THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2015

PAPER 2.10 – UNITED STATES OPTION

ADVANCED INTERNATIONAL TAXATION (JURISDICTION)

TIME ALLOWED – 3¼ HOURS

- You should answer **all** parts of **all** questions.
- Start each answer on a new sheet of paper. 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).

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.

Answer all parts of all questions. The weightings assigned to the various questions and parts of questions are indicated in brackets.

1. Budapest Europe Tech (BET Parent) is a Hungarian corporation based in Budapest. It is a holding company that operates through a number of corporate subsidiaries, including a manufacturing subsidiary in Croatia (Croatia Sub) and a number of sales subsidiaries located in various African countries (Africa Subs). Croatia Sub occasionally purchases materials from US suppliers, but, prior to 2014, BET Parent had never had an office in the United States and neither BET Parent nor any of its subsidiaries had ever conducted significant business activities in the United States.

In January 2014, BET Parent purchased all of the ownership interests in a Delaware limited liability company (Delaware LLC) that was engaged in marketing products similar to the products manufactured by Croatia Sub to customers located in the United States, Canada and Mexico. BET Parent paid $2 million to purchase the membership interests in Delaware LLC and contributed an additional $1 million to Delaware LLC to provide it with adequate working capital. Delaware LLC deposited the added working capital with Virginia Bank (Bank), a US domestic commercial bank with its headquarters in Leesburg, Virginia. Delaware LLC then purchased a new, more modern office building in Rochester, New York, to serve as its US headquarters. Delaware LLC paid $600,000 for the new building, including a $150,000 deposit and the balance of $450,000 borrowed by way of a 39-year mortgage loan bearing interest, payable monthly, at the rate of 7% per annum. BET Parent sent a top sales and marketing executive (US Executive) from Budapest to become the Chief Executive Officer of Delaware LLC. US Executive supervised staff at Delaware LLC consisting of a chief operating officer, a finance officer, three sales specialists and several support staff. US Executive and all Delaware LLC staff are based in Rochester, New York, but US Executive, a Hungarian national, maintains his home outside Budapest and travels there regularly to visit his family.

Delaware LLC immediately added to its product line the products manufactured by Croatia Sub and assigned one of its three specialists to handle wholesale transactions between Croatia Sub and major North American retailers. In these transactions, Delaware LLC located potential customers and conducted initial negotiations but then referred the customers to the central sales office of Croatia Sub in Croatia, which completed negotiations and executed the final contract with the customer. Sales were made by Croatia Sub directly to the North American purchaser, with title passing when the goods were delivered by Croatia Sub to a common carrier at a Croatian port. Croatia Sub did not pay any commissions or fees to Delaware LLC. The same specialist also arranged smaller transactions with local retailers. For these transactions, Delaware LLC paid Croatia Sub cost plus a 9% mark-up for the goods, took title to the goods upon delivery by Croatia Sub in Croatia, transported them to the United States, and stored them in a warehouse in Rochester until delivery to the ultimate purchasers.

For the year 2014, the combined results of BET Parent and its subsidiaries (the BET Group) associated with the activities of Delaware LLC in the United States, after deduction of all production costs and sales and marketing expenses directly related to their respective operations, were as follows:

<u>Croatia Sub</u>	
Direct sales:	
to US Customers	$1,500,000
to Canadian Customers	900,000
to Mexican Customers	700,000
Sales to Delaware LLC	500,000
<u>Delaware LLC</u>	
Sales to US Customers	$1,000,000
Sales to Canadian Customers	300,000
Sales to Mexican Customers	100,000
Interest on Invested Capital	50,000
(Interest on Mortgage)	(64,000)

Continued

1. Continuation

For the year 2014, the assets and liabilities of BET Parent, Croatia Sub and Delaware LLC are as follows:

	BET Parent	Croatia Sub	Delaware LLC
Cash and Securities	$5,000,000	$1,000,000	$2,200,000
Fixed Assets	0	1,500,000	600,000
Inventory	0	750,000	650,000
Investment in Delaware LLC	3,000,000	0	0
Investment in Other Subs	10,000,000	0	0
TOTAL	18,000,000	3,250,000	3,450,000
Mortgage Debt	0	800,000	450,000
Other Obligations	0	0	0

On 31 December 2014, Delaware LLC made a distribution of profits to BET Parent of $1,200,000.

