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THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

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MODULE 2.10 – UNITED STATES OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

Under the substantial presence test of § 7701(b)(3), Johan is a US resident if he is in the US for 183 days or more in the current year, or if he is in the US for at least 31 days in the current year and his current year presence, plus 1/3rd of his prior year presence and 1/6th of his second prior year presence equals 183 days or more (the "three-year rule").

He was present for 122 days in 2016 and had no prior year presence. He is not a US resident in 2016.

He was present for 105 days in 2017. That is less than the threshold of 183 days. Nor is he a resident under the three-year rule. While he was in the United States for at least 31 days in 2017, his 105 days of 2017 presence, when added to 1/3rd of his 2016 presence (1/3rd of 123 is 41) totals only 146 days of presence.

Johan was present in the United States 180 days in 2018. (Note that the test is 183, not 6 months or half year. Because February is a short month, the 183 days threshold is not met until early July, even in a leap year.) That is less than the threshold of 183 days. However, he a resident under the three-year rule. He was in the United States for at least 31 days in 2018, his 180 days of 2018 presence, when added to 1/3rd of his 2017 presence (1/3rd of 105 is 35) and 1/6th of his 2016 presence (1/6th of 123 is 20.5) totals 305.5 days of presence.

Part 2

Johan should qualify for the "closer connection" exception of § 7701(b)(3)(B) and Treas. Reg. § 301.7701(b)-2, and thus should not be a resident for 2018. This exception applies if a nonresident is not present in the US for 183 days or more in the current year but meets the substantial presence test using the three-year rule.

To meet the closer connection exception, Harold must: (1) be present in the United States for fewer than 183 days during the current calendar year; (2) maintain a tax home in a foreign country during the current calendar year; and (3) have a closer connection during to the foreign country in which the tax home is maintained than to the United States.

Part 3

Johan is engaged in a trade or business as a consequence of performing personal services in the US, even for a single day. § 864(b). Under § 861(a)(3), his compensation for services rendered in the US is US source income and will be subject to tax at the normal, graduated rates that apply to individuals. There is a commercial traveler exception for foreigners working within the United States that avoids the sourcing of income to the United States for work conducted there if the following requirements are satisfied:

- the services were performed by a nonresident alien during a sojourn in the US not exceeding 90 days for the tax year;
- compensation for the services did not exceed $3,000; and
- services were performed for:
    - a nonresident alien, foreign partnership or corporation not engaged in a US business; or
    - a place of business in a foreign country or US possession that is maintained by a US citizen or resident, or a domestic partnership or corporation.

Johan is not eligible to claim the commercial traveler's exception since he was present in the US for more than 90 days in each of the tax years. Additionally, his compensation for services rendered while in the US exceeded $3,000 in each year.

Part 4

The US Model treaty provides for a much broader commercial traveler exemption. Under Paragraph 2 of Article 14, an individual resident of the treaty country will not be taxable in the US with respect to income from services performed in the US if:

- he is present in the US for no more than 183 days in any 12-month period beginning or ending in the taxable year;
- the compensation is paid by a non-US resident employer; and
- the compensation is not borne by a PE that the employer has in the US.

There is no limit to the income which can be earned if these tests are met.

Johan, even though he was in the US for only 122 days in 2016, and 105 days in 2017 would not qualify for the treaty exemption in either of those years. While the substantial presence test counts days in the calendar year, Article 14 counts days in "any twelve-month period" – a rolling year. For the 12 months ending 4/15/2017, Johan was in the US for 227 days which disqualifies him from treaty protection for 2016 and 2017. However, for the 12 months ending 6/30/2018, Johan was in the US for only 180 days and is eligible for treaty protection.

Question 2

Part 1

US Sales

As a result of the recent changes in United States taxation of corporations, USCo will pay a flat 21% tax on its US source sales income.

