THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

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SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

Under the substantial presence test of § 7701(b)(3), Marie is a US resident if she is in the US for more than 182 days in the current year, or if she is in the US for at least 31 days in the current year and her current year presence, plus 1/3rd of her prior year presence and 1/6th of her second prior year presence exceeds 182 days.

Marie is not present in the United States more than 182 days and has no days of presence in prior years. Therefore, she is not a tax resident of the United States.

However, a nonresident of the United States engaged in a United States trade or business is taxed by the United States on its taxable income effectively connected with the conduct of that trade or business. The performance of personal service in the United States, even for a single day, is treated as being engaged in a trade or business within the United States. Marie will be taxable on the portion of her salary from Eversharp allocable to the days she was working in the United States.

Note that the "commercial traveler" exception would not protect Marie since in requires, among other things, that Marie be present in the United States for not more than 90 days during the year and that she earn not more than $3,000 for her services performed in the United States. She violates the 90 day limit and most likely the earning limit as well.

Part 2

While Marie remains engaged in a United States trade or business, there is a much broader commercial traveler exception provided in Article 14 of the Model Treaty which might apply. It requires that Marie by present in the United States for a period not exceeding in the aggregate 183 days for all twelve-month periods commencing or ending in the taxable year concerned; her salary be paid by a non-United States resident and which does not have a United States permanent establishment. There is no income limitation.

Marie was in the United States for only 150 days in 2014 and Eversharp is neither a US resident nor does it have a United States permanent establishment. Marie would not be subject to United States tax on her allocable salary while working in the United States.

Part 3

Under the substantial presence test of § 7701(b)(3), Marie is a US resident if she is in the US for more than 182 days in the current year, or if she is in the US for at least 31 days in the current year and her current year presence, plus 1/3rd of her prior year presence and 1/6th of her second prior year presence exceeds 182 days.

Marie is not present in the United States more than 182 in 2015. However, when you add her 160 days of presence in 2015 to 1/3rd of her 150 days of presence in 2014 (50) they total 210 days which exceeds 182 days.

However, under the facts presented, Marie should qualify for the "closer connection" exception since she: 1) was present in the United States for fewer than 183 days during 2015; 2) maintains a tax home in a foreign country during the during 2015 (because that is where her business in based); and (3) has a closer connection during to the foreign country in which the tax home is maintained than to the United States (because that is where her family lives and where she returns after traveling.

As a United States resident Marie would have been subject to tax on her worldwide income during her residency period. Although not treated as a resident under the closer connection test, she will still be taxed on her allocable salary while working in the United States.

Part 4

Under the substantial presence test of § 7701(b)(3), Marie is a US resident if she is in the US for more than 182 days in the current year. Since she was in the United States for 190 days in 2016 she is a tax resident of the United States. The “closer connection” exception does not apply in this situation since she was not present in the United States for fewer than 183 days during 2016.

Part 5

Under Article 4 of the Model Treaty Marie is a resident of both France and the United States for 2016. Article 4(3) provides “tie breaker” rules. Article 4(3)(a) provides that if an individual is a resident of both contracting states, he shall be deemed to be a be a resident only of the Contracting State in which he has a permanent home available to him. Marie has a permanent home only in France. Thus she will not be treated as a tax resident of the United States under the treaty.

Question 2

Part 1

DejaBrew is a US resident since it was formed in the US. The residence of its shareholders is irrelevant. DejaBrew will be taxed by the United States on its worldwide income of $1,000,000. DejaBrew may deduct the $150,000 it paid in foreign taxes, or seek a foreign tax credit. If it deducts the foreign taxes, it will pay United States tax of $297,500 ($850,000 x 35%).

Crediting the foreign taxes could reduce DejaBrew's United Stated federal income tax liability subject to the foreign tax credit limitation. Under the limitation, the maximum foreign tax credits that can be taken in a year is limited to an amount determined by multiplying the US tentative tax liability by a fraction, the numerator of which in foreign source taxable income and the denominator of which is total worldwide taxable income. We must determine how much of DejaBrew's $1,000,000 2016 income is foreign source income.

Unfortunately, DejaBrew has $0 foreign source income. While it has international sale, the source of income generated from manufactured goods is determined under § 863(b)(2), which first divides that income between manufacturing income and selling income and sources each separately. While there are three methods for making this division, the default is the 50/50 rule which splits the income equally. The 50% allocated to manufacturing will be sourced based on the place of manufacture – entirely US source. The 50% allocated to sales will be sourced by location of sale, based on where title passes. Here since title passed in the United States, all this income in US source. Since DejaBrew has no foreign source income, its foreign tax credit limitation is $0.

