons,[132] the nature of stapled stock dictated that the paired foreign entity would avoid United States tax liability.[133] Such flagrant manipulation of jurisdictional rules to circumvent United States tax laws threatened the integrity and continued viability of United States foreign tax provisions.[134]

Congress's decision to attack stapled stock through legislation avoided the pitfalls of uncertainty and inadequacy that would result from an administrative solution imposed by the Internal Revenue Service. The most likely administrative solution[135] would have required the IRS to disallow pairing as a means of creating separate corporations; yet, inconsistently, would have taxed the distribution of the newly issued paired entity's stock on the grounds that beneficial ownership resided in the hands of the shareholders.[136] Moreover, the policing of transactions between domestic and paired entities to ensure arms-length transfer pricing would most likely have failed to limit or prevent the abusive use of stapled stock,[137] because the necessary and relevant provision of the Code had

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128 *See supra* note 111 and accompanying text.

129 *See supra* note 88.

130 *See A Plan to Shelter Overseas Profits*, BUS. WK., Oct. 9, 1978, at 112; Cliff, *supra* note 86; Fitzgerald, *supra* note 90; Schuldenfrei, *supra* note 41.

131 *See, e.g.*, L.E. MYERS CO., *supra* note 88, at 2 (pairing allows stockholders to participate in foreign subsidiary's earnings at corporate level and reduces threat of adverse consequences resulting from international boycotts).

132 *See infra* note 160.

133 *See supra* notes 85-86 and accompanying text.

134 *See supra* note 110 and accompanying text.

135 *See* Corry, *supra* note 38, at 186-87.

136 The IRS would continue to tax the distributing corporation as if it retained beneficial ownership of the paired entity. *See supra* note 81 and accompanying text.

137 A domestic entity could sell goods below cost to its foreign paired entity. The foreign entity then could sell the goods at a price sufficient to recoup the domestic corporation's losses and add its own profits. I.R.C. § 482 (1982) allows the IRS to restruc-

proven cumbersome and inadequate.[138] Even the Treasury Department lobbied for a legislative solution to the complex problems posed by stapled stock.[139]

B. The Jurisdictional Problems of Section 269B

Extending jurisdiction under section 269B deviates from the standard of reasonableness that traditionally governs expansion of United States tax jurisdiction. Although section 269B targets foreign entities created and paired for the purpose of avoiding United States tax liability, Congress failed to assert persuasive grounds for direct tax jurisdiction over a completely foreign corporation's worldwide income. Section 269B sweeps more broadly than necessary to achieve Congress's aim, and consequently creates needless conflict with other tax jurisdictions.

Under section 269B, the United States asserts in personam tax jurisdiction over paired foreign corporations by treating them as domestic corporations.[140] A domestic corporation, defined as a corporation "created or organized in the United States or under the law of the United States or of any State,"[141] pays United States tax on its worldwide income.[142] Because section 269B does not derive in personam jurisdiction from residency or citizenship,[143] jurisdiction presumably springs from the foreign corporation's pairing arrangement with a domestic corporation. That is, section 269B must predicate jurisdiction not on the ownership characteristics themselves, but on the intangible interactive effects emanating from the ownership characteristics a paired domestic entity shares with its sister foreign entity.[144]

Asserting direct United States tax jurisdiction on the basis of

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ture the pricing as if the transaction occurred between arms-length dealers and assign reasonable profits to the domestic corporation.

138 *See* HOUSE REPORT, *supra* note 104, at 1544, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 1179. *See supra* notes 106-08 and accompanying text.

139 In 1980 Rep. Rostenkowski introduced H.R. 8110, the Treasury Department's proposed legislative solution. *See supra* notes 95-101 and accompanying text.

140 I.R.C. § 269B(a)(1) (Supp. II 1984). *See supra* notes 113-14 and accompanying text.

141 I.R.C. § 7701(a)(4) (1982). *See supra* notes 10, 26 and accompanying text.

142 I.R.C. §§ 11, 61 (1982 & Supp. II 1984).

143 Section 269B is silent on its basis for asserting in personam jurisdiction, but it cannot rely on residency or citizenship because the paired foreign corporation is a foreign corporation doing business in a foreign country.

