Question 1

Part 1

To: Bogart
From: Tax Advisor
Re: US Income Tax consequences arising on receipt of certain income

Further to your request for advice in respect of the above, I have outlined below the US tax consequences of the income that you have received in 2014.

US residents / citizens are subject to US tax on their worldwide income and gains. As such as you are a lawful permanent resident you will be subject to tax on the worldwide basis. The amount of days that you spend in the US or the fact that you are a citizen of Islandia are not considered relevant in arriving at this conclusion.

The amount of tax that you pay will depend on the underlying source of the income, whether it is US or non-US income. To the extent that it is the latter foreign tax credits may be available (although this is outside the requirements of this advice memo).

The US sources of income are as follows:

- Personal Services undertaken within the US ($500,000) [Code Sec: 861(a) (3)]
- Dividend Income received from US Corporations ($25,000) [Code Sec: 861(a) (2)]
- Interest Income received from US Corporations ($5,000) [Code Sec: 861(a) (1)]
- Interest Income on US bank account ($500) [Code Sec: 861(a) (1)]

The non-US sources of income are as follows:

- Personal Service undertaken outside the US ($400,000) [Code Sec: 862(a) (3)]
- Dividend Income received from non-US corporations ($10,000) [Code Sec: 862(a) (2)]

You should be in a position to qualify for a reduced rate, under code section 1 (h) 11 so that the dividend income is subject to tax at the long term capital gains rate of 20%. This applies to dividends from domestic corporations ($25,000) above and also qualifying foreign corporations, including corporations listed on stock exchanges. For the purposes of this memo i will assume that the foreign dividends so qualify.

This results in the following US tax summary:

- Income taxed at assumed rate of 40% ($905,500)
- Income taxed at long terms CGT rate of 20% ($30,000).

This results in an overall tax charge of $368,200.

As mentioned above foreign tax incurred on the foreign source income may be available as a foreign tax credit to reduce this income.

Alternatively Bogart could apply under code section 911 to exempt a portion of his foreign earned income. Given the scale of Bogarts earnings and the fact that he would need to waive any entitlement to a credit for tax, this may not be very beneficial.

Part 2

The circumstances would change if you are not considered a resident for immigration purposes. Non-US resident are only subject to US tax on their foreign source income. Individuals who spend a significant period of time in the US over a period of three years (in excess of 183 days) will be regarded as resident under the provisions of code section 7701.

You have spent 360days in the US over the past three years, although a reduced weighting is given to previous years as follows:

- Current Year: 1 (120days)
- Preceding Year: 1/3 (40 days)
- 2nd Preceding Year: 1/6 (20 days)

Total weighted days: 180days.

On this basis you would be considered non-US resident for 2014 and subject to US tax on US source income only (as outlined in Part 1 above).

The income from US personal services would be regarded as US source income as it is statutorily regarded as the undertaking of a US trade / business (code section 864). Given the amounts involved the exemption do not apply. This only applies to services undertaken within the US so no US tax will arise on services performed outside the US irrespective if they were done for US-based clients.

The remaining income will be treated as FDAP income and potentially subject to a 30% withholding as none of the income is connected with the business.

There is an exemption for non-residents in respect of interest income received on portfolio investments which should apply in this case which means that the interest income will not be subject to US tax.

In summary therefore the $500,000 of personal services income will be subject to tax at the assumed rate of 40%. The dividend income will be subject to a 30% withholding tax at source.

Part 3

The circumstances would change if there was a treaty in place between the United States and Islandia.

In Part 1 above, Bogart is considered a US tax resident and as a result subject to tax on his worldwide income. He will be entitled to claim double tax relief under the provisions of the treaty on any foreign source income.

The changes in Part 2 will be greater. As Bogart is not regarded as a resident of the US, it shall only be taxed on income that he derives from a permanent establishment in the US (Article 5). It’s not clear from the information provided whether Bogart has sufficient permanence in the US (for example, operates from a fixed office) to determine for certain but on the assumption he doesn't, the personal services income of $500,000 would not be subject to tax in the US.

Bogart is also subject to withholding tax of 30% under Part 2 above. This would be reduced to 15% under the provisions of Article 10.

If you have any further queries please do not hesitate to contact me.