Direct Foreign Sales

Section 250(a)(1) provides for a reduced rate of taxation of Foreign Derived Intangible Income ("FDII") by providing that a US company can deduct an amount equal to 37.5% of its FDII for the taxable year. Income eligible for the deduction generally includes certain income received for: 1) property sold by the taxpayer to a non-U.S. person for a foreign use and 2) services performed by the taxpayer for a Non-U.S. person which are performed outside the U.S. When combined with the 21% corporate tax rate, FDII earned by a US corporation is taxed at a beneficial rate of 13.125%.

The calculation of the FDII deduction begins with the determination of deduction eligible income, and then foreign derived deduction eligible income – in this problem it equals the $30 million net income from USCo's direct sales to foreign customers. However, not all of this income is eligible for the FDII deduction. The deduction applies only to its deemed intangible income, which is the excess of the USCo's foreign derived deduction eligible income over 10% of its qualified business asset investment.

The qualified business asset investment is calculated by taking the quarterly average (determined at each quarter end) of the adjusted basis of "specified tangible property." Specified tangible property includes only tangible property used in the production of gross tested income and is limited to property eligible for depreciation deduction. We must therefore ignore all the assets other than the machinery and buildings. The quarterly adjusted basis of such items is $50 million at the end of the first quarter, $60 million at the end of the second quarter, $60 million at the end of the third quarter and $40 million at the end of the fourth quarter. The average of USCo's qualified business asset investment of the four quarters is $50 million of which 30%, or $15,000,000 relates to its direct foreign sales. Ten percent of its qualified business investment related to direct foreign sales is $1,500,000.

As a result, $1,500,000 of its direct sales income will be taxed at the full 21% and only the $28,500,0000 excess is eligible for the FDII deduction. With respect to these direct foreign sales, USCo will pay US tax of $4,055,625 tax ($30 million reduced by an FDII deduction of $10,687,500 times a 21% tax rate) for a blended tax rate of 13.5%.

Branch Income

A branch is ignored for US tax purposes and USCo's branch income will be reported along with it direct foreign sales income on its corporate tax return. However, unlike the direct foreign sales income, branch income is not eligible income under FDII and will be taxed at the full 21% rate.

YCo Income

Under the new Global Intangible Low Tax Income ("GILTI") regime, income earned by a controlled foreign corporation, up to a certain threshold, is eligible for a US tax rate of 0% under the participation exemption and income over that certain threshold (GILTI) is eligible for a 50% deduction. The deduction is available only to corporate shareholders. Under our facts, none of YCo's income is eligible for the participation exemption (since it has no basis in its assets) but all of YCo's income is GILTI, eligible for the 50% deduction. Thus, USCo will report the $5,000,000 of YCo, income, claim a deduction of $2,500,000 and pay tax at 21% on the remaining $2,500,000 for an effective tax rate of $10.5%.

Part 2

From a purely tax perspective, it would be better to have the equipment purchased by YCo and it begin manufacturing operation. An increase in US assets used to generate direct foreign source income will increase the amount of that income tax at the full 21% US corporate tax rate and reduce the amount of FDII eligible for a 37.5% deduction. However, increase in foreign assets owned by a CFC will increase the amount of that income eligible for the participation exemption and taxed at 0%, with the balance being GILTI eligible for a 50% deduction. The new rules encourage foreign investment in qualified business assets.

PART B

Question 3

In 2019, the parties had the following income and paid the following foreign taxes:

GlobeCorp

- $20 million US source sales. It paid no foreign taxes on this income.
- $30 million direct foreign sales, all of which qualified as Foreign Derived Intangible Income. It paid $2 million of foreign taxes with respect to this direct foreign income.
- $30 million of foreign sales effected through its branch in Country Z. It paid $9 million of foreign taxes with respect to this branch income.

GCo

- $30 million of foreign sales. Of that income, $3 million constitutes net deemed tangible income eligible for the participation exemption. GCo paid a total of $2 million of foreign taxes with respect to its $30 million of income.

How much may GlobeCorp claim in foreign tax credits from these 2019 foreign tax payments?

US Source Sales

The sales within the US did not attract any foreign tax. The foreign tax credit limitation will apply to prevent foreign taxes paid on foreign source income from reducing the US tax on this US source income.

