Chartered Institute of Taxation
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# THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

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# PAPER 2.10 – UNITED STATES OPTION

**Suggested Solutions**

## PART A

Question 1

Part 1

Under the US entity classification regulations (commonly known as the 'check the box' rules), SFS is not a per se corporation and may therefore elect to be treated either as a corporation or as a partnership or disregarded entity. Because its sole owner enjoys limited liability, SFS would be treated as a wholly-owned foreign corporation owned by OklaCorp in the absence of an affirmative election to be treated as a disregarded entity. OklaCorp's filing of a timely election to have SFS disregarded for US federal income tax purposes causes SFS to be treated from inception as an unincorporated US branch of OklaCorp.

Part 2

Since SFS is treated as an unincorporated branch of OklaCorp, the losses SFS incurred in 2013 and 2014 are reportable directly on OklaCorp's US federal income tax return. Assuming that OklaCorp has taxable income from other activities for those years at least equal to the SFS losses, OklaCorp will reduce its overall US taxable income by the amounts of the SFS losses and thereby save US taxes otherwise due at the rate of 35%. If there is no such income, the normal net operating loss carryover rules apply, and OklaCorp will be able to carry the losses back two years and then forward 20 years before they expire.

Part 3

By virtue of the new election that becomes effective on 1 January 2015, OklaCorp is treated as forming a new French corporation (FrenchCorp) and contributing the assets of SFS to FrenchCorp as of 1 January 2015.

As a general proposition, the transfer of assets to a wholly owned subsidiary is not taxable in the United States by virtue of Section 351 of the Internal Revenue Code of 1986, as amended (the 'Code'). Where the transferee corporation is a foreign corporation, the transfer is potentially subject to Code Section 367(a), which may in certain circumstances require the transferor to recognise income in the United States or to enter into a 'gain recognition agreement' with the Internal Revenue Service (the 'IRS') in order to defer any recognition of income. Section 367(a) does not apply, however, to the transfer of assets to a foreign corporation for use in the active conduct of a business outside the United States, and thus will not apply to the deemed incorporation of FrenchCorp – except that OklaCorp will be required to recognise gain (if any) to the extent of the losses it deducted in 2013 and 2014 in respect of SFS.

The foregoing analysis does not apply to OklaCorp's transfers of certain intangibles to SFS. For a discussion of intangibles, see the answer to question 5 below.

Part 4

Effective 1 January 2015, SFS is a foreign corporation engaged in the active conduct of business outside the United States. It does not appear to be generating any income that might be includible in the income of OklaCorp under the controlled foreign corporation rules of Subpart F of the Code. Accordingly, while OklaCorp and SFS must keep records of SFS's activities under US tax accounting principles and while OklaCorp may have certain information reporting obligations in the United States with respect to the activities of SFS, SFS itself is under no obligation to file US federal income tax returns or pay US federal income tax.

Part 5

In general, the offshore income of an offshore corporation is not taxable in the United States until it is repatriated to the United States in the form of dividends.

However, under Code Sections 482 and 367(d), transactions between related parties are closely scrutinised. If the IRS were to audit OklaCorp and examine its transactions with SFS for 2015, it would almost certainly require OklaCorp to report income in the United States with respect to the License. The amount of OklaCorp's income would be determined under the 'commensurate with income' standard and would likely take the form of a royalty at a rate determined with reference to comparable transactions between unrelated persons.

<u>Question 2</u>

<u>Part 1</u>

The United States will not tax X Corp on any of its income in this situation. X Corp is a foreign corporation under Code Section 7701(a)(5) that is taxed under Code Section 881(a) on certain fixed or determinable annual or periodical ('FDAP') items at a 30% withholding rate, unless a treaty applies. The income generated here is from the sale of goods, which is not an FDAP item. Thus X Corp cannot be taxed under Section 881(a).

X Corp is subject to tax under Code Section 882 (a)(1) on income that is effectively connected with any trade or business it carries on in the United States. For it to have a United States trade or business, X Corp would have to perform 'considerable, continuous, and regular' activities in the United States. X Corp does not appear to have any activities in the United States, nor to have any agents active in the United States. Moreover, in the absence of any fixed place of business in the US attributable to X Corp, its sales income is foreign source income and is for that reason not effectively connected with any U.S. trade or business.