Yours sincerely

Tax Advisor

Question 2

Part 1

To: Fleet Feet Co (Fleet)
From: Tax Advisor
Re: US income tax consequences of sale of shoes

I understand that the IRS has contacted you with regard to the sales of shoes to US customers and proposal to impose a 35% tax on the net profits realized by Fleet in respect of those sales. You have asked for my thoughts on this proposal and also on whether you would be entitled to a credit for income taxes paid in Sudlandia on the same income.

Sale of shoes to US customers

As a non-US resident Fleet will be subject to US under 2 regimes, either on income effectively connected with a trade or business or on FDAP income (e.g. interest income) that is sourced in the US.

The sale of shoes is clearly not FDAP income so we must consider whether it arises from a trade or business.

Code section 863 (b) specifically provides for a situation where goods are produced in one country and sold in another noting that income / expenses should be apportioned appropriately. This may be way of a 50/50 split by reference to a more scientific method - for example, looking at sales to domestic customers as a barometer.

As the title to the goods passes in the US the sales will be regarded as taking place there under US legislation - or in other words, the income arising (subject to apportionment above) will be regarded as US source.

Code section 864 (c) (3) notes that US source income arising from sales in the US will be regarded as income effectively connected with a US trade / business.

Therefore the contention put forward by the IRS seems reasonable. Given the scale of income I would recommend that Fleet examines in detail the income / expenses arising from the sales to US customers to ensure that the net income subject to US tax is appropriate.

Tax paid in Sudlandia.

As noted above, the income subject to US tax will be regarded as US source income. Unfortunately therefore Fleet will not be in a position to get credit for income taxes paid in Sudlandia. The US taxation system will only provide a credit for foreign income taxes arising on foreign source income.

If you have any further queries please do not hesitate to contact me.

Yours sincerely

Tax Advisor

Part 2

To: Fleet Feet Co (Fleet)
From: Tax Advisor
Re: Branch vs Subsidiary

I refer to my previous memo and also your subsequent request to provide additional advice in respect of the proposed establishment of a US factory. In particular you require advice on the form of which the investment should take (branch vs subsidiary) and also whether a portion of the investment should be made in debt.

I understand that for the purposes of the above, you expect the operation to be loss making in the first two years and profitable from year 3 onwards. Once profitable 50% of yearly profits will be repatriated and the remaining reinvested.

In general Fleet will be subject to federal income tax of 35% on the net income arising from the operation (after utilizing any losses carried forward from years one or two) – this tax will either arise in the name of Fleet if a branch is set up or in the name of the subsidiary if that route is chosen. The operation will also need to pay local / States taxes and will need to register for Sales Tax with the NYS authorities.

Branch

With this option, Fleet itself will be subject to tax in the US and will be required to file US tax returns / make tax payments in its own name. One of the main benefits of a branch presence is that the losses in the first two years can be used to shelter profits arising in Fleets worldwide income (taxed in Sudlandia) as well as being used to carry forward against future US ECI income.

A further benefit can arise in some jurisdictions whereby there is no withholding tax on repatriations of profits to the home country - essentially because it is a payment within the same legal entity. This benefit does not however arise in this case as the US (through code section 884) implemented a Branch Profits Tax (BPT). The purpose of this legislation was essentially to replicate the withholding tax that applies to distributions from a US corporation to a non-resident shareholder.

The BPT would not apply in the first two years as there would be no current year earnings and profits. As in subsequent years Fleet intends to repatriate 50% of the profits of the business it is likely to apply from year three onwards. The relevant rate is 30% and it will be applied on the dividend equivalent amount, calculated by the following formulae:

Current Year earnings & profits plus decreases in net equity less increases in net equity (from start of year to end of year).

At a high level, given the repatriation policy, it is likely that a BPT of 30% will apply to the amount of dividend – as that it is likely to represent the reduction in equity during the year.

Subsidiary

The main disadvantage of a subsidiary, in comparison to a branch, is that the initial losses cannot be used to shelter profits of Fleets worldwide operation. However the other elements of loss relief remain (e.g. carry forward for 20 years).

As alluded to above the repatriation of income will result in the imposition of a withholding tax of 30% (on the gross amount) as the dividend payment will be regarded as US source income, subject to the FDAP withholding regime.

While not a strict tax consideration a main benefit of a subsidiary company is that it can avail of limited liability and is legally distinct from its parent entity. This is probably important for Fleet particularly given its other operations in the US (as referenced in my earlier memo).

