THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

May 2005

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

You are required to 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 and that the same rate applies to dividends distributed by US corporations to US individual shareholders. 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").

Where possible to do so, calculate the U.S. tax consequences of your analysis using the simplified tax rate assumptions described in the previous paragraphs. Where taxpayers are individuals, ignore possible personal deductions and exemptions.

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. Manuel, a citizen and resident of Chile, in 2003 purchased for $100,000 one thousand shares of General Electronics Co. common stock on the New York Stock Exchange. General Electronics is a United States corporation all of whose business activities take place in and income derives from the United States. In 2003 Manuel also purchased for $50,000 one thousand shares of the common stock of Cayco Inc., a Cayman corporation whose shares are listed and sold on the New York Stock Exchange but all of whose income is derived from investments and activities in Caribbean countries. In both instances, Manuel used a New York broker who had discretionary authority to buy and sell for Manuel without seeking specific authorisation by him.

   During 2003, Manuel received dividends of $10,000 from General Electronics and $5,000 from Cayco. During 2004, Manuel received dividends of $5,000 from each company. However, he sold half of his General Electronics shares for $60,000.

   1) Analyse and explain the U.S. income tax consequences, if any, for Manuel in 2003 and 2004. (11)

   2) How, if at all, would your answer to 1) change if Manuel had sold half of the General Electronics shares in 2004 for $40,000? (3)

   3) How, if at all, would your answer to 1) change if Manuel had sold all of the Cayco shares in 2004 for $75,000? (3)

   4) How, if at all, would your answer to 1) change if the U.S. Model Tax Treaty were in force between the United States and Chile? (3)

   5) How, if at all, would your answer to 1) change if Manuel also received in 2003 and 2004 interest payments of $1,000 on a Eurobond issued by General Electronics that was in registered form and traded on European financial markets? (5)

   Total (25)

2. International Properties Co., a U.S. corporation, is owned by Alpha, Ltd., a corporation organised under the laws of Greece. Alpha Ltd invested $60,000,000 in return for all of the shares of International Properties Co at the end of 1997. In 1998 International Properties Co invested the $60,000,000 in the following way: $20,000,000 was invested in undeveloped land in Florida, USA; an office building in London, England was acquired for $20,000,000; $20,000,000 was invested in shares representing no more than one percent interest in various publicly traded U.S. corporations specialising in U.S. real property investments. By 2005, each of the investments had prospered. The Florida real estate was worth $40,000,000. The London office building was worth $30,000,000 (although its adjusted basis was only $15,000,000). The shares of publicly traded stock were worth $30,000,000.

On March 2, 2005, Alpha Ltd sold the shares of International Properties Co for $100,000,000.

You are required to:

1) Analyse and explain the U.S. income tax consequences, if any, to Alpha Ltd. from the sale of the International Properties Co stock. (5)

2) How, if at all, would your answer to 1) change if the value of the London office building at the time of the sale was $50,000,000 and the value of the publicly traded stock was only $10,000,000? (5)

3) How, if at all, would your answer to 1) change if International Properties Co had been organised under the laws of Panama? (5)

4) How, if at all, would your answer to 1) change if the U.S. Model Tax Treaty were in force between the United States and Greece? (5)

5) How, if at all, would your answer to 1) change if Alpha Ltd had invested $80,000,000 in the shares of International Properties Co and International Properties Co had originally also invested another $20,000,000 in equipment and raw materials necessary to operate a business in Texas, if such property (equipment and raw materials) was worth $20,000,000 with an adjusted basis of $5,000,000 at the time of the sale, and if the proceeds of the sale of International Properties Co stock was $120,000,000. (5)

Total (25)

3. Raw Steel Corp. is a corporation organised under the laws of Korea, owned by Korean citizens and is wholly financed from capital sources in Korea. During 2004, Raw Steel Corp sent 10 salesmen from Korea to the United States who travelled throughout the year to every state to meet potential customers. Even though they worked out of modest hotel rooms, the Korean salesmen were very effective. The salesmen would take orders and forward them for final approval to the home office in Korea. U.S. customers would take title to the products when the shipments were received from Korean factories. As a result of these efforts Raw Steel Corp realised net income of $20,000,000 from sales to customers in the United States during the year, all of which was reinvested in its Korean manufacturing operations. As a reward for their successful sales efforts, the salesmen were each paid a bonus of $20,000 in addition to their salaries of $100,000.

