# THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2015

# PAPER 3.05 – UNITED STATES OPTION

## ADVANCED INTERNATIONAL TAXATION
## (THEMATIC)

TIME ALLOWED – 3¼ HOURS

- You should answer any **TWO** questions from Part I and any **TWO** questions from Part II.
- Each question carries equal marks.
- 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 income is taxed at those rates, unless the long-term capital gains rate applies. Assume further, that the long-term capital gains rate is 20% and that the statutory withholding on certain payments to foreign persons 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 two questions from Part I and two questions from Part II.

Each question is weighted equally. In some instances the number of marks allocated to different parts of a question is indicated in brackets.

## PART I

**You are required to answer TWO questions from this Part.**

1. Bogart, an economic consultant, is a citizen of Islandia and a lawful permanent resident alien of the United States under applicable US immigration laws (i.e. a US green card holder). However, Bogart spends only 120 days in the United States each year. During the remainder of the year, Bogart travels outside the United States while working for US and foreign clients. During 2014, Bogart earned net income of $500,000 for work performed in the United States for US clients and net income of $400,000 for work performed in other countries, half of which was paid by US clients. In addition, Bogart received dividends of $25,000 from US corporations and $10,000 from foreign corporations. Bogart also received interest of $5,000 on registered and publicly traded US corporate bonds, and interest of $500 from a US bank in respect of a personal bank account that was not used in connection with Bogart's business.

   **You are required to answer the following questions:**

   1) **Prepare a memorandum analysing the US income tax consequences to Bogart of the above events.** (7)

   2) **How, if at all, would your response to (1) change if Bogart was not a lawful permanent resident of the United States?** (10)

   3) **How, if at all, would your response to (1) and (2) change if there was a tax treaty in force between Islandia and the United States that was identical to the US Model Convention?** (8)

   Total (25)

2.

1) Fleet Feet Co (FFC) is a corporation organised under the laws of Sudlandia, a country in which it is one of the largest shoe manufacturers. For many years FFC has been selling shoes to several retail chains in the United States. While FFC would prefer its customers to acquire the shoes in Sudlandia and pay for their transportation, US purchasers refuse to accept shipments until they have had an opportunity to inspect the shoes. The goods are therefore held in a bonded warehouse in a US port until they are inspected by the US purchaser before they clear US customs. FFC has no agents or employees in the United States. Orders are accepted and approved electronically at the company headquarters in Sudlandia.

   In most years, FFC has realised gross income of $10 million from its sales to US customers. These sales have produced average annual profits of $6 million. Thus far, FFC has paid no US income taxes. However, the IRS has contacted FFC and is proposing to impose a tax of 35% "on the net profits FFC realises from sales in the United States because of FFC's regular, substantial and continuous exploitation of the US market that produces US source income."

   FFC has retained you as US tax counsel. It has asked you whether or not it should contest the proposed tax assessments.

   In addition, FFC has advised you that it pays an income tax of 20% in Sudlandia on worldwide income, including income from the US sales. If FFC is required to pay US income tax, the company further asks whether the Sudlandian taxes would be creditable in the United States in the event that FFC is required to pay US taxes.

   **You are required to prepare a memorandum responding to the two questions posed by FFC.** (10)

2) FFC is considering an investment opportunity in the United States.

   Noting adverse weather conditions in northern areas of the United States, it has decided to establish a factory in Buffalo, New York which will manufacture winter boots and snow shoes. The company does not know whether to conduct the investment as a branch in which FFC itself will directly operate the factory and market the production, or whether to establish a US subsidiary to do so. Under the tentative business plan, FFC will invest $20 million in the Buffalo venture. After enduring a period of start-up losses, FFC expects profits to be realised by the third year of operation, and thereafter expects to repatriate half of the profits to be used for investments in other countries and for dividend distributions. The remaining profits will be reinvested in US business assets.

   **FFC has asked you for advice with respect to this venture. In particular, FFC asks which of the two business plans would be preferable, taking into account the start up losses and intended repatriation of profits. It has also asked whether it would be desirable to characterise a portion of its Buffalo investment as debt.**

   **You are required to prepare a memorandum responding to these questions.** (10)

3) **How, if at all, would your responses to (2) change if there is a treaty in force between Sudlandia and the United States?** (5)

Total (25)

3. Global Real Properties Ltd (Global) is a corporation organised under the laws of Industria. Global is a large publicly-traded corporation whose shareholders reside in many countries.

Global has invested in real property development in many countries, including the United States. Global pursues a common financial and corporate structure for its investments. For example, its ventures in the US are undertaken through North America Land Co (NAL), a wholly-owned US subsidiary.

NAL has been a very successful operation for more than two decades. Beginning in the mid-1990s, NAL developed a very simple and successful business plan. It scoured the country to locate agricultural land that was fairly near to expanding urban areas. After acquiring the land, NAL would lease the property to farmers. The farmers would pay rent to NAL and would also pay all real property taxes owing with respect to the property. When the urban area grew in the direction of the purchased land, NAL would terminate the leases and develop residential and commercial properties which it would rent.

This process produced substantial returns in almost every year, and tax year 2014 was no exception. During that year, NAL received rents from farmers of $5 million, rents from residential units of $5 million and rents from commercial properties of $10 million. The farmers also paid real estate taxes of $1 million on the properties they leased. NAL's operating expenses (including real estate taxes of $2 million which NAL paid directly) were only $5 million, and it also took appropriate depreciation deductions of $3 million.

