THE CHARTERED INSTITUTE OF TAXATION

THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

May 2006

PAPER III

PRINCIPLES OF CORPORATE AND INTERNATIONAL TAXATION

A – UNITED STATES OPTION

TIME ALLOWED – 3 HOURS

- You should answer any **TWO** questions from Part I and any **TWO** questions from Part II.
- Each question carries equal marks.
- Start each answer on a new sheet of paper.
- All workings should be made to the nearest month and dollar unless the question requires otherwise.
- Marks are specifically allocated for presentation.

General Note

Prepare memoranda analysing the United States income 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 US 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.

PART I

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

1. Borges, a citizen and resident of Argentina, is an international business consultant. Some of Borges' clients are in the United States, but most are in other countries. As a result, Borges spends 120 days working in the United States each year from which he earns fees of $250,000 and is reimbursed for all expenses. During the rest of the working year Borges is usually working in Argentina or in other countries from which he earns fees of $500,000 and is reimbursed for all expenses.

   Borges maintains no office in the United States, but has an account with a New York commercial bank which he uses to pay expenses associated with his travel. During 2005, Borges received interest income of $1,000 from that account.

   Borges loves his country and spends as much time as possible there, usually including holidays. During 2005, however, Borges also took a two week holiday at Disneyworld in Florida. Borges had never taken such a holiday in the United States previously, had a terrible time standing in long queues and vowed "never to have a vacation in the United States again."

   Borges has always travelled on a business visitor visa and has never considered applying for permanent residence in the United States. He has, however, considered establishing a US corporation through which to implement his operations in the United States. In such case, he would become the only employee of the corporation. His business activities in other parts of the world would not be affected.

   You are required to prepare a memorandum:

   1) **Advising Borges of his US Income Tax liability, if any, for 2005.**

   2) **Advising Borges of the US Income Tax consequences of establishing a US corporation through which to undertake business activities in the United States.**

   3) **Explaining how, if at all, your response to 1) and 2) would be affected if the US Model Treaty were in force between the United States and Argentina.**

   (25)

2. 1) Andersen, a citizen and resident of Monaco who never visits the United States, is an author and a wealthy investor. Andersen often buys and sells stocks listed on the New York Stock Exchange ("NYSE"), and implements those transactions through a US stock broker with a big office on Wall Street in New York. While Andersen usually decides when to buy and sell stocks, he has granted authority to the New York broker to decide when to make purchases and sales. During 2005, Andersen realised gains of $200,000 and losses of $50,000 from transactions on the NYSE upon which Andersen decided. Andersen also realized gains of $100,000 and losses of $10,000 from transactions on the NYSE that were decided upon in the Wall Street offices of the broker without consulting Andersen. Further, Andersen received dividends of $90,000 from shares of stock that had been acquired through the account, of which half were attributable to shares purchased by the broker without consulting Andersen. All of the stock acquired by Andersen for the account were issued by US corporations.

You are required to prepare a memorandum for Andersen explaining his US Income Tax liabilities, if any, for 2005 as a result of the foregoing events.

(13)

2) Andersen is contemplating an offer from a US publishing house to write a new book. His literary agent has indicated that the publisher would be willing to use any of three alternative formulations:

(a) Andersen would write the book at his vacation home in Denmark, obtain all copyrights and license publication in the United States in return for a royalty.

(b) Andersen would write the book in Denmark, obtain all copyrights and sell the copyrights to the publisher for a lump sum payment equal to the estimated royalties that would be generated over five years under option (a) above.

(c) Andersen would enter into a contract pursuant to which he would write the book in Denmark and be paid a cash amount equal to that contemplated under option (b) above, but the publishing house would under the terms of the contract own all copyrights to the book.

You are required to prepare a memorandum for Andersen analysing the U.S. Income Tax consequences that would arise from the three options that have been presented to him.

(12)

Total (25)

3. Delta Co is a corporation organised under the laws of Greece that is owned by Greek citizens. Epsilon Inc is a corporation organised under the laws of Cyprus, but is also owned by Greek citizens even though it has no assets in Greece. Delta Co and Epsilon Inc became equal partners in a partnership to engage in international business transactions. During the course of 2005, the partnership, primarily by using employees who travelled throughout the United States and operated out of hotel rooms, ran a US business that produced net US-source income of $1,000,000. The employees had no power to bind the partnership contractually, so that all decisions were made by the presidents of the two partner-corporations. All of the partnership income was reinvested in the growing business operation in the United States; none was distributed to either partner.

Assume that the US Model Treaty is in force between Greece and the United States and that there is no tax treaty in force between Cyprus and the United States.

You are required to prepare a memorandum analysing all of the US Income Tax consequences of the foregoing for Delta Co, Epsilon Inc and the partnership.

