Chartered Institute of Taxation
Excellence in Taxation

THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2015

PAPER 3.05 – UNITED STATES OPTION

ADVANCED INTERNATIONAL TAXATION
(THEMATIC)

Suggested solutions

PART I

Question 1

Part 1

Bogart is a permanent resident alien of the United States under applicable immigration laws. As such, Bogart is subject to the rule of worldwide taxability. Thus all of the income realised by Bogart is subject to US tax. Most of this income is taxable at ordinary tax rates (assumed to be 40 percent). However, a portion may be taxable at the lesser long-term capital gains rate (assumed to be 20 percent). Dividends paid by US corporations to domestic individual taxpayers will be taxed at the long-term capital gains rate if the shares have been held for more than one year (the holding period required for long-term gains when a capital asset has been sold or exchanged). As a result, dividends received from US corporations will be subject at the assumed rate of 20 percent in circumstances in which Bogart held the shares for at least one year. Dividends paid by foreign corporations will be eligible for the same benefit if they are "qualified dividend income." To be so qualified, the corporation must generally be a resident of a treaty country and the IRS must have determined that applicable qualification standards are satisfied. Code Section 1(h)(11). The factual statement provides no basis for determining whether Bogart is entitled to the long-term capital gains rate for any of the dividends received.

Part 2

If Bogart was not a permanent legal resident of the United States under applicable immigration laws, he will almost certainly be treated as a foreign (rather than as a domestic) taxpayer. There are some instances in which an alien will be treated as tax resident even though he/she is not a legal resident. The "substantial presence" applies if the alien is physically present within the United States for a total of 183 days or more using the following formula:

Days in the tax year:	one day= one day
Days last year:	one day = 1/3 day
Days in prior year:	one day = 1/6 day

Code Sec. 7701(b). Bogart spends 120 days each year in the United States. Under this test:

This year	120
Last year	40
Prior year	20
Total	180 days

Bogart is not US tax resident and will be subject to US tax as described below.

Compensation for work performed in the United States is US-source income that is statutorily defined to be effectively connected to a US trade or business ("USTB"). Code Sec. 861(a)(3). Net income effectively connected with a USTB is taxed at ordinary income rates applicable to the taxpayer. Code. Sec. 864(b)(1). Bogart is taxed on net US-source compensation of $500,000 at the assumed rate of 40 percent.

Compensation realised for work performed in other countries is regarded as foreign-source income not subject to US tax. Bogart is not taxed on the net foreign-source compensation income of $400,000. Note that compensation derived from work abroad is foreign-source income even though the client is from the United States.

Dividends received from US corporations will be treated as US-source income that is not effectively connected to the USTB of the shareholder. Code Sec. 861(a)(2). Such passive income is taxed at the statutory rate of 30 percent. Code Sec. 871(a). Dividends received from foreign corporations are generally treated as foreign-source income not subject to US tax.

The $5,000 of interest received from US corporations would be treated as US-source income not effectively connected to Bogart's USTB. However, because the bonds held by Bogart are registered and publicly traded, the interest qualifies as "portfolio interest" exempt from the US withholding tax. Code Sec. 871(h).

The interest of $500 received from a US bank is also treated as US-source income. However, because the interest is not related to Bogart's USTB, an exemption applies so there is no US tax. Code Sec. 871(i)(2)(A).

Part 3

If a treaty is in force between the US. and Islandia, several complications arise.

First, Bogart may be regarded as a domestic taxpayer in Islandia and the United States under their respective laws. In that event the "tie-breaker" provisions of Article 4 of the Treaty must be applied. Article 4(3) sets forth a series of tests in descending order of importance. The facts presented in the question do not indicate how these tests would apply.

If Bogart is treated as a resident of the United States, the results described in Part A will obtain and there would be no modification in the analysis set forth above.

If Bogart is treated as a resident of Islandia, the results described in Part B will be varied. Under Article 10(2)(b) of the Treaty, the withholding rate on the dividends paid by US corporations will be reduced to 15 percent. It is also theoretically possible, but highly unlikely, that Bogart could successfully argue that he was not conducted the USTB through a permanent establishment. In that event, Article 7 would exempt his US-source compensation income from US tax even though he is operating a USTB, as defined by the Code.