NAL also paid a management fee of 20% of its gross rental income to Land Management Ltd (Land Management), a corporation organised in Nellania that is also wholly owned by Global. Land Management has no employees in the United States. However, it hired independent real estate experts to identify possible investment opportunities for NAL. The management fee paid by NAL to Land Management was in compensation for this service. The fee for 2014 was $4 million. Nellania has no income taxes.

**Prepare a memorandum analysing all of the income tax consequences to NAL, Land Management and Global of all activities which took place in 2014. The memorandum should clearly include any gains and losses that are recognised, and the adjusted basis of any properties acquired by NAL during the year.** (25)

## PART II

**You are required to answer TWO questions from this Part.**

4. World Wide Industries Ltd (WWI) is a corporation which was organised under the laws of Anadonia at the end of 2012. Lincoln Co, a New York corporation, owns 3,000 shares in WWI. Washington, a citizen of the United States, owns 1,000 shares in WWI.

   During 2013, the first year of its operation, WWI recorded pre-tax income of $10 million and paid the revenue authority of Anadonia income taxes of $4 million. At the end of the year, WWI paid a dividend of $1,500,000 to Lincoln Co and $500,000 to Washington. The dividend payments were subject to a withholding tax in Anadonia of 10%.

   During 2014, WWI recorded pre-tax income of $5 million, but paid only $1 million in income taxes in Anadonia. At the end of the year WWI paid a dividend of $1,200,000 to Lincoln Co and $400,000 to Washington. The dividend payments were again subject to a 10% withholding tax in Anadonia.

   **You are required to prepare a memorandum analysing the US income tax consequences of the above events for Lincoln Co and Washington in 2013 and 2014.** (25)

5. Omaha, Inc. (Omaha) is a US corporation with branches in three countries: Alpha, Beta and Gamma. During 2014, Omaha realised pre-tax income $500,000 from business operations in each of the three countries. Omaha paid income taxes of $100,000 to the revenue authority of Alpha in respect of its manufacturing business there. Omaha paid income taxes of $200,000 in Beta in respect of its agricultural business there. Finally, Omaha paid income taxes of $300,000 in Gamma in respect of its consulting business there.

   During the course of 2014, Omaha also loaned $10 million to Nugrow, Inc. (Nugrow), a corporation organised under the laws of a fourth country, Zeta, whose profits derive wholly from the operation of a business in Zeta. Under the terms of the loan agreement, Nugrow is required to make an interest payment each year of $600,000, net of any taxes owing in Zeta. During 2014, Nugrow paid $600,000 to Omaha and paid a Zeta withholding tax of $180,000.

   1) **You are required to prepare a memorandum analysing the US income tax consequences of the foregoing events for Omaha.** (17)

   2) **How, if at all, would your analysis be modified if the Government of Alpha had replaced its income tax regime with real estate taxes so that the $100,000 paid to Alpha was a real estate tax liability?** (4)

   3) **How, if at all, would your response to 1) be modified if Alpha had granted a tax holiday to Omaha as part of a programme to attract foreign investment so that Omaha was required to pay no taxes in Alpha in 2014?** (4)

   Total (25)

6.

1) Beach View Co (BVC) is a corporation organised under the laws of Outlandia. BVC has a total of 1,000 shares outstanding, which are owned as follows:

- 400 shares are owned by Sands, Inc. (Sands), an Outlandian corporation;
- 400 shares are owned by Regent Corp (Regent), a Delaware corporation;
- 150 shares are owned by Smith, a citizen of the United States; and
- 50 shares are owned by Jones, a citizen of the United States.

Sands and Regent are not related. The individual shareholders are related; nor do they own shares in Sands or Regent. All of the major decisions regarding BVC are made by Sands and Regent without consulting either Smith or Jones, who often contest corporate policy decisions with which they disagree. During the course of 2014, BVC recorded gross income of $20 million from the operation of a resort complex in Outlandia, which produced a net profit of $15 million, and $10 million of interest income from a loan made to an unrelated borrower in a third country. BVC paid no dividends during the year.

**You are required to prepare a memorandum analysing any US income tax consequences relating to the above activities for BVC, Sands, Regent, Smith and Jones in 2014.** (10)

2) International Mining Co (IMC) is a Maryland corporation engaged in mineral exploitation in many different countries. IMC organises some of its investments through wholly-owned subsidiaries established in countries where operations have been undertaken, while in other cases operating through foreign branches of IMC.

During 2014, the following activities relating to IMC subsidiaries and branches took place:

- A branch operating in Alamania realised gross income of $10 million from the exploitation of oil reserves in that country. IMC incurred operating expenses of $2 million during the year and paid taxes of $4 million to the Government of Alamania. The usual corporate income tax rate in Alamania is 20%; however, petroleum companies operating in Alamania are subject to an income tax of 50%.
- B Co, a subsidiary operated in Boitia, produced net income of $6 million and paid no income taxes in Boitia. However, its expenses included a bribe of $1 million paid to a public official in return for a tax exemption ruling.
- C Co, a subsidiary operated in Chamesia, recorded net income of $10 million. Its expenses included transfer taxes of $2 million; however, there are no income taxes in Chamesia. C Co paid no dividends during the year. However, it made a loan of $5 million to IMC. Under the terms of the loan agreement, IMC is required to pay an appropriate rate of interest each year for five years, at which time the principal of the loan is to be repaid.

**You are required to prepare a memorandum analysing the US income tax consequences, if any, of the above activities.** (15)

Total (25)