DejaBrew could have improved its tax position by transferring title to foreign sales outside the US. If it had done so, under the title passage rule the $200,000 of its foreign sales income allocable to its selling activity would have been treated as foreign source. Since 20% of its worldwide income would now be foreign source, it could claim a foreign tax credit of 20% of its $350,000 tentative tax liability, or $70,000 reducing its US tax liability from $350,000 to $280,000. Additionally, the $90,000 of foreign taxes paid which exceeded the foreign tax credit limitation would carry forward to potential use in future years.

Part 2

Since FCo1 is not a per se corporation will be treated either a corporation or a disregarded entity. Its classification can be elected under the US entity classification regulations (commonly known as the 'check the box' rules). In the absence of an election, the default classification of foreign entities varies depending on whether any of the owners of the entity have unlimited liability for the debts of the entity under the laws of the country of formation. Since we are told that the owners of FCo1 have no liability for the debts of FCo1, FCo1 will default to corporate status. With a timely made check the box election, FCo1 will be treated as a disregarded entity – a branch of DejaBrew.

If FCo1 is treated as a disregarded entity, then DejaBrew will report all $100,000 of FCo1's profits on DejaBrew's corporate tax return and attempt to claim a direct foreign tax credit for the $30,000 in foreign taxes paid. If FCo1 is treated as a corporation, the result is different.

If treated as a foreign corporation, FCo1 is subject to the deferral rule. Under this rule, the income of FCo1 will not be taxed by the United States unless FCo1 is engaged in a US trade or business or has a permanent establishment in the United States if eligible for treaty relief. Further, DejaBrew as the shareholder of FCo1 is not taxed on the income of FCo1, nor can it claim a foreign tax credit for the taxes paid by FCo1, until that income is repatriated in the form of a dividend.

However, under the anti-deferral rule of Subpart F, certain income is not eligible for deferral. Foreign base company sales income is excluded from the deferral rule and immediately taxable as if a dividend were paid. Foreign base company sales income is generated when FCo1 purchases Product from DejaBrew (a related party) and resells some of the product outside its country of formation. The sales in Country A do not generate subpart F income. However, the sales outside of Country A will be so treated and result in a deemed dividend.

FCo1 earnings and profits for the year $70,000 ($100,000 profits less $30,000 in tax). Since 60% of its sales are foreign base company income, $42,000 of its earnings and profits are deemed distributed to DejaBrew as a dividend. Additionally, DejaBrew will be entitled to claim 60% of FCo1's foreign taxes as an indirect foreign tax credit. Under the § 78 gross up, DejaBrew must report $60,000 of income ($42,000 deemed dividend increased by the $18,000 indirect foreign tax credit), and offset its United States tax by the indirect foreign tax credit.

Part 3

FCo2 is a foreign corporation entitled to the deferral rule. Under the manufacturing exception, none of its income is Subpart F income. Since FCo2 is a manufacturer, the place of sale is irrelevant under Subpart F. However, under § 956, certain income eligible for deferral can become a deemed dividend when "invested in United States property." The loan of $160,000 to DejaBrew is an investment in United States property. At the time of the loan, FCo2's earnings and profits equaled $1,600,000 ($2,000,000 income less $400,000 in taxes). The investment in United States property equals 10% of FCo2's earnings and profits resulting is a deemed dividend of $160,000 and an indirect tax credit of $40,000 (10% of FCo2's taxes). Applying the § 78 gross up, DejaBrew will report $200,000 of income and claim an indirect foreign tax credit of $40,000. Additionally, DejaBrew will claim a direct foreign tax credit of $60,000 in withholding taxes collected related to the royalty.

PART B

Question 3

Part 1

When a foreign person is engaged in a US trade or business, it is subject to US net-basis taxation on its income that is "effectively connected" with its US trade or business. "Effectively connected income," or ECI, is defined in § 864(c). Under § 864(c)(3), US source business income is always ECI, while under § 864(c)(4), foreign source business income is only ECI if it falls into one of three specifically defined categories. The purchase of inventory in the US and its resale in the US will be US source income effectively connected with JBr's US trade or business.

Part 2

The interest income is fixed and determinable, annual and periodical ("FDAP") income which is generally taxed at 30%. However, FDAP income can be treated as ECI when there is an actual connection between the income and the trade or business. This connection is determined under either the "asset use" test or the "business activities" test. § 864(c)(2).