(25)

PART II

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

4. Hawthorne is a US citizen. Vargas is a citizen and resident of Peru. Lincoln Inc is a US corporation. Hawthorne and Vargas each own 25 percent of the stock of MP Co, a corporation organised under the laws of Peru and operating a major manufacturing plant there. Lincoln Inc owns 50 percent of the shares of MP Co. During 2005, its first year of operation, MP Co earned income of $2,000,000 from sales in Peru and paid Peruvian income taxes of $400,000. MP Co also paid dividends of $100,000 to Hawthorne and Vargas and $200,000 to Lincoln Inc. Peru imposed a withholding tax of $15,000 on the dividends paid to Hawthorne, no withholding tax on the dividends paid to Vargas and $10,000 on the dividends paid to Lincoln Inc.

   You are required to:

   1) Prepare a memorandum analysing the US Income Tax consequences of the foregoing events to Hawthorne, Vargas and Lincoln Inc.

   2) How, if at all, would your response change if the US Model Treaty were in force between the United States and Peru?

   (25)

5. 1) Envirocar Inc, a US corporation, produces hybrid cars in Ohio. The cost of producing a car is $20,000. Some of the cars are sold to dealers in the United States for $30,000. In such instances, the dealers take title to the cars in Ohio and pay for the costs of transportation. Other cars are exported to markets in Latin America. Latin American dealers, who take title to the cars in their home countries, pay $35,000 per car plus the cost of transportation. Envirocar Inc. sells 100,000 cars to Latin American dealers under the terms described above.

   You are required to prepare a memorandum advising Envirocar Inc. how to determine the maximum foreign tax credit that may be available to it under US Income Tax law. (12)

   2) The United States has concluded a treaty with Dominica, a relatively small island republic, that includes the following provision: "The parties to this treaty may tax compensation paid to residents of the other country for services rendered as members of the board of directors of any corporation organised in the taxing country." Norman, a citizen and resident of Dominica, serves on the board of directors of Outbound Inc, a US corporation engaged in the production of electronic equipment. In this capacity, Norman generally attends board meetings through a speaker phone hookup from Norman's home in Dominica. However, once a year, Norman actually attends one meeting in the United States and also hosts a meeting of the board of directors at a beach resort in Dominica. During 2005, Norman participated in five meetings of the board of directors, three by speaker phone, one in the United States and one in Dominica, for which Norman received $50,000 ($10,000 per meeting).

   You are required to prepare a memorandum analysing Norman's US Income Tax liabilities for 2005. (13)

   Total (25)

6. American Electronics Co is a US corporation that has been successful in the development and marketing of computers and computer equipment in North America and in other parts of the world. It has two major centres of production. The home office and a substantial production facility is located in Chicago, USA. Another major production facility is located in the country of Britannia, where it has been organised and operated as a branch of the corporation.

During the past few years, American Electronics has been quite successful. The US operation has been generating net pretax income of about $10,000,000. The Britannia branch operation has been generating net pretax income of about $5,000,000, which has been subject to a Britannia Income Tax of 50 percent.

The Board of Directors of American Electronics has approved a plan to expand its international focus. Three options are on the table. One is to invest $50,000,000 to increase the size of the operation in Britannia. A second is to purchase 50 percent of Zipco, a corporation organised under the laws of Islandia, from its sole shareholder, Interdigital Ltd, for $50,000,000. Islandia is a less industrialised country where the corporate income taxes are only 20 percent, but where there is a real property tax that is estimated to be equal (although not calculated thereby) to about 10 percent of the income of an Islandian corporation. The third involves the establishment of a partnership in Islandia with Interdigital Ltd under the laws of Islandia in which American Electronics Co and Interdigital Ltd would be equal partners. Both partners would invest $50,000,000 in the partnership. The partnership laws of Islandia are virtually the same as those in the United States.

Under each of the three options, the Board expects to generate pretax income of $10,000,000 that will be realised by or attributable to the American Electronics Co investment without adversely affecting the profitability of the existing operations. However, the Board expects that such income will be reinvested in the expanding international operation for three to five years.

Neither Britannia nor Islandia imposes withholding taxes on dividend distributions and neither imposes a branch profits tax. There is no treaty between the United States and either Britannia or Islandia.

The CEO of American Electronics would like to know the tax implications of the three plans and has asked you to prepare a memorandum explaining them and providing your guidance as to which of the three options should be pursued.

You are required to write the memorandum and give your counsel. (25)

7. 1) A dual capacity taxpayer is one that is entitled to a foreign tax credit even though it benefits from a tax holiday.

2) A unitary tax system is one in which a US shareholder of a foreign corporation may receive a credit for income taxes paid by the foreign corporation.

3) The “commensurate with income” requirement means that royalty arrangements between related entities may be successfully challenged by the IRS even though they reflected fair market values at the time they were established.

4) As a result of Subpart F of the Internal Revenue Code, a US corporation may be entitled to foreign tax credits even though it has neither earned income in another country nor received a dividend from a foreign corporation.

5) If foreign Income Tax rates are higher than the effective rate of US tax for a US corporation doing business in other countries, the corporation will usually choose to deduct the foreign income taxes rather than credit them.

You are required to indicate whether you agree or disagree with the five statements above and explain fully all of the reasons for your position in a way that demonstrates your understanding of all relevant terms and issues.

(25)