# THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

May 2004

# PAPER III

## PRINCIPLES OF CORPORATE AND INTERNATIONAL TAXATION

A – UNITED STATES OPTION

TIME ALLOWED - 3 HOURS

Candidates should answer any **two** questions from Part I and any **two** questions from Part II.

Each question will carry equal marks.
Start each answer on a fresh sheet.
All workings should be made to the nearest month and dollar unless the question requires otherwise.
Marks are specifically allocated for good presentation.

## General Note

Prepare memoranda analysing the United States income tax consequences as instructed in the directions for each question. Assume in each case that there are no other transactions in the taxable year that affect your answer. If you find that a question is ambiguous or that you do not have sufficient data to answer it, respond to the question and explain the nature of the ambiguity or describe the missing information.

In each of the questions, assume for purposes of arithmetic simplicity that the normal United States income tax rate is 35 percent for individuals and 35 percent for corporations (the approximate maximum rates under current law) and that all net income is taxed at those rates. Assume further that the long-term capital gains rate is 15 percent. The statutory withholding tax rate, where applicable, is 30 percent. You need not consider the impact of personal deductions and/or exemptions in your answers.

Unless otherwise indicated, assume that there is no bilateral income tax treaty in force between the United States and any other country referred to in the questions [even if you know that there is in fact such a treaty between the United States and the other country]. When the problem indicates that a treaty is relevant to the analysis, apply the terms of the 1996 US Model Tax Treaty ("US Model Treaty").

Answer two questions from Part I and two questions from Part II.

Each question is weighted equally.

## PART I

You are required to answer **TWO** questions from this Part.

1.

1) Ahmadu, a consulting engineer, is a citizen of Nigeria who spends 140 days each year in the United States. During 2003, Ahmadu earned $100,000 from his work in the United States, $100,000 from his work in Europe (where he spends 100 days each year) and $100,000 in different countries in Africa (where he spends 125-6 days each year). Ahmadu is legally within the United States because he has a visitor's visa allowing him to conduct business activities within the country. Ahmadu maintains luxury apartments in London and Geneva, where he spends a few days each year for rest and relaxation. Although Ahmadu carries a Nigerian passport, Ahmadu spends very little time in that country because of allegations that he has not satisfied all of his tax obligations there.

   Ahmadu has substantial investments in Europe and the United States. During 2003, Ahmadu received dividends of $50,000 from European companies doing business in Europe and $50,000 from US companies doing business in the United States.

   **Prepare a memorandum analysing Ahmadu's US income tax liability, if any, for 2003.** (13)

2) Benson is a citizen and resident of New Zealand who spends no time in the United States. On January 1, 2001, Benson purchased 1000 shares of Cola Co. stock for $10,000 and 1000 shares of Dementia Corp. stock for $20,000. Cola Co. is a US corporation all of whose business is effected in the United States. Dementia Corp. is a Panama corporation all of whose business is effected in small Caribbean countries. On December 31, 2003, Benson sold the Cola Co. shares for $18,000 and the Dementia Corp. shares for $19,000. All purchases and sales of the shares of both companies were implemented on the New York Stock Exchange by US brokers to whom Benson had granted discretionary authority to buy and sell securities without consulting him, and in fact the shares had been bought and sold by the brokers without prior consultation with Benson. During the course of 2003, Benson also received dividends of $1,000 from both corporations.

   **(a) Prepare a memorandum analysing Benson's US income tax liability, if any, for 2003.** (9)

   **(b) How would your analysis be affected, if at all, if the US Model Treaty were in force between the United States and New Zealand?** (3)

Total (25)

2.

1) Epsilon Ltd, a corporation organised under the laws of Greece, operates a factory through a branch in California. At the beginning of 2003 the US branch had assets worth and with a tax book value of $5,000,000 and liabilities of $1,000,000. During 2003 the US branch had net income of $1,000,000. At the end of the year after US income tax liabilities had been satisfied, the US branch had assets worth $6,000,000 with a tax book value of $5,400,000, but had reduced its liabilities to $900,000.

   **(a) Prepare a memorandum analysing Epsilon Ltd's US tax liabilities, if any, for 2003.** (10)

   **(b) How would your analysis be affected, if at all, if the US Model Treaty were in force between the United States and Greece?** (3)

2) Epsilon Ltd is considering a joint venture proposal made by Lincoln Corp, a US corporation. Under the terms of the proposal, each joint venturer would own half of the new business, which would be established and operated wholly in the United States. It is expected that the business will incur a net loss for the first three years of operation, but thereafter will produce substantial profits. Lincoln Corp has indicated that it would prefer to operate the business as a US partnership, but has left the decision as to entity form to Epsilon Ltd.

