THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2019

MODULE 2.10 – UNITED STATES OPTION

ADVANCED INTERNATIONAL TAXATION (JURISDICTION)

TIME ALLOWED – 3¼ HOURS

This exam paper has **three** parts: **Part A**, **Part B** and **Part C**.

You need to answer **five** questions in total.

You must answer:

- **Both** questions in **Part A** (25 marks each)
- **The** question in **Part B** (20 marks)
- **Two** questions from **Part C** (15 marks each)

Further instructions

- All workings should be made to the nearest month and in US Dollars, unless otherwise stated.
- Start each answer on a new page and clearly indicate which question you are answering. 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.
- Marks may be allocated for clarity of presentation of your answers.
- The time you spend answering questions should correspond broadly to the number of marks available for that question. You should therefore aim to spend approximately half of your time answering Part A, and the other half answering questions in Parts B and C.
- The first 15 minutes of the exam is reading time. You will be allowed to annotate the question paper during this time; however, you will **not** be permitted to start writing or typing your answer. The Presiding Officer will inform you when you can start answering the questions.

For your information this paper is accompanied by:

United States Model Income Tax Convention 2016

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.

Unless otherwise indicated, apply the law in effect subsequent to the adoption of the Tax Cuts and Jobs Act of 2017.

Unless otherwise indicated, assume for purposes of arithmetic simplicity that the normal US Federal Income Tax rate is 40% for individuals and 21% for corporations and that all net income is taxed at those rates. For individuals, however, assume that long-term capital gains, as well dividends paid by US corporations or by foreign corporations from countries that have a tax treaty 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 2016 ("2016 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 deductions and exemptions.

In all circumstances, statements of gross income, deductions and net income are the same under US and foreign principles.

Assume no year mentioned is a leap year.

PART A

You are required to answer BOTH questions from this Part.

1. Johan is a citizen and resident of Country F. He works for FCo, a Country F corporation. Johan's first full day of presence in the United States on behalf of his employer was on 1 September 2016 and he worked continuously in the United States until 15 April 2017. Johan was paid $100,000 for this time spent in the United States.

   Johan returned to the United States on 1 January 2018 and remained there until he went home to Country F on 30 June 2018. He was paid $75,000 for the time spent in the United States in 2018. Johan had never been in the United States prior to 2016 and did not return after 30 June 2018.

   1) **In which years, if any, did Johan meet the substantial presence test for US residency?** (8)

   2) **Would your answer to (1) change if Johan were the founder and CEO of FCo and maintained a home in Country F where he lived with his wife and children whenever he was not in the United States on behalf of FCo?** (7)

   3) **Without prejudice to your answers to (1) and (2), assume Johan is not a United States resident under the substantial presence test in any of the three years. Would Johan be subject to US taxation on his salary earned while working for FCo while in the United States?** (5)

   4) **Would your answer to (3) change if there was an income tax convention between the United States and Country F identical to terms to the 2016 US Model Convention?** (5)

Total (25)

2. USCo is a leading worldwide manufacturer and seller of widgets, which it manufactures in the United States for sale worldwide. Some of USCo's international sales are made directly by USCo and some are made through USCo's Country X branch. All foreign sales are made to unrelated third-party customers for foreign use.

Additionally, USCo owns 100% of shares in YCo, a foreign corporation, formed and operated in Country Y, which purchases widgets from unrelated third parties on a consignment basis and sells them solely within the Country Y market for use therein. Neither USCo, its Country X branch, nor YCo pays foreign income taxes on any of its income.

In 2018, USCo received the following income after the correct allocation of expenses:

- $50 million in net income from sales of widgets within the United States;
- $30 million in net income from the direct sale of widgets outside the United States; and
- $20 million in net income from the Country X branch sale of widgets

USCo's adjusted basis in its assets at the end of each quarter was as follows:

<u>31 March 2018</u>

$30 million in machinery; $20 million in buildings not including land; $1 million in land on which buildings are constructed; $10 million in bonds held; $3 million of inventory

<u>30 June 2018</u>

$51 million in machinery; $19 million in buildings not including land; $1 million in land on which buildings are constructed; $10 million in bonds held; $2 million of inventory

<u>30 September 2018</u>

$42 million in machinery; $18 million in buildings not including land; $1 million in land on which buildings are constructed; $10 million in bonds held; $4 million of inventory

<u>31 December 2018</u>

$23 million in machinery; $17 million in buildings not including land; $1 million in land on which buildings are constructed; $10 million in bonds held; $5 million of inventory

There is no interest expense allocable to any of these assets.

