THE CHARTERED INSTITUTE OF TAXATION

THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

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PAPER III

PRINCIPLES OF CORPORATE AND INTERNATIONAL TAXATION

A – UNITED STATES OPTION

Answers

Part I (50 Points) (Questions 1-3)(Answer 2 questions)

Question 1

(a) Manuel is a nonresident alien of the United States. He will not be taxed in the United States unless he has U.S.-source income or receives foreign-source income in a manner that is deemed to be effectively connected with a U.S. trade or business. The dividends received from General Electronics are U.S.-source income subject to a statutory withholding tax of 30 percent. The dividends received from Cayco are foreign-source income because they are paid by a foreign corporation. The fact that Manuel purchased the shares on the New York Stock Exchange is irrelevant. The gain of $10,000 realized upon the sale of the General Electronics stock (proceeds of $60,000 less adjusted basis of $50,000) is foreign-source income because Manuel is a nonresident of the United States even though General Electronics is a U.S. corporation. Code Sec. 865(a)(2). Moreover, Manuel is not deemed to be conducting a U.S. trade or business because of his use of a New York broker with discretionary authority. Code Sec. 864(b)(2).

As a result of the foregoing analysis, Manuel is subject to U.S. taxes of $3,000 in 2003 and $1,500 in 2004. Code Sec. 872(a)(1). (11)

(b) If Manuel had sold half of the General Electronics shares in 2004 for $40,000, he would have realized a loss of $10,000 (proceeds of $40,000 less adjusted basis of $50,000). This loss is regarded as deriving from foreign sources because he is a foreign resident. It does not reduce the withholding tax on dividend income paid by General Electronics. (3)

(c) If Manuel had sold all of the Cayco shares in 2004 for $75,000, he would have realized a gain of $25,000. The gain would be foreign source because Manuel is a foreign resident even though the transaction was implemented on the New York Stock Exchange. (3)

(d) If the U.S. Model Tax Treaty were in force between the United States and Chile, the withholding tax on dividends paid by General Electronics would be only 15 percent. No other part of the analysis would change. Art. 10(2)(b). (3)

(e) The results would not change. The interest paid on such bonds would be “portfolio interest” exempt from U.S. tax under Code Section 871(h) even though deriving from U.S. sources. (5)

Question 2

(a) Alpha, Ltd. is a foreign resident because it is a foreign corporation. Code Sec. 7701(a)(c). It has realized gain of $40,000,000 (proceeds of $100,000,000 less adjusted basis of $60,000,000) on the sale of International Properties stock. The gain is ordinarily treated as foreign-source income not subject to U.S. taxation because of the residence of the taxpayer. However, Code Sec. 897 (enacted as the Foreign Investor in Real Property Tax Act of 1981, or “FIRPTA”) may change the result. The question is whether more than half of the value of certain assets during the five year period prior to the sale of the stock consists of U.S. real property interests. The other relevant assets are assets used in a trade or business and foreign real property holdings. The shares of publicly traded stock are not considered in the analysis. Thus, U.S. real property is worth $40,000,000 and the

London real property is worth $30,000,000. Since more than half of the relevant properties consists of U.S. real property interests, FIRPTA applies and the gain is taxed as if it were effectively connected with a U.S. trade or business. Note that neither the original cost nor the adjusted basis of the relevant assets held by International Properties is relevant to the analysis. Note further that FIRPTA will effectively tax the gain attributable to properties other than the U.S. real property interest. (5)

(b) Again, the value of the publicly traded stock is not relevant to the analysis. In this instance, the value of the U.S. real property interest is only 4/9ths of the total value of the relevant assets. FIRPTA does not, therefore, apply. The gain is not taxed. (5)

(c) If International Properties had been organized in Panama, it would be treated as a "U.S. real property holding company" because more than half of the value of the relevant assets was attributable to U.S. real property interests. However, a foreign corporation will not generally be treated as a "U.S. real property interest." Accordingly, FIRPTA would not apply and the gain would not be taxed in the United States. (5)

(d) There would be no change in the result. The U.S. Model Treaty explicitly authorizes the results that obtain under FIRPTA. See Article 13. (5)

(e) The assets used in a trade or business are considered in the denominator of the calculation under FIRPTA. As a result, the value of all of the relevant assets is $90,000,000 ($40,000,000 of Florida real estate plus $30,000,000 of London real estate plus $20,000,000 of assets used in a trade or business). The publicly traded shares are not considered in the analysis. The U.S. real property interest is again worth only 4/9ths of the value of the relevant assets. FIRPTA does not apply and the gain is not taxed in the United States. (5)