144 Alternative explanations of § 269B's basis for asserting in personam jurisdiction fail for lack of logic and evidence. Unlike subpart F, application of § 269B does not hinge on defined ownership characteristics that might prove that the foreign corporation operated on behalf of a concentrated, predominantly United States ownership. Nor does § 269B rely on proof of common management, evidence of close operational ties, or the existence of strict pairing rules that make future separation highly unlikely, any of which might indicate the distribution and pairing constituted a sham.

common ownership ignores the separate legal personality typically accorded incorporated entities[145] and fails to conform to policy considerations underlying previous attempts to bring foreign corporations within United States tax jurisdiction. Through sections 881[146] and 882,[147] Congress expressly approved international jurisdictional standards providing that taxing authorities could only levy direct taxes against foreign corporations on earnings effectively and substantially connected with the geographic territory of the taxing authority.[148] Additionally, under subpart F, Congress recognized that even concentrated United States ownership of a foreign corporation did not necessarily justify direct tax jurisdiction over that foreign corporation.[149] Instead, Congress took advantage of an exception to the standard rules of international jurisdiction to look through the separation between a corporation and its shareholders by imposing a tax on the United States shareholders who comprised the foreign corporation for their pro rata share of the foreign corporation's earnings.[150]

Section 269B, in contrast, radically departs from traditional and accepted rules of international tax jurisdiction. First, it disregards incorporation in order to ascertain common ownership. Then, unlike subpart F, which imposes indirect tax through the individual shareholders already under United States tax jurisdiction, section

145 *See infra* note 149.

146 I.R.C. § 881 (1982 & Supp. II 1984). Section 881 taxes foreign corporations on income derived from United States sources. United States source income is defined in *id.* §§ 861-864.

147 *Id.* § 882. Section 882 taxes income earned from conducting a United States trade or business.

148 Regardless of a jurisdiction's taxing method, nonresident or noncitizen taxpayers need only pay taxes on income earned from sources located within the taxing power's territorial jurisdiction. *See* Norr, *supra* note 7, at 438.

149 The principles underlying United States and international law recognize that incorporation creates an entity distingnishable from its shareholders. *See* H. HENN & J. ALEXANDER, LAWS OF CORPORATIONS § 78 (3d ed. 1983). The characteristics and conduct of the corporation, not its shareholders, generally determine which governments may exercise jurisdiction over the corporation. *Id.*; *see also* Thompson, *United States Jurisdiction Over Foreign Subsidiaries: Corporate and International Law Aspects,* 15 LAW & POLICY INT'L BUS. 319 (1983). An exception arises where the separateness does not relate to legitimate business purposes. *See* H. HENN & J. ALEXANDER, *supra*, § 146. In such a case, a government may pierce the corporate veil of separateness and impose jurisdiction over the shareholders for conduct of the foreign corporation. *See* Thompson, *supra*, at 365; RESTATEMENT OF FOREIGN RELATIONS LAW OF THE UNITED STATES (REVISED) § 216 & comment d (Tent. Draft No. 6, 1985) (noting that United States may regnlate foreign subsidiary through territorial and national links to entities that control or own it). For a discussion of corporate separateness as it relates to issues of taxation, see Watts, *Tax Problems of Regard for the Corporate Entity,* 20 INST. ON FED. TAX'N 867 (1962); J. BISCHEL & R. FEINSCHREIBER, *supra* note 9, at 283-84.

150 *See supra* notes 27-32 and accompanying text.

269B extends jurisdiction directly over the foreign corporation.[151] Moreover, unlike sections 881 and 882, section 269B does not require a substantial nexus between United States territory and taxable income as an alternative to United States residence or citizenship. A common ownership link between a domestic and foreign corporation hardly demonstrates that the corporation's worldwide income stems directly from a United States source or a United States trade or business. Rather, the American unwillingness to tax directly a foreign paired corporation's worldwide income when it operates as a foreign subsidiary strongly suggests that this income lies outside the traditional boundaries of United States tax jurisdiction.[152]