Under the asset use test, US source investment income is ECI if it is derived from assets used in, or held for use in, the conduct of a trade or business in the US. It applies, as here, where the business activities do not directly give rise to the income. Assets are treated as used in, or held for use in, the conduct of a US trade or business if: 1) the assets are held for the principal purpose of promoting the present conduct of the trade or business in the United States; 2) they are acquired and held in the ordinary course of the US trade or business; or 3) they otherwise held in a "direct relationship" to the US trade or business. Treas. Reg. § 1.864-4(c)(2)(ii).

Under the asset use test, bank accounts, securities, and other investments are used in a US business if they are "held to meet the present needs" of the business, as distinguished from "its anticipated future needs." Treas. Reg. § 1.864-4(c)(2)(iv)(a). The interest earned on the working capital needs would be effectively connected with the US trade or business. The remaining interest would not.

Part 3

Roaylties are generally FDAP income. However, under the business activities test, FDAP income is ECI if the income, gain, or loss, "even though generally of the passive type, arises directly from the active conduct of the taxpayer's trade or business in the United States." Treas. Reg. § 1.864-4(c)(3)(i). Since the royalties are for the use of the JCo name in the United States, it will all be ECI.

Part 4

The sale of the diamond would generally be foreign source income under the residence of the seller rule and not subject to US tax. However, since the diamond is inventory to JCo, the title passage rule applies and its income would be US source but still unrelated to any other business JCo conducts in the United States. However, under the "limited force of attraction" rule of § 864(c)(3), if a foreign corporation is engaged in a US trade or business, all its US source income is "attracted" to the business and treated as ECI even if unrelated to the US business. JCo's sale of the diamond will give rise to ECI.

Part 5

It would initially appear that the source of this income would be foreign under the title passage rule for the sale of purchased inventory. §§ 861(a)(6) and 862(a)(6), and Treas. Reg. § 1.861-7. However, under § 865(e)(2), a foreign person's income from the sale of personal property, including inventory, will be US source income if the person maintains an office or other fixed place of business in the US, and the income is attributable to that US office or other fixed place of business (the "source override rule"). JCo's branch is a US office or other fixed place of business. Under Treas. Reg. § 1.864-6(b)(2)(iii) the income is attributable if the office or other fixed place of business in the US is a material factor in the production of income from sales of goods which it is if it actively participates in soliciting the order, negotiating the contract of sale, or performing other significant services necessary for the consummation of the sale which are not the subject of a separate agreement between the seller and the buyer. JCo US branch's involvement in the sale would satisfy this test and the income is US source despite title passing in Canada.

Part 6

While JBr remains involved in the sale, this is not ECI even if the sale is "attributable" to JBr. Under § 865(e)(2)(B) the source override rule does not apply to inventory which is sold for use, disposition, or consumption outside the United States if an office or other fixed place of business of the taxpayer in a foreign country materially participated in the sale. Under Treas. Reg. § 1.864-6(b)(3)(i), a foreign office is treated as materially participating in a sale if it performs any of the activities mentioned in part 5.

Since the goods are sold into Mexico and JCo materially participated in the sale, this is foreign source income under the title passage rule and not subject to the source override rule.

PART C

Question 4

Under § 897(c)(1)(A)(ii), a U.S. real property interest (USRPI) includes any interest (other than an interest solely as a creditor) in any domestic corporation which meets the test of being a United States real property holding corporation (USRPHC). A USRPHC is defined in § 897(c)(2) as any domestic corporation if the fair market value of its USRPIs equals 50% or more of the aggregate fair market value of its USRPIs, its interests in real property located outside the US, and any other of its assets used or held for use in a trade or business.

PCo is not a USRPHC, even though 50% of its assets consist of USRPIs, since it is not a domestic corporation.

In determining whether NATCo is a USRPHC, the test is applies just looking at trade or business assets and real property. The $20,000,000 of cash on hand is ignored. Ultimately, whether NATCO is a USRPHC depends on the treatment of its stock in PCo. Since PCo would be a USRPHC it is were a domestic corporation, the PCo stock is treated as a USRPI. Under the general rule, we would treat the entire $10,0000,000 of value of PCo as a USRPI, making NATCo a USRPHC. However, since NATCo controls PCo (it owns 50% or more of the value of all classes of PCo stock) the entire investment in PCo is not treated as a USRPI. Rather, a look through rule applies and the USRPI test is applied as if NATCo owned its proportionate share of all the assets of PCo. See § 897(c)(5) and Treas. Reg. § 1.897-2(e)(3). Thus, NATCo would own $9,000,000 of USRPIs (the $4,000,000 it owns plus the $5,000,000 PCo owns) out of a total of $18,500,000 of total included assets (the $8,500,000 of included assets it owns plus the $10,000,000 of included assets PCo owns), or 48.6%. NATCo would not be a USRPHC.