<u>Question 3</u>

(a) Raw Steel will be deemed to be conducting a U.S. trade or business if it engages in "regular, continuous and substantial" business activities in the United States. Although there is no statutory definition of these criteria, the regular presence of ten salesmen in the country generating net income of $20,000,000 each year would likely be considered to be a U.S. trade or business. See Code Sec. 864(b). Note that a U.S. trade or business can result even if the business activities are not being undertaken by a permanent establishment. Therefore, the fact that the salesmen work out of hotel rooms and move about the country would not be a defense to the allegation that a U.S. trade or business is being operated. Income "effectively connected" with the U.S. trade or business will be subject to tax on a net basis at the usual corporate rates. Code Sec. 882. Because the U.S. customers take title in the United States, the income realized from the sales will be regarded as U.S.-source income effectively connected with the U.S. trade or business. Code Sec. 865(b). Thus, the $20,000,000 of net income will be taxed at the corporate tax rate (assumed for purposes of this examination to be 35 percent). Moreover, since the profits were not reinvested in a U.S. branch operation, a branch profits tax of 30 percent would apply on the after tax income of Raw Steel's U.S. trade or business. (8)

(b) If the Korean salesman are resident aliens for immigration purposes, they will be regarded as residents for income tax purposes. As such, they will be taxable on their worldwide income. If they are not residents for immigration purposes, they may nevertheless be treated as residents for income tax purposes as a result of the application of the substantial presence test prescribed by Code Section 7701(b). That test requires the identification of the number of days spent in the United States during the current previous two taxable year. Each day of the current year counts as a day. Each day of the prior year counts as 1/3 of a day. Each day of the year before that counts as 1/6 of a day. If the total number exceeds 183, the taxpayer is generally treated as a resident subject to the rule of worldwide taxability. Thus, if a salesman is in the United States for more than 183 during the taxable year, he will be treated as a resident alien. However, if the salesman is in the United States for less than 183 days during the current year, he may still be classified as a nonresident for income tax purposes even if he fails the substantial presence test by demonstrating that he has a "tax home" in another country.

If a salesman qualifies as a nonresident alien under the foregoing tests, he will nevertheless be subject to tax on his net income attributable to his activities in the United States. The performance of services (with a modest de minimis exception) is treated as a U.S. trade or business. Code Sec. 864(b)(1). Compensation for services rendered in the United States is U.S.-source income. Code Sec. 861(a)(3). Therefore, the compensation received by the salesmen, including the bonuses, will be subject to U.S. income taxes regardless of the currency in which it is paid and the place where it is deposited. Code Sec. 872. The salesmen will, however, be able to deduct trade or business expenses and certain personal items. Code Sec. 873. The tax rates are those prescribed for individuals (for purposes of this examination assumed to be 35 percent). (8)

(c) There would be a significant difference for Raw Steel if the U.S. Model Treaty were in effect. Under Article 7 of the Treaty, business profit is only taxed if it is attributable to a permanent establishment being operated in the taxing country. Permanent establishments are defined by Article 5. The activities of the mobile salesmen in the United States will not likely constitute a permanent establishment under that provision. Note that the salesmen are not authorized to approve sales on behalf of the company. (4)

The salesmen, if they are nonresidents for income tax purposes, may possibly escape U.S. tax if the U.S. Model Treaty were in force. Article 14 of the treaty provides a tax exemption for foreign employees in certain circumstances. If the salesmen remain in the United States not more than 183 in any twelve month period and are not paid from a permanent establishment, they will not be taxed even though the realize U.S.-source income effectively connected with a U.S. trade or business. Are the salesmen nonresident aliens? The U.S. rules have been described in the answer to part (b) of this question. It is possible, however, that they are also regarded as residents of Korea. As in most bilateral income tax treaties, the U.S. Model Treaty contains a series of tie-breaker provisions that apply in circumstances in which an individual is regarded by both countries as a resident under their respective laws. See Article 4. It is possible that the salesmen will be treated as nonresidents of the United States even though they would be treated as residents under the statutory prescription. (5)

Part II (50 points)(Questions 4-7)(Answer two questions)