The Treaty would not, of course, impose a tax where no tax is imposed under the Code.

Question 2

Part 1

FFC has substantial US-source income. As the shoes were manufactured in Sudlandia and sold to US customers with title passing in the United States, a portion of the income derived therefrom is foreign (because of the place of manufacture) and a portion is US (because of the title passage test applicable to profits from the sale of inventory). The amounts cannot be determined on the basis of the facts. FFC can use either the 50-50 formula or the “independent factory price” option. In either event, it is clear that FFC has received substantial amounts of US-source income. Code Sec. 863(b)(2).

The IRS will contendthat FFC is taxable at least on its US-source income because it derives from “regular, substantial and continuous exploitation of the US market.” FFC should be advised to challenge the IRS position.

There are two taxing regimes applicable in the US to foreign taxpayers. The tax on net income effectively connected with a USTB and the 30 percent withholding tax imposed on “fixed or determinable annual or period” (“FDAP”) income. Profits deriving from the sale of property are not generally considered to be FDAP income. The essential question, therefore, is whether FFC is conducting a USTB and, if so, whether the US-source income is effectively connected to it.

The statutory definition of USTB is rather limited (perform services in the United States-- yes; use a US securities broker-- no). One is left, therefore, with the rather broad criteria developed and applied by the courts in the limited number of cases dealing with the issue: Is there regular, continuous and substantial business activities in the United States? As FFC has no employees or agents functioning within the United States, it has a very strong case for the proposition that it is not engaged in a USTB. If it is not so engaged, no income (regardless of source) can be considered to be effectively connection with a USTB.

If somehow the IRS successfully contends that FFC must pay US taxes, no foreign tax credit (“FTC”) would be available because the US tax would be based solely on US-source income, and the FTC is only available when there is a foreign income tax on foreign-source income. Code Secs 901 et seq.

Part 2

If the Buffalo operation is established as a branch, its net income would be subject to the usual corporate income tax of 35 percent. The start-up losses could be applied at least against future profits. Even though the repatriation of profits would not constitute an income realisation event, it would be subject to a branch profits tax of 30 percent (Code Sec. 864).

If the Buffalo operation is established as a US subsidiary, its income would be subject to the 35 percent corporate income tax. Net operating losses from the early years would reduce taxes when the subsidiary began to be profitable. Any dividends distributed to FFC would be subject to the withholding tax of 30 percent.

There are a number of other considerations that should be cited. Up to this point, however there is little difference in the total tax cost of the two alternatives. However, while the force-of-attraction doctrine has been largely eliminated from the US tax system, a remnant remains that would apply in this situation. If the Buffalo operation is established as a branch so that IFC is operating a USTB, certain other US-source income would be treated and taxed as if it was effectively connected thereto. As a result, the income realised from the importation of shoes would become taxable. While the early losses realised from the Buffalo operation would be subtracted from the US-source shoe income, there would be a substantial increase in FFC’s US income tax liability. If a US subsidiary is used, IFC would not be conducting a USTB; therefore, the limited force-of-attraction doctrine would not apply. Code Sec. 864(c)(3).

If the subsidiary option is selected, the use of debt provides significant advantages. The interest, while subject to the 30 percent withholding tax, is deductible from the income taxed at the assumed rate of 35 percent. Further, principal repayments, while not deductible, do not constitute income to FFC and are not therefore subject to any US tax. There are two cautionary notes that are appropriate with respect to this issue. Under the criteria listed in Code Section 385, the IRS could argue that the debt should be recharacterised as equity so that payments of principal and interest should be treated as dividends that are not deductible and that are subject to the withholding tax. Further, even if the thin capitalisation doctrine is avoided, the earnings-stripping provisions of Section 163(j) could theoretically come into play and deny a deduction for at least a portion of interest payments if the interest payments were not subject to the US withholding tax.

Part 3

If there is a treaty in force between Sudlandia and the United States, it will affect several aspects of the analysis in Part 2.

First, if FFC established the Buffalo operation as a branch, Article 7 of the Treaty allows the United States to tax only business income that is "attributable" to the permanent establishment. While operating a factory in Buffalo would obviously constitute a permanent establishment, the limited force-of-attraction principle that would allow taxation on US-source income deriving from shoe imports could not permissibly apply.