Foreign Source Direct Sales

We are told that all of the foreign source direct sales qualify as FDII (which means GlobeCorp employed no assets with basis in the generation of this income). As such this entire income is eligible for a 37.5% deduction equaling $11,250,000. The net $18,750,000 will be taxed at 21% resulting in a US tax of $3,937,500. GlobeCorp will be able to credit the full $2 million it paid in foreign taxes on this income (despite the fact that it is not taxed on 100% of the income) but at this point will owe $1,937,500 in residual US tax on the foreign source direct sales income. The issue is whether any foreign taxes paid on the foreign branch income, or the indirect foreign tax credit from GCo's GILTI income, can be used to offset this residual US tax.

Foreign Branch Income

The foreign branch income is not eligible for FDII and will be taxed at the full 21% US corporate tax rate. GlobeCorp paid $9 million in foreign taxes with respect to this branch income for an effective rate of 30%. The entire $9 million will be treated as a direct foreign tax paid by GlobeCorp, creditable in full but subject to the foreign tax credit limitation rule. Since the foreign tax of $9 million exceeds the US tax of $6,300,000 on this branch income, the US tax on the branch income will be reduced to $0 and no residual tax will be owed.

The remaining $2,700,000 of foreign taxes paid on the branch income cannot be used to offset the residual tax of $1,937,500 on the GlobeCorp direct foreign sales income. Branch income is treated as a separate basket under the foreign tax credit limitations rule. The excess credits on the branch income cannot be applied to offset the direct foreign sales income of GlobeCorp, which will be in the general basket.

These excess branch basket foreign tax credits will carry back 1 year and carryforward 10 years. However, they remain in the branch basket and can only be used if there is excess limitation in the branch basket in one of the carryback/carryforward years.

GCo Income

The $3 million of GCo income which constitutes net deemed tangible income eligible for the participation exemption will never be subjected to US tax. As a result, the $200,000 of foreign taxes paid by GCo allocable to this tax exempt income are not eligible to be claimed as a foreign tax credit in any year.

With respect to the $27 million of GILTI income, on which $1,800,000 foreign taxes were paid, this income will be subject to immediate tax in the US at the 21% tax rate, after the 50% GILTI deduction is taken. The US tax on this GILTI income will equal $2,835,000. Under the GILTI rules, only 80% of the foreign taxes paid on GILTI are eligible for treatment as an indirect credit, subject to the foreign tax credit limitation rules. GlobeCorp will be entitled to claim a deemed paid credit of 80% of $1,800,000 or $1,440,000, which is less than the tax owed.

Deemed paid foreign tax credits related to GILTI income are treated as separate basket income. If there were excess credits, they could only be used in the current year to offset residual tax on other GILTI. If not used in the current year, those credits do not carry back or carry forward. Further, under § 78, GlobeCorp's income must be grossed up by the full $1,800,000 indirect foreign tax credit, rather than just by the $1,440,000 of foreign tax credits allowed, resulting in additional US income tax due.

Part C

Question 4

Part 1

A nonresident who owns a single property in the US is not engaged in a US trade or business, especially where he does not take any active role in the management of the property. As a result, the rent payable to Joan is fixed and determinable, annual and periodic income, subject to 30% withholding on the gross amount, without any allowances for deductions. For 2018, Joan's US tax liability will be $60,000 (30% of $200,000). The tenant will be required to withhold 30% of the gross rent, and pay that amount to the Internal Revenue Service, even though that tax equals 100% of Joan's actual net income from the property.

Part 2

Joan can make a § 871(d) election for 2018 to have her real estate investment taxed as if she were engaged in a US trade or business. If that election were made, the rental income would no longer be FDAP income. It will be treated as effectively connected income subject to net-basis taxation under § 871(b). Thus, Joan will be allowed her $160,000 of deductions. She will be taxed at regular, graduated rates on $40,000 of net taxable income. We are told to assume this tax rate is 40%, which will result in Joan's US tax liability of $16,000. Note that while this tax rate is higher than the 30% withholding rate, it results in a lower tax liability because it is applied against a smaller taxable income base.