Question 4

(a) If the Bulgarian entity is treated as a partnership, Amtron is taxed in the U.S. each year on its share of partnership profits, as determined by U.S. tax law. Since no profits can be distributed for five years, this will result in a U.S. tax on income not available to Amtron. Of course, Amtron will have a foreign tax credit for income taxes paid to Bulgaria. Code Sec. 901. However, since the Bulgarian taxes are lower than the U.S. Tax, the net effect for Amtron will be additional U.S. tax obligations with no additional cash to pay them. A Bulgarian corporation provides for deferral. Since it will be operating a trade or business, the anti-deferral provisions will not apply even if the control tests are applicable. Further, because of the indirect credit, which available to U.S. corporate shareholders holding at least 10 percent of the stock of a foreign corporation, Amtron will not lose foreign tax credit potential. Code Sec. 902. (15)

b) The Bulgarian incentive program will allow the joint venture corporation to accumulate assets at a much more rapid pace. Moreover, the higher withholding tax will not impose additional tax burdens on Amtron if it is creditable. While there may be questions about creditability, it looks like an "in lieu of" tax, since it is in lieu of the normal corporate income tax. As such, it is creditable under Code Sec. 903. Is it a "soak-up tax"? Probably not, since its application does not depend upon creditability in the United States. Regs. Sec. 1.902-2(c). Failure clearly to recognize the value of this program is a serious defect in any answer. (10)

Question 5

(a) Because the business is being operated through a partnership, the U.S. partners are subject to immediate taxation on their allocable income even though no actual distribution has been made. However, each will be entitled to a foreign tax credit in respect of the portion of foreign income taxes paid. As a result Tradewinds, Victor and Ulysses will be subject to tax on income of $1,250,000 but will be entitled to a foreign tax credit of $250,000. The result is the same for each taxpayer (assuming for purposes of this examination that the effective U.S. tax rate is 35 percent). The basic U.S. tax will be $437,500 ($1,250,000 x 35 percent). The foreign tax credit will be $250,000. The net U.S. tax payable will be $187,500. George, as a citizen and resident of Agricola, would have no U.S. income tax liability. (5)

(b) It Tradewinds also realized pretax earnings of $250,000 from a branch operation in Islandia and paid income taxes there of $100,000, it would benefit from "cross-crediting." Tradewinds total foreign-source income would be $1,500,000 ($1,250,000 from Agricola and $250,000 from Islandia). Its basic U.S. income tax liability would be $525,000 (assuming a tax rate of 35 percent). It would be entitled to a foreign tax credit of $350,000 ($250,000 in Agricola and $100,000 in Islandia). The net U.S. tax would be $175,000. Note that Tradewinds has effectively reduced its U.S. tax on Agricola income because of taxes paid in Islandia. (6)

If Victor has losses of $750,000 from a branch operation in Industria, it would be affected by the overall limitation on foreign tax credits. Victor's net foreign-source income will by $500,000 ($1,250,000 income in Agricola less $500,000 loss in Industria). The basic U.S. income tax on that income will be $165,000. Victor will, therefore, be limited to a foreign tax credit of $165,000. Victor is in an "excess credit" position. Under current law, Victor may carry over the excess foreign tax credits of $85,000 ($250,000 less $165,000) back for one year or forward for ten years. Code Sec. 904(c). (6)

(c) If the joint venture were organized as an Agricolan corporation, the results would be substantially different. The U.S. shareholders would only be taxed on dividends distributed to them. However, there would be a difference in the net results for the corporate and individual shareholders.

Ulysses would have dividend income of $100,000 and would pay a U.S. tax (assuming a tax rate of 35 percent) of $35,000. Ulysses would not be entitled to a foreign tax credit because he paid no foreign income taxes. (2)

Tradewinds and Victor would be entitled to an indirect foreign tax credit because each owns at least 10 percent of Wow. However, they would be required to "gross up" their dividend income in effect by the taxes paid in Agricola that allowed Wow to make a $100,000 dividend distribution. The tax rate in Agricola is 20 percent ($5,000,000 of taxable income produces $1,000,000 of income taxes). Thus, Wow would have paid $25,000 in income taxes to Agricola to enable it legally to distribute a dividend of $100,000. As a result, the two U.S. corporations would report gross income of $125,000 (the actual dividend of $100,000 plus the gross up of $25,000), which would result in a basic U.S. tax of $43,750. However, the two U.S. corporations would be entitled to a foreign tax credit of $25,000, resulting in a net U.S. income tax liability of $18,750. (6)

