THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

May 2007

PAPER III

PRINCIPLES OF CORPORATE AND INTERNATIONAL TAXATION

A – UNITED STATES OPTION

TIME ALLOWED – 3 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.
- All workings should be made to the nearest month and dollar unless the question requires otherwise.
- Marks are specifically allocated for presentation.

General Note

Prepare memoranda analysing the United States income consequences 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 United States income tax rate is 35% for individuals and 35% for corporations (the approximate maximum rates under current law) and that all net income is taxed at those rates. Assume further that the long-term capital gains rate is 15% and that the same rate applies to dividends distributed by US corporations to US individual shareholders. The statutory withholding tax rate, where applicable, is 30%. You need not consider the impact of personal deductions and/or exemptions in your answers.

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. When the problem indicates that a treaty is relevant to the analysis, apply the terms of the 1996 US Model Tax Treaty ("US Model Treaty").

Where possible to do so, 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.

PART I

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

1. International Exports Ltd is a corporation organised under the laws of Industria owned by citizens and residents of Industria. During 2006, International Exports Ltd made substantial shipments to US customers of products manufactured in two of its factories in Industria: books and plastic toys. The books were marketed to book stores in the United States by an independent agent, acting in the United States in the ordinary course of the agent's business, who undertook extensive sales activities and who was empowered to accept orders for the corporation. The plastic toys were sold directly to toy stores in the United States as a result of orders placed on the corporation's web site in Industria. Title to the books and to the plastic toys passed to customers when shipments arrived at their destination. During 2006, the corporation realised gross income of $1.5 million and net income of $1 million from the sale of books and gross income of $3 million and net income of $2 million from the sale of plastic toys.

   1) You are required to analyse the US Income Tax consequences of the transactions described above. (12)

   2) How, if at all, would your analysis change if the US Model Treaty were in force between the United States and Industria? (8)

   3) How, if at all, would your response to 2) change if all of the shareholders of International Exports Ltd were citizens and residents of Ruritania, which has no tax treaty with the United States? (5)

   Total (25)

2. D'Argent, a citizen and resident of Montagna, spends 30 days each year vacationing in the United States. While he never visits the United States for business purposes, D'Argent employs a stock broker in New York who has been authorised, if extraordinary opportunities develop, to make purchases and sales without first consulting D'Argent.

   During 2006, as a result of activities in the New York account, D'Argent received dividends of $100,000 from US corporations and dividends of $50,000 from foreign corporations. He realised gains of $100,000 from sales of shares in US corporations and gains of $20,000 from sales of shares in foreign corporations. He realised losses of $20,000 from sales of shares in US corporations and losses of $5,000 from sales of shares in foreign corporations. All of the dividends, gains and losses related to shares of corporate stock that were listed on the New York Stock Exchange.

   D'Argent also received interest of $20,000 from publicly traded bonds issued by various US corporations in which D'Argent owned no shares of stock. All purchases and sales effected by the US stock broker were implemented on US securities exchanges. All purchases and sales were made in US dollars. All dividends were received in US dollars and deposited in a New York bank. Because all gains and losses are long-term and because the shares are not inventory to D'Argent, any US tax that might apply to net gains will be imposed at the long-term capital gains rate of 15%.

   Further, D'Argent is a member of the board of directors of West Hemisphere Inc, a US corporation. During 2006, D'Argent participated in six board meetings. On three occasions, he came to company headquarters in New York for meetings lasting two days. On three other occasions, he participated by telephone from his home in Montagna. D'Argent received $20,000 for each of the six meetings, or a total of $120,000.

   1) You are required to analyse the US Income Tax consequences of the events described above. (18)

   2) How, if at all, would your analysis differ if the US Model Treaty were in force between the United States and Montagna? (7)

   Total (25)

3. 1) Olson, a citizen and resident of Scandia, purchased a large farm in the State of Iowa, US, at the end of 2005. The farm was immediately re-leased to Brown, who grew corn on it and made a substantial profit. Pursuant to the lease agreement, in 2006 Brown paid Olson $300,000 and paid a local real estate tax imposed on the owner of the land (Olson) of $300,000.

You are required to analyse the US Income Tax consequences, if any, of the events described above to Olson. (7)

2) Global Properties Ltd is a corporation organised under the laws of New York and owned by four citizens and residents of Industria. When it was established in 2000, each of the shareholders invested $500,000 in the stock of Global Properties Ltd, which in turn purchased land in the United States for $1 million and land in several Caribbean countries for $1 million. By the end of 2005, the US land was worth $8 million and the Caribbean land was worth $2 million. After extensive negotiations, Ericsson, one of the original shareholders in Global Properties Ltd, sold his shares to Jefferson, a citizen and resident of the United States, for $2.5 million, thus realising a gain of $2 million.