Question 5

The analysis of this question depends on whether RUCo is treated as a corporation or a partnership.

If treated as a corporation, RUCo is not eligible for treaty benefits because of the Limitation on Benefits provisions of Article 22. RUCo can qualify for benefits under Article 22 Paragraph 2(e) only if it meets the ownership and base erosion tests. The ownership test requires that 50% or more of the stock in the corporation is owned by persons entitled to the benefits of the treaty. Here Henri and Claude are both individual residents of Country X and entitled to treaty benefits. The ownership test is met. The base erosion test requires that less than 50% of the corporation's gross income is reduced by deductible payments made to residents of other than Country X and the US. Since we are told that 75% of RUCo's income is paid in deductible payments to a Russian bank, it would fail the base erosion test.

If RUCo is treated as a partnership, Henri and Claude, as individuals, resident in Country X, would qualify for treaty benefits. Gerald, a US citizen, would not qualify even if a resident of Country X since the "savings clause" prevents a US citizen from claiming foreign treaty benefits. Richard, could not claim benefits under the US-Country X treaty since he is not a Country X citizen or resident, but could claim the benefits of the US-Country Y treaty if one exists.

Question 6

Part 1

Income earned by a foreign corporation which is eligible for deferral (i.e. not Subpart F or PFIC) becomes taxable to the foreign corporation's US Shareholders when a controlled foreign corporation ("CFC") makes an investment in United States property. Since FCo is 100% owned by a US Shareholder, it is a CFC.

The term "United States property" is defined in § 956(c). Section 956(c)(1) lists four broad categories of property that are United States property, including "tangible property located in the United States." § 956(c)(1)(A) and no exception in § 956(c)(2) applies. The regulations clarify that tangible property includes both real and personal property. Thus, the purchase of the land is an investment in United States property and will trigger a deemed dividend to USCo in the amount paid.

Part 2

The apartment complex in Des Moines is "tangible property located in the United States," § 956(c)(1)(A), and no exception in § 956(c)(2) applies. Thus, the apartment complex is United States property even though FCo's investment will not directly benefit USCo or its business.

Part 3

US Property includes "stock of a domestic corporation. The shares of IBM stock are "stock of a domestic corporation." However, under § 956(c)(2)(F) an exception applies to any stock or debt obligations of a domestic corporation if the domestic corporation is (i) not a US shareholder of the CFC, and (ii) not owned (or treated as owned) 25% or more by US shareholders of the CFC. We need to determine the extent of overlapping ownership between USCo and IBM but it is unlikely to reach the 25% threshold.

Part 4

The account receivable from USCo is "an obligation of a United States person," § 956(c)(1)(C). However, the receivable is likely excluded from the definition of United States property under the exception in § 956(c)(2)(C) which excepts account receivables where the obligation of the US person arises in connection with the sale or processing of property (i.e., an ordinary trade receivable), and at no time during the CFC's taxable year is the amount outstanding more than the amount which would be ordinary and necessary for the conduct of the parties' business if the transaction had been made between unrelated parties. Here, an invoice which is payable in 30 days, and is paid within that time, reflects normal commercial practice and should not raise concerns.

Part 5

A deposit with a bank generally creates a debtor-creditor relationship with the bank. In other words, a bank account is a form of indebtedness owing from the bank to the account holder. Thus, FCo's CD at Bank of America is "an obligation of a United States person," § 956(c)(1)(C). However, under § 956(c)(2)(A), bank deposits generally are excepted from the definition of "United States property." Thus, the CD does not constitute United States property. The (c)(2)(A) exception is designed to remove the disincentive that otherwise would exist for a CFC to invest its excess cash with a US bank.

Part 6

The loan to J creates an obligation of a US person. The question is whether an exception applies. Under § 956(c)(2)(L), an obligation of a US person is not considered United States property if the US person is (i) not a domestic corporation, (ii) not a US shareholder of the CFC, and (iii) not a partnership, trust or estate in which the CFC or any related person is a partner, beneficiary or trustee. Here, resolution of the question turns on whether J is a US shareholder of FCo.

The term "United States shareholder" means a US person that owns 10% or more of a foreign corporation's voting power, § 951(b). J owns none of FCO's stock directly. However, in testing for US shareholder status, the indirect ownership rules of § 958(a)(2) and the stock ownership attribution rules of § 958(b) also must be considered.

