THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

May 2007

PAPER II

ADVANCED INTERNATIONAL TAXATION

B – UNITED STATES OPTION

TIME ALLOWED – 3 HOURS

- You should answer **all** parts of both questions.
- 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

You are required to prepare memoranda analysing United States Income Tax issues 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% for individuals and 35% for corporations (the approximate maximum rates under current law) and that all net income is taxed at those rates. For individuals, however, assume that long-term capital gains and dividends from U.S. and certain foreign corporations are taxed at the preferential rate of 15%. The U.S. statutory withholding tax rate, where applicable, is 30%. 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 all questions. The weightings assigned to the various questions and sub-questions are indicated.

You are required to answer all questions

1. 1) Domestic Energy Inc. (Domestic) is a US corporation with its head office in New York City. Domestic has a wholly-owned Cayman Islands subsidiary, Offshore Petroleum Ltd. (Offshore), which purchases crude oil from Middle Eastern suppliers and processes it into refined energy products such as motor oil at a refinery located in the Caribbean. Offshore sells the refined energy products to customers located in the United States, South America and Europe.

Offshore has a contract with Domestic under which Domestic employees assist with sales of Offshore's refined energy products. Domestic employees in New York solicit, arrange and conclude all sales to US customers. Sales to South American customers are solicited and arranged jointly by Domestic employees in New York and at a Domestic branch office in Venezuela. Sales to European customers are solicited and arranged by Cayman-based Offshore employees, but Domestic employees maintain all European customer paperwork and are responsible for all invoicing and correspondence pertaining to the European customers.

Depending on market conditions, Offshore occasionally chooses to re-sell crude at a profit rather than refining it and selling the finished products. Sales of crude are conducted in the same fashion as sales of finished product.

For all sales of crude and of finished product, title passes at the customer's location.

Offshore's gross income from sales for 2005 (after taking into account cost of goods sold) was as follows:

	US$
Refined Products to US Customers	400 million
Crude to US Customers	10 million
Refined Products to South American Customers	80 million
Refined Products to European Customers	120 million
Crude to European Customers	2 million

You are required to prepare a memorandum in which you determine how much of Offshore's gross income from sales for 2005 is subject to US Federal Income Tax. Assume that there is no applicable Income Tax treaty. (20)

2) Chocolate A.G. (Chocolate) is a Swiss corporation that produces high-end chocolate products at a factory in Switzerland and sells them through its own network of specialty shops throughout the world. Chocolate has a wholly owned US subsidiary, Coffee LLC (Coffee), that has "checked the box" to be disregarded as an entity separate from its owner for US tax purposes. Coffee purchases Hawaiian-grown coffee beans and uses them to make coffee candies in a factory located in Hawaii, USA. Coffee sells these candies exclusively in the United States.

Chocolate's activities are financed through stockholders' equity and outside borrowings. Coffee's activities are financed by loans from Chocolate and unrelated third-party lenders.

In 2005 Chocolate's assets and liabilities were as follows:

Asset/Liability	Basis US$
Swiss Factory	700,000
Inventory	1,500,000
Share stock in Coffee	500,000
Loans to Coffee	400,000
Outside Borrowing	1,900,000

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In 2005, Chocolate generated approximately US$ 4,000,000 in worldwide chocolate sales, of which approximately 1/4 was US source sales income. Chocolate received US$ 400,000 in dividends from Coffee and US$ 24,000 in interest income from Coffee. Chocolate paid interest at the rate of 6% (US$ 114,000 per annum) on its outside borrowings.

In 2005 Coffee's assets and liabilities were as follows:

Asset/Liability	Basis US$
Hawaiian Factory	600,000
Inventory	200,000
Loans from SwissBank	800,000
Loans from Chocolate	400,000

In 2005, Coffee generated approximately US$ 500,000 in US domestic sales and computed its branch income for US tax purposes to be $400,000. Coffee paid interest at 6% on its loans from SwissBank (US$ 48,000 per annum) and on its loan from Chocolate (US$ 24,000 per annum). Coffee paid its entire branch income to Chocolate as a dividend.

You are required to answer the following questions based upon US domestic law, and indicate if the answers would be different if there were a US-Swiss treaty identical to the US Model Treaty.

(a) What portion (if any) of the gross income received by Chocolate and Coffee is subject to US Federal income tax in 2005, and what deductions (if any) may be applied against these amounts? (15)

(b) How much US tax (if any) is due with respect to interest paid by Coffee? (5)

(c) How would the US taxation of Coffee's operations be affected if, instead of distributing US$ 400,000 to Chocolate, it invested that amount on December 29, 2005, in purchasing a Hawaiian farm that produces nuts to be used in Coffee's products? (5)

3) Foreign Investor, a wealthy individual who is neither a citizen nor a resident of the United States, decides to venture into US real estate. On January 1, 2004, he purchases all of the stock of a US corporation, USCo, for US$ 500. The sole asset of USCo is Florida swampland with a fair market value of US$ 500.

During 2004, Foreign Investor is faced with an unfortunate criminal inquiry in his home country and is unable to devote time to his new hobby. By the end of the year, however, his name has been cleared, and in January 2005 he contributes enough cash to USCo to enable it to purchase a variety of machinery and equipment for harvesting swampgrass, along with rights to a newly developed process for making swampgrass into tinsel for Christmas trees. The total purchase price of these newly acquired assets is US$ 800.

On June 15, 2005, Foreign Investor sells all of his stock in USCo for US$ 1,300. On the date of sale the Florida swampland has appreciated and is worth US$ 600 while the fair market value of USCo's other assets has declined to US$ 700.