<u>Question 6</u>

(a) A U.S. shareholder of a foreign corporation will generally have no U.S. income tax liability until dividends are paid by the foreign corporation or until gain is realized from the sale or other disposition of shares of the foreign corporation. Since no dividends were paid, Federated Funds has no U.S. income tax liability. (4)

(b) However, Subpart F of the Code will result in the recognition of a constructive dividend if a controlled foreign corporation realizes certain forms of income without making an actual dividend distribution of such income. See Code Secs. 951 et seq. A foreign corporation will be treated as a controlled foreign corporation if "U.S. shareholders" (as specially defined for these purposes) own collectively more than 50 percent of the voting power or value of the foreign corporation. A "U.S. shareholder" is a U.S. taxpayer who owns at least 10 percent of the voting power or value of the foreign corporation. The shares owned by each of the five individual U.S. citizens represent a 4 percent interest. Thus, they are not counted in determining whether General Goods is a controlled foreign corporation. As a result, only the 40 percent interest owned by Federated Funds are counted. General Goods is not a controlled foreign corporation and the domestic shareholders have no U.S. income tax liability. (6)

(c) If two U.S. individual shareholders each owned 10 percent of the stock of General Goods, each would be a "U.S. shareholder". General Goods would thus be a controlled foreign corporation because "U.S. shareholders" collectively would own 60 percent of the corporation. However, only "Subpart F income" will generally be treated as a constructive dividend. The passive investment income of $1,000,000 would be treated as Subpart F income. The net profit of $1,000,000 from the operation of a trade or business is not Subpart F income. As a result, Federated Funds would be treated as the recipient of a dividend of $400,000 (40 percent of $1,000,000) even though no actual dividends were distributed. However, Federal Funds would be allowed to increase its adjusted basis in the shares of General Goods by $1,000,000 because no cash has been distributed by General Goods. The two other U.S. shareholders, each of whom owns 10 percent of General Goods, would each be taxed on a constructive dividend of $100,000 and would be entitled to increase his adjusted basis in the General Goods shares by the same amount. (10)

(d) If Subpart F income exceeds 70 percent of the gross income of the controlled foreign corporation, a full inclusion rule requires that all of its income be included in the constructive dividend. Code Sec. 954(b)(3). In this situation, 81 percent of the gross income ($9 million of $11 million) is Subpart F income. The Rule applies. Federated Funds will be treated as having received a constructive dividend of $4,000,000. The individual U.S. shareholders will be treated as having received a constructive dividend of $1,000,000 each. Their adjusted basis in the stock of General Goods will be increased accordingly. (5)

<u>Question 7</u>

1. Tax sparing has nothing to do with subpart F as such. Tax sparing is a foreign tax credit in respect of foreign income taxes on foreign source income that would have been paid but for the provision of a tax holiday in (usually) a developing country. It is not the tax holiday itself. Subpart F comes into play when arrangements are made to "use" a tax haven corporation to realize income that generally is passive or has nothing to do with the jurisdiction where the corporation has been organized. It is unlikely that a tax holiday would be provided from usual corporate taxes in such circumstances. Tax holidays are much more likely where foreign investors have been induced to invest in ways that create jobs or help deal with foreign exchange issues by stimulating exports or providing for import substitution.

2. Most U.S. taxpayers would prefer a foreign tax credit to the deduction. There are circumstances, however, where that might be the case. The easiest example arises when there are losses in some foreign countries or an overall loss to a U.S. company. To get full credit, a numerical example must be provided. Also, the impact on various carryover provisions must be analyzed.

3. Both confront unacceptable exploitation of deferral available from the use of a foreign corporation. Describe the two methods and their differences. The primary differences are control and the kind of income targeted. The methods differ. Subpart F creates the constructive dividend, coupled with an increase in the adjusted basis of the stock. PFIC imposes an interest charge on the value of the deferral, as if the U.S. Treasury has made a loan of the taxes deferred during the period of deferral.

4. There are special rules for advancing a number of foreign policy objectives having nothing to do with tax policy. They include the restriction on foreign tax credits for sanctions, the antiboycott provisions, the Foreign Corrupt Practices Act and the partial exemptions for nation-states and diplomats.

5. They are two methods of approaching the question of how much income is properly allocable to a particular taxing jurisdiction. Both systems and the evidence relevant to the two approaches should be described. It is almost certain that the two systems will not produce the same result in very many cases.