1) Analyse the U.S. tax consequences, if any, of the foregoing to Raw Steel Corp. (8)

2) Analyse the U.S. tax consequences, if any, of the foregoing to the Korean salesmen. (8)

3) How, if at all, would your answers to 1) and 2) change if the U.S. Model Tax Treaty were in force between the United States and Korea? (9)

Total (25)

PART II

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

4. American Electronics ("Amtron") is a U.S. company engaged in the manufacture and sale of consumer electronic products. All of Amtron's production activities have thus far taken place in the United States. However, it has sold product in European markets for a number of years at a profit margin substantially exceeding that on domestic sales. Amtron pays a tax of 35 percent on net income in the United States. Its sales to European customers have been effected in ports on the East Coast of the United States so that no foreign taxes have been paid.

   Amtron is currently considering a proposed joint venture that would result in the establishment of a factory in Bulgaria. The joint venture vehicle would be either a partnership or a Bulgarian corporation. In either event, all profits would be reinvested in Bulgaria for at least five years. Half of the joint venture would be owned by Amtron. The remaining half would be owned by Sofia Corp., a Bulgarian company. Each party would invest $10,000,000 in the joint venture.

   There is a Bulgarian corporate income tax of 25 percent which is imposed on the net income of all Bulgarian companies and the trade or business income of all non-Bulgarian companies doing business there. Moreover, Bulgaria imposes a 10 percent withholding tax on all dividend distributions and interest payments by Bulgarian corporations to non-Bulgarian shareholders. Dividends paid by one Bulgarian corporation to another are exempt from tax. Bulgaria has no branch profits tax.

   The Ministry of Finance of Bulgaria is responsible for administering a "development incentive program" intended to attract additional foreign investment. A portion of that program authorises the Minister to exempt designated Bulgarian companies from the 25 percent net income tax. Such companies must, however, withhold 35 percent on all dividends paid to foreign companies or individuals. Moreover, dividends and interest paid by such companies to other Bulgarian companies are fully taxable. This program is not available to foreign corporations operating in Bulgaria.

   Partnerships under the income tax laws of Bulgaria are treated in the way that partnerships are treated under the Internal Revenue Code of the United States.

   There is no tax treaty in force between the United States and Bulgaria.

   You are required to:

   1) Advise whether it would be better from a tax viewpoint for American Electronics if the Bulgarian venture were organised as a Bulgarian partnership or a Bulgarian corporation. (15)

   2) Advise whether American Electronics should negotiate to have the joint venture vehicle qualified for the "development incentive program." (10)

   Total (25)

5. A partnership organised under the laws of Agricola operates a factory there. There are four equal partners: Tradewinds Inc., a U.S. corporation; Victor Co., a U.S. corporation; Ulysses, a citizen and resident of the United States; and George, a citizen and resident of Agricola. During the course of the taxable year, the partnership realises pretax net income of $5,000,000 and pays income taxes to Agricola of $1,000,000. The partnership makes no distributions during the year.

You are required to answer the following:

1) **Analyse and explain the U.S. income tax liability, if any, of Tradewinds Inc., Victor Co., Ulysses and George.** (5)

2) **How would your answer to 1) change, if at all, if Tradewinds Inc also realised pretax earnings of $250,000 from a branch operation in Islandia and paid income taxes of $100,000 and Victor Co. also had losses of $750,000 from a branch operation in Industria.** (12)

3) **How would your answer to 1) change, if at all, if the joint venture in Agricola instead was organised as Wow Inc., an Agricolan corporation in which Tradewinds Inc., Victor Co., Ulysses and George own equal shares, Wow Inc. earned pretax net income of $5,000,000 and paid income taxes to Agricola of $1,000,000, and during the course of the taxable year, Wow Inc. paid a dividend of $100,000 to each of its four shareholders.** (8)

Total (25)

6. Federated Funds Inc., a U.S. corporation, owns 40 percent of the common stock of General Goods Co., a corporation organised under the laws of Islandia. The remaining 60 percent of General Goods Co. is owned by Transnational Ltd., a corporation organised under the laws of Industria. During the taxable year, General Goods Co. realised $1,000,000 of passive investment income from sources in foreign countries other than Islandia and $2,000,000 of gross income from the active conduct of a business in Islandia which produced a net profit of $1,000,000. Islandia has no taxes of any kind. General Goods Co. paid no dividends.