All of these assets are used in direct proportion to the net income generated from USCo's sales activities.

In 2018 YCo earned $5 million in fees from its sales activities. YCo had zero adjusted basis in its assets.

1) How will USCo be taxed in the United States on its US sales, its direct foreign sales, its Country X branch sales, and the income earned by YCo? (20)

2) USCo's management team is considering expanding the company's manufacturing activities. The management team must decide whether to purchase and operate new manufacturing equipment in the United States, or have YCo purchase the equipment and begin manufacturing in Country Y. Based solely on tax considerations, what is your recommendation? (5)

Total (25)

PART B

You are required to answer THIS question.

3. GlobeCorp, a Delaware corporation, is a leading worldwide manufacturer and seller of power tools, which it manufactures in the United States for sale worldwide. Some of GlobeCorp's international sales are made directly by GlobeCorp and some are made through GlobeCorp's Country Z branch. All foreign sales are made to unrelated third-party customers for foreign use.

GlobeCorp also owns 100% of the shares in GCo, a foreign corporation formed and operated in Country G, which purchases power tools from unrelated third parties on a consignment basis and sells them solely within the Country G market for use therein.

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

<u>GlobeCorp</u>

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

<u>GCo</u>

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

How much may GlobeCorp claim in foreign tax credits from these 2019 foreign tax payments? (20)

PART C

You are required to answer TWO questions from this Part.

4. On 1 January 2018 Joan, a resident of Country M, purchased commercial real estate in the United States for $3.9 million. She owns no other property in the United States. Joan did not actively manage the building, but rather leased it to an unrelated property management company that subleased the building to the tenants.

   For 2018, Joan received $200,000 in rent and incurred operating expenses of $140,000 and depreciation of $20,000. On 2 January 2019, Joan sold the complex for $4 million.

   1) What are the US tax consequences to Joan for 2018, assuming that no elections are made? (5)

   2) Are there any steps Joan should take to reduce her 2018 US tax liability? (3)

   3) What are the US tax consequences to Joan for 2019 from the sale of the property, assuming that Joan did not take any of the steps discussed in (2)? (7)

   Total (15)

5. JayCo, a Nevada corporation, has been a leader in car engine design for years. It has recently developed, patented and trademarked technology for a more fuel-efficient engine. JayCo has transferred all of the non-US rights to its new technology to KCo, a wholly owned foreign corporation, so that KCo can manufacture and sell the engines to foreign customers. KCo paid $100 million for the rights, the arm's length price at the time of the transfer. Two years later, however, the engine became profitable beyond anyone's expectations due to increased fuel costs and generated enormous profits for KCo.

   1) What intangibles are potentially being transferred by JayCo to KCo? (5)

   2) Will the IRS accept the $100 million transfer price? (10)

   Total (15)

6. YouCorp, a New York corporation, operates in Country T through an entity treated as disregarded for both United States and Country T purposes (the Country T branch). YouCorp desires to treat the Country T branch as a corporation for US tax purposes, in order to take advantage of the participation exemption and the reduced US rate of taxation on Global Intangible Low Taxed Income (GILTI).

   The Country T branch assets consist of the following:

   - Plant and equipment with a value of $2 million and an adjusted basis of $1 million;
   - Inventory with a value of $500,000 and an adjusted basis of $100,000;
   - A Country T patent with a value of $3 million and an adjusted basis of $0; and
   - Foreign goodwill with a value of $400,000 and an adjusted basis of $0.

   1) What methods are available to YouCorp to convert the Country T branch into a corporation for US tax purposes? (7)

   2) For each identified asset, what are the US tax consequences of the incorporation of the Country T branch? (8)

   Total (15)

7. Delia was born in, and is a citizen of, Country P. She has been living in Country Q for the last ten years and, according to the laws of Country Q, is a Country Q resident. Delia's sole, permanent home is located in Country Q.

In 2018 Delia was present in the United States for more than 183 days, resulting in her becoming a resident of the United States. During the course of 2018 Delia received a $100,000 dividend from a US corporation in which she is a 25% owner. All of the income from the dividend-paying US corporation was earned in the United States.

Country Q has entered into a treaty with the United States which is identical to the 2016 US Model Convention.

1) Under the 2016 US Model Convention, in which country is Delia considered a resident for 2018 and how will she be taxed in the United States on the dividend? (10)

2) How, if at all, would your answer to (1) change if Delia was born in and was a citizen of the United States rather than Country P, but had lived in Country Q her entire life and had never visited or lived in the United States? (5)

Total (15)