(a) You are required to analyse any US income tax consequences to Ericsson of the events described above. (10)

(b) How, if at all, would your answer change if Global Properties Ltd were a corporation organised under the laws of Industria? (4)

(c) How, if at all, would your answer to (a) and (b) change, if the US Model Treaty were in force between the United States and Industria? (4)

Total (25)

PART II

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

4. The Atlantic Group is a US partnership owned equally by Plato, a legal permanent resident of the United States who travels abroad 200 days each year, and AmeriCo, a US corporation all of whose shares are owned by citizens and residents of Industria. During 2006, The Atlantic Group earned $1 million of US-source income from business operations in the United States and $1 million of pretax foreign-source income from business operations in foreign countries. It paid income taxes of $200,000 to various foreign countries in respect of its foreign business income. All of the earnings of The Atlantic Group were reinvested in the businesses. None were distributed to the partners. The partnership agreement provided for an equal division of profits and losses between the partners.

   1) **You are required to analyse the US Income Tax consequences of the transactions described above.** (8)

   2) **How, if at all, would your response to 1) change if The Atlantic Group had distributed $200,000 to each partner at the end of 2006?** (3)

   3) **How, if at all, would your response to 1) change if all US-source income were allocated to Plato, all foreign-source income and the foreign taxes paid thereon were allocated to AmeriCo?** (6)

   4) **How, if at all, would your response to 1) change if AmericCo operated a factory in another foreign country which realised a loss of $400,000 during the taxable year?** (8)

   Total (25)

5. Modern Technologies Corp is a corporation organised under the laws of Industria, all of whose shares are owned by citizens and residents of Industria. While it conducts no business activities in the United States, it has purchased a number of US patents which are licensed for use by several different US manufacturing companies. During 2006, Modern Technologies Corp received $500,000 in royalties for the use of US patents. Half of those royalties was paid by US corporations; the other half was paid by foreign corporations. Further, Modern Technologies Corp sold a US patent to an unrelated US corporation for $1 million. The patent had been acquired for only $700,000 a few years ago. All royalties and the proceeds of the sale were received in US dollars and deposited in a New York bank. Moreover, the sale was concluded in New York.

   As a resident of Industria, Modern Technologies Corp paid a tax of 20% to Industria on all of its income. As a result of the foregoing transactions, therefore, Modern Technologies Corp paid Industrian income taxes of $160,000 in addition to tax on income from other parts of the world.

   1) **You are required to analyse all of the US Income Tax consequences to Modern Technologies Corp of the events described above.** (15)

   2) **How, if at all, would your answer to 1) change if the sale of the US patent was concluded in Industria and the proceeds of the sale were paid in Industrian currency and deposited in an Industrian bank account?** (5)

   3) **How, if at all, would your answers to 1) and 2) change if the US Model Tax Treaty were in force between the United States and Industria?** (5)

   Total (25)

6. Casey, a citizen of the United States, worked as an engineer for the MidEast Construction Co, a foreign corporation, working on projects throughout the Middle East. Casey lived in hotels in various countries in the Middle East where he was working, but during 2006 spent twenty-five working days in the United States discussing projects under construction for US clients of his employer. Casey spent the remainder of the year outside of the United States. Casey received a salary of $180,000 from MidEast Construction Co, of which $20,000 was properly allocable to the days spent working in the United States. Casey also received dividends of $20,000 from US companies and $30,000 from foreign companies. He realised long-term capital gains of $40,000 from the sale of stock in US companies and $20,000 of long-term capital gains from the sale of stock in foreign companies. Casey paid income taxes of $20,000 to various countries in the Middle East during 2006 in respect of the income that he earned there.

1) **You are required to analyse the US income tax consequences of the events described above.** (13)

2) **How, if at all, would your answer change if Casey paid foreign income taxes of $80,000 on the income earned from working in the Middle East?** (7)

3) **How, if at all, would your answer to 1) change if Casey had worked in the United States for fifty days and $40,000 of his salary was properly allocable to the US?** (5)

Total (25)

7. International Holdings Corp is a company organised and headquartered in Delaware, US. International Holdings Corp owns 50% of the stock of Dry Products Inc, a corporation organised under the laws of Freedonia. The remaining 50% of the stock of Dry Products Inc is owned by Hawthorne, a citizen and resident of the United States. During the period since its establishment in 2000, Dry Products Inc has earned income from its business operations there of $5 million from which it paid income taxes in Freedonia of $1 million. During 2006, Dry Products Inc paid a dividend for the first time. While a dividend of $200,000 to both International Holdings Corp and Hawthorne was declared, the two shareholders each received only $180,000 because of a 10% withholding tax in Freedonia. The dividend was not eligible for the one-time tax free repatriation opportunity provided in some instances.

1) **You are required to prepare a memorandum analysing the US Income Tax consequences of the events described above.** (15)

2) **How, if at all, would your response to 1) change, if the US Model Tax Treaty were in force between Freedonia and the United States?** (5)

3) **How, if at all, would your response to 2) change if Freedonia had provided a tax holiday to Dry Products Inc as part of a programme to attract more foreign investment so that Dry Products Inc did not have to pay the income taxes of $1 million that would otherwise have been due?** (5)

Total (25)