THE CHARTERED INSTITUTE OF TAXATION

THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

Specimen Examination Paper

PAPER II

ADVANCED INTERNATIONALTAXATION

B – UNITED STATES OPTION

TIME ALLOWED - 3 HOURS

Candidates should answer **all** questions.

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 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.

Answer all questions. The weightings assigned to the various questions and subquestions are indicated.

You are required to answer all questions.

1.

(a) Mr Olian, a UK citizen and resident, makes and sells ornamental boxes typically sold in antique stores. He purchases the raw materials – wood for the outer shell, lacquer and ornamental designs – from third parties, fabricates the boxes, applies the decorations, and sells the boxes in his London store on Antiques Alley. The cost of each box's components is generally 80% of the sales price of the finished box. This entire business is conducted through Mr Olian's wholly-owned UK corporation, Olian Boxes Ltd.

In 2003, Mr Olian decides to test the US market for his boxes. He does a little research and finds a travelling box salesman, Boxman, who looks promising. Boxman, a UK citizen and resident, represents a variety of box manufacturers, and he travels the world peddling their boxes.

Boxman tells Mr Olian that he is about to make his first sales trip to the US. Consequently, Mr Olian decides to enter into a contract with Boxman. It is a standard Boxman contract, under which he gets to keep 10% of the sales price of every box he sells, plus he is guaranteed a minimum commission of £10,000 from the manufacturer. The contract provides that Boxman can use whatever tools or methods he wants to sell boxes, but each potential sale must be submitted to Mr. Olian for review and final approval. Title to the boxes will pass from Olian Boxes to the purchaser wherever Boxman is at the time of sale.

Boxman spends three months travelling throughout the US and selling boxes in 2003, never staying in any one place for longer than a few days. He sells many boxes, including numerous Olian boxes. The proceeds of his US sales of Olian boxes on this trip amount to $800,000.

Please answer the following questions based upon US domestic law, and indicate if there would be a different answer if there were a US–UK treaty identical to the US Model Treaty.

1) **What are the US tax consequences (if any) to Olian Boxes of Boxman's US sales of Olian boxes in 2003?**

2) **What are the US tax consequences (if any) to Boxman of his sales of Olian boxes in 2003?**

(20)

1.

(b) In 2004, Mr. Olian becomes aware of an Egyptian company, Pyramid Players, which has developed a miniature music box mechanism designed to be encapsulated in small decorative boxes.

Olian Boxes proposes to Pyramid Players to purchase the rights to manufacture and sell boxes enhanced with the Pyramid Players music box mechanism in the UK Pyramid Players agrees, but only if Olian Boxes will also purchase the right to sell the boxes in the US Olian Boxes acquiesces, and Pyramid Players sells Olian Boxes the right to manufacture and sell music-infused boxes in the UK, and to sell music-infused boxes in the US, in return for 15% of all Olian Boxes' sales of such boxes.

Sad to say, Boxman was badly injured in a car crash on the M-25 in December 2004 and has been recuperating in London ever since. Olian Boxes has made no effort to find a replacement for Boxman and has abandoned its efforts to sell its regular boxes in the United States. Moreover, it has no interest in selling music-infused boxes in the US Thus, Olian Boxes sublicenses the US rights to a US corporation, Boxes 'R Us, in return for a 20% royalty. In 2004, the total UK sales of music-infused boxes amount to $5 million, and the total US sales of those boxes amount to $10 million.

What portion, if any of the 2004 income of:

1) Olian Boxes and

2) Pyramid Players

relating to music-infused boxes is subject to US tax under US domestic law? Would your answer change if there were a treaty between the US and the UK identical to the US Model Treaty?

(20)

1.

(c) Mr. Olian is impressed with Boxes'R'Us's operation of its box business. Thus, in 2005 he purchases a sizable chunk of stock in Boxes'R'Us.

The Boxes'R'Us stock appreciates in value considerably, and at the end of 2005 Mr. Olian decides to sell a portion of the stock. At the time of sale, Boxes'R'Us's assets include the following:

Asset	Value $
Box and Components Inventory	500,000
Office and Store Machines	100,000
Box Demonstration Equipment	80,000
US Boxes'R'Us Stores	700,000
Canadian Boxes'R'Us Store	20,000
US Bank Deposits	250,000

Boxes'R'Us also owns a 25% stock interest in a Mexican corporation, Box Dreams S.A., which manufactures decorative designs for boxes. Boxes'R'Us's stock interest in Box Dreams on the date of sale is worth $60,000. Box Dreams's assets on the date of sale include:

Asset	Value $
Design Inventory	40,000
Design Manufacturing Equipment	10,000
Factory in Mexico	60,000
Warehouse in San Diego, CA	130,000

What are the US tax consequences (if any) to Mr. Olian of the sale of Boxes'R'Us stock in 2005?

(10)

2.