You are required to prepare a memorandum in which you address the following questions relating to the US federal income tax treatment of the foregoing activities. Unless otherwise directed, apply only US domestic income tax law, without regard to any applicable treaties.

1) **Which members of the BET Group were engaged in a trade or business in the United States in 2014?** (4)

2) **Which members of the BET Group earned US source income during 2014? How much income was earned, and of what character?** (4)

3) **What, if any, income of Croatia Sub is subject to US federal income tax in 2014, and at what rate(s)? Would the result change upon application of the US-Croatia Income Tax Treaty, assuming it is the same as the US Model Convention?** (4)

4) **What, if any, income of BET Parent is subject to US federal income tax in 2014, and at what rate(s)? Would the result change upon application of the US-Hungary Income Tax Treaty, assuming it is the same as the US Model Convention?** (4)

5) **Assuming only the assets and liabilities listed above, what, if any, interest deduction may Croatia Sub or BET Parent take on its US federal income tax return for 2014?** (4)

6) **What, if any, income of US Executive is subject to US federal income tax in 2014, and at what rate(s)? Would the result change upon application of the US-Hungary Income Tax Treaty, assuming it is the same as the US Model Convention?** (4)

7) **What would be the effect under US federal income tax laws if BET Parent had filed an election to treat Delaware LLC as a corporation, effective as of 2 January 2014?** (4)

8) **What challenge to its transfer pricing methods can BET Parent expect if it reports the income of the various members of its group to the United States Internal Revenue Service in the manner outlined above?** (4)

Total (32)

2. US Wine Corporation (Wine) is a publicly-held Delaware corporation that maintains its corporate headquarters in Napa Valley, California. Prior to 2014, its only assets consisted of all of the stock of US Bottle Corporation (US Co), a Delaware corporation based in San Francisco; all of the stock of European Bottle AG (Austria Co), an Austrian corporation based in Graz, Austria; and 10% of the stock of Korean Bottle Corporation (Korea Co), a Korean corporation based in Seoul, Korea.

US Co produces alcoholic beverages in the United States and sells them to distributors in the United States, elsewhere in North America and in South America. Austria Co produces alcoholic beverages in Austria and sells them to distributors in Austria and elsewhere in the European Union. Austria Co operates under a trademark licensing agreement with US Co, which was executed when Wine formed Austria Co in 1997 and requires Austria Co to pay royalties to US Co equal to 3% of Austria Co`s gross revenues from sales of beverages. Korea Co produces alcoholic beverages in Korea and sells them to distributors in Korea and elsewhere in Asia. Korea Co also operates under a trademark licensing agreement with US Co, which was executed when Wine purchased its 10% interest in Korea Co in 1999 and requires Korea Co to pay royalties to US Co each year equal to 5% of Korea Co's gross revenues from sales of beverages.

On 1 January 2014, Wine caused Austria Co to form Luxembourg Bottle LLC (Lux LLC), a limited liability company based in Luxembourg. Lux LLC timely elected to be treated as a disregarded entity for US federal income tax purposes. Austria Co invested $2 million in cash in exchange for 100% of the stock of Lux LLC and made $8 million in loans to Lux LLC to enable it to begin trading. Lux LLC immediately entered into the business of purchasing beverages from Austria Co for a purchase price equal to their fair wholesale value and reselling them to unrelated retailers in China and various developing countries in Asia and Africa.

The operating subsidiaries of Wine performed well in most markets during the course of 2014. The results of their respective sales activities were as follows:

<u>US Co</u>	
Net Income from Sales	
To US Customers	$10,000,000
To Foreign Customers	2,000,000
Foreign Income Taxes	(800,000)
<u>Austria Co</u>	
Net Income from Sales	$4,000,000
Austrian Income Taxes	(800,000)
<u>Korea Co</u>	
Net Income from Sales	$400,000
Korean Income Taxes	(160,000)
<u>Lux LLC</u>	
Net Income from Sales	$2,000,000
Luxembourg Income Taxes	(100,000)

For 2014, US Co became entitled to royalties from Austria Co and Korea Co in the amounts of $120,000 (based on Austria Co sales of $4 million) and $20,000 (based on Korea Co sales of $400,000).

