THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2017

PAPER 2.10 – UNITED STATES OPTION

ADVANCED INTERNATIONAL TAXATION (JURISDICTION)

TIME ALLOWED – 3¼ HOURS

This paper has **three** parts: **Part A**, **Part B** and **Part C**.

You need to answer **five** questions in total.

You must answer:

- **Both** questions in **Part A** (25 marks each)
- **The** question in **Part B** (20 marks)
- **Two** questions from **Part C** (15 marks each)

Further instructions

- All workings should be made to the nearest month and in US Dollars, unless otherwise stated.
- Start each answer on a new page and clearly indicate which question you are answering. 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.
- Marks may be allocated for presentation.
- The time you spend answering questions should correspond broadly to the number of marks available for that question. You should therefore aim to spend approximately half of your time answering Part A, and the other half answering Parts B and C.
- The first 15 minutes of the exam consists of reading time. You will be allowed to annotate the question paper during this time; however, you will **not** be permitted to start writing or typing your answer, or use a calculator. The Presiding Officer will inform you when you can start answering the questions.

For your information this paper is accompanied by:

- **United States Model Income Tax Convention 2016**

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 also 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%. For individuals, ignore possible personal deductions and exemptions.

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.

PART A

You are required to answer BOTH questions from this Part.

1. Marie is a citizen and resident of France. She maintains her family home in the outskirts of Versailles with her husband and three children. She is the Chief Executive Officer of Eversharp Tools (Eversharp), which designs and manufactures high-end knives and other cutting instruments. Marie's annual salary is equivalent to $1 million. Eversharp has no presence in the United States.

Marie believes there is a market for Eversharp's products in the United States and has made several trips to the US to ascertain the size of the potential market:

- In 2014 she was present in the United States for 150 days;
- In 2015 she was present in the United States for 160 days; and
- In 2016 she was present in the United States for 190 days

Marie was not present in the US prior to 2013. She stayed in hotels during her time in the US, and has never applied for permanent residence in the US.

You are required to prepare a memorandum in which you address the following questions relating to the US Federal Income Tax consequences for Marie.

1) To what extent is Marie subject to US Federal Income Tax in 2014, assuming no income tax treaty between the US and France was in effect? (6)

2) To what extent would Marie be subject to US Federal Income Tax in 2014 if an income tax treaty between the US and France, identical in terms to substantively the same as the US Model Tax Convention, was in effect? (5)

3) To what extent was Marie subject to US Federal Income Tax in 2015, assuming no income tax treaty between the US and France was in effect? (6)

4) Was Marie a US tax resident in 2016, assuming no income tax treaty between the United States and France was in effect? (3)

5) Without prejudice to your answer to (4), assume that Marie is properly treated as a US tax resident in 2016 under US tax principles. What would be the result if an income tax treaty between the US and France, substantively the same as the US Model Tax Convention, was in effect? (5)

Total (25)

2. DejaBrew is a corporation formed in the State of Delaware. All of its shareholders are citizens and residents of Italy. DejaBrew designs and manufactures high-end coffee makers and espresso machines (the Products). In 2016, all manufacturing of the Products took place in the United States. In 2016, all worldwide sales of the Products were made directly by DejaBrew with title to foreign sales passing in the US. DejaBrew earned $600,000 in profits from domestic sales; it also made $400,000 in profits from foreign sales, on which it paid $150,000 in income taxes to various foreign countries.

International interest in the Products has recently grown, and on 1 January 2017 DejaBrew restructured its business with the following results:

DejaBrew formed FCo1, a wholly owned Country A entity, to market the Products in Europe. FCo1 is not treated as a 'per se' corporation under US tax principles. Under Country A law, owners of FCo1 have no liability for the debts of FCo1. FCo1 purchased a large number of Product units from DejaBrew at an appropriate arm's length purchase price and resold the units to unrelated customers throughout Europe. FCo1 earned $100,000 in profits, all attributable to its business operations, and paid 30% tax to Country B. 40% of its sales and profits were made to customers residing in Country B.

DejaBrew formed FCo2, a Country B 'per se' corporation, to manufacture the Products for sale in Asia and licensed all of its intellectual property to FCo2, enabling FCo2 to manufacture the Products for sale within Asia. FCo2 earned $2 million in profits from its manufacturing and sale activities (after deduction for the royalty paid to DejaBrew). Only 10% of its sales were made to customers residing in Country B. Country B taxed FCo2's $2 million manufacturing income at a 20% rate. FCo2 withheld $60,000 from the $200,000 (10%) royalty which it paid to DejaBrew. FCo2 made no distributions to DejaBrew. However, FCo2 issued a loan of $160,000 to DejaBrew.

DejaBrew earned $500,000 in profits from the manufacture and sale of the Products, including its arm's length sales of Products to FCo1, with title to all sales passing in the United States. Additionally, DejaBrew received a $200,000 royalty from FCo2 equal to 10% of FCo2's manufacturing profits, subject to a 30% withholding tax imposed by Country B. The royalty met the commensurate with income test.

You are required to prepare a memorandum in which you address the following questions relating to the US Federal Income Tax consequences for DejaBrew of the above arrangements.

1) How much US Federal Income Tax will DejaBrew pay for 2016 and what, if anything, could it have done to increase its allowable foreign tax credit? (9)

2) What is the default classification of FCo1 for US tax purposes and what are the consequences to DejaBrew of FCo1's 2016 operations, with and without a timely made entity classification election? (9)

3) What are the consequences to DejaBrew of FCo2's 2016 operations? (7)

Total (25)

PART B

You are required to answer THIS question.