The new law is also overbroad in two respects. First, because the mere act of pairing triggers section 269B, the rule precludes analysis of individual pairing arrangements to determine whether the taxpayer intended to avoid tax liability and whether the attributes of control or ownership actually justify direct United States tax jurisdiction. For example, because section 269B only looks for common ownership of foreign and domestic entities, and not at the characteristics of that common ownership,[153] it brings within United States tax jurisdiction pairing arrangements that staple a domestic corporation to its former parent, a foreign corporation.[154] Yet, section 269B's legislative history does not show that Congress intended to expand United States tax jurisdiction to reach the worldwide income of a foreign parent corporation owned by nonresident foreign nationals when the pairing arrangement does not involve United States tax avoidance motives and when interaction between the paired entities may account for only a small fraction of the foreign corporation's total business operations.[155]

Second, by employing a more narrowly drafted statute which equated the tax treatment of paired foreign entities with controlled

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151 *See supra* notes 112-14 and accompanying text.

152 *See supra* notes 26-40 and accompanying text.

153 *See supra* notes 27-32 and accompanying text.

154 Section 269B applies to *any* domestic corporation stapled to a foreign corporation. I.R.C. § 269B(a) (Supp. II 1984). *See supra* notes 112-14 and accompanying text.

155 Nothing in the original legislative history of § 269B suggests Congress intended that the provision tax income that originally lay outside United States tax jurisdiction prior to the pairing. *See supra* notes 103-11 and accompanying text.

In recent legislation, Congress tackled this problem. H.R. 3838, 99th Cong., 2d Sess. § 1810(j)(2), 132 CONG. REC. S8954-55 (daily ed. June 26, 1986) (passed House of Representatives and Senate and now before House-Senate Conference Committee). As modified the new version of § 269B would tax only those paired entities in which half or more of the voting power and half or more of the value of the paired entities reside in the hands of United States persons. I.R.C. § 7701(a)(30) (1982) defines United States person as a citizen or resident of the United States, a domestic partnership, a domestic corporation, and any nonforeign estate or trust.

foreign corporations,[156] Congress could have achieved its express purpose—closing a tax loophole created by stapled stock—without unduly discriminating against foreign stapled entities.[157] As enacted, section 269B inflicts more disadvantageous tax treatment on paired foreign corporations than that given controlled foreign corporations under subpart F. Subpart F recognizes the need of foreign corporations indirectly subject to United States taxation to remain on a competitive par with foreign corporations; it allows controlled foreign corporations to exclude from immediate United States taxation income garnered from business activity concluded within the host country's geographical limits.[158] Section 269B offers no such exclusion to paired entities. Instead, paired foreign corporations must pay tax on worldwide income in the year earned.[159] This tax treatment creates strong incentives for paired entities to implement costly and complex reorganizations to requalify as a controlled foreign corporation. Consequently, section 269B's discriminatory treatment indirectly removes stapled stock from American corporations' repertoire of legitimate organizational structures.[160]

Section 269B's deviation from traditional standards of jurisdiction and overbreadth create needless conflict with foreign governments. A host country maintains a significant interest in taxing and controlling the conduct of an entity incorporated under its laws because the corporation plays a role in the host country's economic and development policies, augments the tax rolls, and creates employment.[161] Subpart F recognizes this significant interest by only asserting indirect jurisdiction over foreign corporations by taxing their United States shareholders.[162] Sections 881 and 882 limit direct taxation of foreign corporations to income derived from

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156 For an example, see *infra* text accompanying notes 185-203.

157 The legislative history indicates no desire to totally eliminate stapled stock. *See supra* notes 103-11 and accompanying text.

158 *See supra* note 33. For example, if a host country taxes corporations at a rate below the United States corporate rate, and the controlled foreign corporation had to pay indirectly through its shareholders the difference to the United States government, then the controlled foreign corporation would have a higher cost structure and lower profit margin than competitors who only paid the host government's tax.

159 *See supra* notes 113-14 and accompanying text. The paired corporations could avoid this problem, but only if the domestic corporation elects to treat the foreign entity as a subsidiary and bear direct liability for taxes on the foreign corporation's income. *See supra* notes 117-20 and accompanying text.