   **Prepare a memorandum for Epsilon Ltd comparing the US income tax consequences of establishing the joint venture as either a US corporation or as a US partnership.** (12)

Total (25)

3. Gardel, a citizen and resident of Argentina, invested $12,000,000 in the American Land Company ("American Land") in 2001 in return for all of the common stock of the company. American Land invested the cash immediately in the following ways. It acquired several apartment buildings in Miami, USA for $3,000,000. It invested $4,000,000 in relatively small holdings of publicly traded US companies. It invested $5,000,000 in inventory for a fancy art gallery operated in rented space on Fifth Avenue in New York, USA.

1) During 2002 and 2003, the apartment buildings produced net income of $800,000, the stocks produced dividends of $40,000 and the art gallery produced net income of $100,000. American Land paid no dividends to him in 2002 and 2003, but paid Gardel a salary of $300,000 each year for his services as president of the company.

**Analyse Gardel's US income tax liabilities in 2002 and 2003, if any.**

(8)

2) In 2004 Gardel was told that he could sell his shares of American Land for $200,000,000.

**Analyse the US income tax consequences to Gardel if he implements such a sale under the following alternatives:**

**(a) The apartment buildings are worth $120,000,000; the stock is worth $40,000,000; the gallery inventory is worth $40,000,000.**

**(b) The apartment buildings are worth $70,000,000; the stock is worth $40,000,000; the gallery inventory is worth $90,000,000.**

**(c) The apartment buildings are worth $200,000,000, but are subject to a mortgage of $160,000,000 which secures loans to American Land, which it has used to finance inventory purchases and executive bonuses; the stock is worth $80,000,000; the gallery inventory is worth $80,000,000.**

(12)

3) **If American Land were a corporation organised in the Cayman Islands, under which of the circumstances described in Part 2) above would Gardel by subject to tax in the event of a sale of his shares in American Land?** (5)

Total (25)

## PART II

You are required to answer **TWO** questions from this Part.

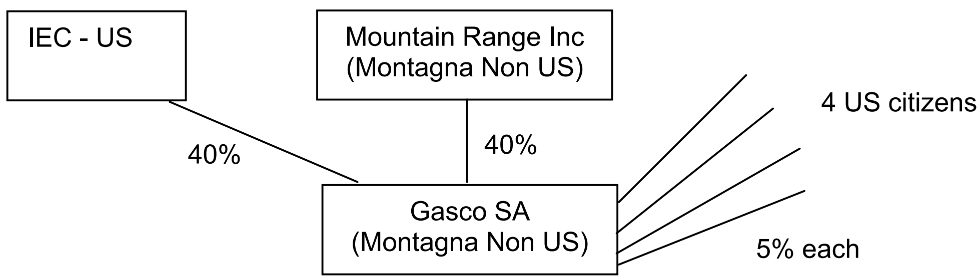
4. International Energy Co. ("IEC") is a publicly and widely held US corporation that has invested in energy production in several countries. IEC owns 40 percent of the common stock of Gasco SA, a corporation organised under the laws of Montagna, and 40 percent of Petex Ltd, a corporation organised under the laws of Sandalia.

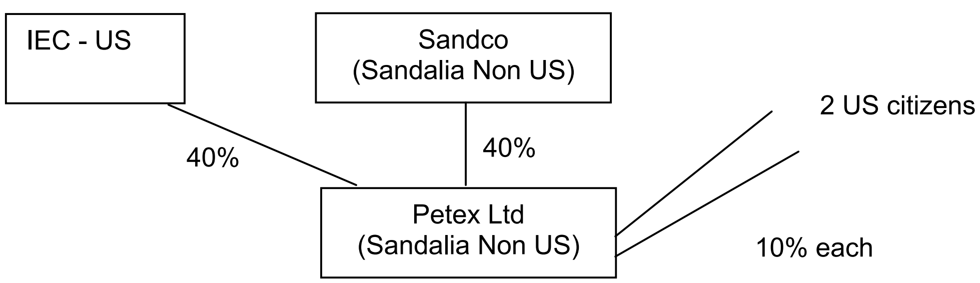
   Mountain Range Inc., a Montagna corporation all of whose shares are owned by citizens of Montagna, owns 40 percent of Gasco SA. Each of four US citizens (who are unrelated and who own no stock in IEC or Mountain Range), owns 5 percent of the common stock of Gasco SA.