The main benefit of a subsidiary operation from a tax perspective will be the flexibility it gives in terms of the type of the investment. Currently an equity investment is planned. The dividend payments arising on this equity will not be tax deductible. However, if the entity replaces some of the equity with debt it should be in a position to reduce its taxable income in the US, and as a consequence its US tax charge.

It should be noted that there are restrictions under code section 163 which limit the level of loan capital that can be put in in comparison to equity although a 1:1 should be appropriate – i.e. a debt investment of $10,000,000. Assuming an arms length interest charge of 5% this would result in an increased tax deduction of $500,000 per annum.

Given the above and the benefit of introducing debt to the operation (which isn't available in a branch context) I would recommend the operation be set up a subsidiary.

If you have any further queries please do not hesitate to contact me.

Yours sincerely

Tax Advisor

<u>Part 3</u>

The overall conclusion to Part 2 above would not change if there was a treaty in place between US and Sudlandia. The branch presence would be regarded as a PE and subject to US tax The main benefit of the treaty would be the reduction in the withholding tax rate to 5% - the branch profits tax rate would also reduce to 5%.

The ability to structure some of the investment in debt would remain and therefore the operation should be established as a subsidiary.

Question 4

To: WWI
From: Tax Advisor
Re: US Tax Consequences arising on payment of dividend to Lincoln / Washington

As requested I have outlined below my advice in respect of the US tax consequences arising on the payment of the dividends to two shareholders - Lincoln (US Corp) and Washington (US Citizen).

For the purposes of this memo, I am assuming that together their shareholdings form a 100% controlling interest in WWI albeit WWI's income is not regarded as falling under sub part legislation (code sections 957 and 952 respectively) and therefore income is only subject to US tax on repatriation.

The dividend income received by the two shareholders would be regarded as non-US source income.

As a general comment US residents are entitled to receive a credit for foreign income taxes paid under code section 901. A withholding tax would qualify for this credit as a tax paid in lieu of income tax (code section 903). In addition to this, a credit can also be claimed in respect of income taxes paid by the entity itself (WWI) in Islandia. This is known as a deemed credit and is provided for under s902. Importantly though it is only available to domestic corporations who own greater than 10% of the voting stock. In this case therefore it would apply to Lincoln but not Washington.

The US income received by Lincoln / Washington should be grossed up at relevant US rates for the purposes of calculating the US tax charge (under both s901 and s902 above).

The amount of any credit is limited to the amount of US tax that would arise on the dividend. In addition, while certain cross sharing of excess credits is allowed this can only be done within the same 'basket' of income (code section 904).

I will deal with the matters in each year separately.

2013

	Lincoln	**Washington**
Cash Dividend Rec'd	$1,350,000	$450,000
Withholding Tax	$150,000	$50,000

Section 902 credit

The credit is calculated by comparing the dividend to earnings and profits with resultant percentage applied to income taxes paid to date.

The following result arises: ($1,500,000 / $6,000,000) * $4,000,000 = $1,000,000

The following US tax calculation arises:

	Lincoln	**Washington**
Dividend Rec'd	$1,350,000	$450,000
Withholding Tax	$150,000	$50,000
s902 deemed tax	$1,000,000	
Taxable Income	$2,500,000	$500,000
Tax at 35% / 40%	($875,000)	($200,000)
Withholding Tax	($150,000)	($50,000)
s902 credit (**)	($725,000)	
Net US Tax	Nil	$150,000

(**) Lincoln has excess tax credits of $275,000 which it can carry back for one year or forward for the next ten years.

<u>2014</u>

	Lincoln	**Washington**
Cash Dividend Rec'd	$1,080,000	$360,000
Withholding Tax	$120,000	$40,000

<u>Section 902 credit</u>

The credit is calculated by comparing the dividend to earnings and profits with resultant percentage applied to income taxes paid to date.

As this is the second year of operation the impact of the previous year's dividends, etc., need to be taken into consideration as follows:

2013 Earnings / Profits	$6,000,000
Dividend paid	($2,000,000)
2014 Earnings / profits	$4,000,000
Total	$8,000,000
2013 Income Tax Paid	$4,000,000
Tax on Dividend (**)	($1,330,000)
2014 Income tax	$1,000,000
Total	$3,670,000

(**) The total amount of tax is removed as opposed to just the element relating to the distribution to Lincoln.