Part 3

As a general rule, nonresidents are not taxed on the US source capital gains. However, real estate is an exception to this rule and under the Foreign Investment in Real Property Tax Act ("FIRPTA") he will be treated as engaged in a US trade or business with respect to the sale, whether or not he made a § 871(d) election. The gain from the sale will be treated as income effectively connected to that trade or business and taxed at normal progressive rates applicable to individuals.

Joan has $100,000 of gain. (Note that the gain would be larger if she made the § 871(d) election because her basis would be reduced by the depreciation deductions taken.) Since Joan owned the property for more than one year, she will be entitled to claim the preferential tax rate for long-term capital gains which we are told to assume is 20%. Her tax liability on sale will be $20,000.

However, under FIRPTA, the purchaser of the property is required to withhold a tax equal to 15% of the gross amount of the sales price. Here the seller must withhold 15% of $4 million, or $600,000, even though that amount exceeds Joan's actual tax liability. However, unlike normal withholding, FIRPTA withholding is merely a deposit and Joan can recover the excess withholding by filing a claim for refund.

Alternatively, Joan could seek a withholding certificate from the IRS which will allow the buyer to withhold just the actual amount of tax due. However, Joan must seek the withholding certificate, establish the actual amount of her tax liability to the satisfaction of the IRS, and present the certificate to the seller, all before the sale closes.

Question 5

Part 1

One of the key issues in transfer pricing is the transfer and license of intangibles, which generally have significant value. Rather than limit the required compensation to the perceived value of the transferred intangibles at the time of the transfer, § 482 requires that the income with respect to such transfer or license “shall be commensurate with the income attributable to the intangible.” Identifying potential intangible transfers is extremely important.

For purposes of § 482, an intangible is an asset that comprises any of the following items and has substantial value independent of the services of any individual:

- Patents, inventions, formulae, processes, designs, patterns, or know-how;
- Copyrights and literary, musical, or artistic compositions;
- Trademarks, trade names, or brand names;
- Franchises, licenses, or contracts;
- Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and
- Other similar items. An item is considered similar to those listed above if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.

The following intangibles are potentially being transferred from JayCo to KCo: patents, trademarks, tradename, manufacturing know how, foreign customer contacts, foreign supplier contacts, its own tradename and trademark, etc.

Part 2

The facts tell us that the $100 million paid was the arm’s length price at the time of the transfer, based on the knowledge and expectations of the parties at the time. But the assumed facts proved to be conservative and the technology wound up being much more valuable.

Section 482 requires that the consideration for an intangible transfer between controlled taxpayers must be “commensurate with the income attributable to the intangible.” Thus, the fact that the transfer price was arm’s length based on the known facts at the time of the transfer, it is not controlling when it turned out to be undervalued in actual fact. Since the facts tell us that the engine was much more successful than anticipated at the time of the transfer, the initial transfer price, even if honestly believed to be arm’s length at the time, must be adjusted for the actual value of the transferred intangibles based on actual economic results.

The commensurate with income standard requires an adjustment whenever “changes over time… create a substantial deviation from the parties' expectations at the time they entered into the contract,” whether these changes are gradual or sudden. If an intangible is transferred under an arrangement that covers more than one year, the consideration charged in each taxable year is adjusted to ensure that it is commensurate with the income attributable to the intangible. The Service considers all relevant facts and circumstances throughout the period the intangible is used. The determination in an earlier year that the amount charged for an intangible was an arm’s length amount will not preclude the Service in a subsequent taxable year from making an adjustment to the amount charged for the intangible in the subsequent year.

Note that there is an exception where the unanticipated results are due to extraordinary events that were beyond the control of the taxpayers and that could not reasonably have been anticipated at the time the controlled agreement was entered into, fall within a certain band, and the other transfer pricing requirements of the regulations have been met.