   Sandco, a Sandalian corporation all of whose shares are owned by citizens of Sandalia, owns 40 percent of Petex Ltd. Each of two US citizens (who are unrelated and who own no stock in IEC or Sandco) owns 10 percent of the shares of Petex Ltd.

   During 2003, both Gasco SA and Petex Ltd earned gross income of $20,000,000 from the active operation of their respective energy businesses outside the United States from which each made a profit of $10,000,000. Both Gasco SA and Petex Ltd also received $10,000,000 in dividend income from investments in various countries outside the United States. Neither Gasco SA nor Petex Ltd has paid any dividends to any of its shareholders.

   The following diagrams are produced below to assist you.




*Continued*

4. *Continuation*

1) **Prepare a memorandum analysing the US income tax consequences, if any, to IEC and the US individuals who own shares in Gasco SA and Petex Ltd as a result of the foregoing events.** (15)

2) **How would your analysis change, if at all, if Gasco SA and Petex Ltd paid income taxes in 2003 to Montagna and Sandalia respectively?** (5)

3) **How would your analysis change, if at all, if the US Model Treaty were in force between the US and Montagna and the US and Sandalia?** (5)

Total (25)

5. Lotus Ltd ("Lotus") is a corporation organised under the laws of Peru. Half of the common stock of Lotus is owned by Management Inc. ("Management"), a US corporation. The remaining half is owned by Nelson, a US citizen living in Peru.

During the first year of operations in 2003, Lotus earned net operating income of $10,000,000 from the operation of a factory producing automotive parts from which Lotus paid Peru income taxes of $2,000,000. On December 31, 2003, Lotus paid dividends of $1,000,000 to each of its two shareholders, but was required to withhold 10 percent of the dividend payments to satisfy Peruvian withholding tax requirements (which had been patterned after those of the United States). Consequently, Management and Nelson each received dividend cheques for only $900,000.

1) **Prepare a memorandum analysing the US income tax consequences, if any, to Management and Nelson.** (20)

2) **How would your analysis change, if at all, if the US Model Treaty were in effect between the United States and Peru?** (5)

Total (25)

6. Oink Inc. ("Oink") is a US corporation engaged in pork production through the operation of animal farms and slaughterhouses in the United States and branches in four different countries. During 2003, Oink earned pretax income of $1,000,000 in Country Alpha where it paid income taxes of $500,000; pretax income of $1,000,000 in Country Beta where it paid income taxes of $200,000; and pretax income of $1,000,000 in Country Gamma where it paid income taxes of $100,000. Oink lost $200,000 in Country Delta, which included a property tax payment of $100,000. Oink also realised net income of $2,000,000 from its US operations. All of the profits were reinvested in the various countries in which they were earned. Moreover, Oink invested an additional $1,000,000 to expand its Delta operation "to try to make it profitable."

1) **Prepare a memorandum analysing the US income tax consequences to Oink of its various operations in 2003.** (15)

2) **How would your response to Part 1) above be affected if Oink had lost $2,000,000 in Country Delta, including the Property tax payment of $100,000?** (5)

3) **How would your response to Part 1) above be affected if Oink had no income or loss from its US operations?** (5)

Total (25)

7. You work as the legislative assistant to Senator Simone Simple. Senator Simple has asked you to consider a new proposal by her colleague, Senator Noah Itall. Senator Itall has proposed the complete elimination of the basket limitations on the foreign tax credit as well as the elimination of Subpart F. In his speech to the Senate when he initially advanced his proposal, Itall said:

> "The basket limitations have increased double taxation for US companies, thereby impairing our ability to compete in the increasingly globalised marketplace. We are shooting ourselves in the foot again. The basket limitations should, therefore, be eliminated at once. This is one of the few occasions when a tax proposal will cost nothing to the US Treasury because the foreign tax credit simply eliminates double taxation. Moreover, the basket limitations constitute a clear violation of US treaty commitments, even as set forth in our own Model Treaty."
>
> "Further, Subpart F is absolutely unnecessary. The foreign personal holding company provisions had been doing their job long before Subpart F was enacted. For the sake of simplicity for taxpayers and tax administrators, Subpart F should be rescinded at once."

Senator Simple believes that double taxation of international transactions is contrary to sound policy because it impedes economic growth and development for all countries. She is also persuaded that the federal income tax system is so complex as to be incapable of rational and fair administration. She is, therefore, inclined to support the Itall proposals. However, she has asked you to prepare a memorandum analysing the consequences of adopting it, evaluating the statements made by Senator Itall in support of his proposal and setting forth your recommendation as to whether she should support or oppose it.

**Prepare the memorandum.** (25)