Further, interest payments by a US subsidiary to FFC would be exempt from the US withholding tax under Article 11 of the Treaty.

Dividends paid by a US subsidiary to FFC would be subject to only a 5 percent withholding tax under Article 10(2)(a) of the Treaty.

Any branch profits tax would be imposed at the rate of 5 percent under Article 10(8)(b) of the Treaty.

Question 3

NAL is engaged in the trade or business of acquiring and developing properties for rental and eventual disposition. The consequences of these actions in 2014 (before turning to the various property transactions) is:

Income:

Farmer rents	5,000,000
Residential rents	5,000,000
Commercial rents	10,000,000
Taxes paid by farmers for NAL*	1,000,000
Total income	21,000,000

Deductions

Operating expenses paid by NAL	5,000,000
Depreciation	3,000,000
Taxes paid by farmers*	1,000,000
Fee to Land Management	4,000,000
Total deductions	13,000,000
Net operating income	8,000,000

* Real estate taxes are the obligation of the landowner. When a tenant pays the tax for the landowner, the payment is considered to be additional rent to the landowner and is a deductible expense of the landowner.

Code Sections 1031 and 1033 must be considered in the analysis of the transactions concluded by NAL during the year. Section 1031 provides for the non-recognition of gains and losses attributable to the exchange of "like-kind properties." Section 1033 provides for the non-recognition of gains deriving from "involuntary conversions," including the expropriation of property. When non-recognition provisions apply, the adjusted basis of a new asset will carry over from the adjusted basis of the old asset unless an adjustment is appropriate.

Sale of Ohio property

Gain realised is $2,500,000. It is taxable even though the proceeds of the sale are immediately invested in property that would be treated as like kind property under Section 1031. There must be a literal exchange for 1031 to apply. The gain would be taxed as a long-term capital gain unless the IRS could show that the property was inventory. As NAL normally realised income from the ownership of property, such an argument by the IRS should fail. The adjusted basis of the Kentucky property is $3,000,000.

Exchange of Colorado property for Iowa property

This qualifies under 1031. NAL realises a gain of $800,000, none of which is recognised. Its adjusted basis in the Iowa property is $200,000.

Exchange of Washington State property for Oregon property

NAL realises a gain of $4,500,000. $500,000 is received as "boot" in the form of corporate stock (which does not qualify under 1031 even though the corporation is engaged in farming). To the extent that gain is realised in the form of boot, it will be taxed. NAL recognises gain of $500,000. Its AB in the Oregon property is $1,000,000. Its adjusted in the stock is $500,000.

Exchange of Arkansas property for Missouri property

NAL realises a gain of $200,000, but receives boot of $300,000. The gain recognised can never exceed the gain realised. NAL is taxed on gain of $200,000. Its adjusted basis in the Missouri property is $400,000.

Exchange of Georgia property for Florida property

NAL realises a loss of $800,000, none of which is recognised under 1031 because it applies to gains and losses. Moreover, NAL pays boot of $200,000 in the deal. NAL's adjusted in the Jacksonville property is $2,200,000.

Expropriation of Texas property

NAL realised a gain of $300,000 in the expropriation. NAL invested all of the proceeds of the expropriation and an additional $200,000 in property that would qualify under Section 1033. As a result, NAL is not taxed on the gain. Its adjusted basis in the new property is $700,000.

Land Management is a foreign corporation. Unless it has agents or employees in the United States, the commission paid by NAL will be regarded as foreign-source income that is not subject to US tax. However, the commission is obviously a classic example of transfer pricing. Section 482 of the Code empowers the IRS to recalculate the consequences of transactions between affiliates. If the amount of the commission cannot be justified by fair market valuation of the services rendered by Land Management, several risks arise. First, the IRS might challenge the magnitude of the deduction for NAL. Secondly, there are cases in which an excess payment by a US corporation to a foreign affiliate results in the assertion of a US tax liability on the foreign parent corporation as if a dividend had been paid by the US subsidiary to the foreign parent which was then contributed to the foreign subsidiary of the foreign parent. The extent to which this is a risk cannot be determined on the basis of the facts set forth in the problem; but the risk should be noted.