3. JCo, a Country J corporation, is in the business of buying and selling clothing and fine jewellery. JCo has a United States branch, JBr, in New York. There is no income tax treaty between Country J and the US. JCo and JBr engaged in the following transactions in 2016:

- JBr purchased clothing from USCo, an unrelated third party clothing manufacturer in California, and resold the clothing in the US, earning a profit of $25 million.

- JBr has a bank account with a balance of $10 million. Of that amount, $2.5 million is needed to fund the operations of JBr's business and the remaining $7.5 million is excess capital being held for possible future business expansion.

- JBr earned $1 million in royalties from unrelated third parties for their use of the JCo name in relation to their US business activities.

- JCo owned a diamond in its inventory, which it sold to a US buyer with title passing in the US.

- JBr was contacted by a potential customer in Canada interested in purchasing clothing. Employees from JBr travelled to Canada in order to make the sale. JBr shipped the product from the US; title passed in Canada.

- JCo was contacted by a potential customer in Mexico interested in purchasing clothing. JCo arranged for JBr employees to travel to Mexico to assist in the sale, but JCo conducted all price negotiations and the product was shipped from Country J.

You are required to prepare a memorandum in which you address the following questions, relating to whether the activities described above give rise to effectively connected income in the United States.

1) **Does JBr's purchase of clothing from USCo and the resale of the purchased clothing in the US give rise to effectively connected income?** (2)

2) **How much of the interest earned by JBr on its $10 million bank balance is effectively connected with its US trade or business?** (3)

3) **How much of JBr's royalty income is effectively connected income?** (3)

4) **How much of JCo's income from the sale of the diamond is effectively connected income?** (4)

5) **How much of JBr's income from the sale of the purchased goods to the Canadian customer is effectively connected income?** (5)

6) **How much of JBr's income from the sale of the purchased goods to the Mexican customer is effectively connected income?** (3)

Total (20)

PART C

You are required to answer TWO questions from this Part.

4. NATCo is a corporation formed in the State of Maryland. Its assets consist of:

- US real property with a fair market value of $4 million;
- cash on hand of $20 million;
- business assets with a fair market value of $4.5 million; and
- 100% of the stock of PCo, a foreign corporation resident in Country P.

PCo's assets consist of the following:

- US real property with a fair market value of $5 million; and
- business assets with a fair market value of $5 million.

You are required to prepare a memorandum in which you determine whether PCo and/or NATCo is a United States Real Property Holding Corporation (USRPHC).

You should assume that there is an income tax treaty between the US and Country P that is substantively the same as the US Model Tax Convention. (15)

5. RUCo, is an eligible entity organised under the laws of Country R. It has one class of ownership interests owned equally by four individuals:

- Henri, a citizen and resident of Country R;
- Claude, a citizen and resident of Country R;
- Gerald, a citizen of the United States resident in Country S; and
- Richard, a citizen and resident of Country S.

RUCo conducts an oil exploration business in Siberia, Russia, and pays 75% of its gross income to a Russian bank in the form of interest payments which are deductible in Country R.

You should assume that an income tax treaty exists between the US and Country R that is substantively the same as the US Model Tax Convention.

You are required to prepare a memorandum in which you determine whether RUCo, or any of its owners, will qualify for benefits under the Limitation on Benefits Article of the US Model Tax Convention. (15)

6. USCo, a corporation formed in the State of New York, owns 100% of the stock of FCo, a foreign corporation. FCo is a manufacturer of widgets. USCo and FCo engaged in the following transactions:

- USCo has decided to build a new, United States-based factory, in Des Moines, Iowa. To make use of foreign cash, USCo has FCo purchase the land on which the factory will be built.
- FCo purchased an apartment complex in Des Moines. The apartment complex was purchased for investment and has no connection to USCo or its business.
- FCo purchased 500 shares in a major NYSE-listed technology company.
- FCo sold USCo widgets to the value $250,000. In accordance with its normal business practice, FCo invoiced USCo at the end of the month, and the invoice is payable in 30 days. USCo paid each invoice when due.
- FCo deposited $250,000 in a certificate of deposit at a bank in San Francisco, California.
- FCo loaned $250,000 to J, a US citizen. J is the CEO of USCo and owns 8% of its stock. J’s husband K, a non-resident alien, owns 4% of USCo’s stock.

You are required to prepare a memorandum in which you address the US Federal Income Tax consequences of the above transactions. You should assume that no applicable income tax treaty exists, that FCo has unrepatriated earnings and profits in excess of the amounts involved in each transaction, and that no actual or deemed dividends have been paid.

What amount of gross income should USCo report regarding:

1) FCo’s purchase of the land on which the USCo factory will be built? (2)

2) FCo’s purchase of the apartment complex for investment? (2)

3) FCo’s share purchase? (2)

4) FCo’s intercompany sale to USCo? (2)

5) FCo’s bank deposit of $250,000? (2)

6) FCo’s loan to J? (5)

Total (15)

7. ABCo, a corporation formed in the State of Florida, owns 80% of MCo, a foreign corporation. The remaining 20% of MCo is owned by John, a United States citizen and resident. ABCo and John have been the sole shareholders of MCo since it was formed ten years ago. MCo has accumulated net earnings of $1.2 million, on which a 10% foreign tax was imposed. Only $200,000 of the earnings were Subpart F income previously included in ABCo’s and John's income. MCo has made no actual distributions to its shareholders. ABCo sells 25% of its MCo stock (representing a 20% interest in MCo) for $300,000. ABCo's basis in the stock sold was $50,000. John sells all his MCo stock for $300,000. His basis in the stock was also $50,000.

You are required to prepare a memorandum in which you determine the US Federal Income Tax consequences to ABCo and John from each of their stock sales. (15)