You are required to answer the following:

1) Analyse and explain any U.S. income tax consequences to Federated Funds, Inc. (4)

2) Analyse and explain any U.S. income tax consequences to Federated Funds and the U.S. citizens if Transnational Ltd. owned only 40 percent of General Goods Co. and the remaining shares were owned in equal amounts by five unrelated U.S. citizens who owned no shares of Federated Funds Inc. or Transnational Ltd? (6)

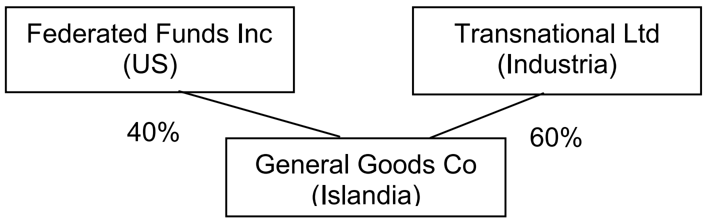
3) Analyse and explain any U.S. income tax consequences to Federated Funds and the U.S. citizens if Transnational Ltd. owned only 40 percent of General Goods Co. and the remaining shares were owned in equal amounts by two unrelated U.S. citizens who owned no shares of Federal Funds Inc. or Transnational Ltd? (10)

4) How, if at all, would your answer to 3) change if during the taxable year General Goods Co realised $9,000,000 of passive investment income, $2,000,000 of gross income from the active conduct of a business in Islandia which produced a net profit of $1,000,000, paid no taxes in Islandia and distributed no dividends? (5)

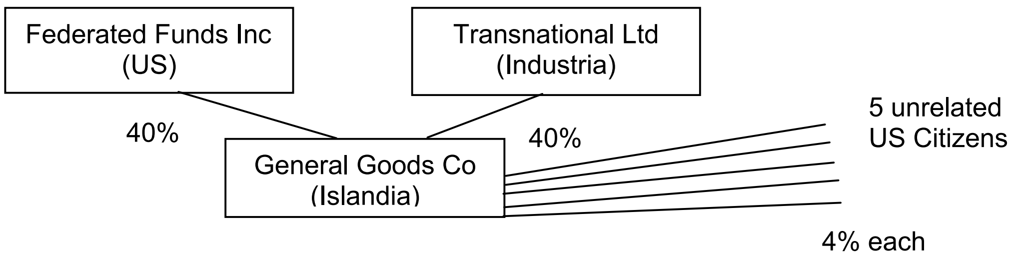
Total (25)

The following diagrams relating to 1) to 3) above are produced below to assist you.

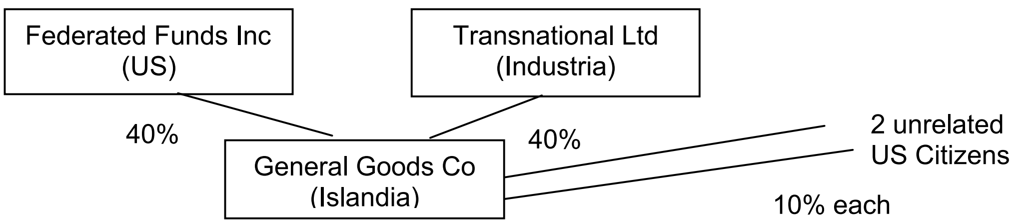
1)



2)



3)



7. Indicate whether you agree or disagree with the following five statements and explain fully all of the reasons for your position in a way that demonstrates your understanding of all relevant terms and issues. Each statement is weighted equally.

   1) **When a foreign government offers significant tax incentives to a U.S. investor, often called "tax sparing," Subpart F will usually come into play.**

   2) **No U.S. taxpayer would ever elect to deduct, rather than credit, foreign income taxes paid on foreign source income.**

   3) **Subpart F and the PFIC provisions represent two equally valid approaches to the same problem.**

   4) **Rules relating to the taxation of international transactions have often been modified to advance foreign policy objectives of the United States.**

   5) **Although the unitary or formulary system of income apportionment is designed to confront potential transfer pricing abuses, it is quite different from the approach authorised by section 482 and is likely to produce rather different results.**

Total (25)