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Continuation

(a) **You are required to describe the US tax treatment of Foreign Investor's sale of his stock of USCo. Would your answer change if USCo were incorporated in the Netherlands Antilles?**

(b) **Assume that in addition to his stock in USCo, Foreign Investor also owns an exclusive hotel and casino in Las Vegas. He has no interest in running the hotel and is not involved in managing the property. Instead, he leases the property to a US hotel corporation under a long-term lease. His US accountant receives from the hotel corporation yearly rent of US$ 100,000 and pays Nevada property tax of US$ 60,000 on his behalf. Analyse the US tax consequences to Foreign Investor of this arrangement.**

Would your answer be affected if the United States had a treaty with Foreign Investor's residence country identical to the US Model Treaty? (5)

Total (50)

2. 1) Domestic Investor, a wealthy individual who is a citizen and resident of the United States, has for many years held a portfolio of stocks of US domestic companies. She prefers a "buy and hold" strategy. Thus, she is used to paying current tax on her dividends but deferring tax on the appreciation in her investments until she eventually sells them off.

While visiting friends in London, Domestic Investor hears about a publicly-traded, UK incorporated investment fund (UKFund) that has recently enjoyed stellar results investing exclusively in stocks and bonds from developing countries of the former British empire. She decides to make a substantial investment in UKFund but, before doing so, she has the presence of mind to check with her accountant. The accountant warns her that this investment may have decidedly unfavorable US Federal Income Tax consequences.

You are required to analyse why an investment in UKFund could produce adverse tax consequences for Domestic Investor. Please assume that there is a US-UK treaty identical to the US Model Treaty. (5)

2) Developer is a successful real estate developer in the United States. He has recently bought an option to acquire a large tract of ocean-front land in the Bahama Islands. He plans to subdivide this land into lots and build condominium units for sale to US individuals as vacation homes and/or vacation "rental" units. He expects to generate two types of income from this project: (i) profits from the manufacture and sale of condominium units; and (ii) interest on purchase money mortgages from the buyers. He understands that the Bahama Islands' government will likely grant him a special tax rate of 10% on any profits he realises through this project.

Developer has a group of US business associates to whom he has turned for investments in the past. Since neither Developer nor his business associates is in need of ready cash, he wants to structure an investment that will allow him to plough back the profits from the first Bahamas project into other projects in the Bahamas or in other low-tax Caribbean jurisdictions – without first paying US tax.

Developer's tax advisers have told him to form a Bahamas Corporation to proceed with this project. You are required to prepare a memorandum explaining how Developer can use a Bahamas Corporation to avoid current US tax on his activities in the Bahamas and elsewhere in the Caribbean. Please assume that there are no Income Tax treaties between the US and any of the Caribbean jurisdictions involved. (20)

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Continuation

3) US Multinational is a Delaware corporation with its worldwide headquarters located in Dallas, Texas, USA. Throughout 2005, Multinational owned 75% of the voting stock of a French corporation (FranceCo) and 5% of the voting stock of an Italian corporation (ItalyCo). Multinational also owned a 40% interest in a Gibraltar general partnership (GibraltarCo) whose only asset consisted of all of the voting stock of a Spanish corporation (IberiCo). Except for the interests owned by Multinational, all of the voting stock of FranceCo and ItalyCo and all of the partnership interests in GibraltarCo were owned throughout 2005 by European corporations unaffiliated with Multinational.

Multinational originally purchased its stock of FranceCo for US$ 3,000,000, its stock of ItalyCo for US$ 300,000, and its partnership interest in GibraltarCo for US$ 3,000,000. Multinational has never received cash dividends or any other form of return from either FranceCo or ItalyCo and GibraltarCo has never received cash dividends or any other form of return from IberiCo.

FranceCo, ItalyCo and IberiCo operate retail grocery businesses in France, Italy and Spain/Portugal, respectively. After some difficulties getting started, FranceCo, ItalyCo and IberiCo have all recently become profitable. Their earnings and tax histories through and including the calendar year ended December 31, 2005, are as follows:

US$	FranceCo	ItalyCo	IberiCo
Operating Earnings	1,000,000	1,500,000	1,800,000
Income Taxes	(350,000)	(520,000)	(630,000)
After Tax Earnings	650,000	980,000	1,170,000

The Income Taxes shown in the above schedule represent Income Taxes levied by France, Italy and Spain/Portugal on the operating earnings of FranceCo, ItalyCo and IberiCo, respectively. Gibraltar does not levy income taxes on dividends received from Spanish corporations.

On December 31, 2005, FranceCo paid a dividend of US$ 400,000 to its shareholders from its cash on hand. On the same day, ItalyCo borrowed US$ 520,000 and paid a dividend of US$ 1,500,000 to its shareholders. Also on the same day, IberiCo paid a dividend of $1,170,000 to GibraltarCo.

Multinational has a finance arm that invests substantial amounts in debt instruments issued by foreign governments and major foreign corporations. During 2005, it received US$ 2,500,000 of interest in respect of debt instruments issued by the government of Germany and various publicly-held corporations in Germany, Holland and Belgium.

France, Italy, Spain, Portugal, Germany, Holland and Belgium all levy withholding taxes on payments of interest and dividends to nonresident corporations at the rate of 30%, but all have income tax treaties with the United States identical to the US Model Treaty. Gibraltar has an agreement with Spain that exempts dividends paid to Gibraltar companies from Spanish withholding taxes. Gibraltar does not levy its own income or withholding taxes and does not have an income tax treaty with the United States.

You are required to compute the US Federal Income Taxes due from Multinational as a result of the above transactions. You should assume that Multinational has no income from other transactions and that its U.S. Federal Income Tax rate is 35%. (25)

Total (50)