160 Although tax avoidance and circumvention of banking laws are the most noted uses of stapled stock, *see supra* notes 61-64 and accompanying text, corporations might resort to stapled stock for other reasons. For example, pairing offers shareholders a better means of insulating a subsidiary from interference by a parent corporation's creditors or other interested third parties. *See supra* note 76 and accompanying text.

161 *See* Thompson, *supra* note 149, at 392-93.

162 *See supra* note 11 and accompanying text.

sources or conduct within United States territory.[163] Section 269B, however, imposes direct jurisdiction over paired foreign corporations, an area traditionally reserved for foreign governments.[164] This direct taxation increases the likelihood of conflict between the traditional interests of foreign governments and the newly extended interests of the United States.[165] Moreover, section 269B legitimates an expansive approach to tax jurisdiction, and exacerbates the problems of double taxation as each government seeks to assert the primacy of its right to tax directly certain entities. For example, foreign governments, resenting section 269B's intrusion on their sovereignty, may similarly expand their jurisdiction to impinge on the United States's sovereignty.

C. Threat to Tax Treaties Posed by Section 269B

Congress acted within the limits of its constitutional authority[166] when it expressly stipulated that section 269B overrides all existing contrary treaty provisions.[167] Nonetheless, this unilateral modification of bilaterally negotiated treaties seriously jeopardizes their viability and the continued cooperation of treaty partners. The important role played by tax treaties in United States tax policy greatly outweighs the anticipated increase in tax revenues generated by section 269B.

A tax treaty is the product of a host of mutually acceptable compromises reached through negotiations between two governments with conflicting tax policies. To achieve its primary aims, each country sacrifices its lesser interests and accommodates the tax aims of the other.[168] When a government unilaterally imposes new terms and alters existing provisions of a tax treaty, it subverts the compromises inherent in a treaty. Hence, by overriding tax treaties, section 269B injects uncertainty into the value and integrity of tax treaties with the United States and discourages potential treaty partners and existing treaty partners seeking to update an existing treaty from participating in good-faith negotiations. Moreover, section 269B's disregard of the sanctity of bilateral solutions to problems created by conflicting tax policies jeopardizes the continued cooperative enforcement of existing tax treaties. For example, the success

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163 *See supra* notes 143, 148 and accompanying text.

164 *See supra* notes 113-14 and accompanying text.

165 For example, through the IRC, Congress sought to penalize the participation of corporations subject to United States tax jurisdiction in international boycotts. *See supra* notes 34-35 and accompanying text. However, a host country may wish to require corporations created under its aegis to participate in such a boycott.

166 *See supra* notes 22-25 and accompanying text.

167 *See supra* notes 124-27 and accompanying text.

168 *See* Kingson, *supra* note 17, at 1157; *supra* note 17.

of treaties rests heavily on the coordinated administration of their information exchange provisions to help prevent fraud or fiscal evasion by taxpayers.[169] A perceived reduction in the United States's cooperative administration of the treaty may induce a corresponding reduction by treaty partners in the priority they accord treaty policing.

Prior to section 269B, Congress expressly overrode treaties on only two occasions.[170] First, the Revenue Act of 1962[171] expressly superseded a minor clause relating to real estate tax contained in a treaty with Greece.[172] The Treasury Department undertook immediate negotiations with Greece which culminated in a revised edition in 1964.[173] Second, the Foreign Investment in Real Property Tax Act of 1980[174] overrode capital gains treatment of income earned from the disposition of United States real property by foreign investors under nine tax treaties.[175] The nine treaties generally involved industrialized or Eastern Bloc countries.[176] Congress intentionally delayed the override by five years to allow the Treasury Department to renegotiate as soon as possible.[177]

In contrast, section 269B overrides the part of nearly all tax treaties that limits direct United States taxation of a treaty partner's corporations to income derived from a permanent United States establishment.[178] Although entities stapled as of June 30, 1983, retain their protected status,[179] the new provision immediately overrides treaties as to subsequently paired entities without providing a delay to allow for renegotiations.[180] Moreover, unlike prior statutory overrides, section 269B directly overrides tax treaties with tax haven

169 *See* Gordon, *supra* note 91, at 163-64; *supra* note 17.