PART II

<u>Question 4</u>

Note that a US corporation can only claim an indirect foreign tax credit if it owns at least 10% of the voting stock of the foreign company paying the dividend. Lincoln Co appears to meet that test.

<u>2013</u>

Dividend of $500,000 to Washington

Total income	$500,000
Basic US tax	$200,000
Direct FTC	$50,000*
Net US tax	$150,000

Dividend of $1,500,000 to Lincoln

Gross up:

Dividend/after tax income (“ATI”) x accumulated taxes (1.5/6.0 x $4,000,000)
$1,000,000

Dividend	$1,500,000
Gross up	$1,000,000
Total income	$2,500,000
Basic US tax	$875,000
Direct FTC	($150,000)
Indirect FTC	($1,000,000)
Net US tax	$0
Excess credits	$275,000**

* There is generally no indirect FTC for an individual shareholder.

** Excess FTC’s can be carried forward for the ensuing ten years and used if in any year the maximum allowable FTC is higher than the foreign taxes attributable to that year.

Effect of 2013 consequences and 2014 developments on ATI and pool of foreign taxes

ATI ($6,000,000 - $2,000,000 + $4,000,000)
$8,000,000

Taxes ($4,000,000 - $1,333,000* + $1,000,000)
$3,667,000

*$1,333,000 taxes derives from taxes attributable to total dividends of $2,000,000 paid in 2013.

<u>2014</u>

Dividend of $400,000 to Washington

Income	$400,000
Basic US tax	$160,000
Direct FTC	$40,000
Net US tax	$120,000

Dividend of $1,200,000 to Lincoln

Gross up:

1.2/8.0 x $3,667,000	$550,000
Income	$1,200,000
Gross up	$550,000
Total	$1,750,000
Basic US tax	$612,500
Direct FTC	($120,000)
Indirect FTC	($550,000)
Net US tax	$0

Excess credits:

- 2014 $57,500
- 2013 $275,000

Total	$330,000

Question 5

Part 1

Omaha has realised pretax foreign-source income from its three branches of $1,500,000. It has paid foreign income taxes of $600,000 in the countries where branch operations have been conducted.

Omaha has also realised foreign-source interest income deriving from the loan to Nugrow with respect to which foreign withholding taxes have been paid. The total income realised from the loan is $780,000 (the interest payment of $600,000 + the satisfaction of Omaha's tax liability in Zeta of $180,000).

The net result of these factors is income of:

Foreign branches	$1,500,000
Interest income	$780,000
Total foreign-source income	$2,280,000

The basic US tax on this income (at the assumed rate of 35 percent) is $798,000.

Omaha has effectively paid foreign income taxes of:

Alpha	$100,000
Beta	$200,000
Gamma	$300,000
Zeta	$180,000
Total	$780,000

Because foreign income taxes are creditable, it would appear that Omaha would have a net US income tax of $18,000 ($798,000 - $780,000). However, there are two limitations on the magnitude of foreign tax credits that must be considered.

The first is the "worldwide limit." The maximum foreign tax credit is the US tax on foreign-source income. As indicated above, that is $798,000. The total foreign taxes of $780,000 are less than the maximum allowed under this test. However, the second set of limitations applies when some of the income involved is passive income. These are called the "basket limitations."

Under the basket limitation test, a separate maximum foreign tax credit is determined for passive income. In this instance, it would appear that Omaha has realised passive income from Zeta of $780,000. The US tax on that income is $273,000. The foreign taxes paid in respect of the passive income is $180,000, which is less than the maximum allowed in the passive income basket. The income in the remaining general basket is $1,500,000. The US tax on this income is $525,000, which is the maximum FTC for the general basket. The net result is summarised below:

	Income	FTC
Passive	780,000	180,000
Active	1,500,000	525,000
Total	2,280,000	705,000

The net US income tax liability is $93,000 ($798,000 - $705,000).

Omaha is in an "excess credit" position of $75,000 ($600,000 - $525,000), meaning that it has paid more creditable taxes than the maximum allowable credit. The excess credit may be carried forward for ten years and used in any year in which the foreign taxes paid for general basket income are less than the applicable maximum for that year in the general basket.