(a) Children's Products, Inc. ("CPI") is a family-held US company that manufactures and sells toys and other children's products. It operates only in the United States and has produced steady – if not outstanding – profits for many years. It pays Federal income tax on its profits each year at the rate of 35%.

CPI has long envied the lower costs and higher profit margins enjoyed by its competitors abroad but has never seen an opportunity to break into the European market – either for manufacturing or for sales. This year, however, it has been approached by a Polish toy manufacturer ("Polco") looking to break out of its historic – but limited – Polish market and into the broader market of the European Union. Polco has proposed a joint venture to which Polco would contribute its existing manufacturing and marketing facilities and know-how in Poland and to which CPI would contribute \$20 million. The joint venture would invest the \$20 million in expanding and modernizing Polco's manufacturing facilities in Poland and in an intensive marketing campaign throughout the European Union. Polco and CPI would split the profits of the venture equally but would be committed to reinvest all of the profits in the venture for at least five years.

Poland imposes two taxes on companies doing business in Poland: first, a corporate franchise tax equal to 1% of the gross income of each corporation doing business in Poland for each taxable year; and second, a business income tax on the annual net income of all companies doing business in Poland, whether incorporated or not, at the rate of 20%. Dividends paid by one Polish corporation to another are exempt from tax. However, Poland levies a 15% withholding tax on dividends and interest paid by Polish corporations to foreign shareholders. Poland does not levy any kind of branch profits tax. Poland taxes limited liability companies as corporations but treats partnerships as pass-through entities for tax purposes, in the same way that the United States treats partnerships under Subchapter K of the Internal Revenue Code. Assume that there is no tax treaty in force between the United States and Poland.

CPI is unwilling to enter into a partnership or common-law joint venture with Polco because of concerns over liabilities that might arise in the new business. Polco has stated that it is indifferent as to whether the business is organized as a corporation or a limited liability company.

Please advise which form of organization would be better from CPI's point of view and which country it should be organized in. (15)

Would your answer change if there were a tax treaty in force between Poland and the United States identical to the US Model Treaty? (5)

Would your answer change if CPI also had a subsidiary in Asia that was generating substantial tax losses? Would your answer to that question depend on whether that Asian subsidiary was a corporation or a partnership for US tax purposes? (5)

Total (25)

2.

(b) Sam is the patriarch of the family that owns CPI. He and his wife own all of the single class of voting common stock of CPI.

Sam's oldest son, Samson, got an MBA (Masters in Business Administration) and went into the family business. He is excited about the prospects of expanding the business overseas and would like to create a business of his own. He decides that there is an opportunity to go into business buying toys from Polco and reselling them in Asia, Africa and Latin America.

To that end, Samson solicits investments in a new company, CPI Overseas (Overseas), from his father, his father's five sisters and brothers, and five unrelated (and wealthy) family friends, all of whom are United States citizens and residents. Each of the eleven individuals invests $200,000 in Overseas in exchange for 9,090 shares of its common stock. Sam is elected Chairman of the Board of Overseas but Samson takes control as President and Chief Executive Officer.

Samson decides to incorporate Overseas in Ireland, where he understands Overseas will pay income taxes at the rate of only 10%. Samson has no intention of moving his family to Ireland, but he does have Overseas lease an apartment in Dublin for him to use when he is in Ireland on business. Overseas spends approximately $250,000 to open a home office in Dublin, spends another $750,000 to build a warehouse in the port of Dublin, and budgets $500,000 to cover first year operating expenses. Overseas invests the balance of its capital, $700,000, in long-term certificates of deposit which the Company will need to use as security to finance the purchase of inventory from CPI.

Samson projects that, during each of its first two years, Overseas will sell $2 million worth of toys at a gross profit (sales proceeds less cost of goods sold) of approximately $500,000. Its only other income will be interest of approximately $35,000 a year on its long-term certificates of deposit. Its deductible operating expenses will be approximately $500,000 in its first year and approximately $250,000 a year thereafter. Samson projects that Overseas' earnings from sales of toys will grow at a healthy rate each following year. Samson will earn a small fixed salary and a percentage of Overseas' annual net earnings as compensation for his services.

Samson has told his investors that he will seek opportunities to reinvest Overseas' earnings abroad rather than paying dividends to the shareholders.

Assume that there is no tax treaty in force between the United States and Ireland.

Please explain the intended US tax consequences of the organization and operation of Overseas for the company and its shareholders. (10)

If the Internal Revenue Service were to seek to tax the income of Overseas, what arguments would it likely make? What can Samson do to protect against this possibility? (5)

Would the intended tax consequences of the organization and operation of Overseas change if Samson received, as part of his compensation package, an option to purchase 50% of the stock of Overseas for the same price per share as the original shareholders? (5)

Assume that Ireland imposes individual income taxes on resident aliens at the rate of 25%. Could Samson achieve any net income tax savings by selling his house in the United States and moving himself and his family to Dublin? (5)

Total (25)