170 *See* 3 R. RHOADES & M. LANGER, *supra* note 6, § 9.02[4]; Rosenbloom & Langbein, *United States Tax Treaty Policy: An Overview,* 19 COLUM. J. TRANSNAT'L L. 359, 400-01 (1981).

171 Pub. L. No. 87-834, 76 Stat. 960 (1962).

172 Convention for the Avoidance of Double Taxation on the Estates of Dead Persons, Feb. 20, 1950, United States-Greece, 5 U.S.T. 12, T.I.A.S. No. 2901.

173 Protocol Modifying and Supplementing the Convention of February 20, 1950, United States-Greece, Feb. 12, 1964, 18 U.S.T. 2853, T.I.A.S. No. 6375.

174 Pub. L. No. 96-499, 94 Stat. 2682 (1980).

175 The Act affected treaties with Sweden, Canada, the Netherlands, Germany, Finland, Belgium, Japan, Romania, and Poland. 3 R. RHOADES & M. LANGER, *supra* note 6, § 11.03[4].

176 *Id.*

177 *See* Rosenbloom & Langbein, *supra* note 170, at 360, 401 (International Tax Counsel of Department of Treasury addressing Subcommittee on Oversight of House Ways and Means Committee).

178 For the Model Treaty definition of a permanent establishment, see *supra* note 19. The United States-Soviet Union tax treaty serves as an exception because it contains no permanent establishment clause. *See supra* note 17 and accompanying text.

179 *See supra* notes 126-27 and accompanying text.

180 *Id.*

jurisdictions.[181] Hence, in seeking to end an abuse of tax havens which costs the Treasury Department approximately $5 million annually,[182] Congress has jeopardized the continued viability of treaties which oversee tax evasion and fraud[183] relating to the more than $23 billion invested in tax havens by American taxpayers.[184]

D. Alternative Solution

Regulating stapled stock presents difficult tax jurisdiction problems. Nonetheless, the Treasury Department's original solution, which indirectly extends United States jurisdiction to treat paired foreigu entities as controlled foreign corporations owned by their domestic counterparts, offers a superior alternative to section 269B. Not only does the Treasury Department's solution fulfill Congress's objectives as successfully as section 269B, but it avoids the serious pitfalls marring section 269B's approach to stapled stock.

The difficulty of finding an alternative solution lies in the complexity of the stapled stock problem. Traditional rules of tax jurisdiction suggest that a paired foreign corporation falls outside direct United States tax jurisdiction.[185] However, the tax avoidance motives underlying typical distribution and pairing of a foreign corporation's stock, coupled with former ownership by a domestic corporation, strongly suggest that stapled stock is a "transparent device"[186] designed solely to circumvent United States jurisdiction.[187] Hence, an alternative solution to section 269B must strike a fine balance between expanding the United States tax jurisdiction and conforming with traditional standards of jurisdiction and bilateral tax treaties.

The Treasury Department's original legislative solution of 1980[188] offers a general approach to stapled stock[189] that avoids many of the more serious pitfalls presented by section 269B.[190] Under the proposal, the Internal Revenue Service regards pairing a

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181 *See supra* note 2. Most stapled stock schemes designed to avoid United States taxes utilize tax havens. *See supra* notes 42-43 and accompanying text.

182 *See supra* notes 21, 111 and accompanying text.

183 *See supra* text accompanying notes 168-69.

184 *See* Gordon, *supra* note 91, at 32. The use of tax havens as measured by United States investments grew rapidly from $4.7 billion in 1968 to $23 billion in 1978 according to Commerce Department figures. *Id.*

185 *See supra* notes 39-40, 81-90 and accompanying text.

186 *See supra* note 110 and accompanying text.

187 *See supra* notes 81-90 and accompanying text.

188 H.R. 8110, 96th Cong., 2d Sess., 126 CONG. REC. 25,411 (1980); *see supra* notes 91-102 and accompanying text.

189 *See supra* notes 98-102 and accompanying text.