<u>Part 2</u>

X Corp will likely not be taxed by the United States in this alternative. Any US taxation would be due to X Corp's use of D Corp as its agent in the United States. Code Section 865(e)(2)(A) treats income of a non-resident on the sale of personal property as being from a US source if the non-resident 'maintains an office or other fixed place of business in the United States' and the sale is 'attributable to such office or other fixed place of business'. Code Section 865(e)(3) applies the principles of Code Section 864(c)(5) to determine whether the non-resident has a fixed place of business in the United States. Code Section 864(c)(5)(A) disregards an office or place of business of an agent unless the agent has authority to conclude contracts in the taxpayer's name, regularly exercises that authority or has a stock of goods from which it fills orders, and is not an 'agent of independent status acting in the ordinary course of his business'.

While D Corp might meet the first two requirements, it will likely fail the third requirement because it operates a separate company with substantial operations, which strongly suggests that D Corp bears a separate entrepreneurial risk.

<u>Part 3</u>

Unlike Alternative 2, X Corp will likely be taxed on the widget sales in this scenario. Because X Corp is directly operating a warehouse in the United States, this will likely be sufficient to constitute a trade or business. Since the income generated is from the sale of produced goods, the applicable source rule is Code Section 863(b)(2), which splits the income from the sale of goods between the place of production (Xanthera) and the place of sale (US). The regulations for Section 863 provide three methods for making this division, but the default is the 50/50 split. Since X Corp has not elected otherwise, 50% of its income will be treated as sales income and sourced to the United States as the place of sale. Since X Corp has a US trade or business, under Section 864(c)(3), the 50% of income from the sale of goods will be deemed effectively connected with the trade or business under the limited force of attraction principle. X Corp will be taxed on the sales income under Code Section 882(a)(1). The other 50% of the income will be foreign source manufacturing income that is not attributable to X Corp's warehouse and not taxed in the US.

X Corp will likely be subject to a 30% tax on its 'dividend equivalent amount' under Code Section 884(a) for any earnings and profits attributable to its effectively connected income that are repatriated to Xanthera.

<u>Part 4</u>

X Corp will not be subject to tax because it is only selling widgets to Y Corp in Xanthera. Y Corp however will likely be subject to tax because it is re-selling the widgets in the United States out of its own warehouse. Because the goods are purchased rather than produced, all of Y Corp's income on the US sales will be US source income under Code Section 861(a)(6). As with Alternative 3, Y Corp's use of the warehouse will likely be sufficient to constitute a US trade or business and Y Corp's income will almost certainly be effectively connected to that trade or business.

The Model Treaty will change these results, and prevent US taxation, if Y Corp can establish that its direct US activities are limited to its warehousing operation, that D Corp is an independent agent, and that Y Corp's activities in Yettoria are substantial in relation to Y Corp's activities in the US.

Part 5

X Corp will not be subject to tax in the United States because it is only selling widgets to its wholly owned subsidiary US Corp in Xanthera. Because US Corp is a domestic corporation under section Code Section 7701(a)(4), it will be subject to tax on all of its income. US Corp can deduct the interest paid to Y Bank under Code Section 163(a); however, this interest may be subject to a 30% withholding tax under Section 881(a), which US Corp must withhold from its payments to Y Bank under Code Section 1442(a). The interest received by Y Bank is an FDAP item under Section 881(a), will be characterised as US source income under Section 861(a)(1) (because the obligor is a domestic corporation), and will not be treated as effectively connected income since the facts do not indicate that Y Bank has a US trade or business. If the loan is made in the ordinary course of Y Bank's business of lending money, the interest is not exempted as portfolio interest under Code Section 881(c)(3)(A).

## PART B

Question 3

Part 1

LuxInvest is a foreign corporation that is not engaged in a trade or business in the United States. All of its US-related income is FDAP income that is potentially subject to US income and withholding tax.