J does not own any of FCo's stock under the indirect ownership rules of § 958(a)(2). Under those rules, a US person is considered as owning its proportionate share of the stock owned through a foreign corporation, foreign partnership, foreign estate or foreign trust. However, this indirect ownership rule stops at the first US entity, which is USCo and it not further attributed.
Under the § 958(b) attribution rules, however, J could be treated as owning the FCo stock actually owned by USCo. In this regard, § 958(b)(3) states that in applying subparagraph (C) of § 318(a)(2), the phrase "10 percent" shall be substituted for the phrase "50 percent." Thus, under § 318(a)(2)(C) as so modified, J will be treated as owning her proportionate share of USCo's FCo's stock if J owns (or is treated as owning) 10% or more in value of the USCo stock. J owns 8% of USCo's stock directly, and J's husband K owns an additional 4% of USCo's stock. J wil meet the 10% test if her husband's stock is attributed to her.

Ordinarily, stock ownership is attributed between spouses under § 318(a)(1)(A)(i), and stock attributed between related individuals may again be attributed through an entity, see § 318(a)(5)(A). However, under § 958(b)(1), stock owned by a nonresident alien individual is not considered as owned by a citizen or resident individual, even if the two individuals are related in the manner prescribed in § 318(a)(1)(A). Thus, under this provision it would seem that J would not treated as owning her husband's USCo stock. However, the flush language of § 958(b) provides that paragraphs (1) and (4) will not apply for purposes of § 956(c)(2) to treat stock of a domestic corporation as not owned by a United States shareholder. Thus, the exception in § 958(b)(1) will not apply and J will be treated as owning K's USCo stock and J will be a US shareholder.

Question 7

Analysis of ABCO. ABCo's gain on the sale of a 20% interest in MCo is $250,000 (amount realized $300,000 less the allocated $50,000 of basis). This would be long term capital gain under normal rules except to the extent that it is treated as a dividend under § 1248. To be subject to § 1248 a US person must own, or have owned, 10% or more of the voting stock of the foreign corporation, directly or indirectly, at some time during the five-year period ending on the date of the sale or exchange. Further, that minimum stock ownership must have existed on a day on which the foreign corporation was a "controlled foreign corporation." § 1248(a)(2) Both of these tests are met.

For corporations, § 1248 generally results in a benefit.

First, for corporations, ordinary income and capital gains are taxed at the same tax rates. Thus, treating part of the sales price as a deemed dividend (based on the corporation's E&P) would not subject it to a higher rate of tax. It could be an issue, however, if ABCo had unused capital losses which could be applied against the capital gains, but not ordinary income.

Second, to the extent the gain is recharacterized as a dividend, ABCo will be entitled to an indirect foreign tax credit. This is a significant benefit.

Third, gain from the sale of a capital asset is generally passive basket income. Thus, the corporation's income from the sale proceeds would generally be passive and US source (residence of seller rule). The deemed dividend on the other hand will be foreign source (paid by a foreign corporation) and will be general basket income to the extent of the look through rule treats the dividend as general basket income.

ABCo will have a dividend equal to $180,000 on the sale of its MCo stock. MCo's untaxed earnings and profits at the time of sale was $900,000. This is calculated by taking the $1,200,000 of earnings, reducing it for the $120,000 of taxes to $1,080,000 and further reducing it for the $180,000 previously taxed Subpart F earnings and profits ($200,000 earnings less $20,000 tax paid) to $900,000. MCo's sale is 20% of this, or $180,000. The remaining $70,000 of the gain is long term capital gain.

ABCo would be entitled to an indirect foreign tax credit of $20,000 calculated as follows: Amount of dividend ($180,000) divided by total earnings and profits ($900,000) times the foreign tax pool of $100,000 ($120,000 less the $20,000 attributable to the prior Subpart F income). ABCo's dividend of $180,000 would be grossed up for the $20,000 indirect credit for a total dividend of $200,000 in addition to the $70,000 long term capital gain.

Analysis of John. As to John, he would also have $180,000 of his capital gain converted into ordinary income. However, unlike a corporation, this is a tax disadvantage since the income will be taxed at ordinary income rather than capital gains rates. Also recall that John, as an individual, would not be entitled to an indirect credit. The remaining $70,000 of gain would be long term capital gain subject to the preferential tax rates on net capital gains.

Note that if MCo is a "qualified foreign corporation," the dividend would be a qualified dividend subject to tax at capital gains rates. § 1(h)(11). A qualified foreign corporation is one formed in a US possession or certain treaty countries, or whose stock is publicly traded.