Chartered Institute of Taxation
Excellence in Taxation

THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2016

PAPER 2.10 – UNITED STATES OPTION

ADVANCED INTERNATIONAL TAXATION (JURISDICTION)

TIME ALLOWED – 3¼ HOURS

You should answer **FIVE** out of the seven questions: **BOTH** questions from Part A; the **ONE** question in Part B; and **TWO** questions from Part C.

Part A questions are worth 25 marks each. The Part B question is worth 20 marks. Part C questions are worth 15 marks each.

You should aim to spend approximately half of your exam time answering Part A, and the remaining half answering Parts B and C. The amount of time you spend answering each question should correspond broadly to the number of marks available for that question.

Start each answer on a new page. If you are using the on-screen method to complete your exam, you must provide appropriate line breaks between each question, and clearly indicate the start of each new question using the formatting tools available.

All workings should be made to the nearest month and US Dollar, unless the question requires otherwise.

Marks are specifically allocated for presentation.

For your information this paper is accompanied by:

United States Model Income Tax Convention 2006

General Note

You are required to prepare analyses of US federal 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 US Federal Income Tax rate is 40% for individuals and 35% for corporations (the approximate maximum rates under the current law) and that all net income is taxed at those rates. For individuals, however, assume that long-term capital gains, dividends from US corporations and dividends from foreign corporations from countries that have tax treaties with the United States are taxed at the preferential rate of 20%. The US statutory withholding tax rate, where applicable, is 30%.

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 such a treaty in fact exists. When the problem indicates that a treaty is relevant to the analysis, apply the terms of the United States Model Income Tax Convention 2006 (US Model Convention); you should not refer to the United States Model Income Tax Convention 2016 unless specifically directed to do so.

Where possible, 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 A

You are required to answer BOTH questions from this Part.

1. The Oklahoma Corporation (OklaCorp) is a Delaware corporation that maintains its corporate headquarters in Tulsa, Oklahoma. It manufactures various kinds of kitchen equipment in plants throughout the United States. Most of OklaCorp's sales come from the United States, but in recent years it has begun to make a significant number of overseas sales.

   In 2012, OklaCorp decided to expand its operations in Europe. To that end, it formed SFS, a French société à responsabilité limitée (limited liability company), to which it transferred $10 million in cash in exchange for a combination of stock ($2 million) and debt ($8 million). It simultaneously granted SFS a non-exclusive, royalty-free licence to manufacture and sell certain items of kitchen equipment within the European Union. SFS invested the funds received from OklaCorp in a plant located in France, from which it manufactured and sold kitchen equipment throughout Europe.

   In 2013, its first full year, SFS reported no sales and a net operating loss of $3 million. In its second year of existence, 2014, SFS reported sales and net income as follows:

Sales Income	$5,000,000
Cost of Goods Sold	($4,000,000)
General & Administrative	($700,000)
Interest on:	
OklaCorp Intercompany Loan	($320,000)
French Bank Loan	($380,000)
Pre-Tax Income	($400,000)

   On the advice of their US tax counsel, upon the formation of SFS, OklaCorp's management decided to file an election for SFS to be disregarded for US federal income tax purposes. In autumn 2014, again on their US tax counsel's advice, and anticipating that SFS would be profitable in 2015 and thereafter, OklaCorp's management filed a new election to have SFS treated as a corporation for US federal income tax purposes, effective from 1 January 2015.

   You are required to prepare a memorandum in which you address the following questions relating to the US federal income tax consequences for OklaCorp of engaging in the activities described above.

   1) What was the effect of filing to have SFS disregarded for US federal income tax purposes as of the date of its formation? (5)

   2) How should the losses of SFS in 2013 and 2014 be reported for US federal income tax purposes? What is the net effect on the tax payable in the United States by OklaCorp? (5)

   3) What is the effect of filing the election to have SFS treated as a corporation for tax purposes, effective from 1 January 2015? (5)

   4) Assuming that SFS is profitable in 2015, what if any tax reporting and/or tax payment obligations does SFS have to the US? (5)

   5) Assuming that SFS pays no dividends to OklaCorp in 2015, on what basis could the Internal Revenue Service assert that OklaCorp is nonetheless taxable in the United States as a result of the operations of SFS? (5)

   Total (25)

2. The X Corporation (X Corp) manufactures widgets in a foreign country, Xanthera, and sells them in Xanthera and elsewhere. It is organised under the laws of Xanthera, which has no income tax treaty with the United States, and its place of management is also located in Xanthera. X Corp's stock is traded on a securities exchange in Xanthera.