First, interest on the debenture from First National Bank of Baltimore appears to qualify as portfolio interest that is exempt from US income and withholding taxes. This is interest on a registered debt instrument issued by a borrower who is unrelated to the taxpayer.

Second, interest on the bond from CalCorp cannot qualify as portfolio interest because LuxInvest owns a 20% interest in the borrower. However, it appears that LuxInvest satisfies the limitations on benefits clause of the US Model Convention and can therefore claim exemption from US income and withholding tax on the interest under the treaty with Luxembourg. LuxInvest will have to file an appropriate Form W-8BEN with CalCorp in order to avoid US withholding tax.

Third, dividends on the stock of Amalgam represent ordinary US source dividend income to the extent of the corporation's earnings and profits. Assuming LuxInvest qualifies for benefits under the treaty, the US income and withholding tax rate will be reduced to 15%, so long as LuxInvest files an appropriate Form W-8BEN with the corporation (or its paying agent).

Fourth, the stock of ShopCTR appears to be a US real property interest ('USRPI') because the company is exclusively engaged in the real estate business in the United States. Accordingly, LuxInvest's gain from the sale of the shares will be taxed as income effectively connected with the conduct of a trade or business in the United States under Code Section 897 and may be subject to Foreign Investor in Real Property Tax Act ('FIRPTA') withholding under Code Section 6039C. The gain should be eligible for long-term capital gain treatment, but there is no preferential rate for corporate capital gains. The US Model Convention does not change these results.

Part 2

USP is not directly engaged in business outside the United States. It is indirectly engaged in business in the European Union, however, through IrishInvest and the subsidiaries of IrishInvest, each of which is a controlled foreign corporation within the meaning of Subpart F.

First, the income of the Romanian manufacturing subsidiary is not subject to current tax in the United States in 2015 because it is derived from the manufacture and sale of retail products in the country of its incorporation.

Second, the income of the Romanian retailing subsidiary is not subject to current tax in the United States in 2015 because it is derived from the sale of retail products manufactured in the country of its incorporation.

Third, the income of the Estonian retailing subsidiary is not subject to current tax in the United States in 2015 because it is derived from the sale of retail products in the country of its incorporation.

Fourth, the income of the Estonian wholesaling subsidiary is includible in the income of USP in the United States in 2015 as a dividend because it is derived from the purchase from an affiliate of products manufactured outside of the country of its incorporation for sale outside of the country of its incorporation. USP will be entitled to indirect foreign tax credits for any foreign income taxes imposed on this income.

Fifth, the income of the Estonian finance subsidiary is not subject to current tax in the United States in 2015 so long as USP can demonstrate that the Estonian finance subsidiary was engaged in the active conduct of an equipment leasing business in 2015.

Sixth, the income of the Estonian investment subsidiary is includible in the income of USP in the United States in 2015 as a dividend because it represents personal holding company income. USP will be entitled to indirect foreign tax credits for any Estonian income taxes imposed on this income.

## PART C

Question 4

Unlike the CFC regime in Subpart F, the Passive Foreign Investment Company ('PFIC') regime applies regardless of the degree of control of any US shareholders.

GC is considered a PFIC if it satisfies either of two tests found in Code Section 1297(a): (1) passive income test (75% or more of GC's income is passive); or (2) passive assets test (50% or more of GC's assets produce passive income). GC's only income in its first two years, $500,000 and $350,000 of interest income, respectively, is unquestionably passive income as defined in Section 1297(b) (income that qualifies as Foreign Personal Holding Company Income under Code Section 954). Under Code section 1298(b), GC is therefore a PFIC in its first two years and continues as a PFIC unless and until its PFIC status is 'purged' – which never occurs in this case, on the facts as described.

When Aimee sells her stock in 2015, she will have to report $700,000 of long-term capital gain income ($800,000 minus $100,000). Aimee will also be required to report ordinary income from an interest charge that will apply to the stock gain. This interest charge will apply from the due date of the return for the tax year in which Aimee acquired the stock (2007) until the due date of the return for the year in which she disposes of the stock (2015). Aimee could instead make a Qualified Electing Fund election under Code Section 1293 to have GC's income be passed through to her each year; GC's income would then be included in her taxable income each year. Aimee would increase her stock basis each year by the amount of income included, with the result that she would realise little to no gain on the stock sale and would not be subject to the interest charge.