Question 6

Part 1

YouCorp has two alternatives. Since the Country T Branch is a Country T entity treated as disregarded by both countries, it is an “eligible entity” and can elect its tax classification for US tax purposes under the check the box rules. Since it has one owner, it can elect to be a corporation or a disregarded entity. If no election, the default classification rules will apply. The default rule varies for each foreign entity based on local law regarding limitation on owner personal liability for the debts of the entity. However, since Country T Branch is a Country T entity treated as a disregarded entity for Country T purposes, it likely defaulted to a disregarded entity for US tax purposes. It would be free to make a check the box election change to corporate status for US tax purposes.

Note that if the Country T Branch originally defaulted to a corporation and made a check the box election to elect disregarded status, a new check the box election cannot be made within 60 months of a prior election.

The second alternative would be to form a new entity in Country T which is treated as a corporation for US tax purposes (either because it is a per se corporation or under the check the box rules) and have YouCorp contribute all of the assets of the Country T Branch to this newly formed entity in exchange for 100% of the stock of the corporation.

Part 2

Plant and equipment

The transfer of branch assets to a foreign corporation (under either method described in #1) is generally a taxable event. However, an exception to taxation exists where the foreign corporation will use the transferred assets in the “active conduct of a trade or business outside of the United States.” YouCorp will not recognize any gain from the transfer of the plant and equipment to FCo because FCo will use these assets in the active conduct of its business outside the United States.

Inventory

The foreign business asset exception does not apply to inventory. YouCorp will recognizes $400,000 of ordinary income from the transfer of the inventory to FCo.

Patent

The transfer of the foreign patent is a deemed sale of the patent in exchange for deemed annual payments that are contingent on the productivity, use or disposition of the patent over the useful life of the patent. An annual royalty must be established under the commensurate with income principle and will constitute ordinary income to YouCorp.

Foreign Goodwill

Foreign goodwill is an intangible, the transfer of which will result in income to YouCorp. In the past, there was an argument that the transfer of foreign goodwill, while an intangible, was excluded from taxation. The basis for this argument has been eliminated by recent regulations. (The language which taxpayers relied on for the exclusion has been repealed and the definition of assets qualifying for the active trade or business exception have been narrowed and can no longer be read to include goodwill.)

The transfer of foreign goodwill will trigger income to YouCorp under the same principles as the transfer of a patent.

Question 7

Part 1

Both Country Q and the US claim Delia as their resident. The US Model Treaty has tie breaker rules for situations where two treaty countries claim the same person as resident under the general definition in Article IV Paragraph 1. Under Article IV Paragraph 3 the first tiebreaker for an individual is the country in which the individual has a permanent home available. Since we are told that she only has a permanent home in Country Q. Delia is a resident of Country Q, and not the US, for treaty purposes. Delia will be able to claim the reduced withholding provisions of the United States Model Income Tax Convention of 2016.

Under Article 10(b) of the United States Model Income Tax Convention of 2016, the normal 30% withholding is reduced to 15%. Delia does not qualify for the Article 10(a) reduction of withholding to 5% because, while he owns a sufficient number of shares, Article 10(a) is only applicable to corporate shareholders.

Part 2

As a US citizen, Delia is subject to US tax on her worldwide income, even though she is not (and has never been) resident in the US. She will not be permitted to reduce her US tax liability under the US - Country Q Treaty, even though she might qualify as a resident of Country Q under Art. IV. Article 1 Paragraph 4 of the United States Model Income Tax Convention of 2016 states that the Treaty "shall not affect the taxation by a Contracting State of its residents (as determined under Article 4 (Resident)) and its citizens. This is known as the "savings clause." US citizens cannot reduce their US tax liability relying US tax treaties, even if they are legitimate residents of the other treaty country.

Accordingly, Delia is subject to US taxation on her worldwide income and will be taxed on the dividend in the same manner as any other US citizen as the prevailing rate for dividend income. Note that Country Q might also seek to impose tax on Delia on the dividend income based on her status as a resident of Country Q. Delia will not be entitled to a foreign tax credit against her US tax liability on the dividend since the dividend is US source income. She must look for relief from double taxation under the Country Q tax code which hopefully provides for a foreign tax credit against Country Q income tax for taxes paid to the US on the dividend.