X Corp sells its widgets in several countries through a wholly owned subsidiary company, the Y Corporation (Y Corp), which is organised under the laws of, and managed in, the nation of Yettoria. Yettoria has an income tax treaty with the United States identical to the US Model Convention. Y Corp's only activity consists of purchasing widgets from X Corp in Xanthera, and reselling them to retailers in Yettoria and several other countries. It has an office, staffed by approximately 40 employees, in Yettoria, but has no physical presence in any other country.

X Corp's widgets are not currently imported into the United States, but X Corp is planning to expand its market in future to include the United States. X Corp's management team has requested your advice on several alternative business and financing plans for expansion into the US market; these are described below. D Corp, which is referred to in the alternatives, is a Delaware corporation that has a substantial business as US distributor of goods from several manufacturers, has offices in seven US cities, and has approximately 700 employees. D Corp is not related to X Corp or any of its shareholders.

The options being considered are as follows:

1) X Corp sells widgets to D Corp, which in turn sells them to retailers in the United States. The contracts of sale are negotiated and executed at the home office of X Corp and provide that title to the goods passes from X Corp to D Corp upon delivery by X Corp to a common carrier at its factory.

2) X Corp appoints D Corp as its agent to sell X Corp's widgets to retailers in the United States, and pays a commission to D Corp for each sale made by D Corp on X Corp's behalf. Sales to US retailers are made on X Corp's standard contract form, which provides that the goods will be shipped directly from X Corp's factory in Xanthera to the retailer's place of business in the United States, and that title to the goods will pass from X Corp to the retailer upon delivery by X Corp to a common carrier at its factory. D Corp handles all solicitations of and negotiations with US retailers. The contract between X Corp and D Corp allows D Corp to make sales contracts with retailers on X Corp's behalf, provided that the contracts are included on X Corp's form sales contract; before signing a contract on behalf of X Corp, D Corp checks with X Corp's factory to make sure that the goods can be delivered by the date specified in the contract.

3) This option is the same as option 2), with the following changes: X Corp has a warehouse in the United States, where it maintains a stock of widgets. X Corp employs approximately 30 employees at the warehouse, who manage the warehouse and handle receiving and shipping operations. The sales contracts made by D Corp on X Corp's behalf provide for the widgets to be shipped from the warehouse to the purchasing retailers, with title passing at the warehouse.

4) This option is the same as option 2), with the following changes: X Corp sells widgets to Y Corp (with title passing at X Corp's factory) and Y Corp ships the widgets to a warehouse in the United States where it maintains a stock of widgets. Y Corp employs approximately 30 employees at the warehouse, who manage the warehouse and handle receiving and shipping operations. Y Corp makes the agency agreement with D Corp. The sales contracts made by D Corp on Y Corp's behalf provide for the widgets to be shipped from the warehouse to the purchasing retailers, with title passing at the warehouse.

Continued

2. Continuation

5) X Corp organises US Corp, a Florida corporation of which it is the sole shareholder. US Corp purchases widgets from X Corp in Xanthera and sells them to retailers in the United States. Most of US Corp's operating capital is provided by a loan obtained from Y Bank, which is organised and managed in Xanthera. The loan bears interest at a rate of 10%, payable quarterly; the principal is payable on demand.

You are required to prepare a memorandum in which you explain the US federal income tax consequences of each of the five options, assuming that neither X Corp nor Y Corp has activities or income in the United States other than those described above. A total of five marks are available for each of the five options. (25)

PART B

You are required to answer THIS question.

3.

1) Luxembourg Investments (LuxInvest) is a Luxembourg public company that is managed from an office located in Luxembourg. Its stock is traded on the Amsterdam stock exchange. LuxInvest raises capital from investors throughout Europe and invests the capital in the United States. All of LuxInvest's investments in the United States are in the form of stocks and debt instruments. In 2015, LuxInvest conducted a series of transactions relating to its US portfolio.

   (a) On 1 May 2015, LuxInvest purchased a debenture issued by First National Bank of Baltimore, a federally chartered commercial bank with its principal office in Maryland. The debenture, for which LuxInvest paid $25 million in cash, has a stated principal amount of $25 million, will be paid in a single instalment of principal on the tenth anniversary of issuance, and bears interest at a rate of 3% per annum, payable on the first day of January, April, July and October of each year. The debenture was issued in registered form; interest and principal will be paid electronically to the owner of record through the Federal Reserve Bank of New York.