## Question 5

USCo is a US real property holding corporation ('USRPHC') because more than half of the value of its assets consists of US real estate. Gain from the sale of stock in a corporation is normally sourced according to the residence of the taxpayer. If the US Corporation has, however, been a USRPHC at any time during the 5 years prior to a disposition of its stock, the stock of such US corporation is a US real property interest ("USRPI") and gain or loss from the disposition of such stock is treated as effectively connected with a US trade or business.

On the date of sale USCo is clearly a USRPHC. Therefore, Gaspar realises US$ 2.1 million ($3 million minus $ 900,000) in income effectively connected with a US trade or business for the year 2015. This gain will be treated as long-term capital gain.

The 2006 US Model Convention would not change the result. Under Articles 6 and 13(2)(b) of the Convention, the United States is authorised to impose FIRPTA withholding tax.

# Question 6

## Part 1

Reading Glass should report as income on its 2015 federal income tax return its profit of $5,000,000 and the royalty income from RG Ireland in the amount of $1,500,000 (ie, 5% of $30 million). The US Model Convention does not change these results.

## Part 2

On audit, two primary adjustments may be made. First, the IRS may seek to reduce the stated purchase price, and increase Reading Glass's US income, on the basis that cost plus 15% does not represent an arm's length purchase price. The IRS may argue that Reading Glass has overstated the 15% markup in order to understate its US income. Absent data on comparable arm's length transactions supporting Reading Glass's purchase price, the IRS will make adjustments accordingly.

Second, the IRS may seek to increase the amount reported as royalty income based on the rule that such royalty income must be 'commensurate with' the income generated by the use of the intangible property. Although Reading Glass's royalty income is properly contingent on the use of the intangible property, the IRS will be entitled to look not only at the facts as known on the date of the transfer but also at subsequent events in arguing that a 5% royalty is not 'commensurate with income'.

## Part 3

Following the primary adjustments, Reading Glass must make consistent adjustments with respect to RG Ireland and must record the adjustments in relevant documentation maintained for US tax purposes, such as the earnings and profits of RG Ireland.

## Part 4

Finally, Reading Glass must make a secondary adjustment to rationalise the actual transaction with RG Ireland. By default, the difference between the actual transaction and the arm's length transaction should be recorded as a deemed capital contribution to RG Ireland. However, Reading Glass may elect to treat that difference as a receivable from RG Ireland.

## Question 7

The trust created by Mr and Mrs Da Costa (the 'Trust') is a foreign trust established by a grantor who was neither a citizen nor a resident of the United States. It is not a grantor trust and is taxable under Subchapter J of the Code.

A trust subject to Subchapter J computes its income for US Federal income tax purposes in the same manner as an individual. Accordingly, in 2015, the Trust has $3 million in interest and dividend income taxed as ordinary income, and $1.5 million in long-term capital gains. All of this income is foreign source. The trust itself, however, does not file US income tax returns or pay US income tax. Instead, distributions to beneficiaries 'carry out' the income of the trust to the beneficiaries to the extent of the trust's distributable net income ('DNI'). DNI includes items of ordinary income such as dividends and, in general, long-term capital gains that are actually distributed to the beneficiaries in the year realised.

In this case, all of the Trust's interest, dividends and long-term capital gains are in fact distributed to the beneficiaries during the year realised and are therefore included in DNI. The portion of the Trust's DNI distributed to the two children who are non-resident alien individuals, that is, two-thirds of the Trust's DNI, is not taxable in the United States either as effectively connected income or as FDAP income.

On the other hand, the third child who lives in Texas appears to be a tax resident of the United States and, accordingly, his or her one-third portion of the Trust's DNI is fully taxable in the United States as the income of a resident alien individual (who needs not be a legal permanent resident if he or she spends at least 183 days in the United States in the calendar year or satisfies the substantial presence test) or possibly citizen. Thus, $1 million of ordinary income and $500,000 of long-term capital gain are subject to federal income tax in the United States.