On 31 December 2014, Austria Co distributed $500,000 to its sole shareholder as a dividend under Austrian law. On the same day, Austria Co purchased $100,000 worth of debentures of Wine on the Chicago Stock Exchange.

Continued

2. Continuation

Also on 31 December 2014, and in keeping with its policy of making regular dividend payments even in lean years, Korea Co distributed $300,000 to its shareholders as a dividend under Korean law. US Co and Lux LLC both retained and reinvested their net after-tax income.

You should assume that neither Austria Co nor Korea Co had any accumulated earnings as of 31 December 2013.

You are required to prepare a memorandum in which you address the following questions relating to the US federal income tax treatment of the foregoing activities. Assume that both Austria and Korea levy a 30% withholding tax on dividends and interest paid to shareholders outside the European Union and Korea, respectively, but that both Austria and Korea have income tax treaties with the United States that are identical to the US Model Convention.

1) **What US federal income tax obligations would be imposed on Wine and US Co if, during 2014, they had no items of income or deduction other than US Co's net income from sales to US and foreign customers during 2014?** (4)

2) **What income must Wine report for US federal income tax purposes, solely as a result of the operations of Austria Co during 2014? What income must Wine report as a result of the operations of Korea Co? What income must Wine report as a result of Lux LLC's operations?** (4)

3) **What are the US federal income tax consequences to Wine of the distributions made by Austria Co in 2014?** (4)

4) **What are the US federal income tax consequences to Wine of the distributions made by Korea Co in 2014?** (4)

Total (16)

3. The Tiger Corporation (Tiger) is a publicly-held New Jersey corporation that maintains its corporate headquarters in Miami, Florida. Its sole asset consists of all of the stock of Lion Corporation (Lion), a Portuguese holding company that in turn owns all of the stock of the Spanish Leopard Corporation (Leopard) and 70% of the stock of the Andorran Jaguar Corporation (Jaguar). Leopard manufactures sports products at a factory outside Barcelona and sells them to distributors in Spain. Leopard also sells its products to Jaguar, which resells them to distributors in Andorra.

Leopard and Jaguar performed well during the year 2014. The results of their respective manufacturing and sales activities were as follows:

<u>Leopard</u>	
Income from Sales	\$20,000,000
Spanish Income Taxes	(5,000,000)
<u>Jaguar</u>	
Net Income from Sales	\$16,000,000
Andorran Income Taxes	(4,000,000)

Lion had no operating income in 2014.

On 31 December 2014, Leopard distributed \$10 million as dividends under Spanish law. On the same day, Jaguar distributed \$12 million as dividends under Andorran law. Finally, and also on 31 December 2014, Lion distributed \$7,100,000 as a dividend under Portuguese law. Leopard invested the balance of its net income in new factory and equipment in Spain. Lion invested the balance of its net income in stocks and bonds traded on the Lisbon stock exchange.

Neither Spain nor Andorra levies a withholding tax on dividends paid to Portugal. Portugal does not tax dividends received by a corporation from outside Portugal but does levy a 5% withholding tax on dividends paid to the United States.

You should assume that Lion had accumulated earnings of \$6 million as of 31 December 2013 (after \$1,800,000 of associated income taxes was paid), but that neither Leopard nor Jaguar had any accumulated earnings (or associated taxes) as of 31 December 2013.

You are required to prepare a memorandum in which you address the following questions relating to the US federal income and withholding tax treatment of the above activities. Unless otherwise directed, apply only US domestic income tax law, without regard to any applicable treaties.