Using same calculation as above the following result arises:

($1,200,000 / $8,000,000) * $3,670,000 = $550,500

The following US tax calculation arises:

	Lincoln	**Washington**
Dividend Rec'd	$1,080,000	$360,000
Withholding Tax	$120,000	$40,000
s902 deemed tax	$550,500	
Taxable Income	$1,750,500	$400,000
Tax at 35% / 40%	$612,675	($160,000)
Withholding Tax	($120,000)	($40,000)
s902 credit (**)	($492,675)	
Net US Tax	Nil	$120,000

(**) Lincoln has excess tax credits of $57,825 for the year which when added to the prior year excess of $275,000, results in an amount of $332,825 which it can carry back for one year or forward for the next ten years.

Should the position continue for Lincoln into future years it should consider electing to take a deduction for foreign taxes in a particular year and utilize the credits forward to shelter any US Tax. This would be preferable if the losses utilization period (10 years) is likely to run out. Lincoln could also use the excess credits to shelter other foreign source income, from the same basket of income, if it so arises.

If you have any further queries please do not hesitate to contact me.

Yours sincerely

Tax Advisor

Question 5

To: Omaha Inc (Omaha)
From: Tax Advisor
Re: US Tax Consequences arising on foreign branch income and loan interest income

As requested I have outlined my advice in respect of the US income tax consequences arising on foreign branch income earned and interest income arising on a loan from an assumed, unrelated, party (Nutgrove).

As a general comment US corporations are entitled to receive a credit for foreign income taxes paid under code section 901. As Alpha, Beta and Gamma are branches, this would covers income taxes paid by those operations in their foreign locations.

The amount of any credit is limited to the amount of US tax that would arise on the foreign income. In addition, while certain cross sharing of excess credits is allowed this can only be done within the same 'basket' of income (code section 904).

An overview of the relevant facts for each branch is outlined below:

	Alpha	**Beta**	**Gamma**
Pre-Tax Income	$500,000	$500,000	$500,000
Income Tax	$100,000	$200,000	$300,000
Tax Rate	20%	40%	60%

The table above highlights the difference in tax rates applied in the local country. It is clear therefore that Omaha will have excess credits arising from its operations in Beta and Gamma (as the rates are in excess of the US assumed rate of 35%) while it will have taxable income in respect of its income in Alpha, as that rate is lower that 35%.

Alpha, Beta & Gamma operate in the manufacturing, agricultural and consulting businesses respectively. While each business is different it does not mean that there is a restriction on the cross utilization of excess credits.

Under code section 904(d)(1)&(2) excess credits cannot be shared between the passive income basket and the general income basket. Passive income is defined in code section 954 (c) and includes such items as dividends, interest, etc.

While all coming from different segments, all of the income earned by the three branches should be considered general basket and therefore excess credits can be shared, subject to the overall limitation referenced above (i.e. can't exceed the US tax arising on the foreign income). The following tax calculation arises for Omaha:

Net Income	$1,500,000
US Tax at 35%	$525,000
Foreign tax credit	($525,000)

Therefore, Omaha has an excess credit of $75,000 which it can carry back for one year or forward for ten against tax arising on foreign income from the same basket.

Loan Income

The income arising on the loan that Omaha provided to Nutgrow would be regarded as foreign source income under code section 862 (a) as Nutgrow is resident outside the States. As noted above, I have assumed for the purposes of this memo that Nutgrow is unrelated to Omaha and that there is no shareholding relationship. If this is not the case, let me know as the advice below could change, particularly if regarded as a controlled foreign company.

As a US corporation, Omaha will be taxed on its worldwide income including the foreign source interest income received from Nutgrow. Omaha will be entitled to a credit for foreign income taxes paid on this income. The withholding tax of $120,000 would be regarded as a tax in lieu of income tax as allowed for under code section 904. The fact that it is paid by Nutgrow, as opposed to Omaha, is to relevant as it is regarded as a tax on Omaha's income.

For the purposes of the US tax calculation the income must be grossed up to include the withholding tax element.

Interest Rec'd	$600,000
Withholding Tax	$180,000
Total	$780,000
US Tax	$273,000
Less tax credit	($180,000)
Net US Tax	$93,000

Omaha cannot use the excess credit of $75,000 arising on the branch income as the interest income on the loan would be regarded as passive income and is therefore captured by the limitation referenced above.

If you have any further queries please do not hesitate to contact me.

Yours sincerely

Tax Advisor