Part 2

FTCs are available for foreign income taxes and taxes paid “in lieu” of foreign income taxes. One might argue that the change in the tax law effected by the Government of Alpha makes the real estate taxes an “in lieu of” tax. However, the language has not been interpreted in this general way. Rather, an “in lieu of” tax arises where a government has an alternative tax regime applicable for certain income of foreign taxpayers that avoids the administrative challenge of collecting taxes from foreign taxpayers that have no readily ascertainable assets in the country. A good example of an “in lieu of” tax is a withholding tax imposed upon a gross income basis.

If the Government of Alpha had replaced its income tax regime with
real estate taxes, the taxes would not be eligible for the foreign tax credit but would be a deductible expense. The result would be as follows:

Total income from branch operations	$1,400,000
Taxes in general basket	$500,000
Maximum credit in general basket	$490,000
Total income	$2,180,000
Total FTC ($180,000 + $490,000)	$670,000
Basic US tax	$763,000
Less total FTC	$670,000
Net US tax	$ 93,000
Excess taxes in general basket	$10,000

Part 3

If Alpha had provided an exemption from its income tax, some countries might apply “tax sparing” and allow a credit for the taxes usually applicable but not paid. The United States has rejected efforts to include provisions for tax sparing in its bilateral treaties.

The result would be as follows:

Total general income	$1,500,000
Maximum FTC in general basket	$525,000
Foreign taxes paid	$500,000
Total FTCs	$680,000
Basic US tax	$798,000
Net US tax	$118,000

Question 6

Part 1

Under Subpart F, certain undistributed income of a CFC will be taxed as a constructive dividend to "US shareholders" (generally domestic taxpayers that own at least 10 percent of the voting power or value of stock in the CFC).

BVC is a CFC because "US shareholders" own more than half of the voting power of BVC. Regent owns 40 percent and Smith owns 15 percent. The shares owned by Sands and Jones do not count in determining whether BVC is a CFC.

BVC has realised net income of $15,000,000 during the year and has paid no dividends. It has realised net business income of $5,000,000 from operations in Outlandia which would not be regarded as "Subpart F income." The interest income of $10,000,000 would, however, be regarded as personal holding company income, which is Subpart F income. As a result, the "US shareholders" will be taxed as if the Subpart F income had been distributed as a dividend. Regent will have constructive dividend of $4,000,000. Smith will have a constructive dividend of $1,500,000. Both taxpayers will be allowed to increase their bases in the shares they hold by the amount of the constructive dividend. The "previously taxed income" account of BVC will be increased by $5,500,000.

Sands (because it is a foreign corporation) and Jones (because she owns less than 10 percent of the BVC) are not "US shareholders" and are not treated as having received a constructive dividend.

Part 2

Alamania branch

A US corporation that is a foreign taxpayer and has a commercial relationship with the foreign government is called a "dual capacity taxpayer."

Historically, US corporations engaged in the exploitation of natural resources were required to pay high income taxes, but low royalties, to a foreign government. This was good news to the taxpayer because income taxes are creditable and royalties are only deductible. Responding to tax policy critics, Congress authorised the promulgation of regulations which require payments to be characterised according to their substance. In circumstances such as those presented here, since the usual corporate tax rate in Alamania is only 20 percent, the regulations would be invoked to limit the portion of payments properly deemed to be creditable income taxes. While the taxpayer might argue for a better result, the regulations provide a safe harbour formula in which would allow the taxpayer to treat $1,000,000 as a creditable income tax and $3,000,000 as a deductible royalty. Reg. Sec 1.901-2A. The result would be:

Income	$10,000,000
Operating expense	$2,000,000
Royalty	$3,000,000
Foreign taxable income	$5,000,000
Tax at corporate rate of 20 percent	$1,000,000

Boitia subsidiary

B Co. is a CFC. There is no indication that it has realised any Subpart F income. However, bribes paid by a CFC are also treated as Subpart F. Code Sec. 952(a)(4). Therefore, IMC will be taxed on a constructive dividend of $1,000,000.

Chamesia subsidiary

C Co. is a CFC. There is no indication that it has realised any Subpart F income. However, Subpart F applies to certain investments by a CFC in US property. Code Sec. 956. The loan of $5,000,000 made to IMC would be regarded as such an investment and would therefore be treated as a constructive dividend. While the constructive dividend might entitled IMC to an indirect FTC, transfer taxes paid by C Co. are not creditable taxes.