190 *See supra* notes 140-84 and accompanying text.

foreign corporation's stock with its former domestic parent as a cancellation of a distribution of the foreign corporation's stock ownership to the domestic corporation's shareholders.[191] Because the distribution of the foreign corporation's stock no longer creates a newly independent entity, the domestic corporation remains the beneficial owner of the foreign corporation. Thus, under subpart F, the domestic corporation becomes a United States shareholder of a controlled foreign corporation.[192]

This alternative solves the problems Congress hoped to resolve with section 269B. First, the alternative cures pre-section 269B ambiguities[193] in the tax treatment of a distribution and pairing.[194] Second, by requiring that the domestic corporation pay United States taxes on the paired foreign entity's earnings under subpart F,[195] the alternative eliminates incentives for the domestic corporation to undercharge its foreign counterpart for goods and services as a means of transferring the domestic corporation's profits abroad.[196] Third, by extending indirect tax jurisdiction over foreign corporations, the alternative allows the Internal Revenue Service to police the compliance of paired foreign corporations with the anti-boycott rules and other regulatory measures enforced,[197] in part, through the Code.[198] Fourth, it ends the abusive use of stapled stock as a "transparent device" that threatens to undermine the integrity of the tax system.[199]

Because the alternative solution uses a domestic corporation to tax indirectly a foreign paired entity, the alternative avoids the jurisdictional problems posed by section 269B,[200] and does not require unilateral modification of tax treaties.[201] Moreover, it avoids section 269B's overbreadth problems.[202] The alternative solution equalizes the tax treatment of paired foreign entities with controlled foreign corporations, and, by focusing on the distribution of a foreign corporation's stock by domestic parents, iguores pairings that involve domestic corporations and former foreign parents.

The drawbacks of the alternative solution do not outweigh prospective increases in revenue. Admittedly the alternative leads to

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191 *See supra* note 100 and accompanying text.
192 *See supra* notes 98-102 and accompanying text.
193 *See supra* notes 81-90 and accompanying text.
194 *See supra* notes 98-102, 135-39 and accompanying text.
195 *See supra* notes 98-102 and accompanying text.
196 *See supra* notes 106-08 and accompanying text.
197 *See supra* notes 34-35 and accompanying text.
198 *See supra* note 109 and accompanying text.
199 *See supra* note 110 and accompanying text.
200 *See supra* notes 140-52 and accompanying text.
201 *See supra* notes 166-84 and accompanying text.
202 *See supra* notes 153-60 and accompanying text.

inconsistent tax treatment between the distribution and pairing of a domestic corporation and a foreign corporation. In the former, the IRS requires the shareholders to recognize the distribution as a taxable event, and in the latter it claims the pairing arrangement cancels the effective distribution. However, such inconsistency is justified because the two pairing arrangements differ to the extent that one ends in a tax avoidance and the other does not. A second problem with the alternative is that the domestic corporation must pay taxes on income earned and distributed by a foreign corporation that theoretically lies beyond its control. However, the congruence of ownership between the two foreign corporations greatly reduces the injustice of such treatment. Indeed, many other provisions of the Code employ constructive receipt to tax income a taxpayer may never have actually received.[203]

Conclusion

Congress acted properly to close the tax loophole exploited by stapled stock. However, section 269B's expansion of United States tax jurisdiction to reach directly foreign paired entities fails to conform with traditional standards of United States and international tax jurisdiction. The new rule does not discriminate between pairing arrangements that remove a foreign corporation from United States tax jurisdiction and pairings in which the foreign corporation originally rested beyond United States tax jurisdiction. Moreover, the Code now taxes foreign paired entities more harshly than similarly controlled foreign corporations. Finally, because section 269B permits the United States unilaterally to override bilateral tax treaties, it jeopardizes the viability of future tax treaties and the continued cooperative enforcement of treaties by current treaty partners.

Congress could better achieve its objectives by equating the treatment of foreign paired entities with controlled foreign corporations. Under this alternative approach, the IRS would ignore the distribution of a foreign corporation's ownership by a domestic corporation when coupled with a pairing, and continue to treat the domestic corporation as the owner of a controlled foreign corporation.

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203 *See, e.g.,* Treas. Reg. § 1.451-2 (constructive receipt); Corry, *supra* note 38, at 193.