1) **Compute the earnings and profits of Leopard, Jaguar and Lion as of 31 December 2014.** (4)

2) **What items of income, gain, loss and deduction must Tiger recognise in the United States as a result of the activities described above?** (4)

3) **Assuming that Tiger has no other items of income, gain, loss or deduction, compute the amount of US federal income tax owed by Tiger for 2014.** (4)

4) **What change, if any, would there be to Tiger's US federal income tax liability for 2014 if Lion paid no dividends but instead on 31 December 2014 invested its current and accumulated earnings in publicly traded bonds issued by Tiger?** (4)

Total (16)

4. Roland Rivers, a citizen and resident of the United States, has for many years held a portfolio of stocks of US domestic companies. In February 2014, on the advice of his Chicago broker, he purchased 100,000 shares of a publicly-traded, Chilean-incorporated investment fund (Chile Fund) that has recently enjoyed spectacular results investing exclusively in South African new ventures and European stocks. His purchase price was $3 per share.

   During 2014, Roland received cash dividends of $1 million from Chile Fund. As of 31 December 2014, the value of his Chile Fund shares had risen to $5 million.

   What is the amount and character of the income, if any, that Roland Rivers must report for US federal income tax purposes in 2014 in respect of his shares of Chile Fund? (5)

5. Geraint, a UK citizen and resident, is a shareholder of Pluto Enterprises (PE), a Delaware corporation whose assets consist of a retailing business in Argentina with a fair market value of $1 million and stock in Sun Corporation (Sun Corp) with a fair market value of $700,000. Sun Corp's principal asset is an office building in Santa Monica, California (with a fair market value of $1 million), but it also holds investment stocks and bonds in Argentine corporations.

   You are required to describe any US federal income and withholding tax consequences to Geraint if he sells his PE stock, in the following scenarios:

   1) PE holds 45% of Sun Corp's stock. (4)

   2) PE holds 65% of Sun Corp's stock. (3)

   Total (7)

6. Eleven US individuals, who are unrelated, organised a wholly owned foreign corporation (Sub F, Inc) in Nauru in March 2014. Each individual contributed $9,090 to the corporation and in return received one share of stock that represents 9.09% of Sub F, Inc. During 2014 Sub F, Inc had foreign base company sales income of $200,000, but its current earnings and profits were $180,000. For the purpose of this question, assume that Nauru imposes no tax on corporate income and that each US individual owned stock on the last day of 2014.

   What is the pro rata share of Sub F, Inc's income that should be included in the gross income of each US individual owning shares in Sub F, Inc in 2014? (6)

7. In 2014, a US corporation (US Co) and a Tunisian corporation (Tn Co) formed a joint venture (US-Tn JV) to supply Tunisian dates and almonds in various African and European countries. Under the joint venture agreement, each corporation supplies 50% of the capital and receives 50% of the net profit (or bears one-half of the net loss) each year.

   In its first year, the venture reported a loss of $10 million for both US and Tunisian tax purposes. This loss was allocated between the two corporations for Tunisian and US tax purposes, as specified in the joint venture agreement.

   What amount of income or loss must US Co report on its US federal income tax return? (6)

8. Mr Tomas, a citizen of Hungary, was present in the United States for 99 days in 2012, 120 days in 2013, and 145 days in 2014. Mr Tomas was not a permanent resident of the United States during any of the three years and was not present in the United States at any time before 2012.

   1) What is Mr Tomas's residency status in the United States for each of the three years? (4)

   2) How would the answer to Part 1 change, if at all, if Mr Tomas was present in the United States for 115 days in 2014? (3)

Total (7)

9. Mr Gold is a US citizen and a resident of Memphis, Tennessee. He retired to Memphis after making a fortune as an oil and gas investor in Texas. He now plans to start and fund a philanthropic organisation that will support children in certain developing countries. Mr Gold believes that his project can make a real difference in the future of young children, but he wants to manage the organisation's investments and direct the expenditure of the organisation's funds himself. In order to further this objective, he is considering moving abroad, preferably to Norway, and renouncing his US citizenship in 2015. Mr Gold wants to leave the United States with all his wealth and regards minimising his US tax liability as very important.

   Mr Gold`s major assets are the following:

Cash in US bank accounts	$100,000,000
Tennessee hotel chain	150,000,000
<u>Investments</u>	
US stocks and bonds	$30,000,000
Asian stocks and bonds	15,000,000
Stocks in oil and gas company	50,000,000
Pension plan	3,000,000
US East Coast fast food chain	9,500,000

   Assuming he goes forward with this plan, how successful will Mr Gold be in avoiding current and future US income, estate and gift taxes? (5)