   (b) Prior to 2015, LuxInvest invested in 1,000 shares of the voting common stock of a California corporation, CalCorp, whose principal office is located in Los Angeles and which has manufacturing facilities located throughout California. The shares represent 20% of the outstanding shares of the corporation's voting common stock. The shares do not pay dividends, but LuxInvest intends to hold them for capital appreciation indefinitely.

   On 1 May 2015, LuxInvest made a follow-up investment in CalCorp by purchasing, for $10 million, a corporate bond with a stated principal amount of $10 million, payable in ten equal annual instalments of principal beginning on the first anniversary of issuance, and bearing interest at a rate of 6% per annum, payable on the first day of January, April, July and October of each year. The bond was issued in registered form; interest and principal will be paid by cheque drawn on a US bank and mailed by the corporation to the owner of record from the principal office of the corporation.

   (c) On 1 July 2015, LuxInvest purchased, for $20 million, 200,000 shares of the voting common stock of Amalgamated Financial Services, Inc (Amalgam), a Delaware corporation engaged in the business of providing accounting, printing and other back office services to financial institutions in eleven southern states. The shares, which LuxInvest intends to hold indefinitely, represent 0.5% of the outstanding shares of the corporation's voting common stock. Amalgam has for many years produced strong and regular earnings, from which it has paid a regularly quarterly dividend of $5 per share; it is expected to continue this practice throughout 2015.

   (d) On 1 October 2015, LuxInvest sold 1 million shares of the stock of ShopCTR, Inc, a Delaware corporation engaged exclusively in the ownership and operation of shopping centres in the state of Texas. LuxInvest received $16 million in exchange for the shares, having purchased the shares for $5 million in 2005.

   You are required to explain the US tax consequences of each of the four transactions above. You should assume that an income tax treaty exists between Luxembourg and the United States that is identical to the US Model Convention. A total of two marks are available for each transaction. (8)

Continued

3. Continuation

2) US Parent (USP) is a Delaware corporation engaged in various manufacturing, sales and financial activities throughout the world.

During 2015, USP owned all of the stock in Irish Investments plc (IrishInvest). IrishInvest and a series of wholly-owned corporate subsidiaries conducted the following income-producing activities solely within the European Union.

(a) A wholly-owned Romanian manufacturing subsidiary manufactured refrigerators and sold them to consumers in Romania and elsewhere in the European Union.

(b) A wholly-owned Romanian retailing subsidiary purchased refrigerators from its Romanian manufacturing affiliate and sold them to consumers within Romania and elsewhere in the European Union.

(c) A wholly-owned Estonian retailing subsidiary purchased refrigerators from its Romanian manufacturing affiliate and sold them at retail within Estonia.

(d) A wholly-owned Estonian wholesaling subsidiary purchased refrigerators from its Romanian manufacturing affiliate, and sold them to distributors for resale in countries within the European Union but outside of Romania and Estonia.

(e) A wholly-owned Estonian lease finance subsidiary purchased refrigerators from its Romanian manufacturing affiliate and leased them to retail customers throughout the European Union.

(f) A wholly-owned Estonian investment subsidiary held a portfolio of income producing stocks and bonds issued by corporations in Ireland and elsewhere in the European Union.

None of USP’s subsidiaries paid any dividends during 2015.

You are required to explain the US federal income tax consequences of each of the six arrangements above. A total of two marks are available for each arrangement. (12)

Total (20)

PART C

You are required to answer TWO questions from this Part.

4. In 2007 Aimee, a US citizen, invested $100,000 in a Greek corporation (GC) founded by her friend, Denis, a Greek citizen and resident. Aimee purchased 1,000 shares of GC's single class of voting common stock. At the same time, Denis and various other foreign individuals and foreign corporations purchased all remaining shares of GC's single class of voting common stock, also for $100 per share.

   At first, GC invested its capital in liquid interest-bearing securities in the European market, earning approximately $500,000 of interest income in 2007 and approximately $350,000 of interest income in 2008.

   In mid-2008, GC began active research to develop a promising new technology in research facilities located solely in Greece. GC drew upon its invested capital as needed to finance its research activities. GC had no operating income and large operating expenses in 2008 and again in 2009, but by 2010 it had succeeded in licensing the new technology to various European manufacturers, generating approximately $5 million in royalty income for the year.

   Aimee sold all of her stock in GC in December 2015 for $800,000.

   You are required to prepare a memorandum in which you determine and explain the amount and character of the income, if any, that Aimee must report on her US federal income tax return in relation to the sale of her GC stock in 2015. You should assume that an income tax treaty exists between Greece and the United States that is identical to the US Model Convention. (15)

5. On 2 January 2010 Gaspar, a wealthy individual who is neither a citizen nor a resident of the United States, purchased all of the stock in a US corporation (USCo) for $400,000 in cash. The sole asset of USCo is a tract of land in the United States with a fair market value of $400,000.

   Neither USCo nor Gaspar engaged in any activity relating to the tract of land during 2010. In January 2012, Gaspar contributed $500,000 to USCo and USCo used this new cash, in addition to the proceeds of a bank loan in the principal amount of $2 million, to build a small shopping centre on its land. The shopping centre was completed by the end of 2012 and, by the end of 2013, USCo had successfully leased all of the rentable space in the shopping centre to commercial tenants.

   On 2 January 2015, Gaspar sold all of the stock in USCo for $3 million. On the date of sale the fair market value of the tract of land was approximately $1 million, and the fair market value of the shopping centre was approximately $4 million.

   You are required to prepare a memorandum in which you determine the amount and analyse the character of the income, if any, that Gaspar must report for US federal income tax purposes in 2015 in relation to the sale of USCo stock. You should assume that an income tax treaty exists between the United States and the country in which Gaspar is resident that is identical to the US Model Convention. (15)

6. The Reading Glass Corporation (Reading Glass) is a Delaware corporation engaged in the business of designing and manufacturing non-prescription medical products including low-cost reading glasses. Reading Glass sells its products to US consumers through a small number of retail shops and a much larger mail order operation.

For many years, Reading Glass's research and development (R&D) department has been trying to devise a cost-effective way to produce lightweight, non-prescription reading glasses that are tinted for outdoor use. Finally, in 2014, the R&D department devised a way to manufacture tinted lenses that are as light in weight as the equivalent clear lenses. Reading Glass's Chief Operating Officer determined that it would be feasible to manufacture glasses using the new lenses in East Asia and import them into the United States. Consequently, the Chief Executive Officer decided that it was time for Reading Glass to expand its horizons outside the United States.

On 1 January 2015, Reading Glass incorporated a wholly-owned subsidiary in Ireland (RG Ireland) and transferred to it all rights to the newly-discovered process for manufacturing lightweight tinted reading glasses outside the United States. In exchange for these rights, RG Ireland issued ten shares of voting common stock to Reading Glass and agreed to pay Reading Glass a royalty equal to 5% of its gross sales of lightweight tinted reading glasses. RG Ireland then contracted with a manufacturer in East Asia to produce the glasses for a fee. RG Ireland sold the glasses to Reading Glass for sale in the United States for its cost plus a mark-up of 15%.

The new glasses were introduced in the United States in July 2015 and proved to be very popular in the market. In the second half of 2015, Reading Glass purchased glasses from RG Ireland for an aggregate purchase price of $30 million, and resold them in the United States for a total of $35 million.

You are required to prepare a memorandum in which you address the following US federal income tax consequences of the above transactions. You should assume that an income tax treaty exists between Ireland and the United States that is identical to the US Model Convention.

1) **What amount of gross income should Reading Glass report on its 2015 US federal income tax return in relation to its reading glass operations?** (6)

2) **What, if any, primary adjustments might the Internal Revenue Service make if it were to audit the above return?** (3)

3) **What, if any, correlating adjustments would Reading Glass then make?** (3)

4) **What, if any, conforming adjustments would Reading Glass make?** (3)

Total (15)

7. Mr and Mrs da Costa are citizens and residents of Brazil. They have two adult children who live in Brazil, and a third child who attended college and medical school in the United States and is now living full time and practicing medicine in a hospital in Texas.

When their first child was born, Mr and Mrs da Costa established a trust in the Cayman Islands for the benefit of their children, and funded the trust with a portfolio of European and South American stocks and bonds. The terms of the trust require the trustee, a Cayman Islands bank, to distribute $500,000 to each child in each calendar year; the trust also permits the trustee to make additional distributions out of either the principal or income, or both.

During 2015, the trust realised $3 million in interest and dividend income from its European and South American portfolio, and $1.5 million in long-term capital gain from the sale of stock out of that portfolio. The trustee distributed the entire $4.5 million in interest, dividends and capital gains in equal shares to the three children.

You are required to prepare a memorandum in which you address the US tax consequences of the transactions that occurred in 2015 to Mr and Mrs da Costa and their three children. You should assume that no income, estate